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LETTER FROM THE EDITORS

Welcome to the *Journal of Legal, Ethical and Regulatory Issues.* This journal is 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.

Readers should note 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. 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.

The articles contained in this volume have been double blind refereed. The acceptance rate, 25%, conforms to the Allied Academies' editorial policy.

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IMPACT OF THE SARBANES-OXLEY ACT ON ACCOUNTANT LIABILITY

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ABSTRACT

President Bush signed the Sarbanes-Oxley Act (SOA) into law on July 30, 2002. At that time he said that it brought about "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt". The SOA was passed in response to corporate scandals involving Enron, WorldCom and others. It was intended to restore public confidence in our capital markets. Much of the SOA is directed at corporate and securities industry behavior. But the SOA also raises the regulatory bar far higher for the accounting profession, especially for accounts who audit public companies. The SOA created a new regulatory agency to oversee accountants' work: the Public Company Accounting Oversight Board (PCAOB). The SOA also imposed high ethical standards, including prohibiting conflicts of interest and even potential conflicts of interest. Civil and criminal penalties for violations were increased. The net effect was to substantially increase the legal liability of accountants.

Business schools are trying to include SOA materials into their curricula. However, as the AACSB publication BizEd pointed out in August 2005, there is a lack of material that is appropriate for classes in accounting and business law. This paper will help to fill that need. It reviews the origins and current attitudes towards the SOA. To provide context it reviews the law of accountant liability. The paper then examines and assesses those parts of the SOA that impact accountant liability, particularly the new regulatory agency and also accountant independence. A new conceptual framework for regulation is suggested, in which it is seen that the SOA is essentially a form of regulation that seeks to prevent a harmful event from happening, as opposed to merely providing a remedy to those harmed by that event. Finally the SOA will be assessed and its future considered.

INTRODUCTION

As most readers know, the Sarbanes-Oxley Act[1] (SOA) is the most far-reaching and significant new federal regulatory statute affecting accountants and corporate governance since the Securities Acts of 1933 and 1934. Corporate scandals involving Enron, WorldCom and others had shaken public confidence in American capital markets. Public outrage[2] plus the obvious need for reform led to the passage of the SOA which was signed into law on July30, 2002.

The SOA significantly increased the legal liability of accountants. A new federal regulatory agency, the Public Company Accounting Oversight Board was created to oversee auditors' work, with authority to conduct inspections, create new standards and punish violators. Conflicts of interest were prohibited, and a high wall was erected separating the audit function from consulting and other non-audit functions. Auditors' civil and criminal liability were increased, and additional record-keeping burdens imposed. Audits of public companies became riskier for accountants but also more profitable, reflecting the greater amount of work and risk involved[3].

The topic of accountant liability is an important one in accounting and business law classes, especially at the Junior, Senior and Graduate level. The SOA significantly impacted this liability. However, business schools have had difficulty incorporating SOA material into their curricula. As the AACSB publication BizEd recently pointed out[4], every school it surveyed "incorporated at least some SOX[5] material in its courses" but there was a "lack of dedicated material on Sarbanes-Oxley" that was appropriate. Most of what has been written on the SOA deals with corporate compliance and is directed at lawyers and practicing accountants. Very little has been written that directly addresses the SOA's impact on accountant liability that is also appropriate for business and accounting students. The contribution of this paper is to help fill that void.

ORIGINS AND ATTITUDES

To say that the SOA is controversial is an understatement. Consider the following titles and headlines: "Sarbanes-Oxley Is a Curse for Small-Cap Companies[6]", "Sarbanes-Oxley to Create Litigation Nightmare[7]", "The Sarbox Conspiracy[8]" and "Dump This Destructive Deadweight[9]". These articles focus on the downside of increased regulation: its added cost and the diversion of management attention from its primary missions of competitiveness, innovation and profitability. On the other hand[10] other titles are positive: "Promoting Public Trust[11]", "Sarbanes-Oxley: A Bridge to Excellence[12]", "Private Companies Embrace Sarbanes-Oxley[13]" and "Sox: Not So Bad After All[14]". These articles focus on the benefits of increased regulation: restoring investor confidence, improving business controls and processes and supporting ethical practices.

Reviewing the origins of the SOA will provide insight to the conflicting attitudes towards it. During the summer of 2002 scandals at Enron, WorldCom, Global Crossing, Adelphia and others attracted great media attention. Investors suffered losses estimated at between $300 billion[15] and $460 billion[16]. There was great public demand for reform.

Congress was anxious to act. Senator Paul Sarbanes (Democrat, Maryland) then chair of the Banking Committee sponsored a reform bill. Congressman Michael Oxley (Republican, Ohio) then chair of the Committee on Financial Services sponsored a different version in the House. A Conference Committee reconciled the differences, which is normal procedure. As public outrage at the unfolding scandals grew, Congress passed the conference bill by the overwhelming votes of 99 to 0 in the Senate and 423 to 3 in the House of Representatives[17]. Congress had passed the most sweeping statute affecting securities regulation and corporate governance since the 1930s. President Bush said that it brought about "the most far-reaching reforms of American Business practices since the time of Franklin Delano Roosevelt[18]". Congress had acted with uncharacteristic haste and unanimity, just as it did when it passed the U.S.A. Patriot Act. And, as with that Act, second thoughts would later emerge.

The scandals that broke in 2001 and 2002 had their origins in the dot-com boom of the late 1990s. Technology companies and others argued that conventional accounting practices of the "old economy" did not apply to the "new economy" based on computers, telecommunications and the Internet[19]. Cozy relationships between investment analysts, auditors and corporations were tolerated while the economy and stock market were booming.

The first major break, and probably still the best known, involved the Enron Corporation. Formed in 1985 as the result of mergers with energy pipeline companies, Enron quickly became a rising star on the investment horizon. By 2000 it had become the seventh largest U.S. company based on revenue[20]. Fortune Magazine called it "The Most Innovative Company in America" each year from 1995 to 1999. However, Enron's success was driven in large part by accounting fraud. It had utilized Special Purpose Entities (SPEs) to hide billions of dollars of debt. Generally Accepted Accounting Practices (GAAP) allows a company to use SPEs, and to keep the SPEs' financial data off that company's balance sheet. But GAAP allows this only if two rules are met[21]: a third party must control most of the SPE's equity and at least three percent of total capital must be equity[22]. Enron made extensive use of SPEs, in many cases in violation of the GAAP rule. Billions of dollars of debt were hidden. Once the truth became known Enron collapsed. Investors were shocked that a company that had been touted as a star was in fact a fraud. Billions of dollars were lost to pension funds, mutual funds and individual investors.

Another prominent example of a corporate scandal involving accounting manipulation was Global Crossing. This company was formed in 1997. Its business plan consisted of laying fiber optic cables under the Atlantic and Pacific Oceans in order to capture telecommunications business. It too became a rising star and quickly achieved a market capitalization of almost $40 billion[23]. However, like Enron, Global Crossing's apparent success was driven in part by accounting fraud. It made extensive use of "pro forma reporting", a method of reporting financial information that is not based on the conventional standards of GAAP. With pro forma accounting a company can inflate its earnings by applying accounting rules that *it* thinks are relevant[24]. Global Crossing and others using pro forma accounting did disclose what they were doing, and also the financial results obtained using GAAP. But some top stock analysts used the rosier pro forma results instead of GAAP results without telling investors. Moreover, in the case of Global Crossing, that company did not even accurately report its pro forma results[25].

Prior to the SOA the accounting profession was largely self-regulated. The Securities Acts of 1933 and 1934 authorized the Securities Exchange Commission (SEC) to regulate accounting methods used in preparing and auditing financial statements included in SEC reports[26]. However the SEC quickly delegated this authority to the accounting profession's principal trade association, the American Institute of Accountants, which later became known as the American Institute of Certified Public Accountants (AICPA)[27]. The AICPA established the Auditing Standards Board (ASB) in 1978[28]. However, there was dissatisfaction with the self-regulatory nature of the ASB and its 15 members, who were volunteers and predominantly practicing accountants at large public accounting firms. Lynn Turner, former Chief Accountant at the SEC expressed strong criticism of the ASB at the Enron Congressional hearings:

> "…those standards tend to be written to protect the accounting firms in case they get in trouble on an audit …it is not drafted with the public interest in mind … As long as you leave that standards setting process in the hands of the firms and of the firm's legal counsel, you are going to get standards written to protect them in court, as opposed to standards written to ensure that they do audits that will protect the public"[29]

In the area of oversight and discipline the accounting profession had also largely been left to regulate itself. In 1977, after a series of accounting-related corporate scandals, the AICPA created the Public Oversight Board (POB). However the POB had no authority to sanction auditors for deficiencies or incompetence that it discovered, and it was funded by the AICPA. In 2000 the AICPA did not agree with the POB's plan to review the Big Five accounting firms' compliance with auditor independence standards, and so the AICPA cut off funding for the POB[30]. In 2002 the members of the POB voted unanimously to disband.

Congress concluded that Enron, WorldCom and other scandals demonstrated that self-regulation by the accounting profession had been inadequate in the areas of standard setting and oversight. The need for improvement in these areas contributed to the passage of the SOA.

THE CONTEXT OF ACCOUNTANT LIABILITY

The SOA is but the latest in a long line of legal authority involving accountant liability. In order to properly understand how the SOA fits into the context of accountant liability, it is necessary to review that larger scheme. Most accountant liability is based on contract, tort and statute law. The changes brought about by the SOA will be noted in the next section, which describes the Act.

Contract Law Liability

When an accountant does work for a client a contract of employment exists. This contract is often called an "engagement letter". In common with all employment contracts, the engagement letter specifies the work to be performed and the compensation to be paid. An accountant is an agent of his/her client therefore agency law also applies to the relationship. Under agency law the accountant-agent owes his/her client important duties, including the fiduciary duty of loyalty, competence in performing the work, keeping the client informed, and following instructions. If an error is made, a question arises whether the accountant has acted with competence. Not all errors are the result of lack of competence.

The standard of competence used by the courts is that of a (hypothetical) reasonably competent accountant. It is essentially a negligence standard, described below. However, most courts agree that a reasonably competent accountant will follow Generally Accepted Accounting Practices (GAAP) and Generally Accepted Accounting Standards (GAAS). An accountant who follows GAAP and GAAS will almost always be held to have acted with competence[31].

An accountant owes these contractual duties to his/her client and also to intended third party beneficiaries. In order to be an intended third party beneficiary, the accountant must be informed and agree that a third party will use and rely on the accountant's work product. The typical example is a corporation seeking a loan from a bank that hires an accountant to prepare financial statements that the bank will use in evaluating the loan application.

Contract liability is important but it is limited. The client or intended third party beneficiary may lose money if the accountant breaches the duty of competence or some other duty, but the amount of money will be limited to the actual losses of just those two parties. In contrast, statutory liability can be vastly larger, as when a securities act violation makes an accountant and his/her firm liable for losses suffered by thousands of shareholders.

Tort Law Liability

The torts of primary concern in accountants' liability are negligent misrepresentation and fraud[32]. If an accountant fails to exercise the degree of care of a (hypothetical) reasonably competent accountant, and as a result he/she issues incorrect financial information, negligent misrepresentation has occurred. Someone claiming a loss would also have to show reliance and proximate cause. Fraud consists of issuing false financial information with knowledge that it is false and with intent to deceive someone. This intent to deceive is called scienter, and is also a requirement for liability under some of the provisions of the Securities Acts, discussed below.

Determining how a hypothetical reasonably competent accountant would act is not always easy. As noted above, this hypothetical accountant will always follow GAAP and GAAS. Also, if suspicions are aroused, he/she should go beyond those requirements. Expert witnesses may be called upon to inform a jury as to how the hypothetical competent accountant would act. If a court finds that negligent misrepresentation has occurred, the accountant will be liable for the financial loss that was reasonably foreseeable (proximately caused).

Two things make negligent misrepresentation a particularly dangerous legal theory of liability for use against an accountant. First, there can be more than one or two plaintiffs. In the discussion of contract liability, we noted that only the client or an intended third party can assert contract liability. Therefore the amount of the loss, and the amount of the accountant's liability, are both limited. But with negligent misrepresentation, a whole class of plaintiffs, perhaps numbering in the thousands, can sometimes assert liability.

This concern for mass liability focused on an accountant, with the potential to destroy that accountant and his/her firm, led Justice Benjamin Cardozo, probably the most respected jurist of his day, to author his famous opinion in the case of Ultramares v. Touch[33] in 1931. In that case Justice Cardozo created a special rule in negligence cases involving accountants. He held that mass liability should not exist; that only the client and an intended third party could hold an accountant liable for the accountant's negligence. Cardozo impeccable logic and word craft shine brilliantly in this often cited part of his opinion:

> If liability for negligence exists, a thoughtless slip or blunder … may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

Cardozo was sensitive to the fact that at that time, before the Securities Acts, independent auditors were the only overseers of the accuracy of financial information relied upon by investors in our capital markets. If accounting firms were destroyed by mass liability for negligence, there would be no reliable affirmation of corporate profitability. The stock market had crashed only two years earlier. Maintaining investor confidence was critical then, just as it was after Enron, Global Crossing, Tyco and Adelphia.

The rule of Ultramares, limiting accountants' liability for negligent misrepresentation only to the client or intended third party remained controlling precedent throughout the United States until the mid 1950s. Then some courts began to expanded the potential universe of plaintiffs in negligent misrepresentation cases beyond just the client and intended third party. The Restatement of Torts, Section 552 adopted a more expansive rule. Section 552 expanded liability to include claims brought "by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information …". The common example is an accountant who prepares a financial statement for a corporation applying for a loan from bank A. Under contact liability, discussed above, only the client and bank A could use negligence as a legal theory of liability. But under the Restatement rule, other banks are in the same "limited group of persons" for whose benefit the accountant has prepared the information. So if bank A turns down the loan, but bank B makes the loan, bank B can hold the accountant liable if negligent misrepresentation causes bank B to lose money.

The Restatement rule has gradually replaced the Ultramares rule as the majority rule used in most States. A few States, like California, briefly flirted with an even more expansive rule, sometimes referred to as the "foreseeability rule" under which almost anyone who suffers a loss as a result of an accountant's negligent misrepresentation can hold that accountant liable, so long as that person's reliance was foreseeable. However, this presents exactly the mass liability problem that Cardozo warned of. California quickly abandoned the foreseeability rule and no jurisdiction uses that rule today.

The other tort of concern to accountants is fraud. As noted above, fraud requires proof of scienter, the intent to deceive. Fraud is rare, and even where fraud exists it is hard to prove. But if fraud is proved, there is almost no limit on the size of the universe of potential plaintiffs. Any foreseeable plaintiff may recover. In addition, a court may award punitive damages in addition to compensatory damages. If a jury becomes incensed at an accountant's behavior, it may award punitive damages that are substantially in excess of the plaintiff's loss.

Statute Law Liability

The greatest potential liability facing accountants, particularly those doing work for public companies, is statute liability. We have seen how contract liability and negligent misrepresentation liability are limited to the client, an intended third party, or perhaps a limited class of intended users. But certain federal statutes, especially the securities acts, extend liability, in some circumstances, to any purchaser or seller of a security[34]. The potential universe of plaintiffs can be enormous.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted following the massive crash of the New York Stock Exchange in 1929. This crash ushered in the Great Depression which threatened the economic and political stability of the United States. The crash had been brought about in part by manipulation, false financial reporting, and fraud. Public opinion called for reform and stricter regulation. As a result, all those associated with the issue or sale of securities faced increased liability, including criminal liability. Included were accountants who prepared financial information regarding public companies.

The provisions of the securities acts affecting accountants are too numerous to cite here. However, two Sections are prominent and serve as examples. They are Section 11 of the Securities Act of 1933 and Section 10b of the Securities Exchange Act of 1934.

Section 11 of the Securities Act of 1933 presents great potential liability to accountants. The 1933 Act governs the issuance and sale of new securities, now referred to as Initial Public Offerings (IPOs). Most IPOs require registration with the Securities Exchange Commission (SEC) although some are exempt. If the registration statement contains a misstatement or omission of a material fact, then the issuer, underwriter and any expert who contributed to the misstatement or omission is presumed to be liable.

Accountants who prepare financial information or issue opinions about financial information are considered experts and are liable for any errors they contribute to the registration statement. Because of the presumption of liability contained in Section 11, a plaintiff does not have to prove that the accountant was negligent or in any other way at fault. All the plaintiff has to prove is that the registration statement contained a material error and that he/she purchased the security and suffered a loss. The plaintiff need not prove any contractual relationship (privity) with the accountant, nor need the plaintiff prove reliance. Liability is presumed.

However, just as with most presumptions in law, this presumption is rebuttable. The accountant does have the opportunity to rebut the presumption of liability by proving that he/she acted with "due diligence"[35]. Due diligence is essentially the absence of negligence, that is, the exercise of reasonable care and competence as discussed above in the section on tort liability. Section 111(b)(3) of the Act states that in order to prove the defense of due diligence, a defendant must have "had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true…" In determining what a "reasonable investigation" consists of, Section 11(c) states that "the standard of reasonableness shall be that required of a prudent man in the management of his own property". Because the universe of plaintiffs is so large, and liability is presumed, Section 11 of the 1933 Act presents enormous potential liability to accountants.

Section 10b of the Securities Exchange Act of 1934 also presents great potential liability to accountants and others. This Section applies to the purchase and sale of almost any security, not just the purchase of IPO securities. If the security has a connection with interstate commerce, the mails, or is traded on a national securities exchange, Section 10b applies. Any communication with investors that contains a material misstatement or omission violates this statute. However, the burden of proof that the plaintiff must sustain is substantially greater than under Section 11. Most important is that the plaintiff must prove that the accountant or other defendant acted with scienter. There was some uncertainty over this, as the SEC had issued Regulation 10b(5) which some argued relaxed the scienter requirement. But the U.S. Supreme Court case of Ernst & Ernst v. Hochfelder[36] resolved the matter in favor of requiring scienter in order to establish Section 10b liability. As noted above, proving scienter is difficult.

Proving scienter might be somewhat easier today because of electronic discovery techniques. A "smoking gun" email or other electronic communication could provide the needed proof of intentional deceit. Modern search engines may make it easier to discover such an email.

THE SARBANES-OXLEY ACT AND ACCOUNTANT LIABILITY

The SOA is a large and complex statute that contains eleven titles. Title I creates a new regulatory agency to oversee auditors' work, the Public Company Accounting Oversight Board (PCAOB)[37]. Title II deals with auditor independence and auditor conflicts of interest. These two titles contain the provisions of greatest relevance to accountants. Title III deals with corporate responsibility. Title IV provides for enhanced financial disclosures. Section 404 of this title requires a management assessment of internal controls. This Section has added substantial cost to audits and is the subject of much criticism and complaint[38].

Title V deals with financial analysts' conflict of interest. Title VI deals with the authority of the Board. Title VII requires various studies and reports by the Government Accounting Office (GAO) and SEC relating to consolidation of public accounting firms and violations of securities laws. Title VIII increases penalties for corporate and criminal fraud. Section 804 makes a significant change in the law by extending the Statute of Limitations for certain securities act violations to two years after discovery or five years after the date of violation. Previously it had been one year and three years. This will be discussed below. Title IX increases penalties for white-collar crime. Title X requires the signing of corporate tax returns by chief executive officers. Title XI increases potential prison terms under the Federal Sentencing Guidelines and deals with corporate fraud and accountability. It also contains a provision prohibiting retaliation against informants. In all there are 1,107 separate Sections in this statute. Those that impact the legal liability of accountants will now be discussed.

The Public Company Accounting Oversight Board (PCAOB)

Title I of SOA created the PCAOB, and defines its authority. This represents the first time the accounting profession experienced direct external oversight by a government-sponsored organization[39]. The Board consists of five members, appointed by the SEC for five year terms. Two must be or have been certified public accountants, and three can not be or have been CPAs. It is a private nonprofit organization but was established by Congress and has strong ties to the SEC. Section 109 describes the funding of the PCAOB and is of interest. Recall that in the section above titled "Origins and Attitudes" the precursor to the PCAOB, the Public Oversight Board (POB) had proven ineffectual in part because it lacked a reliable, independent funding source. Section 109(d) states that PCAOB funding will come from public companies, in proportion to their market capitalization. This is a funding source independent of accounting firms or their professional association.

Sections 104 and 105 may have the greatest impact on accountants' liability of all sections of the SOA. These sections deal with inspections, investigations and disciplinary action that can be taken by the PCAOB against accounting firms and accountants. The PCAOB may in effect audit the auditors. Sections 104 and 105 give the PCAOB strong oversight power, in contrast to the flaccid or non-existent oversight power of the predecessor POB.

Section 104(b) requires the PCAOB to conduct inspections of accounting firms that perform audits on public companies. Larger firms are to be inspected more often: firms that perform audits for more than 100 public companies are to be inspected once each year. Accounting firms that perform 100 or fewer public company audits are to be inspected "not less frequently than once every 3 years". This scaling of inspection frequency to audit firm size and activity is interesting. It is certainly a rational response to treat a Big Four accounting firm differently from a small accounting firm that might perform only a handful of public company audits each year. However the SOA does not provide a similar scaled response to the public companies themselves. Compliance requirements are the same for public companies large and small. Small companies have complained loudly that their cost of compliance with SOA is proportionally much greater than that of large companies[40].

If a regular PCAOB inspection reveals violations, an investigation may follow. Section 105(b) authorizes the PCAOB to perform investigations that include subpoenaing of witnesses and documents. The PCAOB may require the testimony "of the firm or any person associated with a registered public accounting firm". In order to perform audits of public companies, accounting firms must register with the PCAOB, per Section 102. If a person or firm fails to cooperate with the investigation, registration may be suspended or revoked. The teeth of this section are found in Section 105(c)(4): in addition to suspension or revocation of registration, the PCAOB may impose a "civil money penalty" of "not more than $750,000 for a natural person or $15,000,000 for any other person" for violations that consist of "intentional or knowing conduct, including reckless conduct" or "repeated instances of negligent conduct". Note the conjunctive "or". Even a negligent, unintentional violation, if repeated, can bring on these severe penalties[41]. If the violation is not intentional or knowing, the penalties are less severe but still substantial: up to $100,000 for a natural person or $2,000,000 for others. Natural persons are, of course, accountants and other employees of an accounting firm. The "other persons" are the firms themselves. The PCAOB's inspections began in May 2004 and it is currently inspecting the eight largest U.S. public accounting firms and also a number of smaller firms[42].

Section 103 gives the PCAOB the independent standard-setting authority that Lynn Turner (see above in the "Origins and Attitudes" section) and others complained was lacking previously. Section 103(a)(1) gives the PCAOB authority to create "attestation standards, such quality control standards , and such ethics standards to be used by registered public accounting firms…". They must preserve audit papers and "other information related to any audit report, in sufficient detail to support the conclusions reached in such reports" for at least 7 years. Storing these records for 7 years brings accountants into compliance with the requirements of Section 103; a failure to store them for at least 5 years can result in criminal liability that carries a maximum of 10 years in prison, per Section 802, discussed below.

Another Section in Title I that may be of interest to academics is Section 109(c)(2). That Section states that "all funds collected by the Board as a result of the assessment of monetary penalties shall be used to fund a merit scholarship program for undergraduate and graduate students enrolled in accredited accounting degree programs…" Academic Accounting departments may wish to contact the PCAOB regarding that provision.

The Board has been creative in seeking complaints. It recently created a new online form (www.pcaobus.org/tips), an email address (tips@paaobus.org) and a toll-free phone number (800.741.3158). It is interested in receiving tips on potential violations of the SOA, especially if they are relevant to one of the PCAOB's inspections. Information can be provided anonymously[43].

Auditor Independence

Title II of the SOA addresses auditor independence. Lack of auditor independence from the companies they are auditing is generally credited with contributing to audit failures and accountant-related corporate scandal[44]. Many accounting firms collected substantial professional fees for non-audit related services performed for their audit clients. In some cases the non-audit fees exceeded the audit fees. For example, Arthur Anderson collected $21 million annually for audit services and $29 million annually for consulting services[45]. An auditor in that position would not be inclined to push too hard on the audit side for fear of losing the even more lucrative consulting side. Such an auditor faces a clear conflict of interest. In order to eliminate that conflict, SOA puts up a high wall separating audit work from other accounting work.

Section 201 provides a laundry-list of nine specific services that an auditor may not perform for a public company audit client. These include bookkeeping, financial information system work, appraisal or valuation, actuarial services, internal audit outsourcing, management or human resource services, investment banking, legal work related to the audit and “any other service that the Board determines, by regulation, is impermissible.”

Section 203 requires audit partner rotation. The “lead (or coordinating) audit partner (having primary responsibility for the audit)” may not work for more than 5 years on audits for the same public company. In this way the SOA hopes to curtail the natural congenial relationships that may develop over many years between corporate managers and auditors. These relationships pose a potential conflict of interest. Also, the knowledge that a new audit partner will be reviewing his/her work may tend to make the audit partner behave more correctly. However, at least one commentator feels that audit partner rotation does not go far enough[46].

Title II contains a section that has not drawn much attention, but is potentially very significant. Section 207 calls for the Comptroller General of the U.S. to conduct a study of the “potential effects of requiring the mandatory rotation of registered public accounting firms.” This goes far beyond merely rotating auditing partners within the same firm. Perhaps Congress is waiting to see how effective SOA will be, and whether even more stringent regulation will be required.

Other Sections That Impact Accountant Liability

While Titles I and II deal directly with audit practice and accountant liability, other sections of the SOA also relate to accountant liability. These include Section 802, which increased criminal penalty for “destruction, alteration, or falsification of records in Federal investigations” to a maximum of 20 years in prison. Accountants are also required by this section to “maintain all audit or review workpapers for a period of 5 years”, and an accountant who “knowingly and willfully” violates this record-keeping requirement faces a maximum sentence of 10 years in prison. Section 806 increases the maximum sentence for securities fraud to 25 years in prison. Section 804 increases the Statute of Limitations cut-off for bringing private actions under the Securities Act of 1934 to 2 years from date of discovery and 5 years from date of violation. Previously it had been 1 year and 3 years. This Section has been extensively litigated, with many private plaintiffs arguing that these longer cut-offs should be applied retrospectively as well as prospectively[47]. However in a recent case titled In re Enterprise Mortgage Acceptance Co. LLC, decided on December 6, 2004, the Second Circuit Court of Appeals resolved this issue in favor of prospective application only. Section 805 may lead to stiffer jail sentences, as it requires the U.S. Sentencing Commission to review its sentencing guidelines for violations of the SOA.

The very last section of the SOA, Section 1107, makes it a crime to retaliate against whistleblowers. The maximum sentence is 10 years in prison. Retaliation includes "any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense". This last section may be of assistance to an accountant such as an internal auditor who discovers a violation and reports it.

A NEW CONCEPTUAL FRAMEWORK FOR REGULATION: THE PREVENTIVE/REMEDIAL DICHOTOMY

While considering the regulatory aspects of the SOA I was struck by the preventive nature of this Act. PCAOB inspections of public auditors, creation and enforcement of stringent auditing standards and the strong separation between the auditing and consulting functions of accounting firms all operate to <u>prevent</u> the accounting-related corporate meltdowns experienced by Enron and other companies. It seems that all regulation can be divided into two categories: preventive or remedial.

Consider for example the problem of industrial accidents. Two regulatory responses have emerged. First, workers' compensation was developed, around the turn of the twentieth century[48]. Then, in 1970 Congress created the Occupational Safety and Health Act[49] (OSHA) to deal with the same problem.

Workers' compensation is an example of remedial government regulation. It provides a remedy <u>after</u> the injury has occurred. This was an improvement over the previous situation in which the injured worker was not likely to be able to recover at law for his/her injures. (Most negligence lawsuits against the firm were barred at that time by three legal defenses: contributory negligence, assumption of risk, and the fellow servant rule[50]. Injured workers were left without funds to pay for medical care or wage loss.) Workers' compensation, with its no-fault provision, guaranteed that an injured worker would be fully covered with regard to medical expenses and would also receive partial wage loss compensation, so long as the injury arose out of employment.

Congress recognized in 1970 that a superior solution to the problem of industrial accidents is to prevent them from happening in the first place. OSHA uses this preventive approach. By mandating safety standards and inspections, injuries are prevented. This was a complete reversal of perspective from workers' compensation, which viewed industrial accidents as inevitable and merely sought to ameliorate the financial impact on victims.

All regulatory schemes contain elements that are either preventive of remedial, or perhaps a combination of both. For example, the Securities Acts of 1933 and 1934 are predominantly remedial, in that they provide remedies to investors who suffer loss from misrepresentation and fraud. They are also preventive in that they also require extensive periodic disclosure of financial information so that investors can avoid losses resulting from investments with poor or inadequate financial fundamentals.

While preventive regulation is clearly more desirable from a societal point of view, it is often less popular with those affected than remedial regulation. When the government steps in to provide a remedy after the damage has already been done everyone recognizes the problem and the need for remedy. But preventive regulation is often viewed as needless government meddling and interference. Business' complaints about OSHA are an example. Also, with remedial regulation victims may receive money or benefits from the government, for example with workers' compensation. On the other hand, preventive regulation typically requires firms to spend money for compliance. It also diverts some managerial attention from core business objectives. These are exactly the complaints being leveled against the SOA.

