Volume 10, Number 2 ISSN 1544-0036

JOURNAL OF LEGAL, ETHICAL AND REGULATORY ISSUES

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Whitney Press, Inc.

Printed by Whitney Press, Inc.
PO Box 1064, Cullowhee, NC 28723
www.whitneypress.com

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LETTER FROM THE EDITORS

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THE GEORGIA ECONOMIC LOSS RULE

John Hoft, Columbus State University

ABSTRACT

The Georgia Economic Loss Rule is a common law rule that inhibits claimants from seeking tort damages for losses in disputes about the functionality of products that are traditionally remedied in contract actions. The rule arises out of a desire by the courts to maintain separation between damages for breach of contract and the more expansive damages recoverable in tort. The rule provides that absent injury to person or property, other than to a malfunctioning product itself, where the loss is a pecuniary one like loss of the value or use of the product itself or the cost of repairing it, the claimant may not sue the provider for negligence. Application of the rule limits the claimant to remedies for breach of contract or warranty. The rationale is that where only the defective product is damaged due to an inherent defect an action for recompense seeks merely the benefit of the claimant's contractual bargain. Unfortunately, the application of this rule can produce harsh results when the claimant's breach of contract claims are time barred. Several exceptions to the rule have emerged that ameliorate its sometimes harsh effect. This paper will explore the rule, its rationale, and its limitations in Georgia.

INTRODUCTION

In the early 1970's, Mr. Nick Long purchased a new General Motors automobile from the Jim Letts Oldsmobile dealership in Georgia. The engine persistently ran hot and was even blowing out the liquid in the radiator. Long returned the car to the seller for repairs on several occasions. Neither the dealership nor General Motors were able to correct the problem. After 22 months and 27,000 miles, Long alleged that the engine was completely destroyed. Long sold the car for less than its book value and sued General Motors in tort for negligently manufacturing the car and Letts for negligently failing to repair it. Long did not sue the manufacturer or seller for breach of contract or warranty. Long alleged that his compensatory damages included expenses for repairs, time lost from work, loss of use of the car while being repaired, and diminution in the value of the car due to its propensity to overheat. These kinds of compensatory general damages are typically recoverable in a tort action. The trial court, however, granted summary judgment in favor of General Motors and Letts on all of Long's negligence claims. Long appealed. The appellate court affirmed and held that the breaches of duty to produce a car that would not overheat and the duty to fix a car that does were only breaches of contract duties and that Long's lawsuit for negligent tort could not stand. The appellate court reasoned that where the only damages claimed were to the product itself, and the only loss claimed was the value or use of the thing sold or the cost of repairing it, and there was no

accident and no physical damage to person or other property caused by the defective item, that such losses were only pecuniary and were not entitled to protection from mere negligence. The court explained that the breach of duties alleged by Long arose solely from the automobile contract and therefore Long's claim amounted to a breach of contract and not a viable claim for negligence (Long v. Jim Letts Oldsmobile, Inc., 1975).

This case illustrates the application of the Economic Loss Rule in Georgia. The decision reinforced the dichotomy between that which is actionable in tort with its attendant damages and that which is actionable in contract with damages that are limited and not as expansive as tort damages. This paper will explore the Georgia Economic Loss Rule and its impact on the recovery of damages in products and services cases.

TORT AND CONTRACT

In Georgia "A tort is the unlawful violation of a private legal right other than a mere breach of contract, express or implied" (Ga. Code: Torts – General Provisions, 1933). The terms "tort" and "trespass" are interchangeable (Southern Ry. Co. v. City of Rome, 1934). A tort is a legal wrong committed upon the person or property of another independently of contract (Rawls Bros. Co. v. Paul, 1967).

On the other hand, in Georgia "A contract is an agreement between two or more parties for the doing or not doing of some specified thing" (Ga. Code: Contracts – General Provisions, 1933). An action in tort will not be permitted for a mere breach of contract, even if the breach was negligent or willful (A.L. Williams & Associates, Inc. v. Faircloth, 1989).

MEASURE OF DAMAGES DISTINGUISHED

The measure of damages for tort is different from an action based upon a contract. Tort damages have been defined in Georgia as "a pecuniary compensation or indemnity, which may be recovered in the courts by any person who has suffered loss, detriment, or injury, whether to his person, property or rights, through the unlawful act or omission or negligence of another" (Hertz & Link, 2004). The object of tort damages is to place the injured party, as far as money can do it, in the situation the party would have occupied had the wrong not been committed (Olsen & Company, Inc. v. Lunsford, 1959). Tort damages are more far reaching than damages for breach of contract. In tort, the wrongdoer is liable for all consequences which naturally flow from his wrongful act, provided only that they be not too remote (Carr & Co. v. Southern Railway Co., 1913). In fact, Georgia statutes authorize tort damages in cases "in which the entire injury is to the peace, happiness, or feelings of the plaintiff" (Ga. Code: Torts – Damages, 1987). Therefore tort damages can include compensation for mental pain and anguish and the broad measure of such mental

anguish damages is limited only by the enlightened conscience of impartial jurors (Waldrip v. Voyles, 1991).

By contrast, damages for breach of contract in Georgia are limited to those damages which arise either naturally according to the usual course of things from the breach or may reasonably have been in contemplation of both the parties at the time they entered into the contract (Stewart v. The Lanier House Company, 1885). In short, damages for breach of contract must be those that can be traced solely to the breach, must be capable of exact computation, must have arisen naturally and according to the usual course of things from such breach, and must be such as the parties contemplated as a probable result of the breach (Sanford-Brown Company v. Patent Scaffolding Company, Inc., 1945). Therefore, in a contract action no element of damages is recoverable unless it can reasonably be considered to have been within the contemplation of the parties at the time they entered into the contract. In actions in tort, however, the wrongdoer is liable for all consequences which naturally follow from his wrongful act and it is immaterial that such damages were not within the contemplation of the parties (Olsen & Company, Inc. v. Lunsford, 1959). In other words "foresight and hindsight respectively furnish the key to the question of the extent of liability in the respective fields of contract and tort." (Carr & Co. v. Southern Railway Co., 1913). In tort: "It is the unexpected, rather that the expected, that happens in the great majority of the cases of negligence" (Horwitz v. Teague, 1948). Damages in tort, then, can be higher than damages for breach of contract because of the very definite difference generally recognized by the courts between the two theories of action (Bennett v. Tucker & Pennington, 1924).

THE GEORGIA ECONOMIC LOSS RULE

The Georgia Economic Loss Rule is a judge-made rule, not a statute, which bars purchasers of goods and services from asserting negligence on the part of the provider or manufacturer as a basis upon which to recover purely economic losses caused when the goods or services are defective and fail.

In Holloman v. D. R. Horton, Inc. (1999) the Georgia Court of Appeals stated the rule thusly: "The economic loss rule provides that absent personal injury or damage to property other than to the allegedly defective product itself an action in negligence does not lie and any such cause of action may be brought only as a contract warranty action. The rationale underlying this rule is that when a defective product has resulted in the loss of the value or use of the product itself, or the cost of repairing it, the plaintiff is merely suing for the benefit of his bargain." Therefore, the economic loss rule, when applicable, bars claims for damages for such items as repair or replacement and interruption of business (Alco Standard Corporation v. Westinghouse Electric Corporation, 1992). In Bates & Associates, Inc. v. Romei (1993), a case involving services (defective shop drawings), the Georgia Court of Appeals discussed the rule in more detail and explained: "The Georgia 'economic loss rule' in essence prevents recovery in tort when a defective product has resulted in

the loss of the value or use of the thing sold or the cost of repairing it. Under such circumstances, the duty breached is generally a contractual one and the plaintiff is merely suing for the benefit of his bargain. The rule does not prevent a tort action to recover for injury to persons or to property other than the product itself, because the duty breached in such situations generally arises independent of the contract."

The purpose for the economic loss rule is to retain a separation between that which is contract-like with duties arising from agreement with attendant benefit-of-the-bargain attributes and that in which the duty is imposed by general law proscribing an unreasonable violation of the rights of others. The effort to retain a separation between contract and tort in the context of the economic loss rule has been criticized in Georgia and elsewhere. One Georgia scholar has written that the courts have been unsuccessful in drawing the line between contract and tort (Ribstein, L.E., 1979). Nevertheless, the courts of Georgia have continued to strive for the separation between contract and tort and retain the efficacy of the economic loss rule (General Electric Company v. Lowe's Home Centers, Inc., 2005).

One consequence of the economic loss rule, then, is to encourage buyers of goods and services to assure that they have adequate remedies under the contract with the seller or provider for compensation in the event the goods or services are defective. If the buyer makes a bad bargain and has failed to provide for a contractual remedy in the event the goods or services prove defective then he must absorb the loss because an action for negligence will be barred by the economic loss rule. For example, On June 1, 1996, Bernard Foster purchased a new Dodge Ram pick-up truck from a Chrysler dealership. Though the truck remained in Foster's name, Charles Busbee began using the truck exclusively in return for making the finance payments. In February 1997, the truck engine seized and stranded Busbee on the highway. Busbee sued Chrysler for the loss of use of the truck claiming that Chrysler was strictly liable in tort for selling a defective product. The court held that the economic loss rule barred Busbee's claim for loss of use of the truck. The court, citing Georgia precedent, stated: "The Georgia 'economic loss rule' in essence prevents recovery in tort when a defective product has resulted in the loss of the value or use of the thing sold, or the cost of repairing it. Such economic losses are not recoverable under strict liability or negligence theories." The new car warranty did not apply to Busbee because Foster was the record purchaser of the truck. Busbee had no remedy because the economic loss rule barred his tort action (Busbee v. Chrysler Corporation, 1999).

In another case illustrating application of the economic loss rule, Flintkote purchased a ship unloader from Draco in 1966 and used it until April, 1978, when the unloader twisted and bent. No personal injuries or damage to other property resulted from this event but the unloader was made inoperable and required $252,000 to repair it. Flintkote sued Draco for negligence in the design, fabrication and erection of the unloader and demanded damages for the repair costs and the cost of the loss of use of the unloader during the time necessary to repair it. Draco defended the claim by asserting that Flinkkote could not recover for purely economic losses in a negligence action and that

relief could only be obtained under the law of contract. The federal court applying Georgia law held that Flintkote was barred by the economic loss rule from recovering its repair costs and loss of use, purely economic losses, in tort. The statute of limitations had run on the contract and therefore Flintkote had no remedy for its losses because of the application of the economic loss rule (Flinkote Company v. Dravo Corporation, 1982).

By its very terms, the economic loss rule will not bar a negligence action against a provider of goods or services when the defective product or service causes damage to property other than the defective property itself. The consumer may recover damages in negligence for damage to other property but not the property or services provided by the defendant. For example, in a building construction case involving roof support components, the building owner sued the components manufacturer for supplying defective roof support products and for damages that those components caused to other materials comprising the building when the roof collapsed. The court held that under the economic loss rule the owner could not recover purely economic damages for the defective components supplied by the manufacturer. However, the owner was permitted to recover for damage that those defective components caused to other property comprising the building. In that case the roof of the building was damaged due to inadequate strength of the manufacturer's components and recovery would be allowed in an action sounding in negligence for economic damages associated with the repair of the roof but not for repair or replacement of the defective components themselves (Mike Bajalia, Inc. v. Amos Construction Company, Inc., 1977).

THE UNITED STATES SUPREME COURT RATIONALE

In East River Steamship Corp v. Transamerica Delaval, Inc. (1986) the United States Supreme Court decided an admiralty case sounding in tort products liability. In that case, a shipbuilder entered into a contract with Delaval to design, manufacture and supervise the installation of turbines that would be the main propulsion units for four supertankers being constructed by the shipbuilder. When the ships were put into service the turbines on all four ships malfunctioned due to design and manufacturing defects. Each supertanker's defectively designed turbine components damaged only the turbine itself. The ship-owners sued Delaval in tort for products liability for more than $8 million in damages for the cost of repairing the ships and for income lost while the ships were out of service. The issue framed by the Court was "whether a cause of action in tort is stated when a defective product purchased in a commercial transaction malfunctions, injuring only the product itself and causing purely economic loss?" A unanimous Court answered the issue "No". The Court reasoned that preserving a proper role for the law of contract precluded imposing tort liability where a defective product causes purely monetary harm. Despite decisions to the contrary in state and federal courts the Supreme Court found that the rationale for permitting tort actions for recovery of purely pecuniary losses resulting from damage only to the subject of the sales contract to be unsatisfactory. Because the harm in all such cases was only to the product itself the Court

reasoned that the resulting losses for repair costs, decreased value, and lost profits was essentially the failure of the purchaser of the product to receive the benefit of the bargain, an issue traditionally the core concern of contract law. The Court reasoned that the views held in decisions permitting tort treatment of the injury failed to account for the need to keep products liability and contract law in separate spheres and to maintain a realistic limitation on damages. The Supreme Court held that a manufacturer in a commercial relationship had no duty under either a negligence or strict products liability theory to prevent a product from injuring itself. The Court quoted from Seely v. White Motor Co. (1965), a California case, in explaining its reasoning as follows: " The distinction that the law has drawn between tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary and does not rest on the 'luck' of one plaintiff in having an accident causing physical injury. The distinction rests, rather, on an understanding of the nature of the responsibility a manufacturer must undertake in distributing his products". The Court opined that when a product injures only itself the reasons for imposing a tort duty are weak and those for leaving the party to its contractual remedies are strong. The tort concern with safety is reduced when an injury is only to the product itself. When a product injures itself the commercial user stands to lose the value of the product, risks the displeasure of its customers who find that the product does not meet their needs, or as in the case at bar, experiences increased costs in performing a service. Losses like these can be insured. The Court concluded that contract law, and the law of warranty in particular, was well suited to commercial controversies of the sort involved in the case at bar because the parties may set the terms of their own agreements. Under such circumstances, the manufacturer can restrict its liability, within limits, by disclaiming warranties or limiting remedies. In exchange, the purchaser may pay less for the product. Recovery on a warranty theory would give the ship-owners their repair costs and lost profits and would place them in the position they would have been in had the turbines functioned properly. In contrast, tort damages generally compensate the plaintiff for loss and return him to the position he occupied before the injury. A warranty action also has a built-in limitation on liability whereas a tort action could subject the manufacturer to damages of an indefinite amount. The limitation in a contract action comes from the agreement of the parties and the requirement that consequential damages, such as lost profits, be a foreseeable result of the breach (Citing Hadley v. Baxendale, (1854), which is also cited in Georgia's landmark contract damages case styled Stewart v. The Lanier House Company, (1885). In justifying its decision in a broad economic sense, the Court reasoned that permitting recovery in tort for injury only to the product itself for all foreseeable claims for purely economic loss could expose a manufacturer to liability for vast sums especially for potential claims of persons downstream who may encounter its product. Thus, concluded the Court, a separation of that which is recoverable for breach of contract and that which may be redressed in tort must be maintained.

EXCEPTIONS TO THE GEORGIA ECONOMIC LOSS RULE.

Georgia courts and federal courts applying Georgia law have recognized four common law exceptions to the economic loss rule. The exceptions permit a tort action despite the underlying contractual nature of the cases. The exceptions are identified as (a) The accident exception; (b) The negligent construction exception; (c) The negligent misrepresentation exception; and (d) Asbestos-Hazardous Product exception. These exceptions to the economic loss rule and their rationale are discussed below.

The Accident Exception.

As stated above, the essence of the economic loss rule is that claims for damages resulting from a defective product or service where the injury is solely to the product or service itself are limited to contract warranty actions and consequent damages limitations. In short, when the economic loss rule applies, warranty is the appropriate cause of action. However, where the product or service fails in a sudden and calamitous event, and even though damages result only to the product or service itself, the economic loss rule will not bar a negligence action. The rationale for this exception is that the product or service, by failing in a calamitous way, posed an unreasonable risk of injury to persons or to other property which are events traditionally redressed in a tort action. This exception in Georgia is vividly illustrated in the Georgia Supreme Court opinion in Vulcan Materials Co., Inc. v. Driltech, Inc. (1983). In this case, the defendant manufacturer supplied a drilling machine to the plaintiff buyer. During its operation, a component part in the drill fractured releasing a spray of hydraulic fluid. The fluid ignited and the drill machine burst into flames. The drill operator managed to escape without injury but the drill machine was damaged beyond repair. Despite this harrowing episode the fire caused no personal injury or damage to property other than to the drill itself. The plaintiff buyer sued the manufacturer in federal court for compensation for the loss of use of the drill under a negligence theory. The trial court decided that the negligence claim was barred by the Georgia economic loss rule because the loss was only to the product itself and no personal injury or other property damage occurred. The buyer appealed. The federal appeals court certified a question to the Georgia Supreme Court asking whether Georgia recognized an accident exception to its economic loss rule. The Georgia Supreme Court replied in the affirmative. The Georgia Supreme Court reasoned that warranty remedies were designed to provide benefit of the bargain damages to a buyer's disappointed expectations when a defect renders a product inferior or unable to adequately perform its intended function. Tort remedies, however, are more appropriate to redress product or service failure when the product or service poses an unreasonable risk of injury to persons or other property. Therefore, when the event signaling the failure of the product or service is sudden and calamitous and could have injured person or property, other than the item itself, then the economic loss rule will not bar an action sounding in tort.