The SOA is an excellent example of regulation that is predominantly preventive in nature. PCAOB's inspections of public auditing firms and its promulgation of standards to promote accurate financial reporting and avoid conflicts of interest directly parallel OSHA's preventive approach. No one should be surprised that the same kind of objections and complaints that are made regarding OSHA's activities are also made regarding SOA compliance. Nevertheless, the conclusion is irresistible that preventing harm is better than remedying its effects. It has been variously estimated that the corporate scandals of 2000 and 2001 have cost investors` between $300 billion[51] and $460 billion[52]. While compliance with SOA certainly has costs, it is highly unlikely that these costs even approach the magnitude of investors' recent losses.

CONCLUSION

We have seen that the SOA substantially changed the liability environment in which auditors of public companies must operate. Before the SOA liability would typically come about only <u>after</u> a corporate collapse. But while auditors knew that the resulting liability would be great, they also knew that for any given audit it was very unlikely to occur. Now, as William McDonough, Chair of the PCAOB has said "under the new system, auditors understand that their work is much more likely to be reviewed within months or even weeks by the PCAOB's well-experienced, full-time inspectors"[53.] It is now far more likely that violations will be caught.

Auditors are now much more sensitive to conflicts of interest. The SOA lists specific conflicts to avoid, such as consulting work and other non-audit work. It also gives the PCAOB authority to outlaw additional conflicts. This has changed the fundamental economic structure of the public accounting profession. Audits can no longer be "loss leaders" supporting other more profitable work. Congenial personal relationships between auditors and corporate officers are now discouraged and the term of a "lead accountant" auditing a public company is now limited to 5 years. Audits have become more adversarial, and more expensive[54].

Accountants now face greater risk when performing audits of public companies. A PCAOB inspection could result in suspension or termination of the accountant's and/or the firm's registration status. Without registration, the accountant or firm is prohibited from performing audits of public companies. In a worst case scenario, prison terms of 10 years could result from willfully failing to maintain all audit workpapers for five years. An accountant could spend 20 years in a federal prison for willfully destroying or altering documents.

No longer will auditing standards be formulated by an industry-friendly body like the Auditing Standards Board of the AICPA. They will now be formulated by the tough-minded PCAOB. The more stringent standards and practices mandated by the SOA might become accepted as best practices and be imposed even in ordinary negligence lawsuits.

All these changes might seem disheartening to accountants and especially those auditing public companies. And yet there is a very bright and hopeful side to the changes that the SOA has brought about. Progressive firms like Deloitte & Touche view the SOA as "a bridge to excellence"[55]. Their booklet by that title states "corporate leaders who embrace the spirit of the law – strong ethics, good governance, reliable reporting – will get a re-energized company, reassured investors, and maybe even reduced costs"[56]. Business Week Online recently reported a decline in "vehement railing against Sarbanes-Oxley" as corporations begin to see benefits of improved business controls and processes[57].

It is clear that the SOA is here to stay. It addresses the critical need to restore investor confidence following unprecedented business scandals. While it has increased the cost of compliance for corporations and added to auditors' legal liability, it has also brought about more reliable financial reporting, improved internal control processes and eliminated many conflicts of interest. It has also led to a greater emphasis on ethical behavior. Moreover, the SOA represents the best kind of regulation: that which seeks to prevent a harmful event, not just to provide a remedy to those injured by that event.

The benefits of the SOA appear to outweigh its costs. Moreover it is unlikely that Congress will significantly weaken it. It would be politically inopportune to appear to side with the corporate abusers. However, it is well recognized that the SOA was drafted in haste, and fine-tuning will no doubt occur. One measure that is almost certain to be adopted is a reduction of the regulatory burden and cost on small corporations. Congressman Oxley has recently said that if he could do it all again, he would provide "a bit more flexibility for small and medium-size companies".[58]

ENDNOTES

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[17] *Id.* at 135.

[18] E. Bumiller (July 31, 2002). Bush Signs Bill Aimed at Fraud in Corporations, *N.Y. Times,* A1.

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[24] *Supra* note 18 at 246.

[25] *Id.*

[26] Securites Act of 1933 Sec. 19(a), 15 U.S.C. 77s(a); Securities Exchange Act of 1934 Sec. 13(b), 15 U.S.C. 78m(b).

[27] Nagy, D.M. (2005). The SEC at 70: Playing Peekaboo With Constitutional Law: The PCAOB and its Public/Private Status. *Notre Dame Law. Review,* 80, 977-1071.

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[30] *Id.* at 941. Testimony of Charles Bowsher, former Chairman of the POB and former Comptroller General of the U.S.

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[34] For example, Section 10b of the Securites Exchange Act of 1934.

[35] The classic case is Escott v. Barchris Construction Corp. 283 F.Supp. 643 (1968).

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[42] Oversight of the Public Company Accounting Board: Hearing Before the Subcommittee on Capital Markets etc., 108th Congress 6 (2004), statement of William McDonough, Chairman of the PCAOB, at 45.

[43] Information Management Journal, November/December 2004 at 14.

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[52] Nagy, D.M. (2005). The SEC at 70: Playing Peekaboo With Constitutional Law: The PCAOB and its Public/Private Status. *Notre Dame Law Review,* 80, 977-1071.

[53] Testimony of William McDonough before the Committee on Financial Services, U.S. House of Representatives, April 21, 2005 at page 15.

[54] Gifford, R.H. & H. Howe (2004). Regulation and Unintended Consequences: Thoughts on Sarbanes-Oxley. *The CPA Journal,* June 2004 (N.Y. State Society of PAs).

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[56] *Id.*

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PROPERTY LAW, PERSONHOOD AND ETHICS: STEM CELL RESEARCH & ITS IMPACT ON PROPERTY LAW

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ABSTRACT

Developments in biotechnology raise a myriad of issues relating to intellectual property law and ethics. Intellectual property law and specifically patent law, has been forced to create guidelines for patenting living matter. Patent law permits patent-holders to obtain a limited-time monopoly for patents of novel, useful, non-obvious processes and devices. Matter found in nature cannot be patented. However, processes to discover stem cells and transgenic animals have been approved by the U.S. Patent and Trademark Office. This paper explores the definition of legal definitions of property and intellectual property and the legal basis for patentability of stem cells. It points out some inconsistencies in the laws relating to property as contrasted to the laws of "personhood" and explores ethical issues. It ends with several suggestions to use the information to stimulate critical analysis and evaluation of cases in the classroom.

POTENTIAL INTEREST: Faculty that teach business law and who incorporate business ethics into their courses can use the information in this paper to construct class activities and to enhance their presentation of information on property law and ethics. This paper can be used to generate research projects for students relating to these topics.

INTRODUCTION

"[P]roperty is that sole and despotic dominion which man claims and exercises over the external things of the world in total exclusion of the right of any other individual in the universe" (Blackstone, 1883). Blackstone's declaration forms the core of the traditional common law conception of property and property law: some *thing* that a person owns, controls and exerts complete power over. Although there has been a gradual shift in the analysis of property under the law, Blackstone's core explanation remains valid. In a market-driven economy, a commonly accepted legal and social definition of property and the legal rights involved are essential. Effective, efficient transfer of these rights is one of the foundations of the free exchange of goods along with an agreed definition of contract law.

Research and advances in biotechnology have created new challenges for the courts and the legal system. Courts must apply property law principles to define legal rights and entitlements to the processes and results of these scientific advances. Specifically, stem cell research has, on the one hand, been heralded as a new scientific wave for developing treatment and cures for intractable diseases and on the other hand, attacked as a scientific symbol of society's moral decay. In this paper, the author presents an overview of the issues that arise with this intersection of intellectual property law, scientific advances and morality and an explanation of how the legal system has attempted to reconcile very different and sometimes opposing concerns. The paper concludes with several recommendations to assist instructors to incorporate discussions of these issues into in class and online discussions that critically analyze these issues.

BACKGROUND: PROPERTY AND INTELLECTUAL PROPERTY

What is property and how is it defined under the law? For the past hundred years, courts and scholars have primarily focused on property as "a malleable, divisible, disaggregable, functional set of rights among people. New property interests can be created in intangibles, as well as tangibles, and in abstract concepts, as well as concrete realities." (Arnold 2002). Under this definition, property includes all manner of things. Property rights are frequently defined as a bundle of rights that include ownership, exclusive control and dominion, and present and future interests (Arnold, 2002). Although in common parlance, property is an "intangible or tangible thing" the legal definition focuses on the property holder's power (and attendant rights) over that "thing."

Real property includes land, easements to land, estates in land (temporary to permanent rights to use land), buildings, vegetation growing on the land and the airspace above and the subsurface below. Under the common law, real property included the rights to airspace to the upper reaches of the universe and to the center of the earth. Property includes the right to own animals in addition to the right to own inanimate and intangible objects. Under Article 2 of the Uniform Commercial Code, it is clear that animals are treated as "goods;" that is, a type of tangible property. Along with the right to own animals is a duty to treat the animals in a way that does not violate the law: this includes an obligation to feed animals, care for them and not abuse them. Animal rights activists would argue that abuse occurs in many forms, including the process of raising and slaughtering animals for meat. The law does not prohibit or directly control uses of meat for food from a property law standpoint. The law's focus in this area is upon the suitability of the food for consumption.

Intellectual property laws have added new ways that individuals can own animals. Intellectual property includes rights in items that are tangible representations of ideas (copyrights), tangible representations of unique or novel processes that are neither obvious nor found in nature (patents), and tangible representations of a business, its reputation and its goodwill (trademarks, trade names and trade secrets). Patent law has been interpreted to permit individuals to own a patent in animals, if those animals are not found in nature. In 1987, the United States Patent Office (PTO), which is the initial agency responsible for approving or denying patents, "announced that it would accept applications for 'nonnaturally occurring nonhuman *multicellular* living organisms, including animals'." The PTO stated that to be patentable the animals must be "given a new form, quality, properties or combination not present in the original article existing in nature in accordance with existing law" (Woessner, 2001).

In 1988, the PTO issued its first patent for a transgenic, non-human animal. Patent no. 4,736,866 was awarded to Philip Leder and Timothy A. Stewart of Harvard University, in a patent frequently referred to as the "Harvard mouse." The Harvard mouse is transgenic in that one additional gene had been added to the mouse to alter its natural state. The mouse was created to test anti-cancer drugs. Inserted into the Harvard mouse was an additional gene that caused it to create tumors. That additional gene could be passed on to its descendents. Since that time, the PTO has issued patents on transgenic mice with a variety of genetically altered characteristics, including mice with enlarged prostates, mice with an increased ability to fight infection and mice with an added ability to produce certain ingredients for drugs more efficiently and in larger quantities than bacteria (Woessner, 2001).

STEM CELL RESEARCH AND INTELLECTUAL PROPERTY LAWS

Stem cell research has been at the forefront of biotechnological advances because of the potential curative uses of the cells. Research into stem cells and how they divide can help provide answers about how cells divide and, it is hoped, ultimately teach researchers how improper cell division occurs in cancer and birth defects. Once the scientists learn the process of cell division in these, the hope is that they can then develop cures. Research into stem cells can lead to improvements in the efficiency of drugs for treatment of a variety of illness. In addition, many researchers believe that stem cell research can help them develop cures for diabetes, cardiovascular and other diseases by helping scientists develop processes for creating new body organs or repairing existing body organs that have become diseased (Lill & Hecht, 2002; Miller, 2003). Stem cells are cells that have the ability to divide indefinitely and to differentiate into any type of cell, including organ, skin or any other type of cell. Stem cells are created as part of the fertilized egg or zygote that is created in the first few days after an egg is fertilized. As the zygote divides into more cells, it becomes an embryo (Lill & Hecht, 2002). Human stem cells are generally isolated from either the embryo (known as embryonic stem cells) or from fetal tissue (known as embryonic germ cells).

In 1981, scientists isolated stem cells in mice. Nearly fifteen years later, scientists at the University of Wisconsin (through its Wisconsin Alumni Research Foundation or WARF) isolated stem cells in rhesus monkeys and applied for a patent on that process. Shortly thereafter, UW researchers developed a successful process for isolating human stem cells (J. Thompson, 1998). WARF obtained patents on the stem cells and on the process. This research and the subsequent patents raise two relevant property law issues: ownership of the stem cells and/or zygotes themselves and ownership of the processes of creating the stem cells and zygotes.

In 1988, the PTO ruled that no one could patent a human-animal hybrid. Jeremy Rifkin and Stuart Newman filed patent applications for a variety of human-animal hybrids, including hybrids that were up to 50% human. Rifkin and Newman were human rights activists concerned that the patent office would issue patents on humans. Rifkin and Newman filed for the patents to stimulate debate on the morality of such patents. The Office's decision, which is not binding on the courts, was that human matter is not patentable. The PTO's decision was based on its interpretation of Congressional intent that "Congress did not intend the patent law to include the patenting of human beings" It also undoubtedly based its decision on the thirteenth amendment which prevents involuntary servitude (T. Magnani, 1999).

The holder of a patent in any area of stem cell research can expect a number of commercial benefits. Because stem cell research has the potential to result in financially lucrative treatments for common and for life-threatening illnesses, pharmaceutical companies have been eager to support stem cell research. WARF and Geron Corporation, the company that funded WARF's research, own the patent to the human stem cells WARF scientists isolated and the patent to the procedures the scientists used to isolate the cells.. Patent holders exert a government-authorized monopoly over the products and processes for which they hold a patent. Because of their ownership of the patent for human stem cells, progress in stem cell research, is, to a certain extent, controlled by WARF and Geron. This is because researchers must obtain permission from WARF and Geron to use its cells and processes for such research. WARF's policy is to permit academic institutions to use its stem cell lines for the cost of producing them. However, if the academic institution develops a promising treatment, it must reach a licensing agreement with WARF (Miller, 2003). Although WARF's policy on academic research is noteworthy, it may inhibit competition. What institution or entity would want to develop a new treatment when its profitability depends on reaching an agreement with WARF? WARF would have the upper hand and could negotiate terms that were extremely favorable to it. The academic institution would be forced to agree to WARF's terms, especially if it had invested significant sums in its research.

STEM CELLS, ZYGOTES AND EMBRYOS: ARE THEY LEGALLY HUMAN?

The "human" status of an embryo, if any, is complicated and arguably non-existent under the law. Zygotes are the first combination of cells that grow into the embryo, shortly after fertilization. An embryo develops after the initial fertilization and from the zygotes. At the point of fertilization, the zygote (and thus the embryo) has the potential to become a "born" human being. It possesses all the chromosomes necessary to become a distinct, unique human being, although it is not sentient. Embryonic stem cells grow after the initial fertilization and before the embryonic cells differentiate into brain cells, tissue cells, and other specific cells of the body. As noted above, the law treats the stem cells as property (as noted above) that can be patented. Zygotes are also treated as property; the next question is the law's treatment of embryos: are they persons or property?

In the battle over possession of frozen embryos, most state courts have concluded (explicitly or implicitly) that the embryos are not persons entitled to protection. The issue arises when couples who used in-vitro fertilization techniques to bear children seek control over the frozen embryos upon the divorce. In these situations, the parties did not reach a previous written agreement about disposition of the embryos in the event of divorce or death or one or both parties challenge any agreement because they have changed their minds. Typically, one spouse wants to keep the embryos for implantation at a future date or for donation to an infertile couple and the other spouse wants the embryos destroyed. The courts deal with the issue by ignoring the status or any human rights of the embryos (treating them as property) and focusing on the interests of the two divorcing spouses. The central issue in these cases is the disputing spouses' rights to procreate or not to procreate. In these frozen embryo disputes, the courts take the stance that the rights of the existing persons are the most important issue to be resolved. So far, the courts have determined that the potential parent's right to not procreate takes priority. There are varying justifications given for this preference, but the most consistently cited justification is that individuals should not be forced into the role of parent because of its significant financial and social obligations (Waldman, 2004).

As noted above, in frozen embryo cases, the courts focus on the rights of the existing parties and do not treat the embryos as human. Had the courts determined the frozen embryos to be human children worthy of protection, the courts would have employed the typical standard applied in child custody disputes, "best interests of the child". In *Davis v. Davis*, a Tennessee case, the parties disputed ownership of the embryos; the husband wanted the seven embryos destroyed and the wife wanted the embryos either implanted or donated to an infertile couple. The trial court sided with the wife, ruling the embryos were *"human beings existing as embryos"* and *"children in vitro"* whose best interests required *"that they be available for implantation"* and it awarded the embryos to Mary Sue. That decision was reversed on appeal and both Tennessee appellate courts determined that the right to avoid procreation was stronger. The appellate court reinforced the standard that the focus in these disputes was to be on the rights of the parties, absent an agreement to the contrary. (Shapiro, 1998)

Under abortion law the "rights" of the embryo are also not considered paramount. Instead the embryo's rights (if any) are subsumed under the woman's right to choose and thus the woman's right to choose has priority (*Roe v. Wade*, 1973; *Planned Parenthood v. Casey*, 1992). Although in the current political climate there have been modifications of abortion rights by permitting states to limit access to abortion, the decision is *Roe* has not been overturned by the United States Supreme Court.

The law on the legal status of an embryo is further muddied when one examines fetal murder statutes. For example, California's Penal Code section 187, subdivision (a), provides that "murder is the unlawful killing of a human being, or a fetus, with malice aforethought." Prior to a 1994 decision, the California Supreme Court had ruled that the "fetus murder" statute did not apply until the fetus was viable. Viability has been defined as "that point in fetal development when a fetus, if born, would be capable of living normally outside the womb." The California Supreme Court reached that conclusion based on its interpretation of *Roe v. Wade*. Its interpretation was that the privacy rights of the mother until viability outweighed the state's interest in protecting the fetus. Implicit in the court's decision is the assumption that the fetus was not considered a human life until it was capable of existence outside the womb. In 1994, the California Supreme Court ruled that one could be convicted of murdering a fetus regardless of the viability of the fetus (*People v. Davis*, 1994). In that case, the California Supreme Court re-defined "life" by concluding that an individual could be convicted of fetal murder even if the fetus has not yet reached viability. The court concluded that as long as the privacy interests of the mother are not involved, killing the fetus, before or after viability, constituted taking a life.

Animals are living property for which the law provides some protection. Although animals are "goods" as noted earlier, the law prohibits exerting dominion and/or control over the animals in a way that causes undue suffering or pain. States prohibit dog fighting, for example, and the law also prohibits cruelty to animals. Abuse or neglect of animals can result in criminal penalties and civil liability. Zygotes and embryos are for most purposes under the law, classified as property not entitled to the protection that animals receive, except as illustrated by the California case noted above.

This legal analysis, although based on somewhat conflicting court rulings and statutes, indicates that the stem cell, zygote and embryo are not human lives warranting legal protection, unless the life is taken *in utero* without the consent of the existing humans involved.

STEM CELLS, ZYGOTES AND EMBRYOS: ARE THEY MORALLY HUMAN?

The ethical issues are as thorny and complicated as the legal issues. There is also no final arbiter to determine how the moral issue should be resolved. The legal analysis at least demonstrated the courts' stance on the human rights of embryos. From a moral perspective, if the stem cells are merely cells, i.e. property, and the stem cells are not persons, then the ethical issue is different than if the stem cells, zygotes and/or embryos are persons. A brief summary of key ethical theories follows:

Immanuel Kant's key moral principle is the concept of a good will. The good will exists beyond intelligence, power, wealth, and happiness. Although intelligence, power, wealth, and happiness can be evidence of a good will, these qualities are not intrinsically good will because they can be perverted (Clark & Smith, 1931). It is the good "character" which helps to determine whether someone's actions are moral or not. Duty is the objective manifestation of good will and an action is moral if it is done because of this duty, regardless of consequences. The ultimate good in Kant's eyes is the individual's decision to act consistently with the principles that help to obtain the ultimate goal, a good will, which is valuable in and of itself. A key maxim for Kant's philosophy is the categorical imperative: "Act so that you treat humanity, whether in your own person or in that of another, always as an end and never as a means only."

How does Kant's analysis apply here? The key would be to determine whether there were any duties to stem cells, zygotes or embryos. One could argue, although Kant seemed to support scientific inquiry, that whether stem cell research was valid depended on whether zygotes would be treated as human. Since they are parts of nature, perhaps one could argue that application of a Kantian analysis results in a prohibition against treatment of zygotes as a means to an end, rather than as human beings. This would be independent of a determination of whether the zygotes or embryos were human or not. One could also use Kant's analysis to support a position that the duties would be to those who are currently existing, e.g. that the duty to permit individuals to procreate (or not) is a higher duty.

Utilitarian philosophy requires analyzing an action or a principle to determine whether that action maximizes the good for society. Jeremy Bentham and his student, John Stuart Mill, defined the principle of utility as relating to the issue of maximizing the pleasure or good for the individual and thus for society (Clark and Smith, 1931). The principle of utility focuses on determining whether an action is moral or right based on the consequences. As Bentham explained, "By utility is meant that property in any object, whereby it tends to produce benefits, advantage, pleasure, good or happiness. . . or. . . to prevent the happening of mischief, pain, evil or unhappiness to the party whose interest is considered: if that party be the community in general, then the happiness of the community; if a particular individual, then the happiness of that individual". Under this philosophy, actions or concepts that will bring pleasure may be instrumentally good, i.e. because they help to accomplish the ultimate good-pleasure. There are no true intrinsic goods except the maximum of happiness.

An analysis of stem cell research would then focus on whether the ultimate good of pleasure, or the alternative, the absence of pain, would be accomplished through the research. The current literature supports the concept that the ultimate good (i.e. future successful treatment of birth defects, chronic illnesses, heart disease and other health problems) could be accomplished through stem cell research. The relatively small amount of harm (destruction of embryos) would be overcome by the total ultimate benefit to society. A utilitarian analysis is incomplete if there is no analysis of alternatives to stem cell research. Some argue that there are alternative forms of research that might yield similar results without the use of zygotes. Exploration of those alternatives is beyond the scope of this paper. However, examination of those alternatives would be useful for those performing a more credible utilitarian analysis of whether such research is ethical.

The two ethical theories reviewed here do not provide a clear, unequivocal answer to the morality of cell research and the use and destruction of zygotes or embryos.

TEACHING USES OF THIS INFORMATION

The issues used here can be discussed from economic, legal and ethical perspectives. Instructors can use in class and on-line discussions to encourage students' critical consideration and analysis of issues that arise when biotechnological research meets with property law, personhood and ethics. A sample discussion question follows:

According to Blackstone, a well-respected and often quoted legal scholar and judge, a property right is "that sole and despotic dominion which [person] claims and exercises over the external things of the world in total exclusion of the right of any other individual in the universe." Is that how property rights are currently defined? Look in the text and examine the definitions. Biogenetic research has resulted in new questions about the definition of property and the ethical implications of such definitions. After reading the articles, watching the videos and reading the text, what is your conclusion about property? Do we "own" genes? Genetic material? Stem cells? Research on stem cells? Frozen embryos? "

In a graduate class on the legal environment, government regulation and ethics, students were asked to start their examination of property law with a discussion of the dispute between two baseball fans over who caught (and thus claimed ownership over) Bonds' baseball in San Francisco (Barry Bonds' Baseball Dispute, 2005). After students read about the case and discussed the issue of property ownership involved in that case, students were asked:

How do concepts of property and ethics relate to zygotes? For background, read: "Who Owns The Ova?" http://www.tobysolomon.com/articles/ova.html, "Cloning: What Hath Genomics Wrought?" http://www.commondreams.org/views/020300-102.htm and "Hello Dolly: With Cloning of a Sheep, Ethical Ground Shifts" http://www.wowzone.com/clone.htm

Students presented a relatively sophisticated analysis in online discussions based on each of the above questions. For example, one student explained:

"[Before answering the question]Who owns what?", it is necessary to establish if zygotes in question are property. I believe ,and court seems to have eventually supported this thought, that they can be considered property and not life since only in the later stages of embryonic development can the embryos be given more respect than mere human cells because of their potential for life. Once we established that, the question becomes a bit easier to answer. . . ."

To clarify the point, another student responded:

> *The point where a zygote is considered to be living organism, or "human being" in our discussion is clearly important. For some scientists, the zygote, even though is produced by the fusion of two cells, genetically is not different from the ones that shed from our skin. There is no evidence the zygote is "alive", until the division continue. According to this theory, there is life only after the brain produces the first electrical signals to start heartbeat. So, the heartbeat is associated to life (and death) and in humans, the heart start beating close to the end of the first trimester."*

Not everyone agreed that stem cell research was justified. A student who argued that the human zygote was entitled to protection said:

> *"I think one salient and immutable fact that would help clarify issues,is to recognize a zygote or embryo as a human being. This is because they are formed from the fusion of 2 separate human gametes(sperm and egg). Therefore, all inalienable rights that are conferred on humans ,should also be vested in them. This would prevent bizzare cases like the UK patent on a human embryo. This would amount to new-age slavery. Furthermore, a patent can only be granted on a new product or process. There is nothing new or unique in creating an embryo-Humans have been doing it for several millenia, quite naturally!"*

Students could be asked to present research papers or essays on the interrelationship among stem cell research, zygotes and the legal and ethical issues. In one online discussion, students were asked to present a summary of their analysis and why. The most complete student summary of the position that zygotes should be treated as property stated:

> *I have said it in my previous posting and will say it again here: the American judicial system has established that only in the later stages of embryonic development the embryos can be given more respect than mere human cells. The trimester approach to abortion outlined in Roe v. Wade gives us foundation not to consider zygotes human life. And all arguments that human life begins at conception will remain a mere philosophical exercise without legal consequencies otherwise abortion would have been banned now. And since they are not human life and they come from a person who created them, they are property of that person.*
>
> *As for processes for creating human clones, here we have at least two matters to deal with. First, can the cloning process be patented as intellectual property? I believe it can and this possibility is granted by the US Constitution (Article 1, Section 8, Clause 8) which states that Congress shall have the power "to promote the*

> *Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." The peculiarity of the Intellectual property is that exclusive rights to most of it don't last for ever unlike other kinds of property. Creators of the intellectual property (e.g. writers) are given exclusive rights to their intellectual property for a limited period of time. I don't know all the specifics but for example a writer and his descendants will retain the exclusive rights to the writer's works only for 50 years after the writer's death. The exclusive rights are supposed to reward the creators of intellectual property for their hard work and to encourage them to go on. Cloning process can be benefitial (sp.) for the humankind so its inventors must be rewarded. This point can be connected with the second matter we have to resolve here: Would the person being cloned have an intellectual property right or basic human right to control their DNA? In my opinion, the person could be given property right to his DNA but he cannot be given property rights to the clone that will be created through the use of his DNA. It would be wrong to let the person own his clones, as the clones are human beings and as such cannot be considered property in the USA. But is the right to a person's DNA intellectual property right? The DNA was not created by a person's intellect, the DNA actually is the core of the person's organism so I wouldn't call the right to a person's DNA intellectual property right. It is a regular personal property right. Intellectual property implies some value and some work that is done to create this property. A person didn't work to create his DNA, he was born with it. And this personal property right will allow the person to prohibit other people from making his clones with his DNA or permit them to do so. And what is the value of a particuar piece of DNA? Who can tell?*

The most complete student summary of the position that zygotes should not be treated as property stated:

> *In my opinion, zygotes are not property. I came to this conclusion, long before reading the definitions Professor Jones asked us to read through my own ethical and religious biases. However, I feel that the definition of property supports this, and found the website in regards to intellectual property especially convincing of this. Zygotes are not an invention of man...pure and simple, and therefore do not fall into the property of intellectual property. Man has manipulated a way to create human beings outside the normal, "natural process". If anything, one can make an argument that the scientists whom have discovered the process, can patent the process and therefore own the zygotes. In this case, the zygotes would not belong to the mother or father, but rather the scientists. Like many other patents, it is not the material that comes together to form the product which is patented, but rather the process. So in*

> *that case, I can see one doctor or scientist arguing that the means of doing so be protected, or patented from other institutions, scientists, or doctors patenting...but as far as property ownership...in the legal sense, neither mother nor father shouls (sp) have ownership.*
>
> *On an ethical level, my opinion still is that no one (scientists including) should have ownership over any human being, including zygotes whom have the potential for life. There is much discussion about pets...and it is alarming to me that people actually make the comparison between animals and human beings...animals, even according to the definition, are property...you and I are not....and no one owns us (except for those whom believe in a greater being like myself, God does)....but no man should own another.*

Through selective guidance and careful stimulation of discussion, students critically evaluated a wide range of legal and ethical issues in these discussions.

CONCLUSION

Human beings entitled to the rights of inalienable human rights or property deserving little protection and that can be bought and sold? That is the question that this paper explores regarding stem cell research, zygotes and embryos. The law has provided an answer to date: that stem cells, processes of isolating stem cells, zygotes and embryos are property that is entitled to protection as property, but not entitled to the rights of human beings. These conclusions and the attendant ethical issues ae the subject of debate as scientific research continues.

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KELO V. CITY OF NEW LONDON: IS EMINENT DOMAIN FOR ECONOMIC DEVELOPMENT PUBLIC USE OR PUBLIC ABUSE?

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ABSTRACT

The U.S. Supreme Court's majority opinion in the eminent domain case of Kelo v. City of New London is one that elicited public outrage, abundant commentary, and wide-spread condemnation – pun intended. In a passionate dissent, Justice Sandra Day O'Connor stated that "[a]ny property may now be taken for the benefit of another private party." Given that perceptions can be formed with virtually no information, limited information, or misinformation, and given the public's outcry over the Kelo decision, a close examination of what the case actually said might be in order. Is the alarming reaction to Kelo well-placed indignation or unwarranted hysteria?

Before answering this question, anyone aspiring to an informed opinion would seemingly be curious about the following: 1) What are the facts surrounding the Kelo case and exactly who was the "private party" on whose behalf the City of New London initiated eminent domain condemnation proceedings? 2) Does the majority opinion, as Justice O'Connor asserts, really stand for the proposition that "[a]ny property may now be taken for the benefit of another private party"? 3) What attention and respect did the majority opinion give to previous Supreme Court rulings on the scope and reach of eminent domain? 4) What have previous Supreme Court rulings said about the meaning of the phrase "public use" as it appears in the eminent domain clause of the Fifth Amendment? 5) What deference, if any, did the court give federalism and to the legislative branch in addressing what is permissible in the context of eminent domain proceedings? 6) How does Justice O'Connor's well publicized dissent compare to a previous Supreme Court decision on eminent domain that she authored? 7) Of what significance is it that the condemned property in question wasn't even blighted? 8) What recourse, if any, is available to those offended by the decision? For all who welcome further inquiry into the issues raised by these questions, by all means, read on.

THE FACTS

What are the facts surrounding the case and exactly who was the "private party" on whose behalf the City of New London initiated eminent domain proceedings? In 1990, after decades of economic decline, a Connecticut state agency declared the City of New London ("City") to be designated a "distressed municipality" (*Kelo v. City of New* London, 125 S.Ct. 2655, 2658 (2005)). By 1998, the City's unemployment rate was nearly double that of the State and its population was the lowest it had been since 1920 (*Kelo* at 2658). Nevertheless, in 1998, Pfizer had begun construction of a new research facility on the outskirts of New London. The City decided to use this opportunity to reactivate the New London Development Corporation, a private entity "under the control of the city government," to consider plans to redevelop the neighborhood around the Pfizer facility.

Just who the "private party" was in the *Kelo* case is a point worth emphasizing. For seemingly lost amid all the controversy over how a "private party" benefited from the eminent domain condemnation action, it bears mentioning that in this case the "private party" was none other than New London Development Corporation, a private entity "under the control of the city government." This city owned and operated "private party" is a far cry from the private corporate entity Pfizer, even though Pfizer is often misrepresented as the private party in question. The City simply hoped that reactivating its own government controlled Development Corporation would encourage new economic activities that might be brought in by the Pfizer plant that was already under construction (*Kelo v. New London*, The Development Plan. Retrieved February 14, 2006 from http://en.wikipedia.org.wiki/Kelo_v._New_London).

The development plan that resulted from the city's efforts divided the area to be developed into seven parcels. Parcel 1 was for a waterfront conference hotel at the center of a "small urban village" that would include restaurants and shopping. There would be marinas for commercial and recreational uses [open to the public]. A pedestrian "riverwalk" [open to the public] would begin here and continue down the coast, connecting the waterfront areas of the development (*Kelo* at 2659). Parcel 2 was the site of 80 new residences to be organized into an urban neighborhood and linked by a public walkway [open to the public] to the remainder of the development, including the state park [open to the public]. The parcel also included space for a U.S. Coast Guard Museum [open to the public] (*Kelo* at 2659). Parcel 3, located to the immediate north of the Pfizer facility, would contain 90,000 square feet of research and development office space (*Kelo* at 2659). Parcel 4A was a 2.4 acre site to be used either to support the state park [open to the public] by providing parking and retail services [open to the public], or to support the nearby marina with its commercial and recreational uses [open to the public] (*Kelo* at 2659). Parcel 4B included a renovated marina and the final stretch of the riverwalk [open the public]. Parcels 5, 6, and 7 would provide land for office and retail space, parking [open to the public], and water-dependent commercial uses (*Kelo* at 2659).

The city counsel [the local legislative body duly elected by the citizens of New London] approved the redevelopment plan in 2000 and authorized the New London Development Corporation ("NLDC") [the city owed and operated "private party"] to purchase property or acquire it by exercising eminent domain in the City's name (*Kelo* at 2659-2660). NLDC successfully negotiated the purchase of most of the land in the 90 acre area known as Fort Trumbell. The owners of 15 of the Fort Trumbell properties did not wish to sell to the corporation. Of the 15 properties, ten were owned by occupants, and five by investors – who did not even live in the properties. These owners were the petitioners in this case; the lead plaintiff, Susette Kelo, owned a small home on the Thames River in the development area (*Kelo v. New London*, The Development Plan).

Because the remaining property owners would not voluntarily sell their land, the City chose to exercise its right of eminent domain. "The city ordered the development corporation, a private entity acting *as the city's legally appointed agent* [emphasis added], to condemn the fifteen holdout owners' lots" (*Kelo v. New London*, The Development Plan). The properties were not alleged to be blighted or in poor condition. The condemnation occurred solely because the properties were located in the city council designated redevelopment area.

THE EMINENT DOMAIN PROCEEDINGS

In November 2000, the City initiated condemnation proceedings. The homeowners responded by suing the City in Connecticut state court. (Nine parties owned the fifteen different properties). The homeowners' argument was that the City had misused its powers of eminent domain. The Fifth Amendment to the U.S. Constitution states that the federal government may not take private property for public use without just compensation. The Fourteenth Amendment to the U.S. Constitution imposes this same restriction on state and local governments. Plaintiff homeowners argued that economic development did not qualify as public use.

The case was heard in the New London Superior Court in December, 2000. After a seven day bench trial, the court granted a permanent restraining order that prohibited the taking of the properties located in parcel 4(A). The court denied relief as to the properties located in parcel 3 (McAdams, Tony (2005). *Law, Business & Society* (8^{th} Edition), McGraw Hill Irwin, at 195). Both rulings were appealed. The Supreme Court of Connecticut held that the City's proposed takings were valid (McAdams, Tony, *Law, Business & Society*).

The homeowners petitioned for writ of certiorari, which the United States Supreme Court granted. The Supreme Court had not heard a major eminent domain case since 1984. The Supreme Court would be forced to address the issue that the development corporation was a private entity. The homeowners would argue that it was unconstitutional for the government to take private property from one individual or corporation and give it to another entity, even if the other entity would use the property to generate higher tax revenues. Certiorari was granted to determine whether a city's decision to take property for economic development satisfies the "public use" requirement of the Fifth Amendment.

ANALYSIS OF MAJORITY OPINION OF THE U.S. SUPREME COURT

Does the majority opinion, as Justice O'Connor asserts, really stand for the proposition that "[a]ny property may now be taken for the benefit of another private party?" The majority opinion begins its legal analysis in Section III of the decision and immediately takes up the question of whether the government may take property from one private individual or entity and give it to another private individual or entity. Showing its respect for precedent, the majority explicitly states that "…it has long been accepted that the sovereign may not take the property of A for the *sole purpose* of transferring it to another private party B...The City would no doubt be forbidden from taking petitioners' land *for the purpose of conferring a private benefit* on a particular private party" [Emphasis Added] (*Hawaii Housing Authority v. Midkiff,* 467 U.S. 229 (1984)).

So while the majority unambiguously states that government may not take land for the "purpose of conferring a private benefit" on a particular private party, government may in fact transfer property from one private party to another if the "purpose is for use by the public." Accordingly, in recognizing how the "purpose" of the transfer is a critical factor in eminent domain analysis and that government may not take land for the "purpose of conferring a private benefit," the majority also states "…it is equally clear that a State may transfer property from one private party to another if future 'use by the public' is the purpose of the taking; the condemnation of land for a railroad with common-carrier duties is a familiar example" (*Kelo* at 2661). Despite the foregoing distinction with respect to how the "purpose" of a eminent domain transfer is critical, the majority concedes that "...[n]either of these propositions, however, determines the disposition of this case" (*Kelo* at 2661).

What attention and respect did the majority opinion give to previous Supreme Court rulings on the scope and reach of eminent domain? In 1984 U.S. Supreme Court took up the case of *Hawaii Housing Authority v. Midkiff*, which challenged the use of eminent domain under Hawaii's Land Reform Act of 1967 ("Act"). The Hawaii Housing Authority ("HAA") had implemented the Act after the Hawaiian legislature discovered that only a small number of landowners owned the state's land (*Midkiff*). After a determination that concentrated land ownership was responsible for inflating land prices and injuring the public tranquility and welfare, the HHA held a public hearing regarding the acquisition of the landowner's property and made a statutory finding that the acquisition of property under the Act effectuated a "public purpose." The Act provided for condemnation by the state of housing development tracts, at prices set by condemnation trial or negotiation between lessors and lessees, and resale to lessees of the property (*Midkiff*). The landowners brought suit in U.S. District Court in Hawaii. The case eventually made its way to the U.S. Supreme Court.

In an 8-0 decision (Justice Marshall abstaining), the Court held that the public use clause of the Fifth Amendment, made applicable to the states through the Fourteenth Amendment, did not prohibit the state from taking residential property from lessors and transferring it to lessees in order to reduce the land oligopoly in Hawaii. The unanimous opinion, written by Justice O'Connor, states in pertinent part as follows:

> *The State of Hawaii has never denied that the Constitution forbids even a compensated taking of property when executed for no reason other than to confer a private benefit on a particular private party. A purely private taking could not withstand the scrutiny of the public use requirement; it would serve no legitimate purpose of government and would thus be void. But no purely private taking is involved in these cases. The Hawaii Legislature enacted its Land Reform Act not to benefit a particular class of identifiable individuals but to attack certain perceived evils of concentrated property ownership in Hawaii – a legitimate public purpose. Use of the condemnation power to achieve this purpose is not irrational. Since we assume for purposes of these appeals that the weighty demand of just compensation has been met, the requirements of the Fifth and Fourteenth Amendments have been satisfied* (*Midkiff* at 245).

Accordingly, please keep in mind that in 1984 Justice O'Connor personally authored a unanimous Supreme Court opinion upholding the right of a duly elected legislative body to determine how a private taking served a public purpose.

RESPECT FOR PRECEDENT

What have previous Supreme Court rulings said about the meaning of the phrase "public use" as it appears in the eminent domain clause of the Fifth Amendment? The Supreme Court "long ago rejected any literal requirement that condemned property be put into use for the . . . public" (*Kelo*, citing *Midkiff* at 244). "Rather, it has embraced the broader and more natural interpretation of public purpose as 'public use'" (*Kelo*, citing *Fallbrook Irrigation District v. Bradley*, 164 U.S. 112, 158-164). The Supreme Court has, without exception, defined the concept of "public use" broadly.

In *Berman v. Parker*, the District of Columbia Redevelopment Act ("Redevelopment Act") was a legislative determination that certain areas of the District of Columbia were injurious to public health (*Berman v. Parker*, 368 U.S. 26 (1954)). Pursuant to the Redevelopment Act, a project was launched to redevelop an entire area of the District of Columbia. The project required acquisition of all land rights in a particular area. The main purpose of the project was to rid the area of housing that was in extremely poor condition. A challenge to the project was made by property owners who owned land upon which a department store was located. They argued that their property could not be constitutionally taken for the project because it was commercial, not residential. They further argued that the project was under management of a private, not a public, agency and redeveloped for private, not public, use (*Berman* at 31). Moreover, the property owners maintained that merely upgrading or improving property was in and of itself not a sufficient "public purpose."

> *We do not sit to determine whether a particular housing project is or is not desirable. The concept of public welfare is broad and inclusive. . . If those who govern the District of Columbia decide that the Nation's Capital should be beautiful as well as sanitary, there is nothing in the Fifth Amendment that stands in the way. . . It is not for the courts to oversee the choice of the boundary line nor to sit in review on the size of a particular project area. Once the question of public purpose has been decided, the amount and character of the land to be taken for the project and the need for a particular tract to complete the integrated plan rests in the discretion of the legislation branch* (*Berman* at 33-35).

The precedent of the U.S. Supreme Court, then, makes clear that "public use" need not be for the use of the "general" public (*Midkiff* at 244). "Public purpose" is broadly interpreted. Economic development by a private developer can achieve a "public purpose" and "a state may transfer property from one private party to another if future 'use by the public' is the purpose of the taking" (*Kelo* at 2661). Since the close of the 19th century, states and the Supreme Court have embraced the broader and more natural interpretation of public use as "public purpose" (*Kelo at* 2662, citing *Fallbrook Irrigation District v. Bradley*, 164 U.S. 112, 158-164 (1896)).

> The homeowners in the *Kelo* case wanted the Supreme Court to engage in judicial activism and create a new bright-line rule that economic development does not qualify as public use (*Kelo* at 2665). The Supreme Court refused to create new law. This case was a clear example of the U.S. Supreme Court following precedent. This was no "activist" decision and should not have surprised anyone. For over a century, "public purpose" has been broadly interpreted. For over twenty years, state and local governments have been using eminent domain for economic development purposes.

FEDERALISM AND DEFERANCE TO STATE LEGISLATURES

What deference, if any, did the court give to federalism and the legislative branch in addressing what is permissible in the context of eminent domain proceedings? As noted, the decision to proceed with the New London redevelopment project at issue in Kelo and to initiate condemnation proceedings in furtherance of that redevelopment project in was undertaken by the duly elected City Council, i.e., the elected local legislators for the City of New London. Accordingly, the majority opinion in Kelo shows great respect for the right of elected local legislators to determine local needs:

Our earliest cases in particular embodied a strong theme of federalism, emphasizing the 'great respect' that we owe to state legislatures and state courts in discerning local public needs [citations omitted]. For more than a century, our public use jurisprudence has wisely eschewed rigid formulas in favor of affording legislatures broad latitude in determining what public needs justify the use of the takings power (*Kelo* at 2664).

The majority is also unwilling to impose its determination, over that of elected local legislators, as to what constitutes a "public purpose," and, accordingly, adopts a hand-off approach:

The disposition of this case therefore turns on the question whether the City's development plan serves a 'public purpose.' Without exception, our cases have defined that concept broadly, ***reflecting our longstanding policy of deference to legislative judgments*** *in this field* [emphasis added] (*Kelo at* 2663).

The majority opinion in *Kelo* is a testament to federalism and deference to the legislature branch. Far from judicial activism, the *Kelo* case is a classic example of judicial restraint, with the majority unwilling to insinuate itself into the process of making judgments properly left to local officials. The majority fully realize that local officials are in a better position to assess local needs and that federalism requires recognition of how the needs of society vary in different parts of the country and evolve over time (*Kelo* at 2664).

O'CONNOR'S DISSENT: FAIR WARNING OR HYPERBOLE?

How does Justice O'Connor's well publicized dissent compare to a previous Supreme Court decision on eminent domain that she authored? Justice O'Connor wrote the principle dissent in *Kelo*, a stinging rebuke of the majority opinion that ignited public indignation. She suggested that the majority's interpretation of eminent domain would spawn a reverse Robin Hood effect (i.e., take from the poor, give to the rich) (*Kelo v. New London*, The Development Plan).

Any property may now be taken for the benefit of another private party, but the fallout from this decision will not be random. The beneficiaries are likely to be those citizens with disproportionate influence and power in the political process, including large corporations and development firms (Kelo at 2667).

Justice O'Connor further opined that the majority's decision eliminated any distinction between public and private use of the property and that the words "for public use" have been effectively removed from the Takings Clause of the Fifth Amendment.

Curiously, however, Justice O'Connor seems to disregard her own rationale from the 1984 Supreme Court case of *Hawaii Housing Authority v. Midkiff*, discussed above, in which she opined that forcibly taking property from the lessors and selling it to lessees constituted a "public use." No doubt mindful of *Hawaii Housing Authority v. Midkiff*, O'Connor's dissent tries mightily to distinguish both the *Berman* and *Midkiff* cases. How?

> *In both those cases, the extraordinary, precondemnation use of the targeted property inflicted harm on society – in Berman though blight resulting from extreme poverty and in Midkiff through oligopoly resulting from extreme wealth. And in both cases, the relevant legislative body had found that eliminating the existing property use was necessary to remedy the harm. Thus a public purpose was recognized when the harmful use was eliminated. Because each taking directly achieved a public benefit, it did not matter that the property was turned over to private use (Kelo at* 2674).

O'Connor's rationale suggests that eminent domain analysis may somehow be subject to a Supreme Court review of those who are so rich that they may pose a harm to society, along with a parallel Supreme Court review of those who are so poor that they may pose a harm to society. Those in the middle – Mrs. Kelo and her neighbors – are purportedly middle class. Since, according to O'Connor's reasoning, the handful of hold-outs in Kelo are apparently neither too rich not too poor to be harmful under her eminent domain analysis, they should be permitted to block a redevelopment project to benefit the entire City – a redevelopment project the elected local legislators of New London deemed helpful to revive their "distressed municipality."

The purported logic of O'Connor's dissent simply cannot withstand scrutiny. Is she really suggesting the Supreme Court should superimpose its will to determine who among us is either too rich or too poor in a harmful way so that the condemnation and taking of our property may or may not serve a "public use?" Moreover, such on incomprehensible Supreme Court review is an affront to federalism and deference to the legislative branch. Cities across the nation have created new jobs and better neighborhoods through the use of eminent domain. Having one's property condemned is seldom a joyful event, even if it is done to build a badly needed freeway or school. Is it the really the role of the Supreme Court to decree that jobs and economic development for a "distressed municipality" such a New London is any less important?

THE CONDEMNED PROPERTY AT ISSUE IN THE KELO CASE WASN'T EVEN BLIGHTED

Of what significance is it that the condemned property in question wasn't even blighted? Although a Connecticut state agency did in fact declare the City of New London to be designated a "distressed municipality," it is fully recognized that the property condemned in the Kelo case was not blighted, and for that reason, the argument goes, the condemnation is especially objectionable. In other words, similar to the sentiment seemingly expressed in Justice O'Connor's dissent, it is permissible to condemn blighted neighborhoods, but not others. Or as the property owners before the Supreme Court in the Berman case put it: "To take for the purpose of ridding the area of slums is one thing; it is quite another, the argument goes, to take a man's property merely to develop a better balanced, more attractive community" (*Berman* at 31).

First of all, the Supreme Court has never held that property must be "blighted" to be condemned. Second, as some seem to suggest, why would it be acceptable to condemn blighted property for economic development, but not non-blighted property? After all, one person's blight may be another person's home. In fact, those displaced from blighted areas likely to have the fewest resources available to assist in relocation. The point is not that government should be prohibited from condemning blighted property for economic development, but rather that the status of the condemn property – blighted or not – should not be determinative of whether property is condemned for economic development. As the majority noted:

> *Those who govern the City were not confronted with the need to remove blight in the Fort Trumbull area, but their determination that the area was sufficiently distressed to justify a program of economic rejuvenation is entitled to our deference. The City has carefully formulated an economic development plan that it believes will provide appreciable benefits to the community, including – but by no means limited to – new jobs and increased tax revenue. As with other exercises in urban planning and development, the City is endeavoring to coordinate a variety of commercial, residential, and recreational uses of land, with the hope that they will form a whole greater than the sum of its parts.* ***To effectuate this plan, the City has invoked a state statute that specifically authorizes the use of eminent domain to promote economic development*** *[emphasis added]* (*Kelo at 2665).*

In other words, if it is acceptable to condemn blighted property for the public purpose of economic development, it should also be acceptable to condemn non-blighted property for the public purpose of economic development if that is the determination of the locally elected legislative body.

IS EVERY HOME IN PERIL?

What recourse, if any, is available to those offended by the decision? So now that Kelo is the law of the land, is Justice O'Connor's dire warning that "[a]ny property may now be taken for the benefit of another private party" cause for alarm? Of course, despite all the hysteria, the *Kelo* decision it truly of little consequence. Why? Well, it is simply of little consequence because the

Supreme Court did not mandate or change anything. The majority merely restated what the law has been for over a century. As the majority opinion in *Kelo* noted:

> *[T]his court long ago rejected any literal requirement that condemned property be put into use for the general public." [Citations omitted] Indeed, while many state courts in the mid-19th century endorsed "use by the public" as the proper definition of public use, that narrow view steadily eroded over time. Not only was the "use by the public" test difficult to administer (e.g., what proportion of the public need have access to the property? at what price?), but it proved to be impractical given the diverse and always evolving needs of society. Accordingly, when this Court began applying the Fifth Amendment to the States at the close of the 19th century, it embraced the broader and more natural interpretation of public use as "public purpose" [Citations omitted](Kelo at 2662).*

Accordingly, the majority opinion – far from threatening – is merely old law, tried and true. As for those offended by the Court's decision, recourse is basic and quintessentially American – demand action from elected officials, attempt to make eminent domain a campaign issue (as many have already done), or otherwise seek to effect a change in the law.

The Supreme Court did nothing more than restate that baseline for local officials seeking to invoke eminent domain condemnation proceedings – a baseline that has long been the law of the land, but one that local officials are free to make more stringent. Far from doing anything novel, it was in the property owners who sought to disregard precedent and assert "a new bright-line rule that economic development does not qualify as public use" (*Kelo* at 2665).

CONCLUSION

The Supreme Court made clear that their opinion in *Kelo* in no way precluded states from placing further restrictions on their exercise of the takings power. Many states already impose "public use" requirements that are stricter than the federal baseline. In some states, these restrictions are part of their state constitutional law. In other states, the state legislature has drafted state eminent domain laws. Moreover, eight states currently prohibit the use of eminent domain for economic development ***except*** to eliminate blight: Arkansas, Florida, Illinois,

Kentucky, Maine, Montana, South Carolina, and Washington (*Kelo v. City of New London*, 125 S.Ct. 2655). Other states have proposed state laws to ameliorate the decision in *Kelo*. California and five other states are currently considering amendments to their state constitutions. Justice O'Connor's dissent, and the surrounding hysteria by the media and the public, was entirely unfounded and unwarranted. The *Kelo* case was an unremarkable decision based on deference to precedent, to federalism, and to state legislatures. Nothing has changed – except, perhaps, a public that is now terribly misinformed about eminent domain and the state of the law surrounding it.

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FEDERAL CIVIL RIGHTS LEGISLATION AND STATE SOVEREIGN IMMUNITY

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ABSTRACT

State governments employ millions of people, and provide services to millions of Americans as well, some of which are of a governmental nature, but many of which are similar to those offered by the private sector. While the employment practices of most private employers are governed by a number of federal laws, state employers may not be required to conform to those regulations. Similarly, while the manner in which private employers provide services to the public are regulated by federal laws, state and local governmental service providers may be exempt from that regulatory scheme. Why? The Eleventh Amendment to the United States Constitution provides that, "The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State." As a result, states may enjoy sovereign immunity, and may not be subject to the jurisdiction of federal courts in cases in which plaintiffs seek judicial relief under federal law. This paper will discuss the application of sovereign immunity with respect to federal civil rights legislation, and discuss the most recent case to present this issue, which was decided by the Supreme Court this term.

STATE SOVEREIGN IMMUNITY

In essence the Eleventh Amendment precludes federal courts from adjudicating disputes brought against state governmental entities "by Citizens of another State, or by Citizens or Subjects of any Foreign State." Although the Eleventh Amendment does not expressly preclude citizens from bringing suits against the state in which they reside, the Supreme Court has interpreted the constitutional provision as precluding federal jurisdiction over suits against nonconsenting States, even by its own citizens. (College Savings Bank v. Florida Prepaid Postsecondary Ed. Expense Bd., 1999). The amendment has been interpreted as prohibiting Congress from authorizing subject matter jurisdiction for suits against states in which the immunity has been neither waived nor effectively abrogated, although it can be argued that that the restriction was intended only to be for suits against states based upon diversity jurisdiction, not federal question jurisdiction. (Chemerinsky, 1997).

Further, the amendment specifically addresses Article III jurisdiction of federal courts, seemingly leaving open the question of whether or not state courts may entertain such federal law claims brought by citizens against states. However, in a case involving alleged violations of the overtime provisions of the Fair Labor Standards Act of 1938, the Court determined that no judicial forum is available for suits against states if Congress has not expressly and legitimately waived immunity. (Alden v. Maine, 1999). “We hold that the powers delegated to Congress under Article I …do not included the power to subject nonconsenting States to private suits for damages in state courts.” (Alden v. Maine, 712, 1999). The Fair Labor Standards Act, however, was passed pursuant to the Interstate Commerce Clause, so the case did not address the legitimacy of suits filed in state court raising federal claims passed pursuant to the Fourteenth Amendment.

Whether or not suits legitimately are permitted by citizens against states under federal law usually involves a two-step inquiry to determine 1) if Congress unequivocally expressed its intent to abrogate that immunity, and 2) if it did, whether Congress acted pursuant to a valid grant of constitutional authority. (Kimel v. Florida Board of Regents, 2000). In *Seminole Tribe of Florida v. Florida* the Supreme Court held that Congress lacks power under Article I to abrogate the states' sovereign immunity. That case involved the Constitution's Indian Commerce Clause, which grants the federal government authority over Indian commerce. Specifically at issue in the case was the Indian Gaming Regulatory Act passed by Congress in an effort to provide a statutory basis for the operation and regulation of gaming by Indian tribes. (25 U.S.C. § 2701 (2005)). Previously, in *Pennsylvania v. Union Gas Company* (1989), a plurality of the Court concluded that the Interstate Commerce Clause granted Congress the power to abrogate state sovereign immunity, stating that the power to regulate interstate commerce would be "incomplete without the authority to render States liable in damages..." (Pennsylvania v. Union Gas Company, 19-20, 1989). However, in *Seminole Tribe* the Court overruled *Union Gas,* confirming that the background principle of state sovereign immunity embodied in the Eleventh Amendment may not be abrogated by Congress, even when the Constitution vests in Congress complete law-making authority over a particular area, such as the regulation of Commerce among the Indian Tribes. The Court concluded that the “Eleventh Amendment prevents congressional authorization of suits by private parties against unconsenting States. The Eleventh Amendment restricts the judicial power under Article III, and Article I cannot be used to circumvent the constitutional limitations placed upon federal jurisdiction.” (Seminole Tribe of Florida v. Florida, 73, 1996).

In contrast, Section 5 of the Fourteenth Amendment, which states “Congress shall have power to enforce, by appropriate legislation, the provisions of this article," does grant Congress the authority to abrogate the States' sovereign immunity. In *Fitzpatrick v. Bitzer*, the Court recognized that “the Eleventh Amendment, and the principle of state sovereignty which it embodies…are necessarily limited by the enforcement provisions of Section 5 of the Fourteenth Amendment.” (Fitzpatrick v. Bitzer, 456, 1976). As a result, plaintiffs may bring suits under civil rights legislation if the Congressional abrogation of immunity is constitutional under the Fourteenth Amendment, Section 1 of which provides in pertinent part that "[N]o State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

Courts are somewhat deferential to the determination of Congress as to the legislation that is needed to secure Fourteenth Amendment rights. In *City of Boerne v. Flores* (1997) the Court concluded that Congress' enforcement powers includes the authority to remedy, as well as to *deter*, the violation of guaranteed rights. By the same token the Court admonished that Congress was only given the power to enforce the Amendment, not to determine what constitutes a violation of rights under the Amendment. The Court observed that the determination as to whether or not *prophylactic* legislation constitutes appropriate remedial legislation, or instead effects a substantive redefinition of the Fourteenth Amendment right at issue, is often difficult. As such, the Court concluded that while Congress should be afforded some deference as to where that line should be drawn "there must be a congruence and proportionality between the injury to be prevented or remedied and the means adopted to that end." (City of Boerne v. Flores, 520, 1997). This "congruence and proportionality" test applies to the validity of applying federal civil rights legislation, to state governments. In other words, courts must examine the history and pattern of civil rights violations by states to determine if such conduct is proportionate to the remedial or preventive objectives of the legislation.

A key factor in such an analysis is the nature of the constitutional right allegedly violated by the state. State practices, which classify persons based upon suspect classifications such as race, are subject to the most rigid scrutiny under constitutional law (Korematsu v. United States, 1944). States must establish a compelling state interest and demonstrate a means narrowly tailored to achieve that interest in order to justify practices that treat persons differently based upon race or ethnicity. (Regents of University of California v. Bakke, 1978; Adarand Constructors, Inc. v. Pena, 1995). In comparison, classifications based upon sex are analyzed by an intermediate level of review, which requires states to establish that gender classifications serve an important governmental objective, and are substantially related to the achievement of those objectives. (Craig v. Boren, 1976; States v. Virginia, 1996). Other classifications of persons by states by other criteria, such as disability, are subject to a rational relationship review under constitutional law, which questions only whether or not the policy or practice is rationally related to a legitimate governmental objective. (Cleburne v. Cleburne Living Center, Inc., 1985). Classifications based upon age fall into this type of categorical review as well. (Massachusetts Board of Retirement v. Murgia, 1976).

In addition to the heightened judicial scrutiny of state classifications for members of suspect classes, constitutional jurisprudence recognizes that certain fundamental rights or interests also merit strict scrutiny under the Fourteenth Amendment. The denial or dilution of voting rights to classes of persons by states is subject to close scrutiny under the Equal Protection Clause (Harper v. Virginia State Board of Elections, 1966), as are state barriers that restrict certain classes of persons from access to the judicial process. (M.L.B. v. S.L.J., 1996).

In sum, state sovereignty is impervious to laws passed pursuant to the Article I power of Congress, but not to Congressional power under the Fourteenth Amendment. Nevertheless, even in exercising those powers under Section Five, Congress must tailor its remedial legislation to fit the civil rights violations addressed by its statutes, and the nature of the alleged violation as it relates to classifications or fundamental rights also must be examined. Even if States are cloaked with immunity, state officers, nevertheless, may be sued in federal court for declaratory or injunctive relief for civil rights violations. (Ex Parte Young, 1908). Furthermore, federal law provides a cause of action "at law, suit in equity, or other proper proceeding" against *persons* "who, under color of any statute, ordinance, regulation, custom, or usage, of any State…subject "any citizen of the United States…to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws…" (42 U.S.C § 1983 (2005)). And, while sovereign immunity bars suits against states, it does not "extend to suits prosecuted against a municipal corporation or other governmental entity which is not an arm of the State." (Alden v. Maine, 756, 1999). In light of this history, how have litigants, who presumably have been given redress under federal law for discriminatory acts, fared?