The negligent construction exception.

The Georgia courts have also decided that the economic loss rule will not bar an action sounding in tort for claims for negligent building construction despite the fact that the damage is only to the building itself (Fussell v. Carl E. Jones Development Company, Inc., 1993). The rationale for this exception is that building construction negligence is an independent and common law tort that exists separately from any contract between the builder and the property owner. A negligent construction claim, then, is not grounded in contract but springs from an implied common law duty that the builder perform the construction work in accordance with industry standards. Under this rationale, then, the economic loss rule is not implicated in a building construction case and the property owner may pursue both breach of warranty and inconsistent negligence claims until complete satisfaction is obtained (Rowe v. Akin & Flanders, Inc., 1999).

The negligent misrepresentation exception.

The Georgia courts have decided unequivocally that the economic loss rule will not bar a tort claim where there is fraud or passive concealment of a material fact even though a defect only caused damage to the product or service itself and no personal injury or other property damage resulted (Holloman v. D.R. Horton, Inc., 1999). This exception has been engrafted upon the economic loss rule in Georgia even though it is not an exception to the economic loss rule as applied in other states such as neighboring Florida (Young v. W.S. Badcock Corporation, 1996). The negligent misrepresentation exception is implicated when the seller of the product or service has failed to disclose a material fact or supplies false information about the product or service that has failed due to a defect even though there is no accident and no physical damage to other property or person (Smiley v. S & J Investments, Inc., 2003). This exception is well illustrated by the case of Holloman v. D.R. Horton, Inc. (1999). In Holloman the court decided a dispute between a dissatisfied customer and a homebuilder in an action for negligent construction. The homebuyer contended that the homebuilder was aware of numerous deficiencies in the construction of the dwelling and failed to disclose these deficiencies to the buyer. The deficiencies and defects in construction related only to the dwelling itself and did not result in injury or damage to persons or other property. The homebuilder asserted that the homebuyer's negligent construction claim was barred by the economic loss rule. The court decided that the economic loss rule would not apply to this case and bar the home-buyer's claim of negligence because of the existence of the homebuilder's passive concealment of the construction defects. The court held that the homebuilder, while engaged in his profession, supplied information about the home to the buyers and owed a duty of reasonable care to them. Here, the homebuilder was charged with notice of the construction defects and his failure to disclose them to the buyers amounted to passive concealment and a breach of the duty of reasonable care. The court asserted that the misrepresentation exception to the

economic loss rule was no more than an affirmation of the principles of passive concealment or plain fraud and that the economic loss rule would not apply in the presence of passive concealment or fraud.

The Asbestos-Hazardous Product exception.

Mercer University brought a negligence property damage action against numerous defendants, including National Gypsum Company, in federal district court alleging that the defendant manufactured asbestos-containing products which were placed in Mercer's buildings and had to be removed because they posed a serious health hazard. Mercer demanded damages for the cost of removing the defendant's products from its buildings. The defendant argued that the negligence claim was barred by Georgia's economic loss rule. Application of the economic loss rule would preclude Mercer from recovering most of its damages since the defect was only to the asbestos-containing products themselves and there was no significant damage to other property or to persons. The district court held that the economic loss rule would not bar Mercer's negligence claim. The court reasoned that Mercer's claim did not involve dissatisfaction with the product because of a defect affecting the product's performance but rather involved an allegation that the presence of such products in its buildings presented an unreasonable personal health risk. The court determined that the nature of the defect complained of was not the quality of the product but was an issue of safety, possible personal injury, and a hazardous product. The court decided that contract warranty law was not suited to correct problems of hazardous products that can cause personal injuries. The court observed that tort law imposes on manufacturers a duty to produce safe products. Therefore, the court decided that the rationale for the economic loss rule was absent from this claim and that the rule would not bar claims for damages associated with hazardous products. The court also noted that courts in other states that apply the economic loss rule have uniformly held that a school's cost in removing asbestos-containing products from its buildings are recoverable in negligence actions. Although this decision was reversed on other grounds the hazardous product exception to the economic loss rule has not been addressed in any subsequent cases and the analysis made in this case is more likely than not to remain the law in Georgia (Corporation of Mercer University v. National Gypsum Company, 1986).

SUMMARY AND IMPLICATIONS

The economic loss rule provides that absent personal injury or damage to property other than to the allegedly defective product itself an action in negligence will not lie and any such cause of action may be brought only as a breach of contract warranty action. The rationale underlying this rule is that when a defective product has resulted in the loss of the value or use of the product itself, or the cost of repairing it, the plaintiff is merely suing for the benefit of his bargain. The economic

loss rule does not bar tort actions for damages for injuries to persons or other property that were caused by the defective product of service.

Parties acquiring products and contracting for services, then, must assure that adequate protections are in place in the contract for redressing damages arising out of the failure of the product or shortcomings in the rendering of the services. If the product proves to be defective and fails without causing injury to persons or other property then the purchaser will be limited to those damages contemplated by the parties at the inception of the contract. That is, damages for breach of contract. Likewise, if services are flawed and cause damages without damage to person or property then the plaintiff will be limited to only contract damages and not the expansive damages permitted in a negligence action.

The analysis made here reveals that, so far, the economic loss rule has been one of limited application in the state. However, when the rule has been applied it has shown to have had a devastating effect upon the plaintiff's case. The rule is most deadly when a defective product is out of warranty or when the contract statute of limitations has run on the defective goods or services. In such cases, negligent manufacture or negligent workmanship may be the only causes of action remaining. The economic loss rule will bar those actions where only the product or service fails without injury to person or other property. Buyers of products and clients for services understanding the remedy limitations imposed by the economic loss rule may be wise to hedge the risks for the potential costs of repair or replacement and for downtime and loss of use by acquiring insurance to compensate for such risks.

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YOU BELONG TO ME: EMPLOYER ATTEMPTS TO KEEP EMPLOYEES FROM QUITTING TO WORK FOR COMPETITORS VIA NON-COMPETE AGREEMENTS IN EMPLOYMENT CONTRACTS

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ABSTRACT

At one point in time, employees remained with one employer for most of their careers. Today, employees are more mobile and are likely to have several employers over the course of their careers. Because of this increased mobility, employers are concerned that former employees will use the knowledge and skills they learned while in the employer's service to compete with their former employer. Thus, employers are faced with the dilemma of how to protect themselves from the competition of former employees. In order to protect their interests, employers often include a covenant not to compete, also referred to as a noncompete clause, in their employment contracts. It is the authors' contention that noncompete agreements are anticompetitive and contrary to the free enterprise system. Because some state courts are hostile to noncompete agreements, some companies have found more effective ways to collect for the expense of training an employee while permitting the employee to leave and immediately compete.

INTRODUCTION

A covenant not to compete, or a noncompete agreement, is "an agreement, generally part of a contract of employment or a contract to sell a business, in which the convenantor agrees for a specific period of time and within a particular area to refrain from competition with the convenantee" (*H. Black & H.C. Black*, 1990). A covenant not to compete that is ancillary to the sale of a business is evaluated differently than one that is derived from an employment relationship because of the difference in the nature of the interests protected (*Central Water Works Supply, Inc., v. Fisher*, 1993). When the covenant is part of a contract for the sale of an ongoing business, the buyer is seeking to protect the goodwill and reputation that was purchased as part of the seller's business. In effect, the buyer is ensuring that "the former owner will not walk away from the sale with the company's customers and goodwill, leaving the buyer with an acquisition that turns out only to be chimerical" (*Central Water Works*). This type of covenant not to compete is generally

more enforceable because a purchaser of a business has more bargaining power than an ordinary employee typically has in an employer/employee relationship (*Central Water Works*; see, *Howard Johnson & Co. v. Feinstein*, 1993). While this type of covenant not to compete is widely used, it is not the focus of this article. Rather, this article will concentrate on the enforceability of covenants not to compete that are part of a contract of employment.

Covenants not to compete in employment contracts allow employers to prevent or restrict employee competition when the employer/employee relationship is terminated. Employers in a wide variety of industries frequently use these noncompete agreements to prevent former employees from using the knowledge and skills obtained during their employment to compete with their former employer. Employers believe that the knowledge and skills they impart to employees belong to the employer's business and that consequently, they should be allowed to prevent employees from using that knowledge to compete with them. In contrast, employees believe the knowledge and skills they acquire during employment belong to them and that they should be able to freely use them in future employment (Stone, 2002).

Because of the contrasting viewpoints of employers and employees, these covenants not to compete are often the subject of litigation. Although many states recognize narrowly drawn covenants not to compete, some states refuse to recognize noncompete agreements that restrain employees from working for their former employer's competitors, unless such an agreement is necessary to protect the employer's trade secrets (*Muggill v. Reuben H. Donnelley Corp.,* 1965). These states strongly favor an employee's right to freely pursue a livelihood and have strong public policies against covenants that restrain that right (see, Cal. Bus. & Prof. Code 16600-602; *Swat 24 Shreveport Bossier, Inc. v. Bond,* 2001).

STATES LIKELY NOT TO ENFORCE

California has a strict ban on covenants not to compete in employment contracts. California Business and Professions Code § 16600 states that unless an exception is provided, "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void" (Cal. Business & Prof. Code 16600-602). Business and Professions Code sections 16601 and 16602 permit broad covenants not to compete in two narrow situations: (1) where a person sells the goodwill of a business, and (2) where a partner agrees not to compete in anticipation of dissolution of a partnership. The latter sections reinforce the conclusion that covenants not to compete in contracts *other than* for sale of goodwill or dissolution of partnership are void" (*Kolani v. Gluska*, 1998).

California courts have continuously held that § 16600 represents the strong public policy of California "to ensure that every citizen shall retain the right to pursue any lawful employment and enterprise of their choice" (*Metro Traffic Control, Inc., v. Shadow Traffic Network*, 1994). "The interests of the employee in his own mobility and betterment are deemed paramount to the

competitive business interests of the employers, where neither the employee nor his new employer has committed any illegal act accompanying the employment change" (*Diodes, Inc., v. Franzen*, 1968).

In interpreting this section, California courts have invalidated covenants not to compete in employment contracts that prohibit "an employee from working for a competitor after completion of his employment or imposing a penalty if he does so, unless they are necessary to protect the employer's trade secrets" (*Muggill v. Reuben H. Donnelley Corp.,* 1965; see, *D'Sa v. Playhut, Inc.,* 2000). The courts have also held that an employer cannot require an employee to sign an employment agreement which contains an unenforceable covenant not to compete as a condition of continued employment (*Kolini v. Gluska*, 1998). If the covenant violates public policy, to require an employee to sign such an agreement as condition of employment is contrary to law (*Baker Pacific Corp. v. Suttles,* 1990).

California courts, however, have upheld narrower contractual restraints on a departing employee, such as those that prohibit a former employee from using confidential information taken from the former employer (*Kolani*, p. 260). In *Gordon v. Landau* (1958), the California Supreme Court held that if the restrictive covenant does not prevent the former employee from carrying on a business, but merely restricts his use of the employer's confidential lists to solicit customers for himself for a period of one year following termination of his employment, the agreement is valid and enforceable.

The Texas Supreme Court also favors limiting the feasibility of covenants not to compete in employment contracts even though the legislature favors their enforcement (Foss, 2003). The applicable law states "a covenant not to compete is enforceable if it ancillary to or part of an otherwise enforceable agreement at the time the agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee" (Tex. Bus. & Com. Code Ann. § 15.50a). This Act requires courts to consider neither the interests of the employee nor the general public and provides that sections 15.50 and 15.51 are "exclusive and preempt any other criteria for enforceability of a covenant not to compete or procedures and remedies in an action to enforce a covenant not to compete under common law or otherwise" (Tex. Bus. & Com. Code Ann. § 15.52).

Although the purpose of the act is to make covenants not to compete enforceable when they meet certain criteria and to provide a means to enforce those covenants (*Cardinal Health Staffing Network v. Bowen*, 2003), the Supreme Court of Texas in *Light v. Centel Cellular Co. of Texas* (1994), nevertheless struck down a covenant not to compete that appeared to meet the required criteria. In the *Light* case, the Texas Supreme Court found that the covenant not to compete was not ancillary to an otherwise enforceable agreement because the covenant was not designed to enforce the employee's consideration or return promise. In this case, the covenant was not designed to enforce the at-will employee's promise to give fourteen days' notice and provide an inventory upon

termination. The court held that if the employee had promised (which she had not) not to disclose confidential proprietary information upon termination, the covenant would have enforced the agreement and have been ancillary to the otherwise enforceable agreement (*Light*).

Louisiana also has "a strong public policy disfavoring noncompetition agreements between employers and employees" (*Swat 24 Shreveport Bossier, Inc., v. Bond*, 2001). This public policy is articulated in La. R.S. 23:921(A)(1), which states the following: "Every contract or agreement, or provision thereof, by which anyone is restrained from exercising a lawful profession, trade, or business of any kind, except as provided in this Section, shall be null and void."

The reasoning behind this restriction is that Louisiana has a "desire to prevent an individual from contractually depriving himself of the ability to support himself and consequently becoming a public burden" (*Swat 24*). Thus, noncompetition agreements are "strictly construed against the party seeking their enforcement" (*Swat 24)*. The exceptions provided for in La. R.S. 23:921 concern employer/employee relationships, corporation/shareholder relationships, partnership/partner relationships and franchise/franchisee relationships. The exception relevant to the employee/employer relationship is Subsection C which states that an employer and an employee may agree to restrict the employee "from carrying on or engaging in a business similar to that of the employer . . . within a specified parish or parishes, municipality or municipalities, or parts thereof, so long as the employer carries on a like business therein, not to exceed a period of two years from termination of employment" (Louisiana Revised Statutes 23: 921 [C]).

In *Swat 24*, the Louisiana Supreme Court interpreted "carrying on or engaging in a business similar to that of the employer" to mean that a former employee could be restrained only from opening his own competing business and from soliciting customers of the employer for his own competing business or the competing business of another. Thus, the Supreme Court nullified covenants not to compete that restrict an individual from securing employment with a competitor of his former employer.

The Louisiana legislature responded to this portion of the *Swat 24* decision by enacting an amendment to the statute which became effective in August 2003. The amendment states that "a person who becomes employed by a competing business, regardless of whether or not that person is an owner or equity interest holder of that competing business, may be deemed to be carrying on or engaging in a business similar to that of the party having a contractual right to prevent that person from competing" (see La.R.S. 23:921 [D]). "Although that language appears to legislatively overrule the *Swat 24* case, we will not apply the new version of the statute retroactively to this case. Since it affects contract rights, it makes a substantive change in the law, and therefore should have prospective application only. (*Hose Specialty & Supply Management Co. v. Guccione*, 2003). Thus, Louisiana courts have not yet applied this amendment and continue to disfavor covenants not to compete.

STATES MORE LIKELY TO ENFORCE

South Dakota allows employers and employees freedom to agree not to compete. "An employee may agree with an employer at the time of employment or at any time during his employment not to engage directly or indirectly in the same business or profession as that of his employer for any period not exceeding two years from the date of termination of the agreement and not to solicit existing customers of the employer within a specified county, city or other specified area for any period not exceeding two years from the date of termination of the agreement, if the employer continues to carry on a like business therein" (South Dakota Codified Laws §53-9-11, 2003).

Thus, in South Dakota, covenants not to compete are an exception to the "general proscriptions against restraint on trade, as long as the noncompetition agreements comport with the statutory language" (*American Rim & Brake, Inc. v. Zoellner,* 1986). If the covenant not to compete complies with the statute, the court does not inquire into the reasonableness of the covenant (*American Rim).*

While some states disfavor noncompete agreements, the general rule in Missouri is that employers do have legitimate business interest that may be protected by a covenant not to compete (Schoofs, 2001). Covenants not to compete that protect a legitimate business interest such as trade secrets and customer contacts are valid and enforceable if reasonable as to time and place (*Schmershal, Treloar & Co. v. McHugh*, 2000). Furthermore, Missouri courts have been willing to modify noncompete agreements that are overly broad. For example, in *Orchard Container Corp. v. Orchard*, (1980), the court modified the geographical area in a noncompete provision from a 200-mile radius to a 125-mile radius. This practice suggests that Missouri courts are willing to protect an employer's legitimate business interests by modifying unreasonable noncompete agreements.

"Missouri courts recognize that public policy approves employment contracts containing restrictive covenants . . . " (*Silvers, Asher, Sher & McLaren, M.D.s, Neurology, P.C. v. Batchu*, 2000). However, even Missouri courts have been unwilling to expand the types of interests that a covenant not to compete can protect. In 2000, a Missouri Court of Appeals found that maintaining a stable at-will workforce is not an interest that can be protected (*Schmershal, Treloar & Co. v. McHugh*, 2000).