GENDER DISCRIMINATION

The Civil Rights Act of 1964 was passed "[T]o enforce the constitutional right to vote, to confer jurisdiction upon the district courts of the United States to provide injunctive relief against discrimination in public accommodations, to authorize the attorney General to institute suits to protect constitutional rights in public facilities and public education, to extend the Commission on Civil Rights, to prevent discrimination in federally assisted programs, to establish a Commission on Equal Employment Opportunity, and for other purposes." (42 U.S.C. § 2000e (2005)). Title VII of the Civil Rights Act of 1964 provides that "[I]t shall be an unlawful employment practice for an employer-- (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin . . ." (42 U.S.C. § 2000e-2(a)(1) (2005)). Further, Title VII makes it illegal for employers "to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin; or (2) to limit, segregate, or classify his employees or applicants for employment in any way which would adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin" (42 U.S.C. § 2000e-2(a)(1) (2005)). The Equal Employment Opportunity Act of 1972 extended Title VII's coverage to state employers, removing the express exclusion of "a State or political subdivision thereof" from the definition of "employer", and amending the definition of "employee" to include individuals "subject to the civil service laws of a State government, governmental agency or political subdivision." (86 Stat. 103, 2(2) (1972)). The Civil Rights Act of 1991 (Pub. L. 102-166) amended the 1964 Act to provide for damages in cases of intentional employment discrimination.

In *Fitzpatrick v. Bitzer* (1976) plaintiffs brought a class action suit seeking money damages against Connecticut under the 1972 Amendments to Title VII of the Civil Rights Act of 1964, alleging that the state's retirement plan discriminated against male employees. In the first case to pit the Eleventh Amendment against Section 5 of the Fourteenth Amendment, Connecticut claimed that a damages award payable to a private party from the state treasury was barred by the Eleventh Amendment's provision for sovereignty. In evaluating Congressional authority to impugn state immunity, the Supreme Court held that clearly Congress intended to abrogate state sovereign immunity under Section 5 of the Fourteenth Amendment with the passage of the 1972 amendments, and that the abrogation was permissible. After examining the circumstances surrounding the passage of the Civil War Amendments, the Court asserted that Section 5 of the Fourteenth Amendment expressly grants Congress "authority to enforce 'by appropriate legislation' the substantive provisions of the Fourteenth Amendment, which themselves embody significant limitations on state authority. When Congress acts pursuant to Section 5, not only is it exercising legislative authority that is plenary within the terms of the constitutional grant, it is exercising that authority under one section of a constitutional Amendment whose other sections by their own terms embody limitations on state authority." (Fitzpatrick v. Bitzer, 456, 1976).

The Court concluded further "that Congress may, in determining what is "appropriate legislation" for the purpose of enforcing the provisions of the Fourteenth Amendment, provide for private suits against States or state officials which are constitutionally impermissible in other contexts." (Fitzpatrick v. Bitzer, 456, 1976). Thus, *Fitzpatrick* allows Congress through the Fourteenth Amendment to inhibit and sanction state action, whether it expresses its intent in the language of the statute itself, or in the legislative history leading up to the passage of the law. (MacConaill, 2005). However, while the Court approved the abrogation of sovereign immunity under Section 5 in principle, it did not decide whether or not the application of the substantive law in Title VII to Connecticut's retirement plan was an improper exercise of that remedial power by Congress under the Fourteenth Amendment.

A subsequent case, *Nevada v. Hibbs* (2003) did address the substantive validity of Congressional abrogation in the context of gender discrimination, not under Title VII, but under the Family and Medical Leave Act of 1993 ("FMLA"). The FMLA entitles eligible employees to take up to twelve work weeks of unpaid leave annually for any of several reasons, including the onset of a "serious health condition" in an employee's spouse, child, or parent, and creates a private right of action to seek both equitable relief and money damages "against any employer (including a public agency) in any Federal or State court of competent jurisdiction." (29 U.S.C. §§ 2612(a)(1)(C), 2617(a)(2) & 2615(a)(1) (2005)).

In holding that "employees of the State of Nevada may recover money damages in the event of the State's failure to comply with the family-care provision of the Act," (Nevada v. Hibbs, 725,

2003) the Court first addressed the issue of Congressional intent to abrogate immunity, concluding rather easily that “[T]he clarity of Congress' intent [to abrogate] here is not fairly debatable.” (Nevada v. Hibbs, 726, 2003). The more complex issue was the substantive validity of the abrogation under Section 5. The Court recognized that gender-based statutory classifications were subject to a heightened standard of scrutiny, which requires the state not only to establish that the discriminatory classification serve important governmental objectives, but also that the means employed to achieve such objectives are substantially related to their achievement (and not merely rationally related to some legitimate objective). As applied to gender discrimination, the state is not permitted to rely instead upon overbroad generalizations or inaccurate stereotypes about the sexes. The Court noted that Congress, in passing the FMLA, had documented a history of discrimination against women by state employment laws, both facially and as applied, including the discriminatory application of parental leave laws. This analysis led the Court to conclude that “the States' record of unconstitutional participation in, and fostering of, gender-based discrimination in the administration of leave benefits is weighty enough to justify the enactment of prophylactic Section 5 legislation.” (Nevada v. Hibbs, 735, 2003).

Further, Justice Rehnquist, writing for the majority, concluded that “Congress' chosen remedy, the family-care leave provision of the FMLA, is ‘congruent and proportional to the targeted violation.’” The Court noted that Congress previously had tried unsuccessfully to address this "difficult and intractable problem," through Title VII and the Pregnancy Discrimination Act, and that its persistence could justify such a prophylactic measure. “By creating an across-the-board, routine employment benefit for all eligible employees, Congress sought to ensure that family-care leave would no longer be stigmatized as an inordinate drain on the workplace caused by female employees, and that employers could not evade leave obligations simply by hiring men.” (Nevada v. Hibbs, 737, 2003). The Court also noted that “the FMLA is narrowly targeted at the fault line between work and family--precisely where sex-based overgeneralization has been and remains strongest--and affects only one aspect of the employment relationship.” That narrow tailoring, coupled with the fact that the statute requires only unpaid leave, applies only to employees who have worked for the employer for at least one year and provided 1,250 hours of service within the last 12 months, requires advance notice of foreseeable leave, allows certification by a health care provider of the need for leave, excludes employees in high-ranking or sensitive, including state elected officials, their staffs, and appointed policymakers, and provides for damages which are strictly defined and measured by actual monetary losses, all of which provisions taken together proportionately taylor the remedy to accomplish the important governmental objective of the legislation.

With the decision in *Hibbs,* the FMLA became the first prophylactic antidiscrimination legislation to pass the congruence and proportionality test announced in *Boerne*, and arguably represents an attempt by the Court to confirm the relevance and feasibility of that test, as well as to clarify Congress's limited power to abrogate the States' sovereign immunity through valid prophylactic antidiscrimination legislation. (Williams, 2004). While *Hibbs* and *Fitzpatrick* concerned gender discrimination in employment, it would seem that in the context of racial and national origin discrimination in employment, Congressional prophylactic legislation, such as Title VII, could meet the congruence and proportionality test in many substantive contexts, particularly since such discrimination by states is subject to even more exacting scrutiny than gender discrimination. However, other antidiscrimination legislation, at least in the employment context, has fared less favorably under *Boerne*.

AGE DISCRIMINATION

Congress considered and rejected amendments to the 1964 Civil Rights Act legislation that would have included older workers in the protected classes of Title VII (General Dynamics Land Systems, Inc., v. Cline, 2004). However, the Secretary of Labor subsequently investigated the issue of age discrimination, and concluded that it was common for employees to be discriminated against in the workplace because of their age, and inaccurate stereotypes about the abilities of older workers. (Recent Case, 2003). As a result, in 1967 Congress passed the Age Discrimination in Employment Act (ADEA) in an effort to eradicate arbitrary discrimination and negative stereotypes about the performance level of older workers. (EEOC v. Wyoming, 1983). The ADEA's purpose is "to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; and to help employers and workers find ways of meeting problems arising from the impact of age on employment" (29 U.S.C § 621(b) (2005)). The ADEA prohibits discrimination against individuals over the age of forty because of their age, and also prohibits covered entities from depriving individuals of employment opportunities or taking any other adverse action against such individuals because of their age. The Act makes it unlawful for a covered employer "(1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age; (2) to limit, segregate, or classify his employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's age; or (3) to reduce the wage rate of any employee in order to comply with this chapter" (29 U.S.C. § 623 (a)(1)-(3) (2005)).

The ADEA as passed in 1967 applied only to private employers; the term employer as originally defined excluded "the United States, a corporation wholly owned by the Government of the United States, or a State or political subdivision thereof." (Kimel v. Florida Board of Regents, 68, 2000). In 1974 Congress amended the definition of "employer" contained in the statute to include "…a State or political subdivision of a State and any agency or instrumentality of a State or a political subdivision of a State…"(29 U.S.C. § 630(b) (2005), while commensurately amending the definition of employee as excluding elected officials and appointed policymakers at the state and local levels. (29 U.S.C. § 630(f) (2005). Congress also amended the enforcement provision to permit an individual to bring a civil action against employers, including governmental entities, in state or federal court. (29 U.S.C. § 216(b) (2005)).

In EEOC v. Wyoming (1983) the Court held that the ADEA represented a valid exercise of Congress' power under the Interstate Commerce Clause, and that the Act did not transgress any external restraints imposed on the commerce power by the Tenth Amendment. The Tenth Amendment to the Constitution provides that “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” However, the fact that Congress had the power to pass the legislation under the Commerce Clause without infringing upon state authority does not necessarily mean that the legislation can be applied to state and local governments.

In *Kimel v. Florida Board of Regents* (2000) plaintiffs brought suit against state government employers in consolidated cases alleging illegal discrimination in violation of the ADEA. The Court recognized that "[U]nder our firmly established precedent…, if the ADEA rests solely on Congress' Article I commerce power, the private petitioners in today's cases cannot maintain their suits against their state employers.” (Kimel v. Florida Board of Regents, 79, 2000). The Court then considered the Congressional action pursuant to the Fourteenth Amendment’s Equal Protection Clause, and its Section 5 remedial authority to enforce that constitutional provision. The Court held that, although the ADEA does contain a clear statement of Congress' intent to abrogate state sovereign immunity, that abrogation exceeded Congress' authority under the Fourteenth Amendment. In its two-part analysis the Court concluded first that “the plain language of these provisions clearly demonstrates Congress' intent to subject the States to suit for money damages at the hands of individual employees.” (Kimel v. Florida Board of Regents, 74, 2000).

However, the Court concluded that under the "congruence and proportionality" test, the substantive requirements the statute imposed on state and local governments were “disproportionate to any unconstitutional conduct that conceivably could be targeted by the Act.” (Kimel v. Florida Board of Regents, 83, 2000). The Court observed that, unlike persons who suffer discrimination on the basis of race or gender, older persons historically have not been subjected to purposeful discrimination. Further, under the analysis of the Equal Protection Clause of the Fourteenth Amendment, age is not a suspect classification; therefore, age discrimination by governmental entities is permissible if the age classification in question is rationally related to a legitimate state interest. In light of this constitutional framework and history, the Court held that the ADEA prohibits very little conduct by state and local governments that would be deemed to be unconstitutional. While prohibiting unconstitutional conduct is not a prerequisite to establishing the validity of a remedial statute as applied to state and local governments, since Congress can enact “reasonably prophylactic legislation.” (Kimel v. Florida Board of Regents, 88, 2000).

However, Congress may not establish new obligations for states. In evaluating the ADEA in this light the Court concluded that “the ADEA's legislative record confirms that Congress' 1974 extension of the Act to the States was an unwarranted response to a perhaps inconsequential problem," because, while Congress had found substantial discrimination based upon age in the private sector, it had never identified a pattern of unconstitutional age discrimination by state or local governmental entities." (Kimel v. Florida Board of Regents, 89, 2000). As a result "in the ADEA, Congress did not validly abrogate the States' sovereign immunity to suits by private individuals." (Kimel v. Florida Board of Regents, 91, 2000).

DISABILITY DISCRIMINATION

The Americans with Disabilities Act ("ADA") was passed in1990, and applies to employers with fifteen or more employees. Title I of the ADA requires employers to make reasonable accommodations for qualified employees with disabilities, so long as the accommodation would not result in an undue hardship, that is, one which entails significant difficulty or expense. The ADA defines the term "qualified individual with a disability" as "an individual with a disability who, with or without reasonable accommodation, can perform the essential functions of the employment position that such individual hold or desires" with consideration being given to the employer's judgment as to what job functions are essential. (42 U.S.C. § 12111(8) (2005)). In other words, a qualified individual must be able satisfy the prerequisites for the position, such as proper training, skills and experience, in addition to possessing the ability to perform the essential function of the job either with or without reasonable accommodation. (29 C.F.R. § 1630.2(m)(2005)).

Further, the Act requires employers to "make reasonable accommodations to the known physical or mental limitations of an otherwise qualified individual with a disability who is an applicant or employee, unless [the employer] can demonstrate that the accommodation would impose an undue hardship on the operation of the [employer's] business." (42 U.S.C. § 12112(b)(5)(A)(2005)). A reasonable accommodation may include, for example, making existing facilities used by employees readily accessible to and usable by individuals with disabilities, job restructuring, part-time or modified work schedules, reassignment to a vacant position, acquisition or modification of equipment or devices, appropriate adjustment or modifications of examinations, training materials or policies, the provision of qualified readers or interpreters, and other similar accommodations for individuals with disabilities. (42 U.S.C. § 12111(9) (2005)). The Act also prohibits employers from "utilizing standards, criteria, or methods of administration…that have the effect of discrimination on the basis of disability." (42 U.S.C. § 12112(b)(3)(A) (2005)). The Act defines "disability" to include a physical or mental impairment that substantially limits one or more of the major life, a record of such an impairment; or being regarded as having such an impairment." (42 U.S.C. § 12102(2) (2005)). A disabled individual is otherwise "qualified" if he or she, "with or without reasonable accommodation, can perform the essential functions of the employment position that such individual holds or desires." (42 U.S.C. § 12111(8) (2005)).

In *Board of Trustees of the University of Alabama v. Garrett* (2001) the Court held that Congress did not validly abrogate the States' sovereign immunity from suit for employment discrimination brought by private disabled individuals seeking money damages under Title I of the ADA. The Court first recognized that precedent established, that in enacting the ADA, Congress could not have abrogated sovereign immunity except under its Section Five authority. The Court then looked to prior cases addressing Fourteenth Amendment Equal Protection claims to determine the appropriate framework for the application of the congruence and proportionality test. In doing so the Court concluded that "States are not required by the Fourteenth Amendment to make special accommodations for the disabled, so long as their actions towards such individuals are rational. They could quite hard headedly -- and perhaps hardheartedly -- hold to job-qualification requirements which do not make allowance for the disabled. If special accommodations for the disabled are to be required, they have to come from positive law and not through the Equal Protection Clause." (Board of Trustees of the University of Alabama v. Garrett, 368-9, 2001).

After defining the nature of the Constitutional right at issue, the Court proceeded to examine if Congress had identified a history and pattern of unconstitutional employment discrimination by the States against the disabled. In doing so the Court determined that "[T]he legislative record of the ADA, however, simply fails to show that Congress did in fact identify a pattern of irrational state discrimination in employment against the disabled." (Board of Trustees of the University of Alabama v. Garrett, 368, 2001). While Congress made a general finding that society tended to isolate and segregate individuals with disabilities, the States were not primarily culpable. The Court further concluded that Title I's broad remedial scheme was insufficiently targeted to remedy or prevent unconstitutional discrimination in public employment. In his concurring opinion Justice Kennedy observed that if the state governments had been "transgressing the Fourteenth Amendment by their mistreatment or lack of concern for those with impairments, one would have expected to find in decisions of the courts of the States and also the courts of the United States extensive litigation and discussion of the constitutional violations," but there was no such record.

In deciding *Garrett,* the Court did not decide the constitutional issue of whether or not Title II, which has somewhat different remedial provisions from Title I, was appropriate legislation under Section Five of the Fourteenth Amendment. The parties did not brief the Court on that issue, and the Court suggested that since Title I specifically dealt with employment claims, Title II may not have be intended to address such claims. Title II provides that "no qualified individual with a disability shall, by reason of such disability, be excluded from participation in or be denied the benefits of the services, programs, or activities of a public entity, or be subjected to discrimination by any such entity." (42 U.S.C. §12132 (2005)). The term "qualified individual with a disability" is defined as "an individual with a disability who, with or without reasonable modifications to rules, policies, or practices, the removal of architectural, communication, or transportation barriers, or the provision of auxiliary aids and services, meets the essential eligibility requirements for the receipt of services or the participation in programs or activities provided by a public entity." (42 U.S.C. §12132(1) (2005)). The Act defines the term "public entity" to include state and local governments, as well as their agencies and instrumentalities. (42 U.S.C. § 12131(1) (2005)).

In *Tennessee v. Lane* (2004) two paraplegics, a criminal defendant and a court reporter, both of whom used wheelchairs for mobility, sued the state of Tennessee, alleging that it had denied them physical access to the state court system in violation of Title II of the ADA. The facts indicated that the criminal defendant had crawled up two flights of stairs to get to the courtroom for his first criminal appearance. For his second appearance, he refused to crawl again (or to be carried by officers to the courtroom), and subsequently was arrested and jailed for failure to appear. The court reporter alleged that she has not been able to gain access to a number of county courthouses, and, as a result, has lost both work and an opportunity to participate in the judicial process. In analyzing Tennessee's claim of immunity from the suits, the Court concluded that the question of whether or not Congress intended to abrogate state immunity was easily answered by reference to the statute, which provides, "[A] State shall not be immune under the eleventh amendment to the Constitution of the United States from an action in Federal or State court of competent jurisdiction for a violation of this chapter." (42 U.S.C. § 12202 (2005)).

The Court then scrutinized the validity of that abrogation. The Court noted that like Title I, Title II, is designed to prohibit irrational disability discrimination. However, in contrast to Title I, it additionally seeks to enforce a variety of other basic constitutional guarantees, the infringement of which may be subject to strict scrutiny review, not merely a rational basis judicial review. For example, the right of access to the courts, which was at issue in *Lane*, is protected by the Fourteenth Amendment. The Court noted that "Congress enacted Title II against a backdrop of pervasive unequal treatment in the administration of state services and programs, including systematic deprivations of fundamental rights," such as exercising the right to vote, to marry and to participate in civic activities like jury duty and voting. The Court also cited a documented pattern of unconstitutional treatment provided by states in their mental health care facilities, penal systems, judicial systems, as well as in public education with respect to the disabled. Congress recognized this pattern of discrimination, as stated in the statutory language: "[D]iscrimination against individuals with disabilities persists in such critical areas as . . . education, transportation, communication, recreation, institutionalization, health services, voting, and access to public services." (42 U.S.C. § 12101(a)(3) (2005)). The Court surmised that "[T]his finding, together with the extensive record of disability discrimination that underlies it, makes clear beyond peradventure that inadequate provision of public services and access to public facilities was an appropriate subject for prophylactic legislation." (Tennessee v. Lane, 530, 2004).

The Court declined to examine the validity of Title II under Section 5 in all of its conceivable applications with respect to public services afforded to disabled citizens (a full breadth inquiry), but only concluded that "Title II unquestionably is valid Section 5 legislation as it applies to the class of cases implicating the accessibility of judicial services..." (Tennessee v. Lane, 531, 2004). The court emphasized that Title II requires only "reasonable modifications" that would not fundamentally alter the nature of the service provided eligible disabled persons, which can be satisfied in a number of ways.

The court further pointed out that regulations did not require States to undertake measures that would impose an undue financial or administrative burden, threaten historic preservation interests, or effect a fundamental alteration in the nature of the service. (28 C.F.R. §35.150(a)(2) & (a)(3)(2005)).

Because the Court's holding was narrowly limited to the application of Title II to access to justice and due process in state courts, a number of unanswered questions concerning the scope of Title II remain. The Court considered one more such issue in part this term. *United States v. Georgia* (2006 U.S. LEXIS 759) presented the question of whether or not Title II of the ADA validly abrogates state sovereign immunity for suits by disabled inmates alleging discrimination by state prison systems. The petitioner in the case, Tony Goodman, is a paraplegic who uses a wheelchair for mobility. His complaint, filed pro se in 1999, alleged that he was held in the Georgia State Prison for more than twenty-three hours a day in a cell so narrow that he could not turn his wheelchair, that the prison failed to make toilet and bathing facilities accessible to him such that he was sometimes forced to sit in his own waste, that he was denied needed medical care, such as catheters, treatment for bedsores and access to mental health counselors, and that he was excluded him from programs and activities because of his disability. The district court granted summary judgment in favor of Georgia based upon the state's sovereign immunity, and the Eleventh Circuit affirmed in an unpublished opinion, holding that the Eleventh Amendment precludes suits against states for money damages. The United States Department of Justice intervened in support of the statute being a valid abrogation of state sovereignty, and in defense of the constitutionality of the ADA.

Petitioner Goodman, in his brief to the Court (Brief for the Petitioner, Goodman v. Georgia, 2005) argued that Title II enforces not only the Fourteenth Amendment's prohibition against irrational discrimination, but other constitutional guarantees that are subject to a more searching judicial scrutiny, such as the right to be free from cruel and unusual punishment protected by the Eighth Amendment and made applicable to the States under the Due Process Clause of the Fourteenth Amendment. With respect to the Equal Protection Clause of the Fourteenth Amendment, the petitioner argued that the States had a pattern of unequal treatment of prisoners with disabilities, and compiled an extensive addendum of cases evidencing the problem of unconstitutional treatment of individuals with disabilities in state correctional facilities. Further, the petitioner argued that upholding Title II in the context of a penal system was particularly compelling since the State has total control of all aspects of an inmate's life and the means of existence. Likewise, the federal government in its brief that Title II of the ADA was appropriate prophylactic legislation as applied to state prison administration. The Attorney General's brief asserted that Congress had documented a deeply rooted pattern of indifference by state penal systems to the health, safety, suffering, and medical needs of prisoners with disabilities. (Brief for the United States as Petitioner, Goodman v. Georgia, 2005).

In response, Georgia argued in its brief (Brief for Respondents, Goodman v. Georgia, 2005) that disability based classifications are subject to a constitutional rational relationship review of state action, and that as long as a prison regulation was reasonably related to legitimate penal interests it should survive constitutional scrutiny. The state further asserted that any Eighth Amendment violations would entitle the Petitioner to relief under other federal laws, and that the ADA was not an appropriate means of addressing such wrongs since the statute was not limited to deliberate indifferences to fundamental needs, but also embraced the denial of nonessential services, programs or activities. As such, the State of Georgia argued that a federal remedy for those denials would render the ADA a seriously disproportionate one, for which there was no historical documentation of a widespread and persistent violation of the constitutional rights of disabled state prisoners.

During oral argument before the Court (Kofke, November 10, 2005) the Justices questioned if the application of Title II in this context would place an undue burden on the states and state budgetary concerns, if the ADA added any additional obligations beyond rectifying constitutional violations (such as claims for equal access to recreational activities), if Title II would allow for adequate deference to state officials who have to confront issues of safety and security in the prison context, and specifically whether or not the reasonableness requirement of the ADA was expansive enough to account for these types of state concerns. Counsel for Goodman and for the United States argued that Title II was congruent and proportional because it primarily targeted violations of constitutional rights. In response, Justice Breyer suggested that it was already established that Congress could sweep discrimination that did not technically violate the constitution into the scope of prophylactic legislation, while Justice Scalia suggested that if Title II did sweep beyond constitutional violations, the Court could uphold it in cases that alleged actual violations of Constitutional rights (an “as applied” analysis). With respect to the history of past state discrimination against prisoners with disabilities, the Justices queried what standard the Court should apply to determine whether or not there was sufficient evidence before Congress of past discrimination to justify an abrogation of state sovereign immunity, how and when the record had to be established, and whether it was appropriate to expose a state to damages when there was no evidence that that particular state had a history of past violations. In other words, the Justices questioned whether or not Congress must establish a record for each state before passing remedial legislation or instead whether or not a more generic national record was sufficient for enacting Section 5 legislation.

Unfortunately, the opinion issued by the Supreme Court in *United States v. Georgia* (2006 U.S. LEXIS 759) left many of these questions unanswered. In a narrow holding, the Court announced that Title II of the ADA validly abrogates state sovereign immunity in suits for damages against states for conduct that *actually* violates the Fourteenth Amendment. Justice Scalia, writing for a unanimous Court, concluded that, while members of the Court have disagreed about the scope of Congress's prophylactic enforcement powers under Section 5 of the Fourteenth Amendment, indisputably the enforcement power of Section 5 includes the power to abrogate state sovereign immunity by authorizing private suits for damages against states for claims based on actual unconstitutional conduct, such as violations of the Eighth Amendment. Because it was not clear from the Petitioner’s filings what conduct he intended to allege in support of his Title II claims, the Supreme Court remanded the case to the lower court for clarification. Furthermore, because the Eleventh Circuit did not address the issue, it was also unclear as to what extent the conduct underlying his constitutional claims violated Title II as well. The Court suggested that some of Petitioner’s allegations were far from actual constitutional violations “under either the Eighth Amendment or some other constitutional provision, or even from Title II violations." Depending upon the nature of the amended complaint, the Court instructed the lower courts to determine on a *claim-by-claim* basis "1) which aspects of the State's alleged conduct violated Title II; (2) to what extent such misconduct also violated the Fourteenth Amendment; and (3) insofar as such misconduct violated Title II but did not violate the Fourteenth Amendment, whether Congress's purported abrogation of sovereign immunity as to that class of conduct is nevertheless valid." In sum, the Court left open the basic question of whether or not (or in what circumstances) states would be immune to private lawsuits under Title II of the ADA in the absence of a parallel constitutional violation.

Justice Stevens, in a concurring opinion joined by Justice Ginsburg, observed that the Court wisely chose for the parties to create a factual record before attempting to define the outer limits of Title II's valid abrogation of state sovereign immunity, particularly since Title II prohibits more conduct than the Constitution forbids. Justice Stevens opined that a factual record, while not absolutely necessary to the resolution of the question, would aid in determining how Title II's reasonableness requirement applies in the prison context.

Justice Stevens also emphasized that the Court's opinion did not suggest that the Eighth Amendment was the only constitutional right applicable in the prison context, and hence relevant to the abrogation issue. He noted that the Courts' approach, nevertheless, was consistent with its recognition that the history of mistreatment leading to Congress' decision to extend Title II's protections to prison inmates was not limited to violations of the Eighth Amendment. He suggested that the record of mistreatment of prison inmates, which Congress reviewed in its deliberations preceding the enactment of Title II, was comparable to the record in *Tennessee v. Lane* that was deemed to be sufficient to uphold the application of Title II to cases implicating the fundamental right of access to the courts. He further recognized that, while cases involving inadequate medical care and inhumane conditions of confinement tended to dominate claims made by disabled inmates, courts also have reviewed allegations involving the abridgment of religious liberties, undue censorship, interference with access to the judicial process, and procedural due process violations, all of which, he concluded, should be taken into account in examining the first step of the "congruence and proportionality" inquiry.

Some observers have concluded that Justice Scalia's opinion vaguely hinted that states will retain immunity if there is no constitutional violation, but that the decision at least establishes that the ADA is valid remedial Section 5 legislation in cases in which the state conduct that violates the ADA also violates the Constitution, without the necessity of plaintiffs having to establish a history and pattern of past state constitutional violations. (Denniston, 2006). What remains the primary mystery, however, is whether or not *in the absence of a concurrent constitutional violation,* Title II of the ADA is congruent and proportional remedial or *prophylactic* legislation based upon a sufficiently documented history of the treatment of state prisoners with disabilities as amounting either to irrational discrimination, or the denial of fundamental constitutional rights or interests, under the Fourteenth Amendment. Other lingering questions include what standard applies to determine whether or not there is sufficient evidence before Congress of past constitutional violations to justify an abrogation of state sovereign immunity, how and when such a record must be established, and if a state may be subject to a claim for damages in the absence of evidence that it specifically had a history of past constitutional violations. The importance of the answers to the questions remaining after the Court's decision in *U.S. v. Georgia* certainly transcends those issues presented in Mr. Goodman's case. How the Supreme Court decides such pivotal questions will have widespread implications for the application of the civil rights legislation to the states as employers, and also as providers of goods and services to the public.

LEGAL AND POLICY IMPLICATIONS

In summary, it appears that the Supreme Court is only willing to justify the abrogation of state immunity under Section 5 of the Fourteenth Amendment when there is a well-documented history of discriminatory treatment involving either a member of a protected class involving race or gender, or the denial of a fundamental constitutional right or interest. Since employment is not a fundamental right, federal civil rights legislation designed to prohibit arbitrary discrimination against persons who are not members of a suspect class, such as the ADEA and the ADA, has failed to constitute a valid abrogation of state sovereign immunity. On the other hand, if the denial of a recognized fundamental right under the Fourteenth Amendment, such as access to the courts or the right to be free from the imposition of cruel and unusual punishment, is at issue, a different result is dictated.

Some commentators argue that this trend in interpreting the Fourteenth and Eleventh Amendments demonstrates the dramatic and disturbing shift in ideology, resulting in state employees enjoying fewer rights than their private sector counterparts because they are effectively deprived of any meaningful remedies. (Royer, 2001). Professor Chemerinsky argues that the recognition of state immunity should be balanced against the need for accountability, since avenues for ensuring state compliance with federal law otherwise would be foreclosed. He concludes that while on one side there is the value of protecting state governments by according them immunity from suit, on the other side there is the value of ensuring the supremacy of federal law by providing for its enforcement in federal court. "Eleventh Amendment doctrines ultimately are about how to balance the desire for state immunity as against the desire for state accountability." (Chemerinsky, 1227, 1997).

Are there other ways to guarantee that states, like their private sector counterparts, will be prohibited from arbitrarily discriminating against citizens? One suggestion for achieving this objective of accountability is that, in the future, Congress itself could do more to ensure the validity of its abrogation of state sovereignty by carefully documenting a pattern of state discrimination against, for example, older citizens and the disabled. (Chemerinsky, 2003). At the state level, states could either enact legislation that parallels federal anti-discrimination legislation and expressly applies to state government, or alternatively states could enact laws which waive sovereign immunity under federal civil rights legislation. Many states have enacted laws comparable to federal civil rights legislation, which prohibit arbitrary discrimination in employment and the provision of services, while some state legislatures, such as Delaware, Florida, Kentucky, New Hampshire and New York have enacted laws waiving their sovereign immunity with respect to discrimination suits under some federal statutes. (Chemerinsky, 2003). After the Court's decision in *Garrett*, North Carolina and Minnesota waived immunity, and consented to being sued in federal court pursuant to federal civil rights statutes. (Shelton, 2003). While a state indeed may waive its sovereign immunity, the Supreme Court has held that such a waiver must be an express one, and not a general waiver of immunity (Atascadero State Hospital v. Scanlon, 1985). It also has rejected the notion of a constructive waiver of immunity. (College Savings Bank v. Florida Prepaid Postsecondary Education Expense Board, 1999).

In lieu of an express statutory waiver of immunity, the Supreme Court has found an implied waiver of immunity to suit under federal law in several instances. For example, a state's voluntary appearance in federal court amounted to a waiver of its Eleventh Amendment immunity. (Clark v. Barnard, 1883). The Court also has held, in the context of a bankruptcy claim, that a State "waives any immunity…respecting the adjudication of a 'claim' that it voluntarily files in federal court." (Gardner v. New Jersey, 574, 1947). In another case, a state was deemed to have waived immunity when it voluntarily agreed to remove the case to federal court, after having been brought involuntarily into the case as a defendant in the original state-court proceedings. (Lapides v. Board of Regents, 2002).

Further, some courts have held that Congress constitutionally may require a waiver of sovereign immunity as a condition of receiving federal funding, or that a waiver of immunity occurs when states accept such funding (Roy, 2004). Of importance in this context is the fact that federal law provides that "[N]o person in the United States shall, on the ground of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving Federal financial assistance." (42 U.S.C. § 2000d (2005)). The term "program or activity" includes the operations of a "department, agency, special purpose district, or other instrumentality of a State or of a local government," in addition to governmental entities that distribute such assistance, colleges, universities, postsecondary institutions, local educational agencies and school systems, as well as entities engaged in the business of providing education, health care, housing, social services, or parks and recreational activities. (42 U.S.C. § 2000d-4a (2005)). More specifically, the Civil Rights Remedies Equalization Amendment of 1986 provides that a "State shall not be immune under the Eleventh Amendment of the Constitution of the United States from suit in Federal court" for a violation of Section 504 of the Rehabilitation Act of 1973, Title IX of the Education Amendments of 1972, the Age Discrimination Act of Title VI of the Civil Rights Act of 1964 or "the provisions of any other Federal statute prohibiting discrimination by recipients of Federal financial assistance." (42 U.S.C. § 2000d-7 (2005)). Specifically, Section 504 of Rehabilitation Act also provides that "[N]o otherwise qualified individual with a disability in the United States…shall, solely by reason of her or his disability, be excluded from the participation in, be denied the benefits of, or be subjected to discrimination under any *program or activity* receiving Federal financial assistance or under any program or activity conducted by any Executive agency or by the United States Postal Service." (29 U.S.C. § 794(a) (2005)). As a practical matter, assuming legitimacy, the privilege of conditioning the receipt of federal money on compliance with federal civil rights legislation is a potent incentive.

However, even though all states receive federal financial assistance, thus assuring at a minimum compliance with the Rehabilitation Act, the ADA's Title II provides a greater level of detail in its coverage (Taggert, 2003), although requiring compliance by states with its more comprehensive directives remains debatable.

Aside from this practical financial incentive, the issue of state compliance with federal laws that provide remedies, including an award of damages, to private litigants in suits against states still represents an important constitutional question under the doctrine of federalism. Whatever other financial strong-arm tactic may be available to the federal government to insure state compliance with its mandates, this issue, so important to the Framers in 1789 remains a source of controversy today. How it is resolved on a case-by case and statute-by-statute basis is of significant importance even in the new millennium, given the growing role of state governments as employers and providers of services to millions of Americans.

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THE NATIONAL LABOR RELATIONS ACT AND NON-UNION EMPLOYERS: POLICY AND PRACTICE ISSUES IN A CHANGING ENVIRONMENT

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ABSTRACT

For most non-union employers, the National Labor Relations Act (NLRA) is probably not the federal statute that has drawn a great deal of attention in recent years. Given the steady decline in union membership, density, and the number of representation elections conducted over the last forty years, the lack of attention is understandable. Yet in spite of the steady decline in membership and organizing activity, the basic rights of workers to form and join unions guaranteed under the NLRA continue to be advanced by financially and politically powerful entities within the American economy. The purpose of this paper is to analyze recent US Court and NLRB decisions, examine recent union organizing initiatives, and to assess their impact on management policy and practice.

INTRODUCTION

Employers in the United States today have numerous federal and state laws and administrative agencies that impact their human resource management policies and practices. At the federal level Title VII of the 1964 Civil Rights Act as amended, enforced through the Equal Employment Opportunity Commission (EEOC), draws most of the attention of employers because of its prohibition of discrimination in virtually all human resource decision-making situations. Depending on the state where an employers' business is located, the presence of state law and state Fair Employment Practice Agencies (FEPA) can further complicate compliance with anti-discrimination regulations. Wage and Hour regulations under the Fair Labor Standards Act, also enforced through both state and federal departments of labor can also occupy a considerable amount of most employers' attention. For most non-union employers then, the National Labor Relations Act and the National Labor Relations Board (NLRB), are probably not the federal law and agency that draws a great deal of attention.

The NLRA applies to all "enterprises whose operations affect commerce" (NLRB, 1997). The NLRB's requirements for exercising its power or jurisdiction are called jurisdictional standards. The standards are based on the yearly amount of business done by the enterprise, or on the yearly amount of its sales or of its purchases. They are stated in terms of total dollar volume of business and are different for different kinds of enterprises. For example, a retail enterprise with at least $500,000 total annual volume of business would be covered by the Act. A non-retail business with direct sales of goods to consumers in other States, or indirect sales through others (called outflow), of at least $50,000 a year; or direct purchases of goods from suppliers in other States, or indirect purchases through others (called inflow), of at least $50,000 a year would also be covered (NLRB, 1997).

The primary responsibility of the NLRB is the prevention and remedying of unfair labor practices under the National Labor Relations Act (NLRA) and the guaranteeing of the rights of employees to organize and bargain collectively with their employers. When you're a non-union employer without an open ongoing union organizing campaign underway, complacency with respect to the NLRA and the NLRB is understandable. Given the renewed interest and efforts on the part of organized labor to organize non-union employers and, NLRB and Federal Court decisions in the last decade, the mindset and perception as to the NLRA and the NLRB's impact on non-union employers should be changing. Organized labor has achieved some very large measures of success in organizing in recent years, and decisions by the NLRB, some already supported by court decisions, have impacted a number of issues important to all employers. The purpose of this paper is to examine recent US Court and NLRB decisions, recent union organizing initiatives, and to assess their impact on management policy and practice.

LEGAL BACKGROUND AND RECENT DECISIONS

Section 7 of the National Labor Relations Act (NLRA) provides employees with the right to…

> *form, join, or assist labor organizations to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection (NLRA, 7, 1935).*

To facilitate enforcement of employee Section 7 rights, Section 8(a)(1) of the NLRA prohibits employers from interfering with, restraining, or coercing employees in the exercise of their right to self-organization. Included among the prohibitions in this regard, are prohibitions against employers threatening, interrogating, or conducting unlawful surveillance of employees in an effort to dissuade employees from unionization. It is important to note, that these prohibitions apply to both union and non-union employers and many employers in non-union organizations find out the hard way about the protections granted to their employees by the NLRA. It is not necessary that the employees be members of a labor union nor that a union organizing drive be underway for the employees' Section 7 rights to exists. Over time, employee rights to engage in concerted activity under the NLRA have been broadly construed by the courts (Suflas, 2005), and a wide variety of efforts of employees to join together for mutual aid or protection have qualified as protected concerted activity "even if those employees are not represented by or attempting to form a union" (Walsh, 2004, p. 363). Recent case examples include Quietflex Mfg. Co., Superior Travel Service, Inc., Trompler, Inc. v. NLRB, and Petrochem Insulation.

In Quietflex Mfg. Co. case, 83 Hispanic-surnamed employees gathered in their employer's parking lot to protest perceived preferential treatment of Vietnamese co-workers. While the NLRB determined that the activity was protected concerted activity, it ruled that the protesters' subsequent rejection of management's offer to meet with a smaller delegation and their refusal to vacate the premises after a reasonable period of time, justified the employer firing the group (Quietflex Mfg. Co., 2005). In Superior Travel Service, the NLRB concluded that an employee who was fired after she prepared, circulated, signed, and presented to her employer a written petition complaining about certain employment policies contained in the employer's handbook, was engaged in concerted and protected activity and that her activity was the cause of her discharge. The employer alleged that the discharge was related to five performance concerns. The NLRB did not find any of Superior's arguments credible, partially because the employee was never written up or disciplined for the alleged shortcomings (Superior Travel Service, Inc., 2004). In Trompler Inc., the NLRB determined that six employees were unlawfully fired after they walked off their jobs in protest of supervisory failures to address sexual harassment, employee drug use, and employee training issues (Trompler, Inc. v. NLRB, 2003). In Petrochem Insulation, the NLRB held that employees who petition governmental agencies with objections to their employer's compliance with environmental standards were also engaged in Section 7 protected concerted activity (Petrochem Insulation, 1999).

While the clear purpose of the NLRA as passed in 1935 was to promote collective bargaining as a means to help stabilize the American economy, subsequent amendments to the Act enhanced employers ability to communicate to employees their opinion on why employees should not support unionization. Section 8(c) of the NLRA provides:

> *The expressing of any views, argument or opinion, or the dissemination thereof, whether in written, printed, graphic, or visual form, shall not constitute or be evidence of an unfair labor practice under any of the provisions of this Act, if such expression contains no threat of reprisal or force or promise of benefit (Labor Management Relations Act, 8(c), 1947).*

Bottom line, employers are "entitled to exercise their freedom of speech to lawfully advise employees about unionization as long as they don't threaten employees with any consequences for unionizing or promise employees that the terms and conditions of employment will improve if they choose not to unionize"(Buttrick, 2003). Employers can utilize new employee orientation and employee handbooks to proactively convey their nonunion philosophy. Employers are cautioned however, that in communicating their nonunion philosophy to new employees the employer's presentation should be more "advisory", and not "coercive". A nonunion handbook policy or orientation program that requires as a condition of employment that employees refrain from union membership will generally be viewed by the NLRB as a violation of the National Labor Relations Act (Buttrick, 2003).

Non-union employers must be aware of a number of other policy and practices that can lead to allegations of unfair-labor practices against them. Segal identified seven Section 7 rights that apply to both union and nonunion employees alike:

Discussion of employment terms
Bad-mouthing the employer
Engaging in work stoppages
Honoring picket lines
Soliciting and distribution
Access to company property
Be abusive *(Segal, 2004).*

For example, it is not uncommon for employers to attempt to prohibit employees from discussing their wages or other terms of employment. The NLRB has determined that such policies interfere with employees attempting to exercise their Section 7 rights. "A rule prohibiting discussions about pay is unlawful, even if the employer does not strictly enforce it" (Segal, 2004, 113). In Main Street Terrace Care Center, the NLRB Administrative Law Judge (ALJ) found that Main Street had promulgated a rule prohibiting employees from discussing their wages. The ALJ then explained that "the mere existence of the rule inhibiting protected conduct, even if not enforced, constitutes an unlawful interference in violation of Section 8(a)(1) of the Act"(NLRB v. Main Street Terrace Care Center, 2000). The ALJ's decision was affirmed by the NLRB and its petition for enforcement was supported by the Sixth Circuit Court of Appeals (NLRB v. Main Street Terrace Care Center, 2000). In a 2005 decision involving Cintas Corporation the NRLB reaffirmed it's position in a case involving the firm's confidentiality rule which read in part "We recognize and protect the confidentiality of any information concerning the company, its business plans, its partners (employees), new business efforts, customers, accounting and financial information" (Cintas Corporation, 2005). The ALJ ruled and the NLRB agreed that the "rule's unqualified prohibition of the release of any information regarding its partners could be reasonably construed by employees to restrict discussion of wages and other terms and conditions of employment with their fellow employees" (Cintas Corporation, 2005).

One of the more controversial issues under the NLRA involves employer no-solicitation rules. Employers can "restrict" employee solicitations on working time but, "a general ban on employee solicitations or distributions will be overbroad and unlawful" under the NLRA (Segal, 2004, 116). Increased concern with security related issues since 9/11 have led employers to enact rules limiting access to employer premises (Suflas, 2005). A policy that bars the return of off-duty employees to the workplace may violate the NLRA. In Mediaone of Greater Florida, Inc., the NLRB found that the handbook provision prohibiting employees from “entering company property after hours without authorization” violated Section 8(a)(1) of the NLRA because they could not prove some business justification for the restriction (Mediaone, 2003). The NLRB in the Mediaone case did uphold the organization’s no solicitation rule. The rule in question stated:

> *The company firmly believes that to help employees do their jobs effectively, they shouldn’t be disturbed or disrupted by solicitors as they perform their duties. You may not solicit another employee in work areas during work time (Mediaone, 2003).*

The NLRB was also called to examine a third provision in the Mediaone handbook dealing with its nondisclosure rule. In Mediaone, the company wanted to prevent its employees from disclosing “proprietary information” outside the company. The handbook described proprietary information to include information assets and intellectual property and listed business plans, technological research, trade secrets, copyrighted works, customer and employee information, including organizational charts and databases. The NLRB concluded that the phrase “employee information, including organizational charts and databases” because it “cannot reasonably be read to prohibit disclosure of employees’ wages, hours or working conditions” did not violate the NLRA. The NLRB did reiterate that employers may not prohibit employees from discussing their own wages or attempting to determine what other employees are paid (Mediaone, 2003).

Inconsistent enforcement of legitimate policies can also create problems for employers. In the Webco case, the NLRB found that while the company had a perfectly legitimate no-solicitation policy, the company inconsistently applied its policy. The company policy prohibited all activities of solicitation and distribution of literature on company property by non-employees. It also prohibited employees from soliciting and distributing literature during working time and in working areas and provided for discipline for violations. The NLRB found that the company commonly allowed employees to sell phone-service products and children’s group sale items like sausages, candy, and cookies, and allowed employees to organize recreational activities like fantasy football and baseball leagues and sporting event pools but disciplined four employees engaged in union related activities (Webco v. NLRB, 2000).

Numerous other non-union employer work rules have been challenged as violating the NLRA. In Guardsmark, LLC, the NLRB found that a work rule requiring employees to bring complaints about workplace issues directly to their supervisors violated the act. The rule stated in part, "while on duty you must follow the chain of command and report only to your immediate supervisor...Do not register complaints with any representative of the client" (Guardsmark, LLC, 2005). Thus, employees can not be prohibited from complaining about their terms and conditions of employment to the employers customers (Clark, 2005). In Claremont Resort and Spa, the NLRB held that an employer violated the law by maintaining a work rule prohibiting employees from having negative conversations about their managers (Model, Alan, (2005). In Claremont Resort and Spa, the employer issued a rule that stated:

"Negative conversations about associates and/or managers are in violation of our Standards of Conduct that may result in disciplinary action." The Board ruled that the rule's prohibition of "negative conversations" about managers could reasonably be construed by employees to bar them from discussing with their coworkers complaints about their managers that affect working conditions, thereby causing employees to refrain from engaging in protected activities and is thus unlawful (Claremont Resort and Spa, 2005).

RECENT UNION ORGANIZING INITIATIVES

The U.S. Department of Labor's Bureau of Labor Statistics (BLS) reported that in 2005, 12.5 percent of wage and salary workers were union members. This was unchanged from 2004, and the BLS reported that the union membership rate has declined from a high of 20.1 percent in 1983, the first year for which comparable union data are available (Bureau of Labor Statistics, 2006). The most recent NLRB report reflected the steady decline in the number of elections held over the last two decades, with 2,234 total representation elections held in fiscal year 2005 compared to 4,247 in 1982. Unions won representation rights in 59 percent of the elections held in 2005 (NLRB, 2005).

A number of significant developments regarding union organizing in the United States in recent years have occurred. The most recent, involves the split in the American labor movement and the formation of the Change to Win Coalition. Another involves the increased use of "top-down organizing methods" like "corporate campaigns", the "card check" and "neutrality agreements" (Mix, 2005 and Babcock, 2005).

The Change to Win Coalition is an "umbrella organization" for a group of seven labor unions that split from the AFL-CIO in 2005. Member unions include the Teamsters, Service Employee International Union (SEIU), United Food and Commercial Workers, the Carpenters Union, Laborers' International Union of North America, UNITE Here, and the United Farm Workers. The formation of the new group was driven in large part by the group's dissatisfaction with AFL-CIO's efforts to organize new workers (Anderson, 2005).

This new coalition of financially strong members may present a powerful unified front in organized labor's efforts to stop the years of decline endured by the movement. The SEIU, described as one of the most vocal critics of AFL-CIO organizing efforts, has been one of the fastest growing unions in recent years, growing from 625,000 members in 1980 to more than 1.8 million members in 2005 (Schramm, 2005). In addition, members of the Change to Win Coalition filed almost half of all NLRB election petitions in 2004, winning nearly 60 percent of the elections they were involved in, with the SEIU earning a 75 percent win rate in elections it was involved in 2004 (Babcock, 2005).

Many believe that the formation of the Change to Win Coalition should lead to more "aggressive organizing", particularly in industries such as health care, facility maintenance services, warehousing, food processing, hotels, restaurants, textiles and construction. (Babcock, 2005, & Anderson, 2005). In addition, according to Anna Burger chair of the Change to Win Coalition, the organization wants “industry wide organizing, coordinated bargaining and political action aligned with aggressive organizing campaigns”:

> *We are going to walk our talk. We are going to get into the streets, together. Hotel maids and Wal-Mart clerks. Child care providers and waste haulers. Farm workers and carpenters. The workers who build the buildings and the workers who clean them* (Burger in Anderson, 2005).

It is also widely expected that the coalition will also make extensive use of top-down organizing methods. Corporate campaigns employ political, economic and legal pressure tactics utilizing the media, and are designed to put pressure on employers to induce neutrality agreements. In neutrality agreements, the employer agrees to remain neutral in the face of union organizing and in many cases, to forgo an NLRB supervised election and to “voluntarily” recognize the union based on the union’s evidence that a majority of employees support it (Ross, 2005). It has been estimated that four-fifths of new union member have won recognition by circumventing the NLRB election process in recent years through the use of neutrality agreements and the card check process. In the card check process, the union persuades the employer to agree to check union authorization cards for majority support and voluntarily recognize the union. Unions generally win recognition about eighty percent of the time in these situations compared to approximately sixty percent of the time in recent NLRB supervised secret ballot elections (Moberg, 2006).

The American labor movement's corporate campaign strategy also includes an international component. Unions have had success in generating neutrality agreements with European parent companies that are binding on their American subsidiaries. The strategy was launched by the Service Employees International Union (SEIU) when Sweden based Securitas acquired three U.S. based firms Pinkerton, Burns International Services Corp. and Loomis Fargo & Co. (Marquez, 2006). Andy Stern, president of SEIU stated that "all of a sudden we found ourselves needing to talk more to CEOs in Europe than in the U.S." as they attempt to legitimize the slogan "workers of the world unite" (Marquez, 2006). The Union Network International, a group of 900 unions with 15 million members around the world was formed in 2000 to promote the signing of global agreements with multinational companies. These agreements are designed to cover labor standards, human rights issues, and the right to organize, including formal neutrality clauses (Marquez, 2006).

The Change to Win Coalition and the Union Network International are both targeting Wal-Mart. The Food and Commercial Workers launched a campaign to put pressure on Wal-Mart through lobbying state lawmakers to propose what they are calling "fair share health care" legislation. The group wants companies like Wal-Mart to provide health insurance to all their workers or reimburse the state when employees enroll in public assistance programs (Anderson, 2005). The state of Maryland was the first to pass a bill that would require employers with more than 10,000 workers in the state to spend at least 8% of its payroll on health benefits or pay the difference to a state fund that would expand

Medicaid coverage for low-income adults. The legislature overrode the governor's veto of the bill and it became law in January of 2006 (Wojcik, 2006).

POLICY AND PRACTICE ISSUES

The increasingly aggressive challenges to non-union employer work rules, the more frequent avoidance of NLRB election procedures and the use of top down organizing tactics coupled with the rise of the Change to 'Win Coalition should signal to employers that once again the death knoll of the American Labor Movement may be premature. Clifford H. Nelson, JR., a partner and head of the labor relations practice at Constangy, Brooks and Smith in Atlanta notes, "some employers have gotten complacent because they haven't felt exposed to this kind of threat in a long time" (Babcock, 2005). The member unions of the Change to Win Coalition will have an estimated $28 million in annual dues that it formally paid to the AFL-CIO to use in organizing campaigns (Marquez, 2005). These campaigns will be aggressive and employ pressure tactics that can come from both U.S. and international forces. The focus of these campaigns is largely aimed at industries and organizations that are among the fastest growing segments of the U.S. economy with labor components that are not easily off-shored or substituted with capital (See Table 1).

Table 1: Potential Targeted Occupations With Largest Expected Employment Growth Through 2012

Job	Current Employment	Projected Growth
	(Millions)	
Nursing Aide	1.3	25%
Customer Service	1.9	24%
Food Preparation	2.0	23%
Janitorial	2.2	18%
Waiter/Waitress	2.1	18%
Retail Sales	4.1	15%
Cashier	3.4	13%

Source: Bureau of Labor Statistics - Projections of job growth from 2002 to 2012 (Schramm, 2005).

Retail, health care, facility maintenance services, warehousing, food processing, hotels, restaurants, and construction are all being targeted. The Communications Workers of America (CWA) and the Service Employees International Union (SEIU) enjoyed a great deal of success as a result of top-down organizing in 2005. The CWA added 16,000 new Cingular workers in 2005 through a neutrality agreement and card check process. In Houston, the SEIU was able to use its corporate campaign to unionize the entire janitorial labor market. The SEIU did this by putting pressure on building owners to accept unionization making neutrality agreements with cleaning contractors easier to secure. By the end of 2005, the SEIU had verified signatures on union membership cards from 5,300 of the 7,000 janitors in Houston (Moberg, 2006).

Unions have also not abandoned a traditional tactic to garner support for its organizing efforts. In April of 2005, Rep. George Miller, a California Democrat, introduce the Employee Free Choice Act. The act would require employers to recognize unions through a card-check process, in which a majority of workers sign union authorization cards (Schoeff, 2005). Two months earlier, Representative Charles Norwood a Georgia Republican, introduced the Secret Ballot Protection Act. That legislation would mandate a secret ballot election conducted by the NLRB to establish a union (Schoeff, 2005). While neither bill has much chance of becoming law at this point, the mostly partisan support for the bills shows that supporters and opponents of organized labor are still active at the national level.

SUMMARY AND CONCLUSIONS

What can employers do in light of these changes to more effectively manager their human resources? Those employers that have become some what complacent with respect to the threat of union organizing must become more active in reviewing and auditing their human resource policies and practices. Work rules in particular must be reviewed to assess whether they do or do not violate the NLRA. It is clear, that rules prohibiting employees from complaining about their terms and conditions of employment to the employee's customers are in violation of the act. In addition, an overly broad work rule, even if the work rule is not enforced is a violation of the NLRA (Claremont Resort & Spa, 2005). Rules that deny an employer's off-duty employees entry to the employer's parking lots, gates, and other outside non-work areas will be found invalid (Walker, 2005). Human resource programs, policies, and procedures that are infrequently utilized, complaint procedures, especially open-door procedures and policies that require employees to first bring complaints to their immediate supervisors should be thoroughly reviewed. Pay secrecy policies, still popular in many organizations should be abandoned. No-solicitation policies, confidentiality, and plant access policies should also be examined in light of the NLRB's recent decisions.

Another area that employers must be careful to not short change is supervisory training. In many organizations, supervisory training in recent years has focused on dealing with allegations of sexual harassment. In California, it is mandatory that every employer of fifty or more employees provide supervisors at least two hours of interactive training on sexual harassment (Law & the Workplace, 2005).

But, just as employers should train supervisors to respond properly to all types of allegations alleging discrimination, including race, religion, national origin, age, and disability in addition to sex, employers must also prepare supervisors to recognize and consistently respond to concerted activity. "The worst thing HR can do is ignore it, because it's not going to go away" (Babcock, 2005, quoting

Nelson). Employers should assess their vulnerabilities and take corrective action where needed, and according to Gary Glaser, a partner in the New York office of law firm Seyfarth Shaw:

> *"ultimately the best way to avoid becoming a target of a global corporate campaign is to make sure employees are getting benefits and wages that are competitive in the industry...This is not just about big business versus big unions...It's about what's best for the employees, and the unions still need employees to want them" (Marquez, 2006).*

In the "ever-changing landscape of union representation in the United States", it should be clear that all employers should engage in proactive efforts to assess their employee relations policies and practices (Model, 2005). At a minimum, annual audits of handbooks, work rules, supervisory training, and complaint procedures should become mandatory.

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AUDITOR NEGLIGENCE LIABILITY TO THIRD PARTIES REVISITED

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ABSTRACT

The Enron disaster prompted the Sarbanes-Oxley Act of 2002 with new auditor independence rules, creation of the Public Company Accounting Oversight Board, corporate governance and certification requirements, whistleblower protections, extended statutes of limitations, and more severe penalties. Although some provisions affect privately traded companies, the Act was primarily aimed at publicly traded companies. In any event, Sarbanes-Oxley did not create a private cause of action against auditors for malpractice. Securities laws that govern fraud carry a heavy scienter burden, and the negligence and strict liability provisions in these laws are limited to specific parties and functions within the purview of the respective Acts. Common law fraud also includes the intentional or reckless disregard burden. The bread and butter of aggrieved investors, lenders, and creditors for claims against accountants performing auditing activities remain the common law negligence and negligent misrepresentation torts. The law on these torts is not monolithic among the states, and because the variance in approaches is dramatic, accountants, lawyers, and academics must constantly revisit auditor liability to nonclients to stay abreast of developments. This article reintroduces the subject in the post-Enron era, reviews key attributes of auditing functions-reports-standards, discusses the historical paradigm of liability, explores recent cases, and offers policy implications for this fact-driven, unsettled area.

INTRODUCTION

The accounting profession has been bombarded with litigation primarily due to corporate failures. The recent collapse of Enron is no exception. Due to this major debacle the accounting profession has once again come under severe attack. The common thread between Enron and other corporate failures is the questionable performance of the companies' accountants (Gomez 2003). According to Impastato, because of audit failures accountants are to blame for investors losing billions of dollars in earnings in addition to market capitalization (2003). These losses usually come as a result of reliance upon misleading or erroneous financial statements (Impastato 2003). Once these companies become insolvent they no longer have the source of revenue to repay upset investors and creditors. These investors and creditors often view accountants as having "deep pockets." Consequently, accountants are sought after in an attempt to recoup their (investors and creditors) losses (Allegaert and Tinkelman 2000).

Although financial statements are assertions made by management and are primarily the responsibility of management, it is the accountant's duty to provide assurance of these assertions for the users of the information (Shore 2000). As the liability of auditors to third parties increases, auditors will be forced to more carefully perform their work and look for additional means of reducing their liability. However, if accountants are not held to a high standard, their incentives to carry out their job will be reduced (Allegaert and Tinkelman 2000). If someone is not held accountable for these erroneous financial statements, investors will be hesitant to invest in the American economy (Gomez 2003).

ACCOUNTING FUNCTIONS AND PRINCIPLES

The Auditing Function

For a better grasp of the accountants' duties, the auditing function must first be understood (Gomez 2003). The audit committee is in charge of hiring an independent auditor. With the oversight of the audit committee, management's responsibility is the preparation of the financial statements. Traditionally the audit function was not in place as a guard against accounting fraud within a company. The assumption that management is dishonest is both impractical and costly (Gomez 2003). The overall goal of the auditing function is to provide assurance to the users of financial statements of the accuracy of the assertions made by management and to ensure the statements comply with Generally Accepted Accounting Principles (GAAP) (Shore 2000).

An audit is a systematic, objective examination of a company's financial statements and results in an opinion expressed by the auditor. Although the company retains the auditor to evaluate the assertions made by management, the auditor is aware his opinion is relied upon by persons outside the company. While the audit function informs management of internal accounting irregularities, the main beneficiaries of the audit are third parties. Individuals rely upon the assurances provided by the auditors to make economic decisions (Gomez 2003). "This validation [by the auditor] is meant to make the financial information reliable; therein lies the value of auditing" (Impastato 2003).