Kansas courts have repeatedly recognized that covenants not to compete are valid if ancillary to any lawful contract, reasonable, and not adverse to the public welfare. Freedom of contract is the driving force behind finding such covenants enforceable (*Weber v. Tillman*, 1996). In *Weber,* the court set forth four factors to be considered in determining whether a covenant not to compete is reasonable: "(1) Does the covenant protect a legitimate business interest of the employer? (2) Does the covenant create an undue burden on the employee? (3) Is the covenant injurious to the public welfare? (4) Are the time and territorial limitations contained in the covenant reasonable?" (*Weber*).

Moreover, even if the territorial limitations are unreasonable, a Kansas court can "reduce such territory to the extent reasonably necessary to insure the contemplated protection and enforce the contract to that extent . . . "(*Weber*). "The paramount public policy is that freedom to contract is not to be interfered with lightly" (*Weber*). However, Kansas courts will not enforce a covenant not to compete if its sole purpose is to avoid ordinary competition (*Weber*).

In New York, an employer is able to restrict more post-employment activities of a former employee than in many other states. New York courts will enforce a covenant not to compete if it is reasonably limited in scope and duration, and necessary to prevent not only an employee's disclosure of trade secrets or an employee's release of confidential information regarding the employer's customers, but also "in those cases where the *employee's services to the employer are deemed special or unique"* (*Ticor Title Ins. Co. v. Cohen,* 1999).

In addition, New York courts are willing to modify an unreasonable provision in a covenant not to compete (*BDO Seidman v. Hirshberg*, 1999). "This definitely reflects the willingness of New York courts to allow employers to restrict their employees' post-termination activities" (Schoofs, 2001).

Florida is also a state which recognizes employers' right to protect their legitimate business interests. Although a covenant not to compete will be enforced only if it is supported by a legitimate business interest (*Passalacqua v. Naviant, Inc*., 2003), a Florida statute contains an expansive list of types of situations which could constitute a "legitimate business interest" (Fla. Stat. § 542.335). This list, which is not all-inclusive, includes trade secrets; valuable confidential business or professional information; substantial relationships with specific prospective or existing customers, patients, or clients; customer, patient, or client goodwill associated with an ongoing business or professional practice, a specific geographic location or a specific marketing or trade area; and extraordinary or specialized training (Fla. Stat. § 542.335[1][b]). Thus, an employer is much more likely to have a covenant not to compete enforced in Florida than in a state such as California.

PROPOSAL

Since some courts are refusing to enforce noncompetition agreements which prevent an employee from earning a living, employers are trying a different approach at recovering the cost of their investment in training employees. The term is called "cost sharing." It is still a restrictive covenant in the employment agreement, but it does not prevent the former employee from competing with the former employer. Instead, in return for receiving training from the employer, the employee agrees to work for a specified length of time. If the employee leaves before that period is completed, the employee must reimburse the former employer for its cost of training (Rives, 2005). This type of restrictive covenant was upheld by the North Carolina Supreme Court in the case of *Eastern Carolina Internal Medicine v. Faidas* (NC 2002), when it affirmed a divided appellate panel's decision affirming a trial court's order for summary judgment in favor of Eastern Carolina and

denial of a motion for a new trial by Dr. Faidas (NC App. 2002). Eastern Carolina had sued Faidas claiming breach of its employment contract with her and sought liquidated damages. Faidas claimed the liquidated damages provision was actually a covenant not to compete, which in North Carolina was against public policy (NC App). The employment contract had a cost-sharing clause that specified:

> *The parties acknowledge and agree that the practice of medicine . . . afforded Employee by Employer requires a large commitment of capital by Employer together with the undertaking by Employer of . . . long-term indebtedness and lease obligations for . . . facilities and equipment provided for Employee; . . . the recruitment by Employer of a qualified physician to replace Employee upon termination of employment is . . . an expensive process; . . . Employer will sustain economic loss [from] termination . . . of Employee and . . . absence of revenue generated by Employee to offset . . . overhead obligations of Employer. . . . Parties stipulate . . . a reasonable estimate of damages and an equitable reimbursement . . . to Employer by Employee is the Cost Share . . . .*
>
> *In the event Employee, within one year [of] termination shall . . . practice medicine in [counties of Jones, Pamlico, or Craven, North Carolina], or become employed with any practicing physician or group practice in those three counties or become employed by any hospital, clinic or other health care provider in those three counties, Employee shall pay to Employer an amount equal to the Cost Share . . . which shall be computed as follows: Total Operating Expense of Employer for the fiscal year immediately preceding the date of termination . . . as [shown] in fiscal year-end financial statements . . . shall be divided by the number of full-time physician employees of Employer during such fiscal year, and the quotient shall be multiplied by twenty-five percent with the product being the Cost Share amount* (NC App).

The appellate court found this provision was not a noncompete clause because Dr. Faidas could practice medicine immediately after termination with her former employer. Further, the court held that the liquidated damage amount was not punitive because it was based on a specific mathematical formula and the amount demanded ($109,029.04) was only 3 percent of the $3.5 million produced by Dr. Faidas in a year (NC App).

Another approach, with which the authors are familiar, was used by an insurance company in the southwestern United States in hiring recent college graduates. The employment contract acknowledged that the new hire would need some time before commissions from sold policies could provide a decent income. Therefore, the employer promised to advance sums to the new agent

against unearned commissions for the first six months. However, if the new agent resigned before the six months, he/she would owe the employer the advanced unearned commissions. To enforce this provision, a promissory note was included in the employment contract, which the new agent signed in addition to executing the contract at its end (one of the authors represented the insurance company for collection of these debts in 1978-79).

Because of the current shortage of nurses for health care positions, some hospitals are offering to rebate tuition if nursing students promise to work for the hospital for a fixed number of years upon graduation (Gaynor, 2005). The Louisiana State University (LSU) School of Medicine in New Orleans is offering a full tuition waiver, worth $50,000-$60,000, over the four-year program to ten medical students who agree to follow a rural practice. The specific parishes are known. Forty-three parishes are experiencing shortages of medical doctors. However, the students do not have to reimburse the state if they do not return to Louisiana after serving their residency to work in one of the rural parishes (Gyan, 2005).

CONCLUSION

In states where the legislature wants to permit some form of noncompete provision in employment contracts from one to two years and the state supreme court is hostile to such involuntary servitude as a violation of public policy against preventing a former employee from earning a living in his/her chosen profession and theoretically becoming a state welfare recipient, it is time to abandon the battle. North Carolina seems to have found the way with its cost-sharing formula. Another way to solve the problem is to use the promissory note. The employee is free to quit at any time, but if he/she has not worked the specified period for the employer to recover the cost of training the new employee, the employee will owe the sum specified in the employment contract and promise to pay by signing the promissory note. The employer must have a formula for proving the cost of the training and a schedule for forgiving a percentage of the cost as the employee works.

The hospitals wanting to pay tuition for nursing school students and the LSU School of Medicine should use the same system used for student loans in undergraduate colleges and universities. The students should sign a promissory note for the tuition. In regard to the nurses, if the program is a four-year degree program, for every year they work at the hospital that paid their tuition, twenty-five percent of the loan would be forgiven. Regarding the Louisiana medical students, for every year after residency that they work in one of the designated rural parishes, twenty-five percent of their tuition loan would be forgiven. Hopefully, the courts will look with favor on this method, since it allows an employee freedom to terminate at any time, but does not preclude the employee from working immediately in his/her chosen profession.

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RFID AND CONSUMER PRIVACY: LET THE BUYER BEWARE!

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ABSTRACT

"Caveat Emptor," or "Let the Buyer Beware," has long been a legal adage warning consumers of the ramifications of purchasing defective products. Until the advent of product liability laws, the consumer suffered without legal recourse when injured by dangerous products. Now, this adage can be used to warn consumers of another potential danger associated with the purchase of goods, the loss of their privacy.

The utilization of Radio Frequency Identification ("RFID") technology in the marketplace has intensified the debate and concern over consumer privacy. The ability to collect and use data through the use of RFID to market to and monitor consumers raises new questions about the consumer's ability to know about, correct and to restrict the collection and use of his or her personal data. While RFID is still an emerging technology, its many uses clearly demonstrate the potential for serious issues for consumer privacy. Currently no federal or state legislation addresses the consumer privacy issue in regard to RFID. Will existing tort privacy law be able to address the privacy issues raised by the collection, use and dissemination of consumer information? This paper considers the nature of the RFID privacy debate and reviews tort privacy law in light of its potential application to consumer suits involving privacy the collection and use of personal data.

INTRODUCTION

"Caveat Emptor," or "Let the Buyer Beware," has long been a legal adage warning consumers of the ramifications of purchasing defective products. Until the advent of product liability laws, the consumer suffered without legal recourse when injured by dangerous products. Now, this adage can be used to warn consumers of another potential danger associated with the purchase of goods, the loss of their privacy.

Radio Frequency Identification ("RFID") is the powerful new tracking technology has intensified the debate regarding consumer privacy. With RFID anything can be tracked, from consumer goods to currency to people. Such a powerful tracking device creates the potential for abuse and that should be a serious concern to consumers. While the privacy debate is not a new one, the fear of the continued loss of privacy reaches new levels with RFID because the tags do not require line of sight to be read and, moreover, data collected and stored in databases with each

reading can be combined to identify the who, what and where of consumer purchasing. This form of data collection and data mining create a reality where consumer purchases can be linked to consumer information, creating the commercial availability of personal and private information.

The applications for RFID, while still emerging, are already vast. In California, an elementary school proposed the use of RFID to track students who would wear RFID devices, called tags, in badges. The students' badges were read as they entered classrooms. In Texas, students were given badges that racked the students entering or exiting from school buses and that information was monitored by police (School RFID plan gets an F). The European Central Bank is developing a plan to embed RFID in currency making it difficult to counterfeit but also allowing law enforcement to track cash transactions (Yoshida, 2001). The Marin County District Attorneys Office uses RFID to track office files. Handheld readers are used to help locate missing files. (Swedberg, 2005a). The US State Department has developed a plan for the use of RFID in passports. Department regulations have been developed to address the privacy issues raided by the ability for passports to be read without the knowledge or consent of the owner. US passports will include a "radio shield" in the cover to allow reading of the tags only when the passport is open (Schneier, 2005). Virginia is considering embedding RFID tags into drivers' licenses. As one critic noted "FBI agents, for example, could sweep up the identities of everyone at a political meeting, protest march, gun show, or Islamic prayer service" (ACLU urges Virginia legislators). In Mexico, RFID chips have been implanted in employees of the office of the Mexican Attorney General. The use of the tags allows for the tracking of persons entering a new anticrime center (Lewis, 2004). Libraries use RFID technology to track and sort materials checked out of the library (Intellident RFID library installation). The potential uses for RFID is limited only by the imagination.

HOW DOES RFID WORK?

RFID is a technology for reading devices embedded on an object. The embedded device is referred to as a "tag" and a tag contains a chip and antennae (Radio Frequency Identification: Applications and Implications*)*.This tag can be scanned by readers via the use of radio waves which then identify the unique signal of the tag (Id). The tag can contain considerable information about the item into which it is embedded. The reader sends the information from the chip to a database that interprets the information contained with the tag. Tags can be passive, they have no power to generate a signal and must be scanned with a reader at a close range, or active, which means the tag contains a transmitter and can transmit its information greater distances (RFID-The Technology).

RFID AND THE PRIVACY DEBATE

Many in business and industry believe that the privacy concerns regarding the use of RFID are exaggerated. These advocates of RFID argue that consumers are already tracked and that

tracking allows merchants to better respond to customers. Moreover, they argue that RFID is still a relatively new and expensive technology that has yet to proven in the marketplace (Brito, 2004). For these commercial applications, RFID proponents argue that consumers will be delighted by the reduced costs they experience as a result of the utilization of RFID. Inventory and tracking control will now be so easily and tightly monitored that there will be cost savings. Every item can be identified and located eliminating unexplained inventory loss and waste (Electronic Privacy Information Center (EPIC) Privacy Page). Furthermore, proponents argue that the technology is far too expensive for extensive use and, therefore, privacy concerns are overblown (Brito, 2004).

On the other hand, opponents argue that the commercial applications for RFID represent another step in the consumer's loss of privacy in that RFID can be, and will be, utilized for purposes other than just tracking inventory. The privacy clearinghouse has published a "RFID Position Statement of Consumer Privacy and Civil Liberties Organizations' detailing the privacy concerns associated with the use of RFID. The position statement reads "…RFID has the potential to jeopardize consumer privacy, reduce or eliminate purchasing anonymity, and threaten civil liberties" (RFID Position Statement of Consumer Privacy and Civil Liberties Organizations) The position statement envisions the possibility that every physical object will have its unique identifier which can be linked to an owner. Moreover, the position of these organizations is that consumers have the right not to be tracked by purchases in the store or out. While the organizations signing on to this statement do acknowledge legitimate uses for RFID, they propose a moratorium on the use of the tags until there is an assessment made as to its implications for consumer privacy (Id).

One organization that signed onto this position statement is Consumers Against Supermarket Privacy Invasion and Numbering. The founder of this organization refers to tags as "spychips" and sees a tremendous threat to consumer privacy (Muncaster, 2005). She envisions a "society where everything could be surveilled at all times" and fears that "retailers could eventually develop databases that link consumers to every item they buy" (Garry, 2004).

US Senator Patrick Leahy has also addressed the privacy concerns associated with RFID. He states "There should be a general presumption that Americans can know when their personal information is collected, and to see, check and correct any errors." He also suggests a dialogue on the uses of and concerns associated with RFID "before the RFID genie is let fully out of its bottle" (Remarks of Senator Patrick Leahy: The Dawn of Micro Monitoring).

The Federal Trade Commission has also been active in promoting discussion about the use of RFID. At a March 2005 workshop, individuals from all effected groups met to listen, discuss and debate the use of RFID. Privacy was a major issue in the discussion. The use of RFID 'has…raised fears that this technology might be used to track individual products out of the store and into consumers' homes or otherwise monitor individual consumer behaviors" (Radio Frequency Identification: Applications and Implications). Several concerns regarding consumer privacy were identified at this workshop. A general concern involves the ability of RFID to identify specific goods with a unique identifier which would allow the increased collection of increasingly more accurate

data. Moreover, participants voiced concerns over the size of the tags. RFID tags can be minute and can remain virtually hidden from consumers. Unlike bar codes, RFID tags have the ability to communicate with a RFID reader at great distances and outside of the line of sight and this was also an expressed concern. Moreover, anyone with a reader could read the tag which could, possibly, allow for multiple readings of a tag. Workshop participants expressed a concern that this could lead to "in-store tracking and surreptitious monitoring in public places, at work and even at home" (Id.) Of special concern was the potential to link a particular item with purchaser information in a database allowing the development of a link between specific products and the consumer who purchases them. This "consumer profiling" would allow the collection of consumer data that a retailer or manufacturer could use, not only to predict purchasing behavior, but also to determine the profitability of a particular customer (Id.). However, the FTC supports self regulation by the industry rather than government regulation (Miller, 2005).

EPCglobal, associated with the organization that administers bar codes, Uniform Code Council, and an association of businesses supporting the use of RFID, take the position that business can be self regulating in this regard (Gilbert, 2004). These advocates propose that industry self regulate the use of RFID as it applies to consumer privacy through the use of specific guidelines. The guidelines provide that consumers be given notice of the use of RFID, be able to discard, remove or disable tags, be given access to information about the applications associated with RFID, and to prohibit the collection of personally identifying information, contained or stored (EPCglobal Inc., guidelines on EPC for consumer products). RFID devices can be produced in a manner that would allow them to be easily peeled off consumer goods or with blockers that would deactivate the ability to read of the tag (Cline, 2004).

FEDERAL RESPONSE TO CONSUMER PRIVACY

But is self regulation a solution to the privacy concerns? Is there a need for specific legislation aimed at controlling the collection and use of consumer information by the use of RFID? Does exiting law provide any protection for consumers?

Many turn to the US Constitution for answers regarding individual privacy rights. The 4th amendment to the Constitution provides that citizens are to be "Free of unreasonable intrusion of government into personal papers…" The 4th amendment is designed to limit government's interference into the personal affairs of citizens by requiring probable cause. However, this amendment is not applicable to non-governmental interference, not from the interference of a private nature, such as an intrusion by a commercial establishment into a consumer's privacy.

However, the federal government has dealt with the issue of consumer privacy in various areas. Several statutes put limits on the disclosure of consumer information and require the self-policing of certain industries. Some of these federal statutes include the Cable Communications Policy Act, the Video Privacy Protection Act, the Telephone Consumer Protection Act and the

Health Information Protection and Portability Act. These statutes often put the onus on the consumers to take an active role in monitoring personal data collected for errors, such as those that may occur on a credit report, and to actively pursue the correction of such errors. Most of these federal statutes also prohibit the disclosure of personal data without the consumers' prior written consent. No federal law specifically addresses such technology and privacy issues as those posed through the use of RFID.

STATES RESPONSE TO CONSUMER PRIVACY

The California Supreme Court succinctly identified the privacy concern in White v. Davis, a 1975 case involving privacy in university classrooms. In referring to the newly added privacy protection to the California Constitution, the court emphasized "The right of privacy is the right to be left alone…It prevents government and business interests from collecting and stockpiling unnecessary information about us and from misusing information gathered…" The Court also noted the major obstacles relating to the individual's ability to access records and the inability of individual's to correct or control data over which s/he has no knowledge.