An important first step in the audit process is for the auditor to gain basic knowledge and understanding of the client's business. This understanding aids the auditor in conducting the audit efficiently and in assessing the "audit risk" of the client (Buffington 1997). Audit risk is defined as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated" (Shore 2000) or the risk that management's financial statements have been materially misstated (Buffington 1997).

One element of audit risk involves management's initiative to present financial statements that are favorable. The auditor's evaluation of the degree of audit risk will be influenced by the groups of third parties management intends to provide the audited financial statements. Therefore, the auditor must know the type of third parties that will rely on the audited report in order to perform an audit risk evaluation (Buffington 1997).

Auditing consists of judgment and technique which could result in certain pitfalls. When conducting an audit, auditors attempt to make seemingly reasonable judgments that may come under question by third parties in the future. They may also fail to detect fraud or misinterpret Generally Accepted Accounting Standards (GAAS) or GAAP. These problems and others often lead to the accountant issuing an incorrect opinion which third parties are placing reliance upon (Feinman 2003).

Additionally, auditors are exposed to many pressures when performing an audit. The auditor owes an ultimate allegiance to the corporations' creditors and stockholders, as well as to the investing public (Impastato 2003). Auditors are also faced with undue pressure from the Securities Exchange Commission (SEC). The SEC requires publicly traded companies to file audited financial statements with standard unqualified opinions only. They will not accept an adverse or qualified opinion. This puts a tremendous strain on auditors to issue a standard unqualified opinion even in questionable situations.

Types of Audit Reports

Upon completion of the audit, the auditor is expected to issue an opinion, which reflects their findings from conducting the audit. There are typically five types of opinions: a standard unqualified report, an unqualified report with an explanatory paragraph, a qualified report, an adverse report and a disclaimer of opinion report (Gomez 2003). However, for the purpose of this report we will concentrate on the standard unqualified opinion. When an auditor issues a standard unqualified opinion, the basic assumption is that the following six conditions have been met: (1) no material violations of GAAP, (2) disclosures are adequate, (3) no scope of limitations, (4) no change in accounting principles with material impact, (5) auditor is independent, and (6) no going concern problems.

The Auditing Standard

To ensure quality control in the auditing process the auditor should look to the following authoritative literature for guidance: the American Institute for Certified Public Accountants (AICPA), the SEC and the Public Company Accounting Oversight Board (PCAOB). The AICPA is responsible for developing standards for peer reviews. The SEC was established to regulate the capital markets and requires regulated companies to file periodic reports with the SEC and stockholders. PCAOB is a five-member board which was created by the Sarbanes-Oxley Act of 2002 and works with the SEC. PCAOB sets auditing standards, inspects auditors' performance and disciplines public accountants (Smith 2003).

Since third parties perceive auditors as guarantors of financial statement accuracy, they nevertheless feel accountants should be liable for any misrepresentations or misstatements (Buffington

1997). Therefore, auditors are viewed as owing a duty of care not only to management but third parties as well (Feinman 2003). But the question of precisely which third parties are owed a duty of care by the firm's independent auditor in cases involving audit failure remains contentious (Shore 2000).

THE DOCTRINAL TRILOGY OF AUDITOR'S LIABILITY TO THIRD PARTIES

Overview: The Paradigm

The controversy surrounding auditor liability has become complicated due to the plaintiffs normally being third parties that have relied upon the audited financial statements rather than the contracted client of the auditor. These plaintiffs generally consist of bankers and creditors that use the audited information to make a determination regarding a company receiving short or long-term credit. Other possible plaintiffs are investors that rely upon the information to make investment decisions (Buffington 1997).

In a paradigmatic case, the third party receives the audited financial report from the company's management and uses this information as one source of criteria for determining whether to conduct business with the company. Eventually, in the paradigm, the company has financial problems, becomes insolvent, and defaults on its obligations to the third party. The audited financial statements used by the third party that portrayed a favorable picture of the financial condition of the company now appear to be incorrect. The client is insolvent and the third party wants to recover damages. Since the auditor is solvent and probably insured, the plaintiff turns to the auditor for restitution (Buffington 1997).

The third party plaintiff will claim that the elements for tort action against the auditor are present. The plaintiff will allege that the auditor owed a duty of care to the third party users and that a breach of this duty has occurred. Due to the material and detrimental reliance on the audited financial statements, the third party will contend causation of financial losses. In many instances the auditor "will respond with a motion for summary judgment, citing the third party's lack of privity with the auditor, and contending that the auditor owed a legal duty of care only to his or her client, and not to third parties" (Buffington 1997).

Historically, restrictive liability made it difficult for third parties to recover damages from auditors due to negligent audits. Beginning in the 1950s to the present, the conventional doctrines were questioned and liability increased primarily through the growth of the law of negligence (Feinman 2003). However, jurisdictions vary on the scope of negligence liability for accountants. There are three different doctrinal views on third party liability: the privity or Ultramares Rule, the foreseeability standard, and the Restatement (Second) of Torts §552 approach. Common law negligence liability is a matter of state law. Therefore, because of the differences in these three approaches, and depending on which view is adopted in a particular state, an auditor may be subject to suit in State A but not in State B under the same set of facts (Pacini, Martin and Hamilton 2000). According to an AICPA tort reform report, thirteen states, the District of Columbia, and the U. S. Virgin Islands have not addressed, or it is unclear, which approach will be followed. (AICPA 2003) States and U. S. territories that have adopted one of the views are reflected in the discussions that follow.

The Privity or Ultramares Rule

The privity rule was first developed in the English case of *Winterbottom v. Wright* in 1842. The defendant was sued by the plaintiff for negligent repairs to a mail coach. The court found in favor of the defendant stating there was no privity of contract between the plaintiff and defendant; therefore, no duty flowed to the plaintiff, and no liability existed (Gomez 2003).

In 1931, the courts applied the privity rule to accountant negligence in the *Ultramares Corp. v. Touche* case. Touche prepared a balance sheet for Fred Stern & Company upon their request. The balance sheet reflected that Stern had a large net worth when in reality the company was insolvent. A lender of Stern, the Ultramares Corporation, loaned large amounts of money to Stern because of the favorable balance sheet figures. Stern later filed bankruptcy and as a result Ultramares sued Touche for negligence. The court ruled in favor of Touche, finding there was negligence on the part of the accountants but a lack of contractual privity between Ultramares and Touche. (Gomez 2003; *Ultramares v. Touche* 1931).

Later in 1985, a New York decision revised the strict privity rule as the "near privity" rule. In the case of *Credit Alliance v. Arthur Andersen & Co.*, the court developed the following three part legal test in determining accountants' liability to third parties:

- "The accountant must have known that his or her work product was to be used for a particular purpose.
- A known party or parties were intended to be able to rely on the accountant's work product.
- Some conduct must have linked the accountant to the relying party" (Pacini, Ludwig, Hillison, Sinason and Higgins 2000; *Credit Alliance v. Arthur Andersen & Co.* 1985).

The facts of the *Credit Alliance* case mirrored those of the *Ultramares* case. The court concluded that the Ultramares privity rule was not fulfilled and that "there was no allegation of any word or action on the part of Andersen directed to plaintiffs, or anything contained in Andersen's retainer agreement . . . which provided the necessary link between them" (Gomez 2003). Therefore, the court reaffirmed the principles expressed in *Ultramares* (Gomez 2003).

An AICPA report indicates that the following states and U. S. territories apply the strict or "near" privity rule according to accountancy or other professional responsibility statute or case law: Arkansas, Guam, Idaho, Illinois, Indiana, Kansas, Louisiana, Montana, Nebraska, New Jersey, New York, Pennsylvania, Utah, Virginia, and Wyoming. (AICPA 2003)

A recent example of the application of a codified version of the near privity rule is the case of *E. Dickerson & Son, Inc. v. Ernst & Young, L.L.P.*, from the Supreme Court of New Jersey. In that case, a grocery wholesaler, Twin County Grocers, Inc., engaged the defendant to conduct audits to provide reasonable assurance of detecting errors and irregularities that were material to the wholesaler's financial statements. The audit reports were negligently prepared for four years due to failure of disclosure that one of the directors perpetuated numerous frauds. The wholesaler eventually filed for bankruptcy. Corporate shareholders brought action against the accounting firm alleging that the firm was aware that the shareholders based the nature and extent of their continued participation in the wholesale corporation on the audited reports. The New Jersey statute for accountant's liability to third parties for negligence read:

> " b. Notwithstanding the provisions of any other law, no accountant shall be liable for damages for negligence arising out of and in the course of rendering any professional accounting service unless:
>
> (2) The accountant:
>
> (a) knew at the time of the engagement by the client, or agreed with the client after the time of the engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant;
>
> (b) knew that the claimant intended to rely upon the professional accounting service in connection with that specified transaction: and
>
> (c) directly expressed to the claimant, by words or conduct, the accountant's understanding of the claimant's intended reliance on the professional accounting service[.] [N.J.S.A. 2A:53A-25b(2)(a), (b) and (c).]" (*E. Dickerson & Son, Inc. v. Ernst & Young L.L.P.* 2004, 1239).

Applying the statute, the Supreme Court of New Jersey held that there was no transaction between the wholesaler company, the auditor and the claimants, and the corporate shareholders were not the clients of the grocery wholesaler's auditor. The court further found that no evidence was presented, beyond the auditor's general knowledge of claimants' business interest in the company, of anything specifically identifying claimants for receipt of auditing services in connection with a specified transaction. The shareholders' general reliance on annual audits alone did not "satisfy the 'specified transaction' requirement. Furthermore, there was no evidence to show any conduct by the auditor acknowledging reliance by any claimant as required in part c." (*E. Dickerson & Son, Inc. v. Ernst & Young L.L.P.* 2004, 1239-41).

The Foreseeability Rule

Only a small number of courts hold accountants liable to all reasonably foreseesable users of financial statements (Shore 2000). The first court to apply this standard was a New Jersey Supreme Court in the case of *Rosenblum, Inc. v. Adler* in 1983. After relying on the audited financial statements of the corporation and completing a corporate acquisition transaction, the plaintiff discovered the financial statements were fraudulent and the stock was of no value. The plaintiff sued the accountants for negligence. The courts determined that in order to protect the public, (Gomez 2003) accountants should have a duty to foreseeable users that receive and rely upon the accountant's finished product (Pacini, Ludwig, Hillison, Sinason and Higgins 2000). The court further concluded that this principle only applies if the audited statements are received directly from the business entity (Pacini, Ludwig, Hillison, Sinason and Higgins 2000). The foreseeability standard exposes an accountant to an indeterminate amount of liability. New Jersey abandoned the rule in favor of the codified near privity rule (E. Dickerson & Son, Inc. 2004, 1241), and Mississippi and Wisconsin are the only two states that currently use the foreseeability rule (AICPA 2003).

In *Citizens State Bank v. Timm, Schmidt & Co., S.C.,* the Wisconsin Supreme Court rejected the Restatement rule limiting liability to a limited group of persons expected to access the information as too restrictive on policy grounds. In this case, a lender sued the accounting firm that for years had prepared the financial statements for the business client. Each year the firm sent an opinion letter to the client, which stated "that the financial statements fairly presented the financial condition of the client and that the statements were prepared in accordance with generally accepted accounting principles" (*Citizens State Bank* 1983, 362). A large U. S. Small Business Administration-guaranteed loan was made by the bank to the business, together with smaller non-guaranteed loans, after reviewing previous year's financial statements. The accounting firm subsequently discovered errors in the financial statements and notified the client and the bank creditor. The loans were called due, and the client company was placed in receivership.

Citizens Bank sued the firm and its malpractice carrier based on negligence. The accounting firm stated in defense that no member of the accounting firm knew until after the fact that the business client intended to or had obtained any loans from the bank. The president of the firm also stated that neither he nor anyone in the firm was told that the auditing report would be used by any lender for loan purposes. Citing risk-spreading and deterrence policies and considering the fundamental principle of Wisconsin negligence law of tortfeasor liability for all foreseeable consequences of acts, the Court adopted the foreseeability rule for the state: "We conclude that accountants' liability to third parties should be determined under the accepted principles of Wisconsin negligence law. According to these principles, a finding of non-liability will be made only if there is a strong public policy requiring such a finding….Liability will be imposed on these accountants for the foreseeable injuries resulting from their negligent acts unless, under the facts of this particular case, as a matter of policy to be decided by the court, recovery is denied on grounds of public policy." (*Citizens State Bank* 1983, 366). The Court enumerated traditional public policy considerations for non-liability and remanded the case for trial on the foreseeability and public policy issues.

In adopting, construing and applying one approach over another, most courts and commentators do not differentiate between negligence and negligent misrepresentation. At least one state makes a clear distinction between ordinary negligence and negligent misrepresentation. California has adopted the strict contractual privity rule for an ordinary negligence claim against an auditor but applies the Restatement rule for a third party suit based on negligent misrepresentation. Negligent misrepresentation occurs when an accountant "makes false statements, honestly believing that they are true, but without reasonable ground for such belief, …, a form of deceit." (*Bily v. Arthur Young & Company* 1992, 768).

Applying the foreseeability rule, the Wisconsin courts do not draw such distinctions. In *Chevron Chemical Company v. Deloitte & Touche*, a Wisconsin Court of Appeals affirmed a trial court judgment notwithstanding the verdict in favor of Chevron, a general creditor of a bankrupt company, against Deloitte, the bankrupt company's auditor, for negligent misrepresentation. Citing *Citizens State Bank* and other authority, the Court held that under Wisconsin negligence law, a failure to exercise ordinary care for negligent misrepresentation requires, "(1) 'mak[ing] misrepresentation under circumstances in which a person of ordinary intelligence and prudence ought reasonably to foresee that such misrepresentation will subject the interests of another person to an unreasonable risk of damage,' or (2) failing to use 'the care that is usually exercised by persons or ordinary intelligence and prudence engaged in a like kind of business or profession,' a standard that is applied to a 'person in a particular business or profession." (*Chevron v. Deloitte & Touche* 1992, 318).

The Restatement Rule

The most frequently used standard by courts today is the Restatement rule, developed by a Rhode Island Federal Court in 1968. Under this rule, the accountant owes a duty to the client as well as other individuals or limited groups that the accountant is aware will benefit from the information (AICPA 2003). This known users doctrine is also sometimes referred to as the "intended beneficiary" approach (*Bily v. Arthur Young & Company* 1992, 757-760). The Restatement approach provides for liability of accountants to third parties without the requirement of privity, only when the accountant provides financial statements or other financial reports such as audit reports for the intended benefit of a known person or class of persons to be justifiably relied upon as guidance for a specific transaction or type of transaction identified to the accountant. (*Bily v. Arthur Young & Company* 1992, 757-758; 48 ALR 5th 389 1997, [FN7]).

Restatement (Second) of Torts § 552 provides in pertinent part:

"Information Negligently Supplied for the Guidance of Others

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information

for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance on the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them." (Gomez 2003, [FN36]; 48 ALR 5^{th} 389 1997, [FN7]; Restatement (Second) of Torts § 552 1977).

For example, if the auditor is preparing an audit with the knowledge the information is intended to be used to acquire a bank loan, the auditor is liable to the bank from which the client receives the loan, because the auditor is aware that the bank is relying upon the audited information (AICPA 2003). In 1988, the North Carolina Supreme Court applied the Restatement rule in *Raritan River Steel Co. v. Cherry, Bekaert & Holland*. Creditors had relied upon the audited financial statements of Intercontinental Metals Corporation (IMC), which contained "materially misstated financial data due to the auditor's negligent audit" (Shore 2000). The court determined that the audit firm owed a duty to the creditors that relied on the audited financial statements and that the audit firm was aware that: "(1) the statements would be used by IMC to represent its financial condition to creditors who would extend credit on the basis of the report, and (2) plaintiff and other creditors would rely upon the audit report" (Shore 2000; *Raritan River Steel Co. v. Cherry, Bekaert & Holland 1988,* [FN102])).

The Restatement rule is more generous than the privity rule but narrower than the foreseeability approach (Gomez 2003). Strict privity is privity of contract, such as between the auditor and the client. The first two criteria for the Restatement and "near" privity approaches are very similar. The difference between these standards is the extent of the relationship required. The "linking conduct" element in the third part of the *Credit Alliance* "near" privity approach requires not only that the third party be known to the auditor, "but that the auditor either directly convey the audit report to the third person or otherwise act in some manner specifically calculated to induce reliance on the report…In this regard, a mere 'unsolicited phone call' by the third party to the auditor is insufficient. The auditor must be aware of a 'particular purpose' for the audit engagement and must act to further that purpose….This additional showing is not required by the Restatement test…" (*Bily v. Arthur Young & Co.* 1992, 754-755). The foreseeability approach encompasses all reasonably foreseeable persons who justifiably rely on the auditor's work, but the Restatement limits foreseeability to only those who would qualify as intended beneficiaries. The AICPA reports that twenty-one states apply the Restatement approach, including: Alabama, Alaska, California, Florida, Georgia, Hawaii, Iowa, Kentucky, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, North Carolina, Ohio, Rhode Island, South Carolina, Tennessee, Texas, Washington, and West Virginia (AICPA 2003).

The application of the Restatement approach is reasonably clear when the auditor actually knows and intends that financial information be relied upon by a particular third party or limited group, but courts have had to contend with how to interpret and how far to extend the intended beneficiary or "knows that the recipient intends to supply it;…" provision. A comment to the Restatement reads in part:

> "…it is not required that the person who is to become the plaintiff be identified or known to the defendant as an individual when the information is supplied…it is enough that the maker of the representation intends it to reach and influence either a particular person or persons, known to him, or a group or class of persons, distinct from the much larger class who might reasonably be expected sooner or later to have access to the information and foreseeably to take some action in reliance upon it…it is enough… that the maker… knows that his recipient intends to transmit the information to a similar person, persons or group. (Restatement (Second) of Torts § 552 1977, comment h.).

The plaintiffs in *Carello v. PricewaterhouseCoopers, L.L.P.*, brought suit alleging they had relied upon negligently audited financial statements of the prospective buyer company in making the decision to sell their business. The plaintiffs as shareholders were to receive a payout in the future for their stock. Sometime following the sale, the purchasing company filed for bankruptcy, and the plaintiffs sued for negligent misrepresentations in financial statements and audit reports. PricewaterhouseCoopers (PwC) had prepared the financial statements and audit reports for the buyer. PwC filed a motion for summary judgment, contending there was no knowledge at the time the audits were being performed of the proposed sale or that the audit reports would be used in connection with the sale. The audited financial statements that the plaintiff relied on were filed with the SEC on March 31, 1998, and March 31, 1999. There was evidence that the plaintiffs were not approached regarding the sale until July 1, 1999. PricewaterhouseCoopers argued, "to be liable for negligent misrepresentation under Restatement Section 552, a defendant must have owed to the plaintiff the requisite duty *at the time* the alleged misrepresentations were made" (*Carello v. PricewaterhouseCoopers, L.L.P.* 2002). However, material evidence was presented by the plaintiffs to the contrary regarding the defendant's knowledge about the potential use of the statements. The plaintiffs contended that further discovery would reveal that PricewaterhouseCoopers was "actively assisting Lason [the prospective buyer] in gobbling up companies" prior to and during the relevant time period and therefore should have been aware that third party sellers would be relying on their work.

Although the Delaware Superior Court referred to all three liability doctrines in this case, the final decision was based on the Restatement rule. In construing the Restatement to allow for an analysis of what the auditor "knew or should have known" at the time the financial statements and opinion are provided, the Court found issues of material fact on what was known to PwC and when it was known, and the PwC motion for summary judgment was denied (*Carello v. PricewaterhouseCoopers, L.L.P.* 2002). The addition of "should have known" is a more expansive treatment of the Restatement than a requirement of actual knowledge.

Texas courts initially adopted the less restrictive interpretation of the Restatement approach by doing away with a strict "knowing" standard. In *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co*., the Texas Fifth District Court of Appeals held that "actual knowledge of a particular plaintiff or class of plaintiffs is not necessary if the defendant should have had this knowledge through current business practices" (Gomez 2003; *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.* 1986, 411-13). Blue Bell was one of a limited number of existing trade creditors at the time of preparation of the financial statements in question, and the defendant provided seventy copies of the financial statements to the client, indicating awareness that third parties would probably be receiving the reports. Based on this decision, Texas courts decide whether an accountant "knows or should know" that his services will be relied on by a limited group of individuals. (Gomez 2003).

An example of a more restrictive interpretation of the knowledge-of-intended-use requirement may be found in *Nycal Corp. v. KPMG Peat Marwick LLP*. The buyer of a controlling interest in Gulf Resources & Chemical Corporation (Gulf) sued the accounting firm for alleged negligent misrepresentation in 1990 financial statements accompanying Gulf's annual report. The sale was completed in 1991. Gulf filed for bankruptcy in 1993, and the investor's holdings became worthless. In a case of first impression in Massachusetts, the Supreme Court of Massachusetts discussed the three doctrinal standards for third party liability and rejected the foreseeability and "near" privity approaches in favor of the Restatement. The Court specifically declined to follow the broad construction in the Texas *Blue Bell* case and opted for the "better reasoned" court decision interpretations "limiting the potential liability of an accountant to noncontractual third parties who can demonstrate 'actual knowledge on the part of accountants of the limited—though unnamed—group to potential [third parties] that will rely on the [report], as well as actual knowledge of the particular financial transaction that such information is designed to influence.'… [Citations omitted]." (*Nycal Corporation v. KPMG Peat Marwick L.L.P.* 1998, 1372). "The accountant's knowledge is to be measured 'at the moment the audit [report] is published, not by the foreseeable path of harm envisioned by [litigants] years following an unfortunate business decision.'" (*Nycal Corporation v. KPMG L.L.P.* 1998, 1372).

The Court in *Nycal* held that there was no duty based upon undisputed summary judgment evidence that the defendant did not prepare the audit report for the benefit of the plaintiff or any group of persons that encompassed the plaintiff and that at the time the audit was being prepared, plaintiff was an unknown and unidentified potential future investor. Furthermore, the defendant was not aware of the particular transaction at the time; the existence of other takeover transactions at the time did not indicate to the audit firm an intent on the part of Gulf to use the audit report to locate a purchaser of corporate stock; the audit report was prepared at the time for Gulf's annual report and not for assisting in any particular transaction; and the record did not reveal that the audit firm knew of any particular use of its audit report. (*Nycal Corporation v. KPMG Peat Marwick L.L.P.* 1998, 1373-74).

As a further illustration of how the issue of "known intended use" can be fact-driven and unsettled, even within a particular state, consider recent Texas cases. In a legal malpractice case in 1999, the Texas Supreme Court decided that Restatement (Second) of Torts § 552 applied to non privity third party claims for negligent misrepresentation against attorneys, and stated that, "a section 552 cause of action is available only when information is transferred by an attorney to a known party for a known purpose." (*McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests* 1999, 794). In the 2004 case of *Tara Capital Partners L.L.P. v. Deloitte & Touche, L.L.P.*, the Court of Appeals of Texas in Dallas held that the plaintiffs in this case were not members of an identifiable limited group of which auditors were aware and intended to influence. The plaintiffs (appellants) in this case were stockholders that made a series of stock purchases in Just for Feet, Inc., based on audited financial statements that Deloitte & Touche had either audited or reviewed. After Just for Feet, Inc., filed for bankruptcy, the appellants sued Deloitte & Touche stating they had relied on the negligent misrepresentations in the audited report. The evidence showed that Deloitte & Touche had issued its last audit report just over a month before the appellants made their first stock purchase.

The Appellants in the *Tara Capital* case were not existing shareholders when the audit report was issued, so they were not in that limited group. Furthermore, there was no evidence that Deloitte & Touche was aware at the time the audit was being conducted that Just for Feet, Inc., intended to use the audited work for attracting new investors. Appellants conceded that Deloitte had no knowledge of their specific identity or contemplated stock purchase. The Court stated that a general awareness of the existence of value investors was not sufficient, and recognizing potential investors would be an adoption of the foreseeability rule. Deloitte's general awareness of conference calls with Appellant's investment analyst agent was also insufficient. Several analysts participated in conference calls, and there was no knowledge of intent to supply the audit work to Appellants through these analysts to be imputed to these business activities. Finally, Appellants argued that they were owed a duty as members of a limited group of existing shareholders after purchasing stock.

The Dallas Court of Appeals did not decide whether existing shareholders do constitute a limited group, but held that the pivotal inquiry in negligent misrepresentation is whether the claimant is within a limited group at the time of the misrepresentation. The Court decided that since Deloitte's last audit report was issued before Appellants made their first stock purchase, they were not existing shareholders at the time the audit report was issued and could not be in the limited group of existing shareholders to which the audit was addressed. Citing the *McCamish* case and according to this Court's construction of the Restatement doctrine, the defendants were not liable, because they did not have actual knowledge of Appellants or any intended specific transaction use at the time of the audit. (*Tara Capital Partners L.L.P. v. Deloitte & Touche, L.L.P. 2004*).

Later in October 2004, the 5th Circuit Court of Appeals cited *Blue Bell*, one of its earlier (1996) decisions, *Scottish Heritable Trust, PLC v. Peat Marwick Main & Co.* (acknowledging the limited foreseeability "should have known" holding in *Blue Bell*), *McCamish*, and *Tara Capital*, in an accountant negligent misrepresentation case under Restatement § 552. In *Compass Bank v. King, Griffin & Adamson P.C.*, the 5th Circuit Court relied primarily on the *McCamish* and *Tara Capital* decisions in deciding that under Texas law, the Restatement's actual knowledge standard applies to accountants. The case was an appeal by a lender from an adverse summary judgment at the district court. The lender also sought certification to the Texas Supreme Court of the question of whether the Restatement (actual knowledge) or the *Blue Bell* (limited foreseeability) standard was applicable to Restatement § 552 negligent misrepresentation cases against accountants. Over strong dissent, the Court affirmed the summary judgment and denied the certification. Although the *McCamish* case is authoritative on the issue, the Texas Supreme Court has not specifically ruled on which test will apply to accountants.

POLICY IMPLICATIONS

As a direct result of the increase in litigation relating to auditor liability, professional liability insurance is not as readily available and now comes with a higher price to accounting firms. The excessive cost of malpractice insurance will most likely be passed on to the clients in the form of higher audit fees. Some also argue that due to the increasing level of liability to third parties, auditors may avoid certain firms which carry a high degree of audit risk. However, some firms may choose to no longer perform audits regardless of what the level of risk may be (Shore 2000).

Additionally, there has been a greater number of accountants leaving the profession. According to a study by the International Federation of Accountants, it suggests that "harsh legal liability weakens incentives for parties to monitor enterprises under their control, has a limited effect on reducing negligence by auditors, and may lead to increased litigation risk because of the availability of insurance money" (Pacini, Martin and Hamilton 2000).

The accounting profession is responding to the epidemic of liability law suits in various ways. One method is the engagement risk approach which "incorporates the accountant's legal environment into client acceptance and retention decisions and setting audit fees" (Pacini, Martin and Hamilton 2000). Using this approach the auditor actually considers the risks and related litigation costs of current and potential clients in the event of audit failure. The question of who is owed a duty of care by the accountant further complicates the client risk assessment as well as the setting of audit fees. Dependent upon whom the third party users may be, the auditor's legal liability could vary considerably and more so for the tort of negligence (Pacini, Martin and Hamilton 2000).

CONCLUSION

The issue of who can sue for negligence is a vital issue to accounting firms (Augenbraun 1993). According to Shore, "When an auditor has performed an audit in a negligent manner and third parties have foreseeably relied upon the auditor's professional opinion and suffered harm, notions of fairness, economic efficiency, and deterrence indicate that the negligent auditor should share the liability" (2000). It is also important to note that a third party's business decision is most likely based on not only the audited information in question but other factors as well; therefore, the auditor should not be totally liable for the losses sustained by the third party (Shore 2000). However, in many business failures the accountant is "left holding the bag" due to being the only solvent party remaining (Feinman 2003).

Auditors should be aware of how valuable their work is to clients and investors and creditors alike. Auditors are required to have an understanding of their client's business according to auditing standards. Furthermore, this knowledge should give them an insight into who the users of the information will be. In an attempt to keep corporate America solvent, accountants should be held to some level of liability for negligence to third parties that knowingly relied upon their financial statements (Allegaert and Tinkelman 2000). However, if the accounting profession is held totally responsible for all financial statement blunders, the result could be a reduced supply of audit services, which will lead to a diminished flow of information (Pacini, Martin and Hamilton 2000).

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THE EFFECT OF PUNISHMENT ON ETHICAL BEHAVIOR WHEN PERSONAL GAIN IS INVOLVED

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ABSTRACT

With the recent onslaught of accounting frauds, the nature of unethical decision making in organizations has shifted from the lack of sensitivity for the ethical aspects of decisions to one where executives have used their positional power for personal gain. Congress reacted with stiffer laws and punishments, raising the question of the role of punishment in deterring corporate crime. This study investigates the effect of four variables, valence of the outcome, probability of getting caught, severity of punishment, and moral values, on ethical decision making. A survey with six ethical scenarios was administered in three different classes resulting in 115 completed surveys. Students were asked to select the scenario option they would actually do in the situation and to rate how significant the four variables were in their decision. The responses for the six scenarios were combined and analyzed using linear regression. Three of the four variables were significant in explaining the variance in selection of the ethical option. Moral values explained the most variance with severity of punishment being second and valence of the outcome third. This study contributes to the ethics literature by demonstrating the importance of punishment in supporting a person's choice of the ethical option.

INTRODUCTION

The corporate problems with unethical decision making have changed in nature over the years from issues related to product safety, environmental impact, and misleading marketing to more obvious uses of corporate power for personal gain. In the last six months we have seen two CEOs prosecuted and sentenced to jail terms for misuse of corporate funds, misleading investors, and misrepresenting financial results. Prior to these prosecutions, examples of unethical decision making at Enron, Tyco, WorldCom, and others have been attributed to a climate where executives have come to believe they are above the law (Bianco, Symonds, & Byrnes, 2002).

In response to the continuing corporate scandals, Congress passed the Sarbanes-Oxley Act, which was signed by President Bush in the summer of 1992. This act, along with the US Sentencing Guideline Amendments and the Department of Justice Principles of Federal Prosecution of Business Organizations, was passed to foster greater financial accuracy and curb corporate malfeasance. These actions demonstrate the first attempt to govern corporate conduct by imposing criminal liability directly on executives for investor fraud. These steps by the government are based on the belief that greater apprehension, prosecution, and punishment will deter these acts of unethical behavior (Imperato, 2005).

Much of the previous research on ethical behavior has taken the perspective of increasing cognitive moral development, raising sensitivity to ethical issues, and improving moral judgment; but much less attention has been paid to the impact that punishment and prosecution has on moral motivation.

LITERATURE REVIEW

The majority of the early research on ethics was based on Kohlberg's (1969) model of Cognitive Moral Development, which described three levels of moral development: pre-conventional, conventional, and principled. These levels correspond to the basis people use to distinguish right from wrong. The Defining Issues Test (DIT) is the instrument most commonly used to measure the level of moral development of research subjects (Abdolmohammadi & Sultan, 2002).

Rest (1986, 1994), in his extensive review of the literature on ethical development, realized that researchers were looking at different aspects of the decision-making process. He proposed a four-component model that includes moral sensitivity, moral judgment, moral motivation, and moral character. Moral sensitivity is the awareness of how one's actions affect other people and the realization that the cause-consequence chain of events that one's actions initiate has moral implications. Moral judgment is the person's ability to judge which line of action is more morally justifiable. The third component, moral motivation, is the importance given to moral values in competition with other values. Moral motivation helps explain why people choose an option they recognize to be less ethical. The last component, moral character, involves ego strength, perseverance, strength of conviction, and courage. Rest's work pointed out the importance of distinguishing between the four components of ethical decision making. Our study focuses on the moral motivation component of ethical behavior and factors in the ethical situation that impacts moral motivation.

One of the major contributions since Rest has been Jones' (1991) attention to the characteristics of the ethical issue itself and how these characteristics affect ethical behavior. He introduced the concept of moral intensity, which is composed of six dimensions that vary with the nature of the ethical issue: magnitude of consequences, social consensus, probability of effect, temporal immediacy, proximity, and concentration of effect.

A number of quantitative studies have tested Jones' model. Reviews of this research on moral intensity (Chia & Mee, 2000; May & Pauli, 2002) have found that magnitude of consequences is one of the most significant dimensions of moral intensity in influencing ethical decision making. Other studies (Morris & McDonald, 1995; Singhapakdi, Vitell, & Kraft, 1996; Singer & Singer, 1997) suggested that the six dimensions could be collapsed into two: potential harm and social pressure.

More recent research studies on moral intensity have found that both magnitude of consequences and probability of effect have stood out in ethical issues analyzed (Leitsch, 2004; Watley & May, 2004).

Our study continues the research on magnitude of consequences but from a different perspective. Most of the early research has viewed the consequences as being inflicted on a victim other than the decision maker. Our research investigates ethical decision making when personal gain is involved. Behavioral theories and their application to ethical decisions have added to our understanding of personal gain and punishment as factors that affect ethical behavior.

Several researchers (Randall & Gibson, 1991; Flannery & May, 2000) have approached ethical behavior based on the well known theory of planned behavior (Ajzen, 1985). The theory of planned behavior posits that intentions are key to explaining behaviors and are shaped by attitude toward the behavior, subjective norms, and perceived control over the behavior. Attitude toward performing the behavior is a function of beliefs that performing the behavior will lead to certain consequences and the individual's evaluation of those consequences. The theory predicts that the more positive the consequences, the more favorable the attitude toward the behavior will be. Randall and Gibson (1991) added moral obligation to the theory of planned behavior, which had been in Ajzen's original model but was later dropped. The results showed that attitude toward performing the behavior explained a large amount of the variance in intention, while subjective norms explained only a moderate amount of the variance.

Flannery and May (2000) proposed that moral intensity would moderate the relationship between the antecedents in the theory of planned behavior—attitudes, subjective norms, and behavioral control and the intention to behave ethically. In a study of ethical decisions related to treatment of hazardous wastewater streams in the metal-finishing industry, the authors chose to focus on only one dimension of moral intensity, and that was magnitude of consequences. The results did prove that magnitude of consequences moderated the relationship as expected.

The behavioral theories have also investigated the impact of punishment on ethical decision making. Early laboratory experiments found that personal gain significantly increased unethical decision behavior, whereas the threat of direct punishment reduced unethical decision behavior (Hegarty & Sims, 1978). Laczniak and Inderrieden (1987) looked at different levels of organizational support for ethical decision making and found that decision making from managers was influenced only when specific sanctions for misconduct were imposed. Trevino and Youngblood (1986), drawing on social learning theory, found that vicarious reward, but not punishment, influenced ethical decision making. In a later study, Trevino and Ball (1992) investigated different severity levels of vicarious punishment and found that only the harsh vicarious punishment group expected management to punish unethical behavior in the future.

The review of the behavior theories reinforces the importance of two of our four variables, valence of outcome and probability of getting caught, which is the basis of the attitude toward performing the behavior. Our fourth variable, severity of punishment, has received some attention in ethics research, but much of the theory comes from the economics of crime.

Horvath and Kolomaznikova (2003) surveyed the most important findings of early models of economics of crime, including three models that studied rational individual decision making about entering into illegal activities (Becker, 1968; Ehrlich, 1973; & Heineke, 1978). That review found that gains from crime and income, probability and size of punishment, and attitudes towards risk are the main variables influencing the results of individual behavior.

Becker's (1968) seminal work on the economics of crime is the basis for all further research (Horvath & Kolomaznikova, 2003). Becker's high-fine-low-probability principle argues that individuals are deterred from criminal activities by a higher fine and by a probability of detection and conviction. The crime is committed only if the gain from the crime is more than the expected punishment, with expected punishment being the probability of detection and punishment times a monetary sanction. Similarly, Levitt (1997) states that changes in expected punishment is the most fundamental predictor for influencing criminal behavior in the economic approach.

Garoupa (2001) shows that substitutability between the probability of punishment and fine holds only if the expected punishment is close to the gain from crime. Specifically, the formula fails with very wealthy individuals who would require a high fine, since a low fine would be of little significance. Thus with very rich criminals, applying both high fines and high detection, a complementary relationship, is more effective.

Block and Gerety (1995) examined reactions to monetary penalties and risk for criminals and for noncriminal students and concluded that individuals are risk averse in general. Criminals tended to be more sensitive to changes in the probability of punishment, while noncriminal students tended to be more sensitive to changes in the monetary penalties. Eide (1994) makes reference to studies where criminals tend to overestimate the probability of apprehension, which would suggest that a low probability of punishment would have a major deterrent effect.

HYPOTHESES

Our research investigates the impact of four variables (moral values, valence of outcome, probability of getting caught, and severity of punishment) and their effect on ethical decision making. Based on the review of the literature, magnitude of consequences and the probability of effect have proven to be important factors. Because we are investigating ethical issues dealing with personal gain, we chose to substitute valence of outcome for magnitude of consequences. Our second variable, probability of getting caught, is closely and inversely related to probability of effect. Following Randall and Gibson (1991), we added a variable to measure moral obligation and called it moral values. The fourth variable, severity of punishment, is directly related to ethical behavior. Based on the economic literature review, we expected severity of punishment to be a deterrent to unethical behavior.

Hypothesis 1.a. *Valence is inversely related to ethical behavior.*

Hypothesis 1.b. *Moral values, probability of getting caught, and severity of punishment are directly related to ethical behavior.*

Hypothesis 1.c. Moral values, valence of outcome, probability of getting caught, and severity of punishment are important and significant factors in explaining and predicting ethical behavior of individuals.

METHODOLOGY

The survey instrument (Appendix 1) was developed by looking for available scenarios that were already tested for validity. The scenarios were adopted from two external sources. The first source was the mini-cases from Lockheed Martin Corporation (Online Ethics Center, 2003). The second source was the Ethical Behavior Worksheet from Bateman and Snell's management textbook (2002, p. 169). The scenarios come with a scoring sheet that provides points from +10 to -10 for the optional courses of action from which the participants select their answers. The most ethical option is given +10 points, and the least ethical option is scored -10. For the Lockheed Martin scenarios, the Law Department of the company reviewed the scenarios and approved the ranking of the options. No validity study was referenced in the source for the scenarios in Bateman and Snell's text.

We tested the six scenarios first for content validity by asking four faculty members who teach management, business law, and ethics to determine if the information provided was clear and if they agreed with the scoring of the options selected. All four faculty members agreed with the scoring of the options but suggested minor wording changes to improve the clarity. The scenarios were revised based on this input. The revised scenarios were then tested for reliability with a convenience sample of twenty students. The students were asked to complete the survey and to retake the survey two weeks later. The paired t-test was run to determine the stability of the option chosen in the scenarios. The average correlation coefficient across the six scenarios was .75 as shown in Table 1.

Table 1: Reliability Coefficients

	N	Correlation	Sig
Pair 1 Scen1 & t2scen1	20	.844	.000
Pair 2 Scen2 & t2scen2	20	.765	.000
Pair 3 Scen3 & t2scen3	20	.674	.001
Pair 4 Scen4 & t2scen4	20	.621	.004
Pair 5 Scen5 & t2scen5	20	.718	.000
Pair 6 Scen6 & t2scen6	20	.856	.000

The survey was then administered in three different classes resulting in 115 completed surveys. After each scenario, the respondents were asked to rate the importance of the four variables in the decision they made on the option selected in the scenario. Respondents rated each variable using a scale from "Not a factor"=1 to "Very significant factor"=5. The scenarios were combined to determine the overall contribution that the variables had in explaining the variance in the ethical score, which was calculated based on the option the participants chose for each scenario. The combination of the four scenarios resulted in 690 data points. A linear regression analysis was run to determine the amount of variance in the ethical score explained by the four factors.

RESULTS

The descriptive statistics and Pearson Correlation Coefficients for all the variables are shown below in Table 2.

Table 2: Correlation Coefficients

Variable	Mean	s.d,	1	2	3	4	5
1. Ethical Score	1.91	7.16	1	-08*	.17**	.19**	.34**
2. Valence of Outcome	3,64	2.56	-.08*	1	.02	.03	-.04
3. Prob. of Getting Caught	3.29	1.36	.17**	.02	1	.62**	.22**
4. Severity of Punishment	3.50	1.42	.19**	.03	.62**	1	.27**
5. Moral Values	3.49	1.31	.34**	-.04	.22**	.27**	1

* Correlation is significant at the 0.05 level (1-tailed)
** Correlation is significant at the 0.01 level (1-tailed)

The correlation coefficients support Hypothesis 1.a. in that valence of outcome is inversely related to the ethical score and is significant at the 0.05 level. The second hypothesis is also supported in that probability of getting caught, severity of punishment, and moral values all have a significant correlation at the 0.01 level with the ethical score. An unexpected result was the significant correlation between severity of punishment and moral values.

To test Hypothesis 1.c., a stepwise multiple regression was run. Table 3 shows that three of the variables were significant in explaining the variance in the ethical score.

The fourth variable, probability of getting caught, showed considerable collinearity. The four-step mediation analysis proposed by Baron and Kenny (1986) was used to test whether severity of punishment mediated the effects of the probability of getting caught. Probability of getting caught was entered into a regression analysis first. Severity of punishment was then added in the second step, which eliminated probability of getting caught from the model, therefore proving that severity of punishment fully mediated the effect of probability of getting caught. Based on these results, we eliminated probability of getting caught as a variable.

The results of the regression analysis (Table 3) show that Hypothesis 1.c. is supported, with the three remaining variables significantly explaining the ethical choices made by the participants.

Table 3: Regression Analysis							
Model	R	Adjusted R Sq	Std. Error	Std. Coeff.	t-Stat.	F	Sig.
1. Moral Values	.344	.117	6.72	.344	9.58	91.69	.000**
2. Moral Values				.315	8.49	50.66	.000**
Sever of Punish	.360	.127	6.69	.109	2.94		.003**
3. Moral Values				.311	8.39	35.33	.000**
Sever of Punish				.112	3.03		.003**
Valence	.367	.131	6.67	-.073	-2.05		.041**

* Correlation is significant at the 0.05 level
** Correlation is significant at the 0.01 level

SUMMARY AND CONCLUSIONS

This study investigated the effect that four variables had on ethical decision making. The four variables are valence of outcome, probability of getting caught, severity of punishment, and moral values. As in past studies, three of these variables, valence of outcome, severity of punishment, and moral values proved to be significant factors in explaining ethical decision making.

The most positive finding in this study is the major role that moral values played in ethical decision making. Moral values, overall, had the greatest impact on participants' choices of the ethical options. This finding demonstrates that people do not operate solely from an economic perspective, weighing only the risks versus the rewards. In this study, moral values took precedence.

The second major finding was the importance of the severity of punishment, a finding that is consistent with past research (Becker, 1968; Levitt, 1997). This variable explained the second largest amount of variance in the choice of the ethical option. In addition, severity of punishment had a significant, positive correlation with moral values. These results imply that the presence of punishment can encourage ethical decision making by giving more credence to people's moral values.

One plausible interpretation of the last finding is that when there is no punishment or when the punishment is so weak, people have more difficultly basing their decisions on their moral values. When other people are getting away with the unethical option and receiving personal gains, doing the right thing becomes harder. Returning to our CEOs, who were motivated to make their companies profitable, the lack of punishment almost gave them a license to steal. The presence of punishment supports moral values by giving people a stronger rationale to do what is right.

The results of this study add to the understanding of ethical decision making by investigating severity of punishment and its relationship to three other more commonly studied variables. The importance of punishment in supporting moral values and choice of the ethical option adds insight to policies that should be established to reinforce ethical decision making in the corporate world. In addition, our analysis sheds light on the controversial policy issue, whether the individual or the institution should be held liable for unethical decisions. The paper provides support to the Bush Administration's stance that it is the individual(s) and not the corporation (stock holders) who should be held responsible and punished for the unethical decisions.

This study also has implications for teaching ethics to business students. Our study indicates that it is important for students to recognize the negative consequences that can result from unethical decisions. These negative consequences can range from damage to the brand or loss of confidence in the company to more severe punishment such as major lawsuits or even criminal charges and time in jail. Consumer confidence in a product and company takes a long time to build but only minutes to destroy.

A limitation of this study is that it was conducted in only one setting, in the School of Business of a public university, and students were aware that they were participating in ethics research. One could argue that a person who was actually weighing the risks involved in these scenarios might have behaved differently when his/her personal gain was actually involved. Abdolmohammadi and Sultan (2002) suggest that people who risk their own money may be more susceptible to lapses in ethical judgments than those involved in scenarios. Future research could be conducted to investigate the possible difference.

Future studies might also involve demographic characteristics of participants as well as differences with private schools, graduate schools, other schools within universities, and in the corporate world as well.

Our study combined the scenarios to determine the overall contribution that the variables had in explaining the variance in the ethical score. Future research is necessary to analyze the individual scenarios to determine the contribution of the variables as they relate to the impact and importance of the different ethical issues to the subjects.

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APPENDIX A: ETHICS QUIZ

Read the scenarios and choose the response that reflects what you believe you would ACTUALLY do in the situation. Try to imagine yourself faced with the situation, even if you have not had a similar experience.

SCENARIO 1: A major accounting project that you need to successfully complete in order to pass the class is due in three days. You have been working the long calculations by hand for one week and will not meet the deadline. A friend owns a $200 copyrighted software program that will allow you to successfully complete the project by the deadline. This software company is aggressively prosecuting individuals. Court records show that 90% of violators who go on trial are found guilty with an average fine of $10,000. What would you do?

A. Accept my friend's offer and make a copy of the software program.
B. Decline to copy it and plug away manually at the project.
C. Buy a copy of the $200 software.
D. Request an extension on the due date.

Use the scale below to rate **each** statement for the role it played in your decision.

Not a factor	Very Little Extent	To Some Extent	Significant Extent	Very Significant Extent
1	2	3	4	5

________ The value of passing the class by completing the project on time

________ The likelihood of getting caught

________ The severity of the punishment if caught

________ The moral basis of right or wrong in this situation

SCENARIO 2: You are on academic probation and are struggling in a very difficult chemistry course in which you must get a "C" to remain in college. Currently you have a just-below-failing average and need 90% or better on the final exam. The custodian knows you personally and informs you that he found a copy of the final exam in the professor's trash and will sell it to you. This is cheating and will give you an "F" in the class if you are caught. You can assume a low probability that the professor will ever know. What would you do?

A. Tell the janitor thanks, but no thanks.
B. Report the janitor to the proper officials.
C. Buy the exam and keep it to myself.
D. Not buy the exam for myself but let some of my friends know that it is available.

Use the scale below to rate **each** statement for the role it played in your decision.

Not a factor	Very Little Extent	To Some Extent	Significant Extent	Very Significant Extent
1	2	3	4	5

________ The value of getting a "C" in the course and remaining in college

________ The likelihood of getting caught

________ The severity of the punishment if caught

________ The moral basis of right or wrong in this situation

SCENARIO 3: You are in college and are interviewing for a pizza-delivery-person position, one of several part-time jobs you're considering. You know that the company will not hire anyone with a moving traffic violation, and the employer asks if you've ever had an accident while driving. Last year you hit a car in a parking lot and left your name and insurance information. You reported the accident to your insurance company but never heard from the driver of the parked car. The accident was not reported to the police and is not on your driving record. The probability that the employer will check your insurance record is very low. What would you do?

A. Tell the interviewer I never had an accident.
B Tell the interviewer that my car was hit while parked in a parking lot and that I reported the accident to my insurance company.
C. Tell the interviewer that I hit a car in the parking lot but it was not my fault.
D. Tell the interviewer that I hit a parked car in a parking lot and left my name and insurance information, which I felt was the right thing to do.

Use the scale below to rate **each** statement for the role it played in your decision

Not a factor	Very Little Extent	To Some Extent	Significant Extent	Very Significant Extent
1	2	3	4	5

________ The value of getting hired for the pizza delivery job

________ The likelihood of getting caught

________ The severity of the punishment if caught

________ The moral basis of right or wrong in this situation

SCENARIO 4: Program funds are short, and your supervisor has directed you to charge your time to a project account you know to be improper. Your company is a government contractor, and falsely charging time to a project is illegal. If the government discovers the false charge, your company will be fined over $100,000. Also, you could be charged with fraud and face a jail term of one to three years. The government currently has no way of checking the validity of your time card, so the probability of being caught is low. What would you do?

A. Explain to my supervisor that mischarging on a government contract is fraud.
B. Refuse to mischarge.
C. Mischarge as directed by my supervisor.
D. Ask finance for an overhead number for charging my time.

Use the scale below to rate **each** statement for the role it played in your decision.

Not a factor	Very Little Extent	To Some Extent	Significant Extent	Very Significant Extent
1	2	3	4	5

________ The value of keeping your supervisor happy or avoiding conflict with your supervisor

________ The likelihood of getting caught

________ The severity of the punishment if caught

________ The moral basis of right or wrong in this situation

SCENARIO 5: You and a friend, John, signed up for a training course. He did not attend the course but was not at work, either. He asks you to cover for him and tell your supervisor that he was at the training course. If you cover for your friend, there is a high probability that the supervisor will discover that you lied. The supervisor can only reprimand you, since you are covered by a union contract. What would you do?

A. Tell my friend I will cover for him.
B. If the supervisor asks, say that so many people attended the training course I'm not sure whether or not John did attend.
C. Suggest to my friend that he report his absence to the supervisor because I will not cover for him.
D. Take the initiative and speak to my supervisor about my friend's absence from the training program.

Use the scale below to rate **each** statement for the role it played in your decision.

Not a factor	Very Little Extent	To Some Extent	Significant Extent	Very Significant Extent
1	2	3	4	5

________ The value of John's friendship

________ The likelihood of getting caught

________ The severity of the punishment if caught

________ The moral basis of right or wrong in this situation

SCENARIO 6: You are CEO of a business you started about 15 years ago with the help of funding from your brother, who does not work at the company. The company went public five years ago, but you and your brother kept a significant amount of the stock. You know that your company has to report a loss at the end of the quarter and the stock value will likely drop. Your brother wants to retire soon and depends on his investment in your company to make his early retirement possible. If you reveal the company's financial situation and your brother sells his stock based on the information, he could be accused of insider trading. If prosecuted and found guilty, both of you would face 3 to 5 years in jail. Insider trading is difficult to prove with no documentation of the conversation, and both of you would deny that the conversation occurred. Therefore, the probability of being charged with insider trading is very low. What would you do?

A. Tell my brother the status of the company's finances and let him decide how to act on the insider information.
B. Tell my brother to meet with a financial advisor to get advice on reducing risk in his investment portfolio.

C. Tell my brother to sell his stock but to never mention that we had this conversation.
D. Not tell my brother any confidential company information and hope that I can turn the business around before the next quarter.

Use the scale below to rate **each** statement for the role it played in your decision.

Not a factor	Very Little Extent	To Some Extent	Significant Extent	Very Significant Extent
1	2	3	4	5

________ The value of helping my brother avoid financial loss

________ The likelihood of getting caught

________ The severity of the punishment if caught

________ The moral basis of right or wrong in this situation

FACULTY ETHICS FROM THE PERSPECTIVE OF COLLEGE OF BUSINESS ADMINISTRATORS

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ABSTRACT

Recent corporate scandals have led to calls for improved instruction in ethics in colleges of business. The leading accrediting body for business programs, the Association to Advance Collegiate Schools of Business (AACSB) has also recently increased its standards concerning ethics in business curricula. Furthermore, the ethics of professors themselves have come under increasing scrutiny. Deans are key contributors to and enforcers of college policies, and their expectations help influence ethics within a college of business. However, there is a dearth of ethical analysis of faculty behavior as viewed by college of business deans and administrators. A questionnaire of American and Canadian college of business deans and administrators was conducted to provide insight into the implications and frequency of particular faculty behavior. The presence of a code of ethics was found to increase sensitivity towards ethical issues but not alter behavior. Reasons for not adopting a code of ethics and potential motivators for adoption are presented.

INTRODUCTION

Ethics is the inquiry into the nature and grounds of morality, which includes moral judgments, standards and rules of conduct (Taylor, 1975,1). There have been many studies on the unethical behavior of academics. The books *Saints and scamps: Ethics in academia* (Cahn,1986) and *ProfScam: Professors and the demise of higher education* (Sykes, 1988) both outline the profile of the unethical academic. According to Sykes, many professors have "abandoned their teaching responsibilities and their students. To the average undergraduate, the professoriate is unapproachable, uncommunicative and unavailable" (1988, 5). The academic is, "mobile, self interested and without loyalty to institutions or the values of liberal education" (Sykes,1988, 7). Cahn (1986) is more specific by providing a brief sketch of the activities of a shirking professor. This professor regularly cancels classes, arrives late, is unprepared, avoids giving exams, leaves mail unopened and never attends faculty meetings.

With the recent ethical crises in corporate governance in North American and European organizations, many business managers are reevaluating their ethical policies and employee perspectives. For example, the European Union has required all companies listed on European exchanges to adopt international accounting standards, considered stronger than the current accounting rules in several European countries (Matlack, 2003). The importance of a code of ethics was reinforced when the Sarbanes-Oxley Act was passed in 2002. Section 406 of the act requires publicly traded companies to disclose whether the company has adopted a code of ethics for their senior financial officers and if not, why not. Companies are further required to report to the SEC when any component of their code is altered. Some have interpreted this act as mandating a code (Integrity Interactive, 2005).

Given the conspicuous breaches of trust identified in the practices of business executives in organizations such as Qwest Communications International Inc., HealthSouth, Enron, WorldCom, Oracle, Sunbeam, General Electric, Royal Ahold NV, Comroad, Global Crossing, Parmalat, and Arthur Anderson it is essential that business schools complete a self evaluation of the practices within their organizations. It is not enough to teach ethical practices; students expect professors to be ethical. In two recent studies of undergraduate students, Kuther (2003) found that students expect professors to be highly competent and current in the classroom and to keep their personal and professional lives separate. She concludes that students view professors as role models who act as exemplars of scholarship and professional behavior. This finding is supported by McLean (2004) who found that medical students also identify their faculty as important role models.

In a similar and perhaps equally important way, the quality, ethics, and governance practices of an academic institution should model to students an appropriate culture in a large organization. What is observed in the university by the student should complement the subject matter being taught. For example, to reinforce the integrated value of business ethics, faculty might use the widely cited research by Governance Metrics International showing a positive correlation between proper corporate governance and superior financial returns (Morgenson, 2003). Corporate role models can also be identified, as exemplified in a 2002 speech by Clarence Cazalot Jr., the CEO of Marathon Oil,

> "Our companies are dedicated to being sustainable companies . . . the only way to achieve that is to incorporate economic, environmental, and social codes of conduct into our business strategy. We are determined to conduct our business . . . with honesty, integrity, and decency to our customers, our suppliers, our shareholders, and to one another."

By contrast, many business professors who raise the topic of business ethics are confronted by quips such as, "Business ethics? Isn't that an oxymoron?!" Which of these two views of the corporate world will the business student accept? In part it may depend on what they observe at their own academic institutions. Business students study management topics such as quality, human resource management, ethics, and competitive advantage through superior value, but equally important is what they experience in higher education.

Management literature advises treating employees and suppliers with respect, but do professors and administrators handle graduate students, adjunct instructors and their own collegial relationships accordingly? If a student studies the management concept of "plan, organize, lead, and control," do the ideas lose credibility if the management professor comes to class unprepared, allows a disrespectful classroom environment, or has an arbitrary grading system? It would be naïve to think otherwise.

Unethical and self-interested behavior of academics has been extensively examined. Activities investigated include: biased journal reviews (Pool, 1988), plagiarism in academia (Xueqin, 2002; Leatherman, 1999; Blum, 1988), faculty pirating software (Taylor, 1993; Deloughry, 1987), false resume claims (Payne, 1987), poor teaching (Baty, 2002), grading peculiarities (Robie & Kidwell, 2003), self interest on issues of work load (Wolfe, 2001), and using crude language in the classroom (Wilson, 2001). Further areas of concern include sexual harassment by university faculty (Larsson, 2003; Jacobson, 2001; Tuana, 1985) and sexual contact or relations between professors and students (Heller, 1986; Fogg & Walsh, 2002). It is important to consider whether the ethical culture of the educational institution becomes a significant ingredient in the formation of the values of the business school graduate.

According to Cahn (1986), it is the extraordinary degree of faculty autonomy that leads academics into an ethical thicket. If academics are going to advocate the adoption of strong ethical principles and ethical self evaluation by faculty, academics and administrators must engage in dialogue to define behaviors that are and are not acceptable. In order to engage in ethical discourse in the classroom regarding the behavior of managers and employees it is essential that business academics clarify amongst themselves how high the bar must be raised within their own domain. A number of surveys have been completed examining the implication and perceived frequency of specific faculty behaviors that have ethical implications. Tabachnick et al. (1991) surveyed American Psychology Association members who worked in institutions of higher education investigating their perspective and engagement in 63 behaviors. The authors identified behaviors that were commonly practiced, such as teaching without adequate preparation, as well as infrequent behaviors, such as sexual harassment. Birch et al. (1999) surveyed faculty and found differences in ethical ratings of only a small number of behaviors between men and women and between those that taught ethics versus those that did not.

A study by Lewellyn (1996) on the attitudes of information systems faculty found that attitudinal differences prevailed between faculty at different appointment levels. Activities considered most unethical included falsifying research data and accepting sex, money, or gifts for grades. Mason et al. (1990) surveyed marketing educators and identified the most frequently occurring issues as using university staff to do personal work, using university resources in one's consulting practice without pay and agreeing to special admissions for athletes. The position of the respondents and the characteristics of the institution were found to relate to the perceived frequency of behavior. Finally, Robie and Kidwell (2003) surveyed a broad base of business professors and found only two behaviors (lowering grades of students who disagree with your views and sexual relationships with undergraduate students currently in your class) that were uniformly understood to be unethical, whereas several behaviors showed significant lack of consensus. They also found differences among faculty based on gender, rank, age, and institution type. Braxton and Bayer (1999) found less consensus about the ethical implications of faculty behavior within academic disciplines with weaker paradigm development. They also identified two inviolable norms of faculty behavior: lack of attention to planning and moral turpitude.

Student perceptions of faculty behaviors have also been measured. Keith-Spiegel et al. (1993) surveyed students on the ethical acceptability of over 107 faculty acts. Student rated professors as unethical if they gave students unearned advantage and acted in ways that embarrassed students. When student ratings were compared with professors' self ratings they were found to be essentially similar. Morgan and Korschgen (2001) found that students and faculty differed significantly in their perception on only four of 16 faculty behaviors. Faculty rated ensuring popularity with an easy test, accepting a textbook rebate and using profanity as more unethical. Students saw failing to update notes as more unethical. Kidwell et al (2003) likewise found faculty and student perceptions to be similar on most, but not all, issues concerning academic ethics of students. Another relevant study, completed by Stevens et al. (1993), evaluated the public's image of university professors in relation to other professions. Overall ratings placed university professors significantly lower than doctors, dentists, pharmacists, and clergy and on par with lawyers.