California and other state legislatures have attempted to address the consumer privacy issue and bills have been introduced in various state legislatures although, to date, no state has enacted legislation protecting the collection of consumer information by use of RFID. Legislators in Missouri, South Dakota, Rhode Island, New Mexico, Virginia, Tennessee, Massachusetts and New Hampshire have also introduced legislation to address consumer privacy and the use of RFID. The bills are similar in approach in that they attempt to resolve the issue of protecting individual consumer privacy. Some legislative suggestions include: detailed labeling on products with RFID devices, the destruction of the devices upon purchase, written consent from an individual before data is collected or shared, prohibitions against using the technology to track individuals, and criminalizing the unauthorized access to information contained within a RFID device (EPCglobal Inc., guidelines on EPC for consumer products).

A proposed California bill would require labeling and express consent by the consumer to allow the collection of date (Gilbert, 2004). Moreover, the bill would require that the RFID tag be deactivated before the consumer purchasing the item left the store (Bowen seeks balance in RFID law). A Missouri bill proposes that products with RFID tags be labeled with specific language (S. B. No. 867, 92nd Missouri General Assembly). A bill introduced in Utah deals with the issue of access to the tag after purchase by unauthorized entities (Radio Frequency Identification - Right to Know Act). A proposed Colorado law would require retailers using RFID to include labels that identify a product as having a tag, and that the information contained in the tag can be read before and after purchase and that the tag, if non-essential to product operation, can be removed by the consumer (Consumer Protection and RFID Systems). An unsuccessful New Mexico bill required

the labeling and removal of tags and required businesses to inform consumers as to the personal data collected (Swedberg, 2005b).

Without legislation to guide the courts regarding the protecting of privacy in the marketplace, existing laws must be viewed in a new light to determine how successfully these laws could be utilized to allow consumers to bring litigation regarding the collection and use of private information by use of RFID.

INVASION OF PRIVACY TORTS

Civil law has long recognized the right to privacy in light of privacy invasions by non-governmental, private persons or businesses. The privacy torts have been part of the legal system for over a hundred years and allow individuals to bring civil actions against others for the harmful misuse of private information. The four torts usually categorized under the umbrella "Invasion of Privacy" are: intrusion upon seclusion, commercial appropriation, publicity given to private life and false light in the public eye. Each of these torts has specific definitions and requirements that must be met for the litigant to successful pursue her or his case. The questions of determining unreasonableness, private affairs or offensiveness as maybe required for a tort is determined on a case by case basis. The seeming vagueness of this law is intentional in that these elements of any must be viewed and molded to a variety of behaviors.

Intrusion upon seclusion is defined as "One who intentionally intrudes, physically or otherwise, upon the solitude or seclusion of another or his private affairs or concerns, is subject to liability to the other for the invasion of his privacy, if the intrusion would be highly offensive to a reasonable person" (Restatement of Law § 652B).

The Court of Appeals for the Eight Circuit tackled the issue of intrusion upon seclusion in Ruzicka Elecric and Sons, Inc. and Thomas R. Ruzicka v. International Brotherhood of Electrical Workers, Local 1, AFL-CIO (2005). As part of a labor dispute, the union hired a private investigator to monitor Mr. Ruzicka. There was testimony that the investigator entered the Ruzicka's residential property and watched and reported his family activities. The Court noted that Ruzicka built his home for privacy and seclusion and that such an attempt to maintain privacy was necessary to prevail on a action based on this tort. The Court remanded the case to the trial court for a jury determination as to whether this constituted an intrusion that was highly offensive. In Illinois, to prevail in an action based on this tort, the plaintiff must establish that the intrusion is of such a nature as to "cause anguish and suffering" (Mucklow v. John Marshall Law School (1988)).

In Medical Laboratory Management Consultants v. American Broadcasting Companies (2002), the Court of Appeals for the 9th Circuit stated that to bring a claim for intrusion upon seclusion; the party would have to demonstrate that there was an expectation of privacy in the location in which events took place. In this instance, the location was an administrative office in a medical laboratory where an interview between an employee and an undercover ABC investigator

took place. The information obtained in that interview was then broadcast nationally. The Court held that the employee's "willingness to invite these strangers into the administrative offices for a meeting and then on a tour of the premises indicated that Devaraj did not have an objectively reasonable expectation of solitude or seclusion…" Moreover, since the employee's conversations were about business operations and not personal matters, the Court determined that there was no invasion of privacy.

In an Arkansas case, the Court of Appeals for the 8th Circuit ruled that the disclosure of medical information without consent did not reach the level of "highly offensive" as required for an action based on this tort, if the information could have been obtained otherwise (Fletcher v. Price Chopper Foods of Trumann Inc. (2000)). The plaintiff is this case sued her employer for obtaining medical information about her without her authorization. Quoting a California Supreme Court case, the court stated that "The plaintiff in an invasion of privacy case must have conducted himself or herself in a manner consistent with an actual expectation of privacy" (Id.)

Another privacy tort, appropriation of name or likeness, also called commercial appropriation, is defined as "One who appropriate to his own use and benefit the name or likeness of another of another is subject to liability to the other for the invasion of his privacy" (Restatement of Law § 652C). This tort requires the use of a person's likeness or name without his or her consent and for a commercial benefit.

To prevail in an action based on this tort, the use of name or likeness must be to benefit from the value of the person's name or likeness. If there is no "unique quality or value" to the person's name or likeness, there is no violation of this tort (Allison v. Vintage Sports Plaques (1998)). A plaintiff who sat at a dog track in pubic seating and who was told that a photo of people in that area was to be used for an advertisement could not prevail on this tort. Simply appearing in the photograph without evidence as to the unique or valuable qualities of the likeness is insufficient to violate this tort (Schifano v. Greene County Greyhound Park, Inc. (1993)). There is no right to protect name or appearance unless the other party uses name or likeness to benefit in some valuable or commercial way (Restatement of Law § 652).

The tort of publicity given to private life involves "One who gives publicity to a mater concerning the private life of another is subject to liability to the other for the invasion of his privacy, if the matter publicized is of a kind that (a) would be highly offensive to a reasonable person, and (b) is not of legitimate concern to the public" (Restatement of Law § 652D)

In a Minnesota case, Phillips v. Grendahl (2002), the defendant procured financial information about the plaintiff, the equivalent to a credit report, without the plaintiff's consent and then disclosed that information to another. Plaintiff argued that the defendant's disclosure of this information to the third party invaded his privacy. However, applying state law, the court determined that disclosure of this information to a single person or a small group pf people did not constitute "publicity." Rather, to reach the level of "publicity" the private information must be communicated

to the public at large so that the information will "be regarded as substantially certain to become one of public knowledge…" (Id.)

In Illinois the information disclosed can be actionable even if made to a small number of people, if those persons have a relationship with the plaintiff and the disclosure to them would be as "devastating as a disclosure made to the public at large." (Miller v. Motorola, Inc. (1990)). In the Miller case, the employer disclosed to co-workers that the plaintiff had had a mastectomy. The case was remanded for the jury to determine whether the disclosure of those private facts was highly offensive. Furthermore, disclosure to a person who has "natural and proper interest" in knowing the information does not rise to the level of this tort (Roehrborn v. Lambert (1995)). In addition, the disclosure of private information must be offensive. In SC, a plaintiff will succeed in an action of this nature only if s/he can demonstrate mental suffering, shame and humiliation (John Doe 2 v. The Associated Press (2003)).

Last, but not least, is the tort of "False Light." Publicity placing a person in false light is defined as "One who gives publicity to a matter concerning another that places the other before the public in a false light is subject to liability to the other for the invasion of his privacy , if (a) the false light in which the other was placed would be highly offensive to a reasonable person, and (b) the actor had knowledge of or acted in reckless disregard as to the falsity of the publicized matter and the false light in which the other would be placed" (Restament of Law § 652E).

To prevail with this tort, the plaintiff must prove that the information made public is materially false (Veilleux v. National Broadcasting Company (2000)). Oklahoma law requires that the plaintiff establish that "as a reasonable man, would be justified in the eyes of the community as feeling seriously offended and aggrieved by the publicity" (Hussain v. Palmer Communications Incorporated (2003)). Moreover, the defendant in such an action must "have had a high degree of awareness of probable falsity or in fact entertained serious doubts as to the truth of the publication" (Id.) The injury suffered by the plaintiff in a suit for false light must be of a mental and emotional nature (Howard v. Antilla (2002)).

APPLICATION OF TORT LAW TO RFID AND CONSUMER PRIVACY

Lawsuits based on the privacy torts, as with all torts, place the burden on the plaintiff to identify the privacy breach that has taken place, the manner in which the breach took place and the person who acted to disclose or wrongfully use that information. Moreover, for the privacy torts to apply, the invasion must be highly offensive; in some cases the invasion of privacy must include a high degree of shame, embarrassment, humiliation and mental distress. As it stands now, these torts might well be the only basis of litigation when privacy issues come to the forefront based on the use of RFID. However, there is no precedent in these common law torts addressing a consumer arguing against a business for the invasion of privacy as it relates to collected consumer and personal information or the use of the information. To complicate the matter even more, each state would

have different outcomes for those actions because that state may not recognize some of the privacy torts or the elements of the tort may be defined differently in each state.

How then would a consumer fare in such an action against a business for the use and dissemination of RFID collected data? The first obstacle would be one of knowledge. The use of RFID could be so subtle that the consumer may not know or have access to the information that has been collected about her or him. With the potential for extensive databases linking information in various ways and on various systems, it might be impossible for a consumer to be able to identify collected information in all systems. Moreover, how does the consumer successfully argue that the use of that information constitutes an invasion of privacy tort if their name and likeness have no likeness and value? Without establishing that, the tort of appropriation would not be an option. For the torts of false light and publicity of private facts, would the disclosure of consumer information between merchants rise to the level of "public disclosure?" Could businesses argue that sharing information does not violate tort law since the businesses have a "natural and proper interest" in the information shared? With intrusion upon seclusion, could a business argue that since a consumer entered a store or business willingly there is no expectation of privacy? Will consumers be embarrassed, humiliated and shamed should some personal information be disclosed?

Moreover, should a consumer be successful in making a case based on the privacy torts, how would damages be calculated? Compensatory damages would be awarded to compensate the plaintiff for injuries that occurred as a result of the misuse of private information. On what factors, other than the emotional aspect of the invasion of privacy, could this compensation be based? Would legitimate litigation be avoided by consumers due to low recoveries? Even punitive damages, which are awarded over and above compensatory damages when the defendant's conduct is shocking and outrageous, would require the consumer to establish that the business acted in a way that was wanton and willful. Would that argument work?

CONCLUSION

Invasion of privacy tort law varies from state to state and there is no federal tort law providing national consistency. The individual's ability to sue for the collection and misuse of personal information by a business would vary in each state creating a patchwork of results. Furthermore, the remedies available, such monetary awards would be different from state to state and may be insufficient to deter use or misuse of collected information.

Clearly, the privacy torts were not developed and have not been applied with new technologies in mind. While court's can interpret and construe the torts based on the factual events of each case, precedent does not exist for consumer actions based on use and dissemination of consumer data collected by businesses. Nor do these torts address the fundamental issue of the collection of personal information. Current law is not sufficient to clearly define the privacy rights of a consumer as to the collection, use and disclosure of data nor does it provide appropriate legal

remedies for the misuse of that information. Law and technology have not been able to keep pace. Ultimately, there must be national legislation that can create consistent nationwide standards for the collection and use of information acquired through the application of RFID and the remedies available for the violations of those standards. Until that time, let the buyer beware.

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PERSONAL VALUES AND ETHICAL VIEWPOINTS OF ACCOUNTING MAJORS: HOW DO THEY COMPARE TO OTHER STUDENTS'?

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ABSTRACT

Corporate fraud and financial reporting scandals have raised significant questions about accountants' ethics and the accounting profession's ability to perform its role in reducing information risk for investors. If accountants are to regain the public's trust, business entities, professional organizations, public accounting firms, and accounting educators must all search for ways to ensure that accountants are poised to make appropriate ethical choices even in difficult situations. A myriad of factors can affect an individual's ethical choices. The more that is understood about these influences the better the profession can prepare accountants to face ethical challenges. This study seeks to provide information regarding the personal values of accounting students compared to those of other students and the relationship of those values to ethical choices. A total of 142 students from one Midwestern state university completed the Schwartz (1992) values inventory. The participants also evaluated the actions of individuals in four ethical dilemma scenarios. Accounting majors were found to differ significantly from the nonaccounting majors on four of ten values: power, security, self-direction, and universalism. In addition, the accounting majors exhibited statistically higher disapproval of the unethical actions than the nonaccounting majors, for all four scenarios. Significant correlations of values to the ethical dilemma evaluations were found for three of the four scenarios.

INTRODUCTION

In the aftermath of the latest corporate financial reporting frauds and audit failures, concern over ethics in business has escalated. The public is demanding more oversight and accountability, particularly for accountants and the audit function, and many business schools are under increased scrutiny in regard to their coverage of ethics in the curriculum. Reducing instances of corporate malfeasance, however, requires an understanding of what drives this behavior. Until that understanding is obtained, it is difficult to determine the most effective means to improving the situation. Is the solution increased ethics education, more extensive laws and regulations, or better recruitment and screening for financial positions?

It has long been posited that individuals' values drive them to act ethically or unethically in pursuit of their goals, but extant empirical research to date is inconclusive as to the nature of the relationship between values and ethical behaviors. One theory of values that has been validated cross-culturally is that of Schwartz (1992). This study seeks to apply the Schwartz value theory together with student reactions to a series of ethical dilemmas in order to determine in what ways the students' reactions to the dilemmas are associated with their personal values. In addition, this study seeks to determine if accounting majors differ significantly from other business majors and nonbusiness majors in what they value and in their reactions to the ethical dilemmas. A deeper understanding of these issues should provide information as to the best approach to improving the ethical climate in business.

RELEVANT PRIOR RESEARCH

Personal values represent those things that are significant to individuals in their lives (Bardi and Schwartz, 2003). As such, values serve as a motivator of behavior, at both conscious and subconscious levels. That is, a person may act in ways that are driven by his or her values, even though that individual is not overtly thinking about those values. This association of values and behavior should encompass all settings, such as work, home, and relationships (Bardi and Schwartz, 2003). In addition, an individual's values tend to remain stable throughout adulthood (Bardi and Schwartz, 2003). Therefore, an individual's values should have a very robust influence on his or her life. While various values measurement scales exist, one that has been extensively tested and validated across cultures is the Schwartz (1992) scale. The Schwartz theory of values suggests that there are 10 general values that represent a range of motivations underlying those values and that those general values are relatively constant across many cultures. These values are described in Exhibit One. Each of the ten values will vary in importance across individuals, but the relationships among values have been shown to be fairly robust (Schwartz and Boehnke, 2004; Bardi and Schwartz, 2003; Struch et al., 2002; Schwartz and Bardi, 2001; Schwartz and Sagiv, 1995; Schwartz, 1994). For instance, conformity and tradition values tend to motivate similar behaviors, whereas hedonism or stimulation might motivate behaviors that would conflict with those motivated by conformity and tradition. Likewise, the power value would be expected to conflict with actions motivated by the universalism value. Behaviors motivated by benevolence would conflict with behaviors motivated by achievement, but not with actions motivated by universalism. However, the value-behavior relationship is not necessarily a one-to-one relationship. An individual's combination of values importance will motivate his or her behavior, with the impact of any one value varying by situation. Therefore, examining these relationships in a variety of scenarios is important to better understanding behavior motivation.

Exhibit One: Schwartz's (1992) 10 Broad Values Described	
Value	Description
Achievement	Striving for personal success, ambition, demonstrating competence
Benevolence	Concern about the welfare of others, being helpful, loyal and responsible
Conformity	Desire to follow societal norms, exhibiting self-discipline, being obedient
Hedonism	Wanting to enjoy life and seek pleasure for oneself
Power	Attainment of social status, authority, wealth, control over others
Security	Feeling secure in personal safety, family security and national security
Self-Direction	Having the freedom to explore, create, and choose one's own goals
Stimulation	Desire for excitement and variety in life
Tradition	Holding a respect for cultural or religious traditions
Universalism	Concern with social justice, peace, the environment and the welfare of all people

Extant empirical work examining the values of accounting majors is limited and has utilized differing values scales. Using the Rokeach values survey (Rokeach, 1973), Baker (1976) compared the values of accounting majors against students majoring in other subjects and found a statistical difference on eight values out of 36 values examined. Baker reported that accounting majors valued family security, being ambitious, being clean, being responsible, and having a comfortable life more than the nonaccounting majors in the sample. The accounting majors valued wisdom, being imaginative, and having a world of beauty lower than the students majoring in other subjects. Giacomino and Akers (1998) used the Schwartz (1992) scale and found that accounting majors differed statistically from nonaccounting majors on five of the 10 broad values and on 13 of the 56 individual scale items. In their study, the accounting majors scored lower than nonaccounting students on the power, stimulation, self-direction, achievement and hedonism values. Baird et al. (2006) also found that accounting majors scored significantly lower than other majors on power, stimulation and self-direction (one exception was that finance majors scored slightly lower on self-direction than the accounting majors), but not on achievement or hedonism. The authors also found that accounting majors scored lower on the tradition value than students in other majors.

Much has been written about business ethics (see Ford and Richardson, 1994; Low et al., 2000, and O'Fallon and Butterfield, 2005), but much is left to be learned through empirical study. Within the business ethics literature, researchers have examined the reactions of individuals to unethical actions taken by others by eliciting their reactions to written scenarios. Certain of these studies have examined the differences in the reactions of individuals choosing different academic majors, with quite mixed results. For example, Hawkins and Cocanougher (1972) reported that students majoring in business subjects were generally more accepting of unethical business practices than were students majoring in nonbusiness subjects. Similarly, Arrington and Reckers (1985) reported that business students reacted more favorably than nonbusiness students to actions

involving tax evasion. The opposite results were reported by Knotts et al. (2000), with business students being more critical of the unethical actions than the nonbusiness students. Lopez et al. (2005) found that formal business education decreased tolerance for unethical behavior and that significant differences existed among business majors based on their specific area of study. Beltramini et al. (1984) found significant differences in ethical concerns of business majors compared to nonbusiness majors on half of the issues they examined, with the business majors indicating a greater level of concern about the ethical issues. Goodman and Crawford (1974) and Curren and Harich (1996), in contrast, found no statistical differences in the ethical judgments of business majors compared to nonbusiness majors. Barnett et al. (1994) and Laczniak and Inderrieden (1987) also compared ethical judgments of students in different majors and found no significant differences. McNichols and Zimmerer (1985) found differences in business majors and nonbusiness majors on some items, but their results were mixed. Fulmer and Cargile (1987) looked specifically at accounting students versus other students and found that the accountants reacted more ethically to the scenarios than other business students, but that they did not ultimately make more ethical choices. Baird et al. (2006) also found a significant difference in the ethical reactions of students by academic major, with accountants exhibiting the most ethical choices. Giacomino (1992) found no statistical differences in the ethical reactions or choices of accounting majors and other business majors.

Studies examining the link between ethical judgments and individuals' underlying values have been limited and have provided mixed results. Many of these studies have focused on the values structures of idealism and relativism and their impact on ethical decision making (O'Fallon and Butterfield, 2005). In general, these studies tend to report that idealism, in comparison to relativism, is associated with more ethical decisions or more ethical awareness (O'Fallon and Butterfield, 2005). For example, both Sparks and Hunt (1998) and Yetmar and Eastman (2000) found a negative relationship between relativism and ethical awareness. Singhapakdi et al. (2000) reported that relativism was negatively correlated with managers' ethical intentions while idealism was positively associated with ethical intentions. Other studies also provide some evidence of a link between values and ethical judgments. For example, Trivedi et al. (2003) found a statistically significant association between personal values, moral reasoning, and tax law compliance decisions. They reported that altruistic individuals are more likely to comply with the tax law than competitive individuals. Donoho et al. (2003) found that achievement-oriented individuals were less inclined to be critical of unethical sales-related behaviors than relationship-oriented individuals. Nonis and Swift (2001), in contrast, reported that the individuals they labeled as "nondriven" based on their values survey were more inclined to make unethical decisions than other types of individuals. Terpstra et al. (1993) found that the more competitive individuals were, the more likely they were to engage in insider trading. Barnett and Karson (1987) found that values could predict ethical behaviors in some scenarios, but not in others. Not all studies, however, have found a correlation between values and actions. Brief et al. (1996) found no significant relationship between managers' personal values and their decisions related to misrepresentation of financial statements.

In summary, the literature theorizes that values drive behavior, and this relationship has been supported in some empirical ethics studies, but not in others. Studies examining values and ethical perceptions of business students compared to nonbusiness students generally reported significant differences between the two groups. The limited studies comparing accounting majors to others provided mixed results. The current study seeks to add to this body of knowledge by using the Schwartz (1992) values inventory to examine differences in values of accountants compared to other academic majors, using ethical scenarios to compare accountants' reactions to those of other students, and examining the relationship between the values and the ethical reactions.

METHOD

For this study, all data were collected at one Midwestern state university in the United States. Questionnaires were administered in five classes: Advanced Accounting, Accounting Information Systems (two sections), Introduction to Physical Geography, and United States Government. The questionnaires were completed in a controlled environment in the classroom, with at least one of the researchers present. The students participated voluntarily and their anonymity was maintained.

Each questionnaire included instructions, a series of four ethical scenarios, the Schwartz (1992) values inventory, and questions eliciting demographic information. The ethical scenarios are illustrated in Exhibit Two. Following the reading of each scenario, the subjects reacted to a statement of agreement with the action illustrated in the scenario, using a seven-point Likert-type scale. A rating of seven signified complete agreement with the action taken and a one represented complete disagreement with the action.

The Schwartz (1992) values scale is comprised of 56 values, which are bifurcated into two lists (30 on one and 26 on the other). The first list includes values that are considered "terminal" values, because they are stated as nouns. The second list includes "instrumental" values, which are stated as adjectives. For example, "equality" is a terminal value, while "loyal" is an instrumental value. The subjects were instructed to react to each value, utilizing a Likert type scale which ranged from -1 (opposed to my values) to 7 (of extreme importance). From the individual value ratings, 45 of the 56 values were used to construct ten broad values developed by Schwartz (1992). The broad values were described in Exhibit One. Strong internal validity and cross-cultural applicability have been found for the 10 value scores (Schwartz and Boehnke, 2004; Bardi and Schwartz, 2003). Value scores are calculated by taking the average of the ratings for the variables that comprise the value. For example, a conformity score is calculated by taking the average of the ratings for politeness, obedience, self-discipline, and honoring parents and elders. The demographic inquiries on the survey included the student's academic major, gender, year in college (i.e. freshman), and prospective career field.

Exhibit Two: Ethical Scenarios
Scenario One
David works for a consulting firm, and his job requires that he travel out of town approximately 50 percent of the time. His company's expense policy allows him to be reimbursed for the actual cost of meals when traveling, up to $40 per day. Most of the employees David knows claim the full $40 per day, no matter how much they really spend. He is not required to turn in receipts for meal costs. He just returned from a trip to Chicago, during which his client provided him free meals in the company cafeteria. He submitted his expense report claiming the full $40 per day meal allowance.
Scenario Two
James is an assistant manager for a Pub style restaurant and bar. On week nights, James is in charge of closing up the restaurant at 1:00 a.m. The restaurant stops serving food at 10:00 p.m. but serves drinks until closing time. The restaurant typically has little business on week nights after 11:00 p.m., so James is the only employee scheduled to work between 11:00 p.m. and 1:00 a.m. on Monday, Tuesday, and Wednesday nights. Since he is there alone, James often closes the restaurant early (sometimes as early as 11:30) when there are no customers, but he reports his full shift hours on his time sheet to his boss.
Scenario Three
Joe is an accountant for a medium-sized manufacturing company. The company is in the process of trying to get new investors so that it can expand its operations. The company's goal is to raise $20 million. Joe's boss, Tim, is anxious to show an increased profit for the current year so that the company will look attractive to potential investors. Tim asked Joe to delay the recording of some large consulting and repair bills until next year, even though this practice is illegal because it violates accounting rules. Failing to report the costs will improve the current year's profits by 20 percent. Joe knows how important the new financing is for the company's success, so he agrees not to record the costs until the following year.
Scenario Four
Tom works for a pharmaceutical company. His company has just finished testing a new antibiotic that is much more effective and has fewer side effects than anything the competition sells. Projections show that this new product could more than triple the company's current sales and dramatically increase the company's stock price. The company is set to announce the new product in one week, but until then all employees have been asked to keep the news strictly confidential. Tom has a friend who has just lost his job and is afraid he may be unemployed for some time. Tom tells his friend about the new drug and encourages him to buy as much stock in the company as he can before the announcement, so that he can make money by selling the stock after the announcement is made. Tom knows that what he is doing violates insider trading laws but his friend really needs the money.

HYPOTHESES

The first hypothesis examines whether ethical choices vary by academic major. As previously discussed, extant research has provided inconsistent results. However, those results do suggest that students choosing different academic majors may react differently to at least some ethical scenarios. The limited research comparing accounting majors to other majors indicates that

accountants may present more ethical views than nonaccountants. This could be explained by both the role of accountants as "watch dogs" and the corresponding emphasis within accounting curriculums on ethics and professional responsibilities. Therefore, it is posited that the accounting majors will rate the scenarios as more unethical compared to the nonaccounting majors (accountants will have lower rating scores). For all analyses, nonaccounting majors are divided into those who are majoring in other business subjects and those who are majoring in areas outside of business, such as the sciences or the arts. This hypothesis will be tested as four separate sub-hypotheses, as follows:

H1a: Accounting majors will have statistically lower ratings for scenario one than will other business majors and nonbusiness majors.

H1b: Accounting majors will have statistically lower ratings for scenario two than will other business majors and nonbusiness majors.

H1c: Accounting majors will have statistically lower ratings for scenario three than will other business majors and nonbusiness majors.

H1d: Accounting majors will have statistically lower ratings for scenario four than will other business majors and nonbusiness majors.

Baird et al. (2006), Giacomino and Akers (1998), and Baker (1976) all reported differences in the personal values of accounting majors as compared to nonaccountants. To the extent that values may drive ethical choices, a deeper understanding of those differences across a variety of samples may aid in understanding how to improve ethical choices in business. However, knowledge to date is not adequate to predict the nature of the differences at this point. Therefore, the second hypothesis is exploratory in nature and posits that:

H2: Value ratings will differ significantly among accounting majors, other business majors, and nonbusiness majors.

The third hypothesis examines whether there is a correlation between personal values and ethical choices. The Schwartz (1992) theory predicts that values drive behaviors. Prior research on business ethics has reported varying associations between personal values and ethical choices (e.g. Baird et. al, 2006; Nonis and Swift, 2001; Donoho et al., 2003; Trivedi et al. 2003). Therefore, it is hypothesized that there will be significant correlations between scores on the ten general values and the ethical scenario ratings. Because of the complexity of the interplay of scenarios, values, and ethical choices, no specific relationships are predicted. Rather, this study seeks to determine what

relationships, if any, exist between the students' personal values and their views of the actions taken in the four scenarios. Therefore, the third hypothesis is:

H3: Personal values scores will be significantly correlated with scenario ratings.

RESULTS

In total, 146 questionnaires were distributed, and all were returned. Four of the surveys were substantially incomplete and were dropped from the study, leaving 142 subjects. Slightly more than half of the students (73) were accounting majors while 68 students majored in other subjects (one student did not list a major). Of the 68 non-accountants, there were 21 students majoring in other business subjects and 47 students majoring in nonbusiness subjects. Seventy-eight of the students were males (55 percent) while 62 (44 percent) were females. Two students did not provide gender information. As to academic classification, 51 of the students were seniors, 47 were juniors, 17 were sophomores, and 26 were freshman. One student did not provide his academic year.

As can be seen in Table One, the accounting majors, on average, agreed less with the actions taken in all four scenarios than the other business majors and nonbusiness majors. Since the scenarios were all designed to represent unethical actions, a lower rating indicates a more ethical reaction.

Table One: Descriptive Statistics: Scenario Ratings

Group	Scenario1	Scenario2	Scenario3	Scenario4
Accounting Majors				
Mean Rating	2.890	1.680	1.420	1.960
Standard Deviation	1.420	0.896	1.040	1.230
Other Business Majors				
Mean Rating	3.480	2.140	2.190	2.900
Standard Deviation	1.806	1.108	1.470	1.609
Nonbusiness Majors				
Mean Rating	3.720	2.230	2.400	3.360
Standard Deviation	1.850	1.433	1.346	1.983

An Analysis of Variance (ANOVA) was run for each scenario, with the scenario rating as the dependent variable and academic major (accounting, other business, nonbusiness) as the

independent variable. These results are summarized in Table Two. The ANOVA results indicate the differences are significant at the .05 level for all four scenarios. Therefore, all four sub-hypotheses for hypothesis one are supported.

Table Two: ANOVA Results: Scenario Ratings						
Scenario		Sum of Squares	Df	Mean Square	F	P-Value
Scenario 1	Between Groups	21.043	2	10.521	3.948	.022
	Within Groups	367.766	138	2.665		
	Total	388.809	140			
Scenario 2	Between Groups	9.675	2	4.838	3.777	.025
	Within Groups	176.750	138	1.281		
	Total	186.426	140			
Scenario 3	Between Groups	30.047	2	15.023	10.143	.000
	Within Groups	204.393	138	1.481		
	Total	234.440	140			
Scenario 4	Between Groups	59.073	2	29.536	11.934	.000
	Within Groups	341.537	138	2.475		
	Total	400.610	140			

Hypothesis two posited that students majoring in different subjects would hold different values. The mean value scores by academic major are shown in Table Three. Interestingly, the accounting majors scored lower than the nonbusiness majors on every value except power. The accounting majors scored lower than the other business majors on every value except benevolence and conformity.

Analysis of Variance results indicate significant differences, at the .05 level, for the following values: power, security, self-direction, and universalism. At the .10 significance level, the values of stimulation and tradition would also be significant. These results are summarized in Table Four.

Hypothesis three posited that the individuals' personal values would be correlated to their reactions to the ethical dilemmas. The statistical results are shown in Table Five. For scenario one, the ratings were significantly and positively correlated with power and negatively correlated with benevolence. That is, the higher the subjects scored on power, the more they agreed with the action taken in the scenario, but the higher they scored on benevolence, the less they agreed with the action taken in the scenario. For scenario two, there were no significant correlations.

For scenario three, a significant positive correlation was found for hedonism. The higher individuals scored on hedonism, the more they agreed with the action taken in the scenario. For the fourth scenario, there was a significant positive correlation for hedonism. Therefore, the more an individual values pleasure in life the more acceptable he or she found the action in the scenario.

Table Three: Mean Value Scores by Academic Major			
Value	Accounting Majors	Other Business Majors	Nonbusiness Majors
Achievement	5.3801	5.5476	5.5000
Benevolence	5.6877	5.6095	5.8696
Conformity	5.1678	5.0833	5.3696
Hedonism	5.2123	5.5238	5.4457
Power	3.5616	4.2500	3.1467
Security	4.9096	5.3048	5.2783
Self-direction	4.9068	5.0952	5.4174
Stimulation	4.3288	4.9683	4.7101
Tradition	4.3068	4.4762	4.7217
Universalism	4.4212	4.7262	5.1603

Table Four: ANOVA Results: Values						
Value		Sum of Squares	Df	Mean Square	F	P-Value
Achievement	Between Groups	.729	2	.364	.472	.624
	Within Groups	106.461	138	.771		
	Total	107.190	140			
Benevolence	Between Groups	1.327	2	.664	1.119	.330
	Within Groups	81.254	137	.593		
	Total	82.581	139			
Conformity	Between Groups	1.912	2	.956	.992	.374
	Within Groups	133.025	138	.964		
	Total	134.936	140			
Hedonism	Between Groups	2.229	2	1.114	.802	.450
	Within Groups	191.686	138	1.389		
	Total	193.915	140			

Table Four: ANOVA Results: Values						
Value		Sum of Squares	Df	Mean Square	F	P-Value
Power	Between Groups	17.595	2	8.797	5.458	.005
	Within Groups	222.417	138	1.612		
	Total	240.012	140			
Security	Between Groups	4.835	2	2.417	3.438	.035
	Within Groups	97.035	138	.703		
	Total	101.870	140			
Self-direction	Between Groups	7.569	2	3.785	4.728	.010
	Within Groups	110.475	138	.801		
	Total	118.044	140			
Stimulation	Between Groups	8.769	2	4.384	2.807	.064
	Within Groups	215.564	138	1.562		
	Total	224.333	140			
Tradition	Between Groups	5.063	2	2.532	2.497	.086
	Within Groups	139.919	138	1.014		
	Total	144.982	140			
Universalism	Between Groups	16.499	2	8.249	7.017	.001
	Within Groups	162.248	138	1.176		
	Total	178.747	140			

Table Five: Correlations of Scenario Ratings to Personal Values Scores					
		Scenario 1	Scenario 2	Scenario 3	Scenario 4
Achievement	Pearson Correlation	.001	-.014	-.071	.014
	Sig. (2-tailed)	.994	.867	.398	.869
Benevolence	Pearson Correlation	-.195(*)	-.118	-.133	-.055
	Sig. (2-tailed)	.021	.162	.117	.517
Conformity	Pearson Correlation	-.070	-.111	-.134	-.064
	Sig. (2-tailed)	.410	.187	.111	.451
Hedonism	Pearson Correlation	.136	.058	.200(*)	.174(*)
	Sig. (2-tailed)	.106	.496	.017	.039

Table Five: Correlations of Scenario Ratings to Personal Values Scores

		Scenario 1	Scenario 2	Scenario 3	Scenario 4
Power	Pearson Correlation	.236(*)	.058	-.004	.044
	Sig. (2-tailed)	.005	.493	.962	.607
Security	Pearson Correlation	.112	.017	.074	.093
	Sig. (2-tailed)	.111	.761	.806	.502
Self-direction	Pearson Correlation	.035	.031	-.017	.065
	Sig. (2-tailed)	.676	.710	.838	.439
Stimulation	Pearson Correlation	.026	.038	.085	.138
	Sig. (2-tailed)	.761	.652	.315	0.103
Tradition	Pearson Correlation	.010	.009	.002	0.027
	Sig. (2-tailed)	.910	.917	.979	0.754
Universalism	Pearson Correlation	.052	-.037	.029	0.107
	Sig. (2-tailed)	.542	.659	.729	0.207

* Correlation is significant at the 0.05 level (2-tailed).

DISCUSSION AND CONCLUSIONS

The results related to hypothesis one are encouraging. The accountants exhibited more ethical reactions than the nonaccountants, and in general the students as a whole disagreed with the actions in the scenarios more than they agreed with them. This is good news, given accountants' significant roles in critical functions such as financial reporting, auditing, financial services, and other oversight functions. In particular, the accountants were most opposed to the fraudulent financial reporting (scenario three). Even though the accountants were more critical of the actions in all four scenarios than the other students were, it is somewhat disturbing that any of the accountants would find these actions at all acceptable. Across all three groups, the action viewed as most acceptable was the padding of the expense report. This may be due to the fact that the scenario indicated that many employees in the company were following the practice. Informal norms within organizations can often drive behavior more than formalized policies. Another possible reason could be that the students perceived a lower likelihood of the person being caught as compared to the other scenarios, since controls were weak within the expense reporting function.

Surprisingly, the second highest rating for all three groups of students was the rating for the insider trading scenario (scenario four). Apparently, for some, the desire to help a friend who

needed money might have caused them to justify the behavior. In that scenario, it was clearly stated that the individual knew he was breaking the law. These results suggest that a simple awareness of laws and ethical rules does not assure ethical and/or legal behavior when conflicting pressures are present.

For all of the scenarios, the accountants exhibited a lower tolerance for the unethical behavior than did the other business students, and the other business students exhibited a lower tolerance for the behaviors than the nonbusiness students. These results suggest that an education in accounting or other business majors may make those students more aware of ethical issues in business than those students in other fields.

The results for hypothesis two are quite interesting. The results indicating that accounting majors scored significantly lower than other business majors on the power and self-direction values are consistent with Giacomino and Akers (1998) and Baird et. al. (2006). However, security and universalism were found to be significantly different across majors in this study, but not in previous studies. The other business majors scored the highest on security and the accountants had the lowest security scores. The accountants also scored the lowest on universalism, with the nonbusiness majors exhibiting the highest universalism scores. This is of concern since public accountants in the auditing function are expected to perform their work with regard to what is in the best interests of the public (i.e. investors and creditors), and yet a fairly low score by accountants on universalism indicates a lower interest in the welfare of the public.

In general, it appears that those who are more driven by power and wealth are more likely to choose a business career. That result is quite intuitive, as business professionals tend to make more money than many other professionals, such as social workers, artists, and musicians. Within business disciplines, it is also not surprising to see accountants scoring slightly higher on conformity because of the rule-based nature of accounting. However, placing a high value on conformity can be an asset or a curse for an accountant. On the one hand, conforming to rules and regulations is critical for accountants. On the other hand, a desire to conform to informal organizational norms can lead an accountant into trouble. For example, in a corporate culture where the focus is on profits and it is deemed acceptable to "pad" the numbers to meet profit targets, an accountant who values conformity might be more likely to succumb to those pressures.

The third hypothesis postulated a correlation between values and reactions to the ethical scenarios. The ratings for scenario one, in which an individual claimed reimbursement for expenses not incurred, were positively correlated with power and negatively correlated with benevolence. The rationale for the power correlation is most evident. The power value includes wealth, and the individual in the scenario was attempting to maximize his wealth. Therefore, the more important wealth was to the students, the more they approved of the behavior. The negative correlation with benevolence is more difficult to explain. It is possible that the students perceived that the behavior would harm other people by costing the company more money.

For scenario two, in which the employee reported hours worked that, in fact, he did not work, there were no significant correlations. One might have expected a positive correlation with power,

such as in scenario one, but no such correlation was found. For both scenarios three (in which the individual was persuaded by his boss to falsify the company's financial statements) and four (in which the individual chose to help his friend by illegally providing "insider" information about the company), a positive relationship was found with hedonism and no other correlations were significant. This correlation is not quite intuitive, unless students saw some personal gain from helping the boss falsify the numbers or helping the friend who needed money. Interestingly, the conformity value was not a significant factor related to any of the four scenario ratings. Intuitively, those who value conformity ought to be more likely to comply with laws and regulations, but this was not exhibited in this study. Further research is needed to explore these relationships.

This study has certain limitations. First, the questionnaires elicit reactions to ethical scenarios, which is typical in this line of research, but there is no assurance that the individuals' opinions regarding the scenario would equate to actions they would actually take if they ever found themselves in a similar situation. Secondly, all of the participants in the study were from one university in the United States. It would be necessary to replicate the study with other samples, both students and professionals, to determine to what extent these results could be generalized.

This study's results provide further evidence that accounting majors' values differ from other students' values, and that the relationship of those values to ethical behaviors is a complex one. Further research exploring this relationship is necessary to improve understanding of an issue so critical to the profession.

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VIRTUAL CORPORATIONS—NO TIME FOR TRUST?

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ABSTRACT

Virtual Corporations (VC's) are temporary flexible networks, dependent on mutual trust, and linked by information technology for the purpose of exploiting fast changing market opportunities. However, the very characteristics which make them so effective at exploiting fast-changing opportunities can create legal difficulties relative to the creation of a legal entity whose rights and duties can be established in a court of law. Specifically, it seems likely that such entities may increasingly be created via "virtual documents" using information technology in addition to, or instead of, conventional paper documents. This may bring into question the validity of the instrument which created the entity and therefore the legal existence of the entity itself. In addition, the creation of an entity via information technology can lead to jurisdictional disputes if problems arise. This paper examines whether VC's can establish an "electronic document" which is enforceable under current law. It also makes recommendations as to what elements might be included in such a document in order to avoid difficulties relative to enforcement and to a lesser extent jurisdiction.

VIRTUAL CORPORATIONS—NO TIME FOR TRUST?

Whenever one begins to discuss "virtual" entities two legitimate questions arise: 1) why use the term at all and 2) what does it mean? The answer to the first question is fairly simple. Two men coined the phrase in the early '90s and it has proven useful in describing a type of entity that did not previously exist. Bill Davidow may have originated the term in his book *The Virtual Corporation* (1992). It was further popularized by John Byrne in an article published in the popular press (Byrne, 1993).

The second question has been answered in a variety of ways. What is a virtual corporation? Jones and Bowie (1998), describe a virtual corporation as a "temporary network of independent companies," which is accurate, but a virtual corporation is more than that. John Byrne expands this definition, and in doing so provides insight into why virtual corporations exist. Byrne says a virtual corporation is "a temporary network of independent companies—suppliers, customers, even erstwhile rivals—linked by information technology to share skills, costs and access to one another's

markets…for the purpose of exploiting fast changing opportunities" (Byrne, 1993). Using this definition, in this paper we examine a) the role that trust plays in the formation of a virtual corporation; b) how a properly written contract may assist in assuring trust within a virtual corporation; c) why participants in a virtual corporation may prefer to be governed by U.S. law; and d) the implications of electronic information technology on the legal risk associated with forming virtual corporations.

We begin by providing an example of a virtual corporation that illustrates the issues of trust, jurisdiction, and electronic information technology. We refer to this example throughout the paper when discussing the issues more fully. Finally, we draw conclusions in the form of recommendations to businesses as they manage the risks inherent in virtual corporations.

Trust and the Virtual Corporation

Agile Web is an excellent example of a virtual corporation. Agile Web is an association of 20 small manufacturers which evolved out of a virtual corporation management project originally begun at Lehigh University (Gilbert, 2001). The project was designed to assist small manufacturers. The small companies pooled their various talents and resources in order to penetrate new markets they would not have been able to enter on their own. For example, one of them (DRS Communications Co.) secured a large contract to sell forklift levers to a large forklift manufacturer. This was an opportunity DRS would have previously forgone since it could not handle such a large contract alone.

However, as a member of Agile Web, DRS was able to turn to a number of its 21 "virtual partners" for help. As a result, one manufactured the plastic handle while another produced the metal components, and DRS soldered and tested the switches, assembled and shipped the final product (Gilbert, 2001). In this way the virtual partners were able to take on a project none of them could have handled independently. Moreover, each partner was able to concentrate on its core competencies (e.g. plastics, metal-working) and turn to its partners for areas of expertise in which it did not excel. The virtual organization to which they all belong allows them to quickly "mix and match" capabilities to rapidly respond to changing market opportunities.

As the Agile Web example demonstrates, a culture based on trust is particularly valuable to virtual corporations since it allows networking organizations to work across boundaries (geographical or organizational boundaries) and acquire skills through "partnering" which eliminates the need to gather expertise through acquisition (Barney & Hansen, 1994; Chutchian-Ferranti, 1999; Coulson and Kantamneni, 2002). Acquisition occurs when the parties undertake some form of internalization (ownership) to establish control (as in O.E. Williamson and Ronald Coase's Transaction Cost Analysis work)

Advantageous as such partnering arrangements may be they depend upon the existence of certain levels of trust among the networking parties. These include trust that the parties will not

exploit each other's vulnerabilities (Barney and Hansen, 1994), and a conviction that all the parties are trusting of each other as well as individually trustworthy themselves (Jones and Bowie, 1998).

In addition, if otherwise disparate entities are to come together as virtual corporations, these organizations must be based on trust and mutual sharing of information, including strategic information. Engleman observed (Engleman, 1993), and the Agile Web example demonstrates, that previously competing partner companies may come together as a VC, to take advantage of market opportunities. Jones and Bowie (1998) also assume virtual corporations can flourish if their disparate components have made an ethical commitment to trust and thus have a trusting corporate character.

However, the temporary nature of virtual corporations gives rise to what has been called the "Virtual Corporation Paradox" (Jones and Bowie, 1998). The paradox is this—while the *ad hoc*, temporary nature of the virtual corporation allows it to quickly respond to developing market opportunities, this same temporary nature greatly impedes the development of long term relationships and the mutual trust which evolves over time in many organizations. Traditional organizations develop trust during repeated interactions and personal contact. The ephemeral nature of virtual corporations simply does not provide the time necessary for the gradual, iterative, development of trust. In this regard, virtual corporations formed in the U.S. may have an advantage over virtual corporations formed elsewhere. Tom Brown (1993) states: "American corporations, because they are grounded in a multiethnic society with a more trusting and open culture, have a leg up where implementing VC's (virtual corporations) is concerned." Additional anecdotal evidence about America's litigious society also suggests the legal system as a possible substitute for trust in national business dealings. Whether or not U.S. society makes it easier for partners in a virtual corporation to trust one another, it seems unlikely that entities like Agile Web could survive without it.

For example, the various members of Agile Web may never have worked together or even had extensive knowledge of each other. Nevertheless, they trust that each member will perform as expected and not misuse the arrangement. Why? Because they have established a workable contract basis for the members by creating a limited liability corporation. The articles of incorporation for Agile Web constituted a written agreement (a contract) among the parties outlining the rights and duties of each party. Even though the individual members may never have worked together, nor had experience with each other, this tangible document provides assurance that members will perform as expected—in so doing, it builds trust.

Trust and the Contract

If most virtual corporations do not have the opportunity to develop trust over time but nevertheless require trust to function, is there any mechanism available which will help members trust that other members of the virtual corporation will perform as expected and not take advantage of each other? Americans may, as Brown believes, be trusting but we can also be litigious with

misunderstandings leading to litigation. One way to avoid misunderstandings and possible litigation is to have a recognized and enforceable contract. In this regard, the members of a virtual corporation, which was created using electronic documents, face a number of possible legal issues. Chief among these are formal entity formation and jurisdiction. The primary concern relative to entity formation is - do the parties have an enforceable entity formation agreement (i.e. a contract)? If so, what kind? Jurisdictional issues relate to if and where the agreement is enforceable by the courts. Both of these potential difficulties can be mitigated if the parties to a virtual corporation create a document (a contract) outlining the rights and duties of the parties. This document may be a conventional hard-copy (paper) contract or it may be an electronic (virtual) document. Electronic (or virtual) contracts become a means of adjusting to changing opportunities quickly as well as a mechanism for assuring trustworthy behavior among the parties (Byrne, 1993).

Since electronic contracts may become crucial to the virtual corporation's success, it is imperative that they be enforceable. However, two problems can arise relative to enforcement: 1) virtual corporations may be used for market entry across international boundaries making international law applicable and 2) since the contract is created through electronic media, proving (in a court of law) that the contract exists may be difficult. The second problem can be addressed somewhat by the use of "electronic signatures" i.e. digital signatures that are the product of large prime numbers and some coding techniques *a' la* the PGP (Pretty Good Privacy) coding similar to that used by international banks when transferring large funds (Kantamneni and Coulson, 1995). Contracts signed in this fashion can be verified. However, even when the existence of a contract is established, questions remain. For example, is it enforceable in court, and if so, which law (international law or the law of a particular nation) should be used to enforce it? While both current international law and U.S. law may recognize such electronic documents, participants in a virtual corporation should examine the advantages and disadvantages of formation and jurisdictional issues from the perspective of both international and U.S. law.

Formation of Virtual Corporations and International Law

The following hypothetical case taken from the *Connecticut Journal of International Law* (Zaremba, 2003) may help to illustrate some of the problems encountered by parties engaged in electronic transactions involving international law. Although Mr. Rose is an individual and not a virtual corporation, the problems he faces are similar to those which would be encountered by a virtual corporation which included international partners or customers:

> *"Tim Rose, a computer programmer who lives in Phoenix, Arizona, designed a virus detection and removal program. He made it available exclusively on the Internet through a website for $39.95, where he guaranteed that the software detects and eradicates 25 specific internet-based viruses, which are precisely described. The website provides a fully-automated ordering system with an electronic order form. Orders are downloaded from the program into their computers. The website does not*

contain a choice of law provision or a jurisdiction provision. Rose is not notified of each individual purchase.

The program is an enormous success. However, after a few months Rose receives a letter from an Italian company that purchased the program. The company is located in Milan, Italy. The letter contains a summons and an English translation to appear in an action filed in Milan for breach of contract. Rose is being asked to defend the suit in Milan. A few days later, Rose receives a letter from another customer. This customer lives in Lyon, France, and in contrast to the Italian company, this customer used the program only for private purposes. The second letter also contains a summons and an English translation to appear in an action filed in Lyon for breach of contract. Rose has never been in Europe and has never had any contact with anyone in Europe, with one exception. Almost a year ago he ordered a specified data organization program from a German software designing company based in Munich. The Munich company designed the program according to Rose's specifications and transmitted it electronically. However, it does not work. The company does not acknowledge that the program does not work and refuses to refund the money.

Rose is confused. He believes that because he lives and developed his program in Arizona, only Arizona law applies to these transactions, and, therefore, he can only be sued before an Arizona court. Also, he would like to sue the German company before an Arizona court, because he does not speak German…" (Zaremba, 2003).

Simply imagine the German company as a "partner" in a virtual corporation and you can envision some of the difficulties faced in such a circumstance—one question is: which country's law should apply?

A number of international accords, treaties and/or conventions could be used to provide the parties to a virtual corporation with a mechanism for resolving differences. Depending upon the nature of the agreement and the parties involved, examples of international accords which could be used include The United Nations Vienna Convention on Contracts for the International Sale of Goods (CISG), European Union Directives, and The Hague Conference on Private International Law, which is currently under negotiation by more than 60 nations (Miller and Jentz, 2004).

A drawback to using (or even allowing) international law to govern a contract (from an American perspective) is that like Tim, you may be obligated to defend an action in a foreign court where you don't speak the language or understand the law. Another serious drawback to using international law to support legal recognition of the formation of a virtual corporation is the essential contract nature of international law. From the perspective of a U.S. company wishing to enforce a contract this creates at least two problems: 1) The only nations bound by an international accord are the signatory nations, 2) Generally, even after signing an international accord, a signatory nation is free to suspend the operation of an international accord or treaty <u>at will</u> if they notify the other signatory nations, and none object (See Vienna Convention On The Law Of Treaties). As a result, even if you are comfortable being governed by another country's law, you must keep in mind that the country in question could elect to suspend the operation of the appropriate international treaty or accord, leaving you no way to enforce your contract across international borders. These legal

risks suggest that current international law may not be a reliable mechanism for enforcing agreements made by virtual corporations.

An alternative to international litigation might be international mediation or arbitration. In this regard, an international clearinghouse that could rate and report upon potential VC partners would provide a valuable service to the international business community. While no such clearing house currently exists, potential Non-Governmental Organizations (NGO's) which could fulfill this need include, but are not limited to: The International Chamber of Commerce (http://www.iccwbo.org), the International Commercial Arbitration Commission, or the London Court of International Arbitration (www.lcia-arbitration.com).

Formation of Virtual Corporations and U.S. Law

When the parties to a virtual corporation are subject to U.S. law, agreement(s) surrounding the formation of a virtual corporation may constitute either an express or an implied contract. An express contract is one stated in words. An implied contract is one that is not stated in words but is implied by the conduct of the parties. In addition, depending on the subject matter being covered by the agreement, the formation of such agreements may be governed by U.S. statutes such as the Uniform Commercial Code (UCC), the Uniform Computer Information Transactions Act (UCITA) and the Uniform Electronic Transactions Act (UETA), or it may be governed by Common Law.

Traditionally, an express contract was formed between parties at the point where an offer had been made and accepted and some form of consideration had passed between the parties. Historically, Anglo-American Common Law has often been very formal in its requirements as to what constitutes an offer or an acceptance. All three of the uniform codes mentioned above reduce these formal requirements. For example, Article II of the UCC, which deals with the sale of goods, states that a contract may be formed "in any manner sufficient to show agreement" including the conduct of the parties (U.C.C. § 2-204 (1998)). UCITA, which deals with electronic transactions in software, multimedia, data, and on-line information, states that "agreement" means "the bargain of the parties...as found in their language or by implication from other circumstances...including course of performance, course of dealing and usage of trade" (U.C.I.T.A. § 102 (a)(4) (2001)). Finally, the UETA which deals with electronic contracts, electronic signatures, and the use of electronic agents for electronic contracting, states "agreement means the bargain of the parties in fact, as found in their language or inferred from other circumstances" (U.E.T.A. § 2 (1) (1999)).

As a result, any party to a virtual corporation formed for the purposes covered by the UCC, the UCITA, or the UETA, who became involved in a controversy as to whether or not the entity actually existed, or whether the alleged agreement of the parties was enforceable, could establish the existence of an express (or at least an implied) contract by producing either electronic evidence of a contractual agreement or evidence of people's actions after the agreement—if those actions demonstrated an intent to form a contract. In this regard, Section 7 of the UETA allows the use of electronic records to satisfy the legal requirements of writings. This means that the enforceability

of a record or even a signature cannot be denied solely because it is in an electronic format. The UETA defines a record as information inscribed in a tangible medium or stored and retrievable in perceivable form (U.E.T.A. § 2 (13) (1999)). It further defines an electronic record as a "record created, generated, sent, communicated, received or stored by electronic means" (U.E.T.A. § 2 (7) (1999)). Finally, the UETA defines an electronic signature as "an electronic sound, symbol, or process attached to or logically associated with a record, used with the intent to sign the record" (U.E.T.A. § 2 (8) (1999)).

The UETA would therefore appear to be an especially useful tool for parties seeking to establish the existence of an agreement reached through electronic means. It could also be useful in determining which parties "signed" the agreement electronically. However, the UETA has serious limitations beyond simply establishing the existence of an agreement and the parties involved in it. The statute has no provisions for determining the effect of the agreement once its existence is established. For that the parties must turn to other substantive law (See U.E.T.A. § 5 (e); Comment (7) (1999)).

In other words, the UETA is a wonderful tool to use if someone questions whether your electronic contract even exists or disputes whether or not a party has electronically signed it. But if someone begins to argue over the actual terms of the contract (as they did in the Tim Rose example), the UETA is no help. You will have to examine the substantive law of the appropriate jurisdiction to solve that issue. As we shall see, this is important to a virtual corporation participant. If Tim Rose's home state of Arizona had adopted the UETA, and his contract had been formed under the laws of Arizona, he would be able to cite it to prove that his electronic document was in fact a contract and had been signed electronically. But this would only constitute a first step. Once he established that he had a signed contract he would still have to turn to someone's contract law (such as the law of Arizona) in order to resolve a dispute.

U.S. Uniform Codes such as the UCC, the UETA, and the UCITA are part of State, not Federal, law and are therefore only enforceable in states that have adopted the particular code in question. The UCC has been adopted by all of the fifty states. The UETA has not yet been adopted by all the states but its passage by all the states seems likely (Bagby, 2003). By contrast, the UCITA is somewhat controversial and has been adopted by only two states, Virginia and Maryland (Bagby, 2003). Nevertheless, the parties to the formation of a virtual corporation could effectively incorporate the UCITA into their agreement by stipulating that the agreement be governed by Virginia or Maryland law. Such a stipulation is called a forum selection clause. This is nothing more than a clause in a contract that establishes a place (such as a country, state, or even a specific type of court) where potential litigation will take place.

In 2000 a new Federal law known as the Electronic Signature in Global and National Commerce Act (E-SIGN) was created. As Federal law it preempts state laws such as UETA. However, this should not be a problem for parties wishing to use UETA because the new Federal law provides that for the most part, UETA's electronic contracts and signatures provisions (Sections

1-16) will apply in states which have substantially enacted the model version of the UETA (Bagby, 2003).

What does this mean to parties who have created a virtual entity through electronic means (such as an electronic contract)? It means they may use such uniform state laws as the UCC, and the UETA (in states that have adopted it) to establish the existence of their contract should it be challenged. In addition, they may rely on the fact that in most cases statutes such as the UETA won't be pre-empted by Federal law. Once the existence of the agreement has been established, the laws of the particular state identified in the forum selection clause could be used to determine the legal consequences of the agreement.

Let us suppose that you are now convinced that any agreement relating to the establishment of a virtual corporation must include documented provisions (electronic writings will suffice) outlining the rights and duties of each party. Suppose that you further agree that the agreement should also stipulate that it be governed by specific applicable codes (suggested codes include the UCC, the UCITA, and especially the UETA), as well as other applicable state law. What happens if you forget?

Given the *ad hoc* and temporary nature of virtual corporations it is entirely possible that the parties involved will fail to make such provisions. What would happen if the parties contacted each other electronically and agreed to pursue a temporary market opportunity without making any of the provisions recommended above? Would they have an enforceable agreement? If so, what type of organization would they have formed?

As stated earlier, both the UCITA and the UETA (as well as Article 2 of the UCC in a contract for the sale of goods) would recognize the existence of a contract from anything that the parties communicated which indicated agreement. In addition, the UETA would recognize the existence of an agreement based on "the context and surrounding circumstances, including the parties conduct" (U.E.T.A. § 5 (b) (1999)). Therefore, even something as basic as a simple agreement to pursue a market opportunity would constitute an enforceable contract. But what type of an organization would be created by such an agreement? In the case of such a basic and simple agreement, the parties would certainly not have created a true corporation (even though they may refer to it as a virtual corporation). A corporation is a creature of the state. It does not exist until the articles of incorporation have been approved by that state's government. Therefore, the parties to a virtual corporation, or any other virtual entity, who had not met the filing requirements of a state, could not have created a corporation. Instead, a general partnership would have been created. Partnerships do not require the filing of documents and can be formed simply by the agreement of the parties.

The common law of most states and the statutory law of any state which has adopted the Uniform Partnership Act (UPA) could be used to establish that the parties to a virtual corporation are, at the very least, general partners. This is so because a general partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit" (U.P.A. § 6 (1) (1914)). The term "persons" generally includes artificial persons such as corporations. Exceptions

exist (for example, where the law requires certain partnership agreements be in writing) but generally, if two or more persons or entities enter a business arrangement whereby they agree to pursue a business interest and to share profits, they will be considered general partners even if they fail to say so (even if they are unaware of the fact) (U.P.A. § 7 (4) (1914)). Therefore, the common law as well as the UPA could be used to illustrate that the parties to an informal virtual corporation are in fact general partners. Both the common law and the UPA will then impose the rights and duties of general partners on all the members of the virtual organization.

The most important of these rights and duties revolve around agency law. Each member of a general partnership is an agent for the partnership for purposes of its business (U.P.A. § 9 (1914)). As such, each partner may bind the entity to contracts and other obligations. In addition, each partner has a fiduciary duty to act in the best interests of the entity even to the exclusion of his/her own interests (See *Meinhard v. Salmon*, 164 N.E. 545 (1928)).

Recognition of these rights and duties could be critical to the development of trust within a virtual corporation which has been formed rapidly in order to exploit a temporary market opportunity. In such an event, it is likely the parties do not know each other well enough to have developed trusting relationships over time. However, despite the fact that they do not know each other, they may trust that their partners will perform as expected, and respect the rights of the other partners, if they are generally aware of the principles discussed above. In other words that they are generally aware that the law recognizes: 1) that a valid agreement exists, 2) that at the very least a general partnership has been formed, and 3) that law exists which imposes the fiduciary duties of partners upon the members of the virtual corporation. Again, even if they are not aware of the specifics, a general awareness that law exists to assure performance and protect the individual interests of each party to a virtual corporation would serve to build some level of trust.

Knowing that a general partnership, and the associated body of law, exists should not make virtual corporation members too complacent however. While it is certainly better than nothing, a general partnership, in the context of a virtual corporation, could be a risky type of organization to form. From the perspective of liability (both liability for debts and liability for wrongful acts of partners/agents) a corporation or a Limited Liability Company (LLC) would offer much more protection. This is so because general partners, as agents, have the power to bind all other partners by their acts. In addition, because a partnership (unlike a corporation or an LLC) is not a legal entity separate from its owners, the personal assets of the partners are at risk. By contrast, the agents of a corporation or LLC (usually its officers) can only bind the corporation by their acts. In addition, the only assets placed at risk are those owned by the corporation or LLC (Hamilton, 1998). The personal assets of the owners (stockholders) are not reachable by plaintiffs or creditors. This could be an important consideration for a virtual corporation when dealing with partners whose assets, degree of capitalization and business judgment are not well known—especially in the international arena.

Jurisdictional Issues Relative to Virtual Corporations

Jurisdiction is the authority of a court to hear a case (Black's Law Dictionary). For a given state to have jurisdiction over a controversy, its laws must apply to the facts of the case. In most instances litigation over the terms of an agreement to form a virtual corporation would constitute a type of contract dispute. In the U.S. contract disputes are normally governed by applicable state laws. While it is true that certain elements of the contract could be governed by Federal law (e.g. intellectual property questions or questions regarding labor law) the issue of the enforceability of an agreement creating a virtual corporation would be essentially a contract issue governed by state law. However, even in a relatively simple entity formation case, questions may arise as to which state's law is applicable.

Usually, when a court is faced with a dispute involving the interpretation of a contract it will apply the law of the jurisdiction where the contract was made. However, in cases where there is dispute as to which state's law should apply (e.g. two or more states could claim jurisdiction over the same case); courts may also apply the law of the jurisdiction where the major part of the contract's performance occurred (Bagby, 2003). Such issues can be confusing and can cause unnecessary litigation.

Even using the relatively simple "where the contract was made" standard, contracts are usually "made" where the last act required for formation occurred. For example, suppose party A in the state of Colorado contacts party B in the state of Kansas and offers party B the opportunity to participate in the virtual corporation. If party B accepts the offer, the last act necessary for formation of the contract (acceptance) took place in Kansas and, all else being equal, Kansas law should govern. Agreements made over the internet, or via e-mail, can create confusion as to where this "last act" occurred. Add to this the potential jurisdictional difficulties which might arise pursuant to liability for crimes, torts or intellectual property disputes and it rapidly becomes clear that any party contracting over the internet should include a choice of law (or forum selection) provision in any agreement reached. To reiterate, a choice of law provision consists of language in the initial agreement of the parties which states that disputes will be governed by the laws of a particular jurisdiction (Black's Law Dictionary).

Forum selection clauses are valuable for more than establishing the formation of a legally recognizable virtual corporation. They can also avoid problems relative to jurisdiction. Failure to include such a clause could result in serious and unnecessary litigation in the event of a dispute. Choice of law provisions may include agreements to submit to arbitration or mediation should any disputes arise. These can be a viable and economical alternative to litigation.

CONCLUSION

The parties to any business entity must trust each other in order to function effectively or they must undertake some form of ownership to establish control. Most entities are able to establish

trust by interacting with each other over time. Since the *ad hoc* and temporary nature of virtual corporations often precludes taking the time necessary to build long-term relationships which lead to trust (the Virtual Corporation Paradox), virtual corporations may assure trustworthy behavior through the creation of hard-copy or electronic contracts which guarantee the rights of each party and upon which the parties can rely in the event that misunderstandings or disputes arise.

U.S. law seeks to recognize and enforce contracts. Laws such as the UETA can be used to recognize a virtual corporation, formed by means of an electronic (virtual) contract, as an actual legal entity. In the absence of effective efforts to create a specific type of legal entity (e.g. corporation, LLC) U.S. law will normally recognize the existence of a partnership and will impose the legal rights and duties of partners upon the members of the virtual corporation. In order to clearly define the will of the parties and to avoid future difficulties, the parties to the formation of a virtual corporation, or other virtual entity, should create an electronic record designating the "rights and duties" of each party to the agreement. This virtual document should include a forum selection clause stipulating that the contract will be governed by U.S. law including, at minimum, the UETA and the state law of a particular (named) state. Such a clause will not defeat the intent of most international accords and treaties. On the contrary, many international treaties anticipate the use of forum selection clauses. For example, both the CISG and The Hague Conference on Private International Law specifically provide that the parties to an international agreement may choose other law (for example, U.S. law) to govern their agreement. Therefore, to avoid the vagaries of international law, a U.S. party to a virtual corporation, which may include international partners, should insist that the agreement include a forum selection clause providing that U.S. law will govern the contract—whether that contract is electronic or hard-copy.

In this manner the UETA as well as state law can be used to establish the existence of the agreement, thereby avoiding difficulties relative to formation. In addition, the applicable state's law can be used to enforce the agreement thereby avoiding questions related to jurisdiction.

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PREVENTING EMPLOYEE IDENTITY FRAUD: POLICY AND PRACTICE ISSUES FOR EMPLOYERS

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ABSTRACT

According to a 2002 report by TransUnion, one of the U.S.'s three credit bureaus, the No. 1 underlying source of identity fraud is theft of employer records. Human Resource departments are a prime target for this type of crime "when someone steals a wallet, they get one name, one SSN – when they steal personnel files, they get away with 10, maybe 100 names and numbers (Wells,2002, p. 33). This paper will examine the potential legal and employee relations consequences associated with the theft of employer records and identity fraud, what employers can do to prevent theft of employer records, and what employers can do to minimize the negative consequences associated with their records being utilized in identity fraud.

INTRODUCTION

> *"The workplace is the source of most records used in identity theft and financial fraud"* (Payroll Managers Report, 2006).

In May of 2006, the United States Department of Veterans Affairs (VA) reported that identifying information for up to 26.5 million veterans was part of the take in a burglary of one of it's employees homes. The stolen data was stored in a laptop computer and external hard drive the employee had taken home. The employee, a data analyst with the agency, was not authorized to take the data home and his behavior was in violation of VA policies (FirstGov, 2006). The (VA) incident is the largest and one of the latest in a long list of recent security breaches to make headlines. The incident also highlights the role of employer records in this regard. Wells, citing a 2002 report by TransUnion, one of the U.S.'s three credit bureaus, reported that "the No. 1 underlying source of identity fraud is theft of employer records" (Wells, 2002, p. 33). Human Resource (HR) departments are particularly rich sources of information that can be utilized in identity fraud. Personnel files that include payroll, benefit, and tax data, contain pieces of information that can facilitate the identity thief's objective and often are secured under the auspices of the HR function.

> *HR is a big target… When someone steals a wallet, they get one name, one SSN. When they steal personnel files, they get away with 10, maybe 100 names and numbers* (Wells, 2002, p 33).

In this paper, the potential legal and employee relations consequences associated with the theft of employer records and identity fraud are examined. In addition, what employers can do to prevent the theft of employer records, and what employers can do to minimize the negative consequences associated with their records being utilized in identity fraud are presented.

BACKGROUND ON THE PROBLEM

The genesis of the problems associated with identity theft and fraud can be traced to the passage of the Social Security Act in 1936. Initially, an individual's Social Security Number (SSN) was to be utilized to track workers' contributions to the social security fund. Marc Rotenberg, in his statement and testimony before the subcommittee on Commerce, Trade, and Consumer Protection Committee on Energy and Commerce in May of 2006 noted that "public concern over the potential abuse of the SSN was so high that the first regulation issued by the new Social Security Board declared that the SSN was for the exclusive use of the Social Security system" (Rotenberg, 2006). Eventually, legislation was enacted that allowed the SSN to be utilized for other purposes, including the authorization granted to the Internal Revenue Service to use SSNs as taxpayer identification numbers in 1961 (Rotenberg, 2006). Rotenberg further cited a U.S. Department of Health, Education & Welfare report prepared in association with the enactment of the Federal Privacy Act of 1974 that

> *"outlined many of the concerns with the use and misuse of the Social Security Number that show a striking resemblance to the problems we face today". "Although the term "identity theft" was not yet in use… the report that provided the basis for comprehensive privacy legislation in 1974, described the risks of a "Standard Universal Identifier," how the number was promoting invasive profiling, and that many of the uses were clearly inconsistent with the original purpose of the 1936 Act* (Rotenberg, 2006).

While Congress recognized the potential problems associated with the use of SSNs as a universal identifier in 1974 and a Senate Committee identified its use as "one of the most serious manifestations of privacy concerns in the Nation", Congress did not limit the use of the SSN by the private sector in the Federal Privacy Act of 1974.

> *"Credit reporting agencies, marketing firms, and more recently, data brokers to build detailed profiles on American citizens exploited this loophole. As a*

consequence, consumers have experienced the extraordinary problem of identity theft" (Rotenberg, 2006).

In spite of the long standing fears associated with the use of SSNs as a universal identifier, stealing someone's identity did not become a Federal crime until 1998. Under the Federal Identity Theft and Assumption Deterrence Act of 1998 identity theft is a felony. Within three years of the enactment of the Act, identity theft ranked as the U.S.'s "top consumer fraud complaint, according to the Federal Trade Commission" (Wells, 2002).

The number of people potentially subject to identity theft and fraud in recent years has become mind-boggling. The 2006 theft of the VA laptop and hard drive had the potential to expose 26.5 million people to identity theft. While the laptop and hard drive were recovered in June of 2006 and authorities insist that FBI analysis shows that the information has not been compromised, the apprehension and frustration of those impacted by the breach will not be easily overcome (FBI Baltimore Press Release, 2006 & U.S. Department of Veterans Affairs, 2006). Since February of 2005, the Privacy Rights Clearinghouse organization reports that over 88,000,000 records containing personal information have been compromised. The February 15, 2005 acknowledgement by consumer data broker ChoicePoint, Inc. of Alpharetta, GA that more than 163,000 consumers in its database had been compromised, has been described as a "watershed event in terms of disclosure to the affected individuals" (Privacy Rights Clearinghouse, 2006). In January of 2006, the Federal Trade Commission (FTC) announced that it had identified at least 800 cases of identity theft from the ChoicePoint data breach and that the company would pay $10 million in civil penalties and $5 million in consumer redress to settle FTC charges that its security and record-handling procedures violated consumers' privacy rights and federal laws. In the settlement agreement reached with the FTC, ChoicePoint also agreed to implement new procedures to protect consumers, to establish and maintain a comprehensive information security program, and to have its procedures audited by an independent third-party security professional every other year until 2026 (FTC, 2006). In January of 2006, the FTC released its annual report detailing consumer complaints about fraud and identity theft in 2005. Complaints about identity theft accounted for 255,000 of the more than 686,000 complaints filed with the FTC in 2005 (FTC, 2006A).

RECENT INCIDENTS

Recently, a number of very prominent companies have had the personal information of current or former employees compromised. Included on the list are Time Warner, Eastman Kodak, Motorola, MCI, Bank of America, Boeing, Ford, and Equifax. In the Time Warner breach, a records management and storage firm utilized by the company lost tapes containing personal information on nearly 600,000 current and former U.S. based employees (Caterinicchia, 2005). Even the lead federal agency in the government's response to identity theft suffered an information breech on June 22, 2006 when two laptop computers containing personal and financial data of approximately 110

individuals were stolen from an employee's vehicle. The data included names, addresses, and Social Security numbers (FTC, 2006B). While organizations have improved their ability to protect data when it is stored behind firewalls on corporate networks, in recent months the "rash of laptop-related incidents" have highlighted the difficulty firms have in attempting to protect information when it is outside their protected networks (Regan, 2006).

Table 1: Recent Data Breaches Involving Laptop Computers	
Company	Number of Records Compromised
Nat'l Assn of Securities	
Dealers (NASD)	73
American Red Cross,	
Farmers Branch (Dallas, TX)	Unknown
Fed. Trade Comm. (FTC)	110
Equifax	2,500
ING (Washington, DC)	13,000
ING (Miami, FL)	8,500
Union Pacific (Omaha, NE)	30,000
Minn. State Auditor	493
IRS (Washington, DC)	291
YMCA (Providence, RI)	65,000
Ahold USA	Unknown
Buckeye Community Health Plan	72,000
Ernst & Young (UK)	243,000
Dept. of Veterans Affairs	28,600,000
Source: Privacy Rights Clearinghouse (2006).	

While the theft of laptop computers have generated most of the headlines in recent months, employer data breaches have also occurred as a result of hackers, loss of records in transit, inadvertent posting of information on-line, information being faxed mistakenly to a third party, and misappropriation by current, former, or contingent workers.

POTENTIAL LEGAL AND EMPLOYEE RELATIONS CONSEQUENCES

Recent examples where employees and consumers have initiated legal action against employers include Ligand Pharmaceuticals Inc., employees of the City of Detroit, Michigan, and Suzanne Sloane's lawsuit against Prince William Hospital and a Maryland temporary help agency. In the Ligand Pharmaceuticals Inc. case, one of its employees found old personnel records from a Ligand acquisition and along with acquaintances, "established more than 25 credit card accounts and purchased $100,000 in goods"(Steptoe & Johnson PLLC, 2004). Ligand was eventually sued for negligence by fourteen of the victims and settled out of court for an undisclosed amount (Steptoe & Johnson PLLC, 2004).

In the employees of the City of Detroit, Michigan case, the primary issue was "who bears the liability for the results of identity theft" (Jones, 2005). This case involved emergency service operators who were members of AFSCME, Local 1023 in the City of Detroit. The employees sued their union asserting that the Union was liable for not safeguarding their personnel information and that the union's negligence facilitated the identity theft perpetrated by a third party (Bell v. Michigan Council 25, 2005). In this case, the Union's treasurer, Yvonne Berry, compared the City's report of all personnel who were members of the union with a similar report generated by the union to ensure accuracy and correct any discrepancies. The City's report contained employee's job classification, social security number, and pension number. Berry on occasion would take the information home to work on it. Some time in 1998 or 1999, Ms. Berry's van was broken into and papers, including the confidential city lists were taken. After the information had been utilized in furthering the identity theft of the employees, the Union treasurer's daughter was arrested for her participation in the appropriation of the emergency service operators' personal information. At the time of her arrest, the police found a notebook in the Union treasurer daughter's bedroom that contained the employees' social security and drivers' license numbers. The daughter admitted to her involvement in the misuse of the information and was convicted on criminal charges. She denied taking any lists from her mother that the Union had generated. Nevertheless, a jury found the Union to have been negligent and the employees were awarded a collective sum of $275,000 (Bell v. Michigan Council 25, 2005). According to Reginald Jones, this decision "broke new legal ground" because it was the first time that a court had found "a custodian of employee information has a duty to guard the data with scrupulous care" (Jones, 2005).

In Suzanne Sloane's multi-million dollar lawsuit against Prince William Hospital and NRI Inc., Sloane alleged that the companies negligently allowed a convicted identity thief to have access to her personal information (Hospital Litigation Reporter, 2006). The temporary worker obtained Sloane's information from her medical records and used it to open several credit accounts and run up thousands of dollars in debt. Settlement agreement terms were not revealed (Hospital Litigation Reporter, 2006).

Lisa Daniel reported on numerous other incidents involving temporary workers, cleaning staff, security staff, and human resource information systems (HRIS) staff. These types of

employees "tend to be invisible" according to Philip Deming a security and risk consultant interviewed by Daniel (Daniel, 2006). In the Daniel article, Deming related a case where a temporary cleaning service worker was able to copy the personal information of the CEO of a large, publicly traded company. When an attorney working on the renegotiation of the CEO's contract left the personnel file on the floor by his desk, the cleaning service worker copied the information and sold it on the street for $75 (Daniel, 2006). In another case, Deming described a situation in a large nonprofit association that "paid more than six figures to correct the credit of 100 of its highest-paid employees" in a breech that involved a temporary worker for an insurance broker who had access to key personal information of the executives. While the financial cost to the organization to repair the executive's credit was substantial, the cost to morale was even more devastating.

> *Months of painstaking investigation ensured-for both the insurance company and the organization. Worse than the financial and administrative burdens was the cost to morale, Deming says. Seven of the association's senior employees quit as a result of the security breach* (Daniel, 2006, p. 131).

The impact of identity theft to a victim's daily life can be "devastating". In a widely cited study on the impact of identity theft, examining the drain on employee productivity and morale, a joint study by the PRC and the California Public Interest Research Group found that "on average, victims of identity theft and fraud spend 175 hours researching and tracking the crime, 23 months correcting credit reports and $800 in out-of-pocket expenses to restore their financial standing" (Wells, 2002, p. 34).

> *If somebody breaks into your house, you can change the locks. But if someone takes your identity, there simply is no quick fix* (Wells, 2002, p. 34).

LEGAL FRAMEWORK

> *A significant new category of employment-related privacy legislation has burst upon the scene: data breach notification laws. Employers need to take data breach legislation as seriously as they take such data laws as FCRA and HIPAA* (Harris, 2006).

The escalating pace of identity theft related incidents involving employer generated data has stimulated a new round of additional compliance and liability issues for organizations. The legal framework regarding employee privacy has been expanding in recent years with the Fair Credit Reporting Act (FCRA) requirements impacting how background checks must be done and Health Insurance Portability and Accountability Act (HIPAA) restrictions on how medical information may be handled and used as prime examples. Additional laws passed in recent years regulating

employers responsibilities with respect to employees' personnel information include the Americans with Disabilities Act, Sarbanes-Oxley Act, and the Patriot Act dealing with the handling of employment documents, and the Fair and Accurate Credit Transactions Act focusing on document disposal. In addition, employers may be "liable under state common laws for any security breach that violates employee privacy" (Daniel,2006, p. 132).

Many employers and HR professionals have been slow to react to data breach notification laws (Harris, 2006). Harris believes that this is due in part because of the misconception on the part of employers that data breach laws are "consumer-focused". This in spite of the fact that a large number of recent data breaches have "involved employee records only" and the fact that "even where the affected individuals are consumers, mistakes and mishaps by employees are most commonly the root cause of the data breaches" (Harris, 2006). Following California's lead in 2001, 31 states have enacted data breach notification laws and state laws restricting the use of an individuals Social Security Number (Perkins & Cole, 2006). As with many areas of HR decision making when state regulation emerges, the laws vary "in regard to the categories of personal data covered, the definition of a breach, the threshold (if any) for harm to individuals that triggers requirements for notification, the timeliness and forms of notification, the involvement of law enforcement and oversight agencies, and penalties and legal recourse" (Harris, 2006). This will certainly complicate compliance efforts for firms with operations in more than one state.

Further complicating the legal framework for employers are state and federal laws requiring employers to maintain certain personnel records. For example, every employer covered by the Fair Labor Standards Act must keep certain records for each covered, nonexempt worker including the employee's full name and social security number, their address, sex and occupation, and basis and rate of pay. Employers are required to preserve payroll records for three years (FLSA, 2006). Equal Employment Opportunity Commission regulations require covered employers to preserve information for a period of one year from the date of the making of the record or the personnel action involved, whichever occurs later. When a charge under Title VII or the Americans with Disabilities Act is involved, the employer must preserve all personnel records relevant to the charge or action until final disposition of the charge or the action (EEOC, 2006).

POLICY AND PRACTICE RECOMMENDATIONS FOR EMPLOYERS

Like most efforts to reduce an organization's exposure to litigation with respect to HR issues, decision makers should begin by reviewing existing policy and practice. In recent years, with the enactment of laws like HIPAA, the Electronic Communications Privacy Act (ECPA) of 1999, the 2003 Fair and Accurate Credit Transactions Act of 2003 (FACTA), and Sarbanes Oxley, plus the increased attention to privacy issues in general, organizations of all sizes and types should be addressing the privacy issue in their workplaces. As part of an organization's overall approach to ensuring employee privacy, policy and procedures to protect personal information, especially information that can be used to enable identity theft and fraud, should be developed. Gary Clayton,

CEO of Jefferson Data Strategies, a Washington, DC based privacy and data management firm, suggest that HR departments should do a "data-flow analysis, looking at what's collected, why it's collected and what the risks are" (Geisel, 2005).

With respect to "sensitive information" like an employee or job applicant's Social Security Numbers (SSNs), employers should examine when they ask them to provide it. The general consensus on the acquisition of SSNs seems to be to not ask for it until "absolutely necessary". In the case of an individual's SSN, you should not need it until you decide to perform a background check on the individual. The potential problems of using SSNs as universal identifies, while well known, have not stopped organizations of all shapes and sizes from using individual's SSNs for that purpose. Today, the general advice on where not to use the SSN is fairly consistent – don't use SSNs as employee identifiers, on insurance cards, benefit claim forms, paycheck stubs, time cards or time sheets, parking permits, staff badges, or training rosters – "on any printed documents that contain an employee's SSN, all but the last four numbers should be masked, just like on credit card receipts" (Caterinicchia, 2005, p. 58). In light of the problems with stolen laptops, employers should not permit employee data to be maintained on laptops or CDs. Additionally "pay particular attention to physical security", and be sure to remind employees to not leave sensitive personal information on the top of their desk – lock up file cabinets, especially in the payroll department or any where personal information is stored (Payroll Manager's Report, 2006).

Additionally, if you are outsourcing the background check process, make sure you examine the vendor's privacy policies and procedures, including whether or not they are checking the background of their employees. Remember the Prince William Hospital case discussed above, where the temporary agency employee with the identity theft conviction was placed in a position where they had access to a patient's personal information. The issue of vendors and other third parties having access to your employees' personal information can be even more troubling when organizations are relocating employees. Roseanne White Geisel reports that experts believe that "the potential for loss or theft of personal information is higher during relocations than during other human resource activities, because many pieces of vital data are transmitted to several different vendors involved in the relocation" (Geisel, 2005). During relocations, many vendors may be involved even when a firm contracts with a relocation management company. Real-estate companies, mortgage companies, banks, and movers all may request personal information that may facilitate identity theft and all should be examined to ensure that they are employing policy and procedures that will protect your employees' personal information (Geisel, 2005).

Once you have collected information, you must monitor what you have, how long you need to keep it, where you will store it, and who may access it. Today, as more and more organizations utilize technology to store information of all types, employers should tightly restrict who may be given access to employee information. Again, who ever will be allowed to access this type of information, their backgrounds should be thoroughly screened. Security and risk consultant Deming also recommends that when cleaning staff are employed in areas where sensitive personal information is stored, "a high-level employee should be present" and that only "the HR director and

maybe one senior executive should have a key to the HR office". Deming also recommends that Human Resource Information System (HRIS) personnel be monitored and that "audits looking for unusual activity or unauthorized access" to HR or employee personal information should be "regularly" conducted (Daniel, 2006). In addition, encryption and password protection are a must. Today, there are more and more firms offering technology to protect and "prevent confidential information from being shared inappropriately via electronic means", but organizations must be willing to invest in the technology if they are serious about protecting employee information (Caterinicchia, 2005). Investing in resources, including training, strict policies, that include enforcement and meaningful consequences for lax application of procedures and the following of procedures, are critical to any effective effort associated with records management. According to Susan Kurdziolek, president of Turn Key Office Solutions in Arlington, VA, "too often, we see that companies address these issues with a wink, and that's it"… organizations must "show that there are consequences for breaking rules". The need for an investment in resources, as in most cases, dictates that "security has to come from the top down" (Daniel, 2006, p. 133). The support from top management has to be more than just lip-service. Real resources, real enforcement with real consequences for not following policy and procedures are critical to demonstrating that the organization is serious about this issue.

Another area that also must be addressed is the proper disposal of information when appropriate. Organizations should have in place "a comprehensive archival and data destruction policy" (Payroll Manager's Report, 2006). This is especially critical for employers that conduct background checks on job applicants and current employees. Under the Fair Credit Reporting Act (FCRA), federal rules governing how employers should dispose of information obtained in employee background checks went into effect in June of 2005. These regulations require all employers to shred or otherwise effectively destroy information obtained on applicants and employees when conducting background checks. The FCRA regulations related to background checks require employers to take "reasonable measures to protect against unauthorized access to or use of information obtained in consumer reports when disposing of it. The regulations also requires that employers take "reasonable measures" including the adoption of policies and procedures that "require the burning, pulverizing, or shredding of papers containing consumer information, so that the information cannot practicably be read or reconstructed" (McCue, 2006). When disposing of information maintained in an electronic format, employers may need to implement special procedures for destroying or erasing the information. Finally, when outsourcing the destruction of information, employers are expected to engage in "some due diligence to ensure that the commercial shredder is complying with the rule" (McCue, 2006). This due diligence should include reviewing an independent audit of the disposal company's operations, checking the disposal company's references, requiring the company be certified by a recognized trade association, reviewing and evaluating the disposal company's information-related security policies and procedures, and taking measures to determine the competency and integrity of the disposal company (McCue, 2006).

When and if security breaches involving employee information occur, employers may have an additional set of responsibilities. In at least 31 states, employers may have notification responsibilities. In the California law for example,

> *any entity that conducts business in California, and that owns or licenses computerized data that includes Personal Information (PI), shall disclose any breach of the security of the system following discovery or notification of the breach in the security of the data to any California resident whose unencrypted PI was, or is reasonable believed to have been, acquired by an unauthorized person (Cal. Civ. Code 1798.80 et seq.).*

Data breach notification laws do vary from state to state so employers with operations in more than one state will have to become familiar with those variations. The bottom line from a legal prospective is that organizations that want to minimize the potential of a security breach with respect to their employees' personal information, must review and audit what they are currently