As early as the 1980s, academics such as Scriven (1982) argued that college faculty must put their own ethical house in order rather than leave ethics as part of the invisible environment. Faculty can advance their understanding of ethical values by examining their own work environment, revisiting university and association policies and reviewing or establishing codes of ethics. The purpose of a code of ethics is to state the ideals of a profession or field, delineate relationships, legitimate the profession in the face of skepticism, and regulate (Callahan, 1982). Features of a code of ethics should include establishing academia's service to society, avoiding conflict of interest, efficacy of instruction, reliable evaluation, specificity of behavior, and enforcement (Schurn, 1982).

One question that remains unresolved is whether codes of ethics change conduct. The evidence on this issue has been mixed. McDonald and Zepp (1989) wrote that codes of ethics help define what ethical concerns exist for an organization. This suggests that employees may be made more attuned to potential problems. However, Wood and Rimmer (2003) note that for a code to affect behavior, it must not only state norms of good conduct, ethical beliefs, and guidance for action; it must be followed by commitment at all levels to its success. Granitz (2003) found that ethical decision making was best understood as a result of individual, social, and organizational characteristics. Although individual characteristics, such as Machiavellianism, and organizational characteristics, such as codes of conduct, were significant determinants in ethical decisions, social interactions had the highest explanatory power in predicting decisions as well as ethical reasoning. Within clique groups in an organization, members develop shared ethical reasoning through interaction, thus different subcultures can emerge within a single organization.

Outside academia research has shown a marked increase in the importance of the qualities of honesty and integrity in hiring. According to a survey of chief financial officers, 58% rated honesty and integrity as important employee qualities after ability and willingness, up from 32% in 1997 (Messmer, 2003). "Organizations that are most successful in promoting ethics make it a top priority from the time staff members are hired, clearly communicating the standards of appropriate conduct" (Messmer, 2003,14). As business schools are interested in graduating students that will be successful in their careers integrating ethics into the curriculum is becoming increasingly important. True and Pelton (2005) argue that colleges of business have an obligation to teach the fundamentals of business beyond merely shareholder interests, including business' role in society and the interest of all stakeholders. However, Macfarlane and Ottewill (2004) concluded that business ethics occupies a more marginal position within the curriculum than previous studies have presented. Their work suggests that an understanding of business ethics is conceived as part of a broad contextual comprehension of the business environment rather than an understanding of theoretical constructs. Research by McDonald (2004) has considered who should teach ethics and how ethics should be taught in a business program. He examined the differences between teaching business ethics as a single course versus an integrative approach. Essential to the discussion of what to teach is defining the domain of business ethics and looking at the factors that influence the domain (Crane & Matten, 2004). Based on a contextual perspective it is important to look at all aspects of a business education such as the environment and perceptions from all levels of the organization and not just the teaching of ethics.

This paper differs from previous research by surveying deans of colleges of business rather than faculty of a specific discipline. The opinions of deans are important given their administrative roles in initiating policies, overseeing accreditation of their schools by the Association to Advance Collegiate Schools of Business (AACSB), dealing with the consequences of unethical behavior and interacting with students, faculty and external stakeholders. Deans generally have experience in multiple schools and network with deans at other institutions. Most have also had administrative experience as either chairs or MBA directors, so they tend to have more knowledge of actual ethical infractions than would professors without administrative experience. A further benefit of surveying deans is reducing social desirability bias on the part of faculty that would occur if commenting on the ethical implications and frequency of their own behavior (Choong & Ho, 2002).

This paper examines the ethical implications ascribed to particular behaviors and the frequency of occurrence of such behaviors as viewed by administrators within colleges of business in the United States and Canada. The research was conducted through a self-administered questionnaire mailed to business school deans. The findings of this research are of particular relevance to management educators because of the impact faculty behavior can have on students, the administrative perception of ethical behavior, and the concern that codes of ethics may be adopted but not adequately implemented.

METHOD

The current study was an exploratory examination of the ethical issues surrounding faculty behavior in teaching, research, and relationships deemed by deans to (a) have the strongest ethical implications, and (b) occur most frequently. In this study, we argue that there will be a broad range of behaviors that administrators will view as having ethical implications, and that those that are most serious are likely to occur less frequently than other behaviors. Because this was an exploratory study, no hypotheses are presented in advance to suggest which behaviors might be the most frequent or important. Rather, this paper argues that administrators will view a fairly broad range of activities as having important ethical implications, and that there will tend to be consistency across schools in what these issues might be. Further, we propose that administrators' perceptions of ethical activities in their schools will vary, depending on whether the school possesses a formal code of ethics.

Questionnaires were sent to deans of American university business schools with membership in the AACSB (659 universities), and 54 deans of Canadian universities with business schools (some, but not all, AACSB members). AACSB members include all universities engaged in the AACSB accreditation process, all accredited universities and some universities not involved in accreditation or accredited but interested in the services offered through the AACSB. The questionnaire was pretested on a small sample of assistant deans. The mailing included an introductory letter with instructions, the questionnaire and a prepaid return envelope. A reminder letter was sent two weeks after the initial mailing to encourage responses.

Respondents were asked to provide institutional information about their university and specific business programs. Next, the questionnaire requested information about the respondents. Thirdly, the questionnaire asked whether the respondent's university, college of business or department had a code of ethics. If they did, further information on the code was requested. If they did not, reasons for not having a code were sought along with circumstances under which the respondent thought a code might be introduced at his or her university.

Finally, a series of faculty behaviors were presented. Respondents were asked to rate these behaviors according to ethical implications on the following three-point scale: (1) "Not an ethical problem," (2) "Maybe an ethical problem," or (3) "Definitely an ethical problem." Respondents were then asked how frequently they believed the specific behaviors occurred on a five-point scale: (1) "Almost never," (2) "Seldom," (3) "Occasionally," (4) "Frequently," (5) "Almost all the time."

There were 32 behaviors dealing with three foci: teaching, research and professional activities, and relationships. The list of behaviors was developed from three general sources. Most behaviors were examined in prior research cited earlier in this paper. Additional behaviors were found in codes of conduct for business academics such as the Academy of Management Code of Ethical Conduct (2003) and various codes at individual institutions. Finally, additional behaviors were added based on personal experience of the authors. See Table 2 for a full list of these behaviors. Minor changes were made based on pretesting feedback.

RESULTS

Of the 713 questionnaires sent out a total of 213 were returned for a response rate of 30%. Survey respondents were representative of universities with a broad range of enrollment sizes and

AACSB accreditation status. Some universities were public and others private, and some had codes of ethics while others did not, and deans from both American and Canadian universities responded. The survey was sent to deans, but the cover letter asked them to forward the survey to the individual most likely to have knowledge of faculty activities if not them. Of the 192 respondents, there were 164 deans, 16 chairs and 12 directors. Almost all respondents had taught and conducted research prior to their administrative role. Some continued to teach and publish in their administrative capacity. Details on the responding universities are included in Table 1.

Table 1: Demographics of Respondent Universities

AACSB Accreditation Status		University Affiliation	
Not accredited, non-candidate	20%	Public	73%
Candidate for accreditation	20%	Private secular	10%
Accredited	33%	Private Catholic	9%
Accredited with Accounting Accreditation	27%	Private other religious	9%

Because there are not well-established guidelines for faculty behavior, yet deans are responsible for activities within their colleges, a helpful start might be gathering information about the most problematic behaviors. To determine which behaviors administrators need to focus on, behaviors with the highest means on ethical implication need to be identified. Table 2 provides the response means in each of the three focus areas for the ethical implication of each behavior in the questionnaire, ranked from highest to lowest. In the area of teaching, the five behaviors determined to be of the highest ethical implication were the following: do not police or enforce academic integrity standards; frequently come to class unprepared; do not communicate to students the grading criteria; refuse to participate in day-to-day tasks of departmental life, such as paperwork, departmental meetings, accreditation, etc.; and, advise students incompetently/incorrectly.

Table 2: Ethical Implication of Faculty Behaviors

Teaching	Mean	Std. Dev.
Do not police or enforce academic integrity standards	2.58	0.546
Frequently come to class unprepared	2.39	0.734
Do not communicate to students the grading criteria	2.34	0.717
Refuse to participate in day-to-day tasks of departmental life, such as paperwork, departmental meetings, accreditation, etc.	2.15	0.803
Advise students incompetently/incorrectly	2.14	0.749
Fail to keep scheduled office hours/appointments	2.08	0.732
Do not return graded exams	2.04	0.806

Table 2: Ethical Implication of Faculty Behaviors		
Create a negative classroom environment	1.97	0.704
Use recycled exams that have been previously released to students	1.96	0.734
Return papers with a grade but no specific feedback	1.74	0.717
Use only subjectively graded assignments for an entire course grade	1.44	0.686
Research		
Falsify data in research projects	2.99	0.073
Plagiarize significant blocks of text	2.99	0.103
Abuse organizational resources for personal consulting	2.79	0.418
Referee papers unfairly or with bias	2.76	0.472
Receive joint authorship of a paper without making a material contribution	2.61	0.567
Simultaneously submit identical articles to two or more journals	2.52	0.590
Allow consulting activities to lead to a neglect of teaching	2.52	0.648
Make personal consulting activities a priority over organizational missions and objectives	2.51	0.640
Sell complementary textbooks for cash	2.31	0.737
Use poor research methodology/lack of attention to detail	1.83	0.680
Relationships		
Violate the confidentiality of research subjects/organizations	2.93	0.261
Violate the confidentiality of students' personal information	2.90	0.323
Accept money from students	2.88	0.326
Treat students or colleagues differently on the basis of sexual orientation	2.77	0.509
Develop consensual intimate relationships with undergraduate students	2.73	0.521
Develop consensual intimate relationships with graduate students	2.64	0.581
Abuse the time of graduate students	2.45	0.646
Gossip about colleagues/administrators to achieve political ends or participate in departmental feuding	2.32	0.695
Openly discuss with colleagues the poor performance of a particular student	2.14	0.616
Accept gifts of value below $25 from students	2.14	0.727
Hire a student who is enrolled in a current class to baby-sit for their children	2.09	0.697

In the area of research and professional activities, the five behaviors determined to be of the highest ethical implication were these: falsify data in research projects; plagiarize significant blocks of text; abuse organizational resources for personal consulting; referee papers unfairly or with bias; and, receive joint authorship of a paper without making a material contribution. In the area of relationships the five behaviors with the highest ethical implication were the following: violate the confidentiality of research subjects/organizations; violate the confidentiality of students' personal information; accept money from students; treat students or colleagues differently on the basis of sexual orientation; and develop consensual intimate relationships with undergraduate students.

Overall, the five behaviors that had the highest means on a 3-point scale across all three foci were these: falsify data in research projects (2.99); plagiarize significant blocks of text (2.99); violate the confidentiality of research subjects/organizations (2.93); violate the confidentiality of students' personal information (2.90); and, accept money from students (2.88). These behaviors also exhibited the greatest respondent consensus, with standard deviations ranging from 0.073 to 0.326. Each had no respondents, or close to no respondents, selecting "not an ethical problem." Only 0.5% - 12% of deans selected "maybe an ethical problem" for the five behaviors, while the substantial majority selected "definitely an ethical problem." Clearly, these behaviors are of most concern to deans in considering unethical faculty behavior, thus policies or other communications should emphasize these issues.

Interestingly, many of the behaviors with the lowest means related to teaching conduct. The five behaviors that had the lowest means across all three foci were to using only subjectively graded assignments for an entire course grade; returning papers with a grade but no specific feedback; using poor research methodology/lack attention to detail; recycling exams that have been previously released to students; and creating a negative classroom environment. These five behaviors did not exhibit the consensus found in the behaviors with high means, with standard deviations of 0.689 – 0.734. It can be argued that lack of clarity on these behaviors reflects uncertainty as to whether these behaviors are unethical or simply underperformance. Some would argue that failure to provide quality teaching to students is in itself unethical, but others differentiate between poor performance and unethical conduct.

Perceived frequency of the 32 behaviors on a 5-point scale is outlined in Table 3. In teaching, the three behaviors that are deemed to happen most frequently are returning papers with a grade but no specific feedback, failing to keep scheduled office hours/appointments, and using only subjectively graded assignments for an entire course grade. In research and professional activities the behaviors which seem to occur most frequently are selling complementary textbooks for cash, using poor research methodology/lack attention to detail, and allowing consulting activities to lead to a neglect of teaching. In the category of relationships, the behaviors believed to happen most frequently are gossiping about colleagues/administrators to achieve political ends or participate in departmental feuding, openly discussing with colleagues the poor performance of a particular student, and abusing the time of graduate students.

In an effort to identify behaviors which are perceived by administrators to be high in both implication and frequency the means on both measures were ranked overall and within each of the three categories of behaviors. Table 3, which lists behaviors in order of frequency within each focus, also shows the deans' rankings of the five most unethical behaviors in each category as well as the top ten overall. In the teaching category, the expected inverse relationship between implication and frequency generally holds. However, the exception is that faculty frequently fail to enforce academic integrity standards, yet this is considered the most unethical teaching behavior in the list. In the research and professional activities category, the inverse relationship exists as well, with the exception of the high ranking, both in frequency and implication, of the abuse of organizational resources for personal consulting. When it came to behaviors in relationships, there were two behaviors ranking high in both dimensions: violating the confidentiality of students' personal information and treating students or colleagues differently on the basis of sexual orientation.

Table 3: Frequency of Behaviors and Rank in Implication

Teaching	Freq.	Implication Rank in Group	Implication Rank Overall
Return papers with a grade but no specific feedback	2.97		
Fail to keep scheduled office hours/appointments	2.76		
Use only subjectively graded assignments for an entire course grade	2.66		
Advise students incompetently/incorrectly	2.64	5	
Refuse to participate in day-to-day tasks of departmental life, such as paperwork, departmental meetings, accreditation, etc.	2.59	4	
Create a negative classroom environment	2.45		
Do not police or enforce academic integrity standards	2.4	1	
Use recycled exams that have been previously released to students	2.33		
Do not return graded exams	2.19		
Frequently come to class unprepared	2.08		
Do not communicate to students the grading criteria	1.96	3	
Research and Professional Activities			
Sell complementary textbooks for cash	2.75		
Allow consulting activities to lead to a neglect of teaching	2.4		
Use poor research methodology/lack of attention to detail	2.4		
Make personal consulting activities a priority over organizational missions and objectives	2.39		
Receive joint authorship of a paper without making a material contribution	2.35	5	
Abuse organizational resources for personal consulting	2.28	3	6
Referee papers unfairly or with bias	2.13	4	8
Simultaneously submit identical articles to two or more journals	2.00		
Plagiarize significant blocks of text	1.63	1*	1*
Falsify data in research projects	1.58	1*	1*

Table 3: Frequency of Behaviors and Rank in Implication			
Relationships			
Gossip about colleagues/administrators to achieve political ends or participate in departmental feuding	2.99		
Openly discuss with colleagues the poor performance of a particular student	2.72		
Abuse the time of graduate students	2.19		
Treat students or colleagues differently on the basis of sexual orientation	2.11	4	7
Develop consensual intimate relationships with graduate students	1.85	10	
Violate the confidentiality of students' personal information	1.82	2	4
Hire a student who is enrolled in a current class to baby-sit for their children	1.81		
Accept gifts of value below $25 from students	1.79		
Violate the confidentiality of research subjects/organizations	1.68	1	3
Develop consensual intimate relationships with undergraduate students	1.67	5	9
Accept money from students	1.24	3	5
* tie			

In identifying administrator's perceptions of faculty behaviors the presence of a code of ethics was considered. Of the universities with codes of ethics, perceived familiarity and effectiveness were measured. Faculty familiarity with a code of ethics had a mean 2.92 on a five-point scale, and effectiveness of the code of ethics a mean of 3.01.

One way ANOVA analysis was used to examine the differences in the mean evaluation of the perceived ethical implications and behavioral frequency of respondents from universities with codes of ethics versus those without. Of the 32 behaviors postulated, 16 revealed a statistically significant difference between the perception of ethical implication by administrators from universities with codes of ethics and those without. Table 4 lists these 16 behaviors. In all but two of the 16 behaviors, the administrators from universities with codes of ethics rated the ethical implications of behaviors higher (of greater ethical implication) than those respondents from universities without codes of ethics. The first exception was violating the confidentiality of student's personal information, and the second exception was receiving joint authorship of a paper without making a material contribution. There was no statistical difference in perception of frequencies of any behaviors between the two groups.

Table 4: Oneway ANOVA Code of Ethics Versus No Code of Ethics			
Teaching	No Code Mean	Code Mean	Sig.
Advise students incompetently/incorrectly	2.02	2.29	0.02
Do not return graded exams	1.88	2.28	0.00
Return papers with a grade but no specific feedback	1.61	1.91	0.01
Use only subjectively graded assignments for an entire course grade	1.32	1.61	0.01
Use poor research methodology/lack of attention to detail	1.7	2.00	0.00
Simultaneously submit identical articles to two or more journals	2.45	2.63	0.04
Research			
Receive joint authorship of a paper without making a material contribution	2.65	2.57	0.01
Allow consulting activities to lead to a neglect of teaching	2.43	2.65	0.05
Make personal consulting activities a priority over organizational missions and objectives	2.42	2.63	0.06
Relationships			
Violate the confidentiality of research subjects/organizations	2.93	2.94	0
Violate the confidentiality of students' personal information	2.91	2.89	0.02
Gossip about colleagues/administrators to achieve political ends or participate in departmental feuding	2.23	2.48	0.01
Abuse the time of graduate students	2.35	2.57	0.01
Develop consensual intimate relationships with			
undergraduate students	2.65	2.83	0.05
Develop consensual intimate relationships with graduate students	2.56	2.76	0.04
Hire a student who is enrolled in a current class to baby-sit for their children	2.00	2.23	0.04

Finally, administrators from universities without codes of ethics identified why a code of ethics had not been adopted. Fourteen reasons were provided, and deans were asked to check all that applied. The top five reasons why a code of ethics had not been adopted were low priority (46%), unnecessary (39%), reluctance to judge behavior of others (31%), faculty are already governed by external codes (23%), and code would not alter faculty behavior (21%).

When administrators from universities without codes of ethics were asked what pressures might encourage the formation of a code of ethics, 81.5% of respondents selected lawsuits against the university or individual faculty members. AACSB accreditation, 37.1%, and politically correct thing to do, 32.3%, were the next two most common reasons selected.

DISCUSSION

Mentoring and role modeling are expected functions of university professors. In researching mentoring relationships between faculty and students, Rose (2003, 487) wrote, “the mentor with integrity is one who exhibits virtue and principled action and is thus worthy of emulation as a role model.” Indeed, she found that faculty integrity was the universal factor in the development of successful student/faculty mentoring relationships. Therefore, if deans want to guide their faculty in their role modeling positions, as well as support the ethical environment called for by the AACSB and for businesses in recent times, they must help develop a consensus on ethical expectations of faculty.

The results of this research present a number of contributions to research on management education. Just as Mintzberg (1973) asked “What do managers do?” students are likely to ask “What do academics do?” Such an evaluation would require an ethical focus linked to an academic’s function as role model. The findings on ethical implications provide a uniquely academic perspective to the link between overt versus covert behaviors by faculty and issues of ethics. This distinction is critical in teaching management as students may evaluate a faculty member’s ethics based on covert behaviors that are not generally known by deans or administrators except in extreme situations. When the implication findings are linked to the frequency findings, a number of behaviors standout as worthy of further investigation. Some of the results indicate a wide variance in opinion by administrators. Narrowing down the most important behaviors for an evaluation of ethics is an important step in focusing efforts on improvement. The results also indicate that a code of ethics has a greater impact on perceptions then behavior. In an effort to provide improvement in management education, it would appear greater evaluation is required in these areas.

The behaviors of highest concern relate to research, followed by relationships, then teaching. Plagiarism, data falsification, violations of confidentiality, accepting money from students, abusing organizational resources, treating others differently on the basis of sexual orientation, refereeing with bias, and intimate relationships with students were the behaviors considered to be definite ethical problems. These findings disagree with those of Krugman and Ferrell (1981), who found that issues of an overt nature are judged to be more unethical than those of a covert nature. Falsifying data, abusing organizational resources for personal consulting and not policing or enforcing academic integrity standards can all be covert actions. Journal submissions assume honesty in the data findings. The review process at a journal is focused on presentation and analysis of findings. There is rarely a requirement to prove the legitimacy of the findings. Findings that are significant breakthroughs in science may be replicated by other researchers and thus challenged, but the majority of research is not groundbreaking and the research is seldom replicated on the same population with all the same parameters, therefore falsifying data can be achieved with limited observation.

The use of organizational resources for personal consulting purposes can also be easily achieved without scrutiny. It is possible to use fax machines, copy machines, phones and even secretarial labor for consulting purposes without being observed and/or questioned. Indifference to academic integrity is easily hidden by not confronting questionable student behavior. Another covert means of ignoring issues of academic integrity is to overlook means to discourage academic cheating. The findings of this study indicate there is no distinction between the ethical implication of covert versus overt behaviors.

Our initial expectations of an inverse relationship between importance and frequency were generally supported, but there were a few factors found to be both frequent and important. When the behaviors that ranked highest in frequency in the three categories are compared with ethical implications, four behaviors stand out. These are failure to enforce academic integrity, abuse of resources, violating student confidentiality, and treating students and colleagues differently on account of sexual orientation.

These findings raise questions typical in quality analysis. What frequency of a particular behavior is tolerable and when should a college be concerned? The level will vary depending on the behavior. For example, 17% said failure to keep scheduled office hours happens frequently/all the time, while 10% said the same for failure to police or enforce academic integrity. Which of these is more problematic? Benchmarking across universities could shed light on how appropriate these figures are. For example, faculty refusing to participate in day-to-day tasks of departmental life was selected all the time/frequently, by 12.7% of respondents, faculty abusing organization resources for personal consulting was selected all the time/frequently by 9.1% by respondents, and faculty receiving joint authorship of a paper without making a material contribution was selected 13% of the time. Would figures of this level be tolerated in a company? What allowance should be made for the difference between academia and business or should an allowance be made at all? Is this an issue of autonomy and even academic freedom, or is it a failure to perform to minimum expectations?

Again, these findings disagree with those of Krugman and Ferrell (1981). The 12 behaviors that rated higher on both dimensions were overt (e.g. refuse to participate in day-to-day tasks of departmental life) and covert (develop consensual intimate relationships with graduate students) in nature. This may be because Krugman and Ferrell (1981) were examining the advertising industry where employees and managers have less independent time, which could mean there is less focus or emphasis on covert activities. Since academics are given more freedom in organizing their activities, this freedom may be accompanied by the expectation of self-monitoring.

While academics may view themselves as purveyors of ethical values by virtue of course content stressing ethics, research by Stevens et al. (1993) suggests academia has reason to examine the behavior of university faculty. Their research found that the rating of honesty and ethical standards of university professors was lower than that of four other professions. One possible explanation for this moderate ranking of the behavior of university professors by academics and deans is a lack of consensus among faculty as to which behaviors are acceptable and which are not, as reflected in this study. Some faculty may be crossing the line of acceptable behavior because clear guidelines have not been established.

Despite consensus exhibited in the five behaviors with the highest means, the response across the three-point rating scale for the remaining 27 behaviors showed wide differences of opinion among respondents. While all but five behaviors had a mean of ethical implication greater than two on a three-point scale, indicating the belief that these behaviors maybe an ethical problem, the standard deviations indicate wide variation in opinion across respondents. Nineteen of the behaviors had standard deviations of over 0.6. These findings suggest college of business administrators and deans perceive the proposed faculty behaviors as open to ethical interpretation rather than absolutely ethical or unethical. Such uncertainty could contribute to opportunistic behaviors.

The results indicate that the presence of a code of ethics in a college of business is helpful in creating greater awareness of the implications of behaviors but does not appear to impact frequency of such behaviors. This suggests that understanding what is and is not ethically acceptable does not necessarily alter the way academics act. This finding agrees with Trevino (1986) who pointed out the relationship between moral judgment and moral action is not yet clearly defined. It also raises the question about enforcement. According to Ferrell and Skinner (1988, 107), the "existence and enforcement of codes of ethics are associated with higher levels of ethical behavior." Business colleges may be good at writing policies or codes of ethics but not dedicated to ensuring their application. More emphasis on the importance of altering, not just identifying, unethical behavior may be required. Universities may also need to protect whistle blowers as a means of changing behaviors.

The survey identified why universities had not adopted codes of ethics. On average, the frequencies of the 32 behaviors were low indicating why administrators might argue it is a low priority, the most commonly selected reason. However, when the individual categories are examined there appears to be reason for concern. In some cases the number of respondents selecting the behavior happens frequently are notable. Over 20% of respondents believed that two of the behaviors occurs frequently, over 10% believed nine more of the behaviors occurred frequently, and for eight behaviors 5 to 10% of respondents selected frequently.

Other frequently selected reasons why universities had not adopted a code of ethics included the following: unnecessary because of legislation, policies or external codes; reluctance to judge behavior of others; and code would not alter faculty behavior. The last two reasons concur with the findings of Birch et al. (1999) who noted that universities are complicated settings for development of standardized expectations of conduct, where attempts to do so may encounter strong resistance.

Respondents indicated that codes might be adopted as a result of a lawsuit against the university or a faculty member, AACSB accreditation requirements, and political correctness. This finding, coupled with the low priority ascribed to drafting a code of ethics indicated the prevalence of a reactive rather than proactive approach to self governance. Current events in the corporate environment may encourage a change in the attitude of university administrators. There may be a growing support for improving governance standards as corporations continue to come under the critical eye of stakeholders. Further, the most recent updates of AACSB standards encourage, but do not yet require, codes of ethics. This may lead to voluntary adoption, particularly by candidate schools.

LIMITATIONS

The conclusions are based on the responding administrators' estimation of events as opposed to a direct measure of actual activities. The respondents were commenting on the activities of others, not themselves. Or they may have answered based on anecdotal discussions with peers rather than first hand knowledge. A second limitation is that the behaviors proposed did not provide context. This could have resulted in some respondents viewing a behavior differently than others due to interpretation.

CONCLUSION

College of business faculty need to clarify what constitutes an ethical problem and what does not. With the current corporate environment encouraging organizational transparency and ethical evaluation, the practice of leaving interpretation and implementation of ethical standards up to individual preference may be ineffective and leave universities open to investigation and lawsuits.

This study identifies specific behaviors that colleges of business may want to study more closely. Of particular interest would be those ranked high based on means of ethical implication and/or frequency. The presence of a code of ethics has a positive influence on raising perceptions of the ethical implication of behavior, however once a college of business has a code of ethics, it needs to concentrate on monitoring and enforcement. One way to encourage the design of an effective code of ethics and improve enforcement is to institute benchmarking. Benchmarking must be based on standards set in academia and outside the industry. Colleges of business need to track the prevalence of particular behaviors and how these behaviors are viewed and responded to by all participants. Such benchmarking would provide information on frequency of activities at an institutional level, information on enforcement and create greater awareness of the application of a code of ethics.

Further research areas stem from these findings. The view of faculty and students in the college of business using the same questionnaire would be helpful to broaden the dialogue. It would be particularly helpful to identify areas where deans and administrators, faculty and students differ and concur in their opinions. This type of comparative research has been conducted in mentoring (Campbell & Campbell, 2000) and student academic integrity (Kidwell et al, 2003). While quantitative style research would be helpful in identifying areas of interest, qualitative research could be used to capture specifics and evaluating the influence of context on perception and enforcement. Such research can further a college's effort to deliver quality education. More specific examples, such as vignettes, can be tested against respondents at varying levels of a business college to see how large a role context plays in dictating outcome. Such information may be very helpful in setting guidelines for enforcement and removing ambiguity from the discussion.

There is also need for research on effectiveness of codes of ethics in the college of business setting. What factors support enforcement and what discourages enforcement? Why are universities without codes of ethics arguing that adoption of a code of ethics is a low priority? Is this because respondent believe that frequency of inappropriate behavior is very low or is it because the stakeholder scrutiny, prevalent in the corporate domain, has not impacted academia as yet? Is this because academics believe they are effectively monitoring themselves and therefore do not need to be told how to behave?

It is essential that academia is proactive in the area of ethical standards if developing ethical leaders is a priority. If business colleges are found to be reactive rather than proactive in embracing standards, their credibility could be seriously undermined as could the effectiveness of delivering quality education. Even if a minority of university business programs are found to be lax in their application of ethical standards, they could tarnish the reputation of programs in general. Additionally, accreditation bodies that expect attention to ethics in curricula but do not extend such expectations to faculty are unlikely to be taken seriously on this issue. In order to maintain the practical component of a college of business it is in the interest of business program administrators to establish strong ethical standards, enforce the standards and differentiate their programs based on these standards.

It is tempting to view a discussion of ethics in academia as disconnected from the core process of teaching business management. However, educators certainly emphasize the creation of competitive advantage, and a good case can be made that ethical business practice generates a sustainable competitive advantage. Michael Porter (1985) argues that a differentiation strategy demands the creation of true unique value to the customer. Faculty behavior—academia's product—must send a parallel message of unique value, a value that includes strong ethical practices.

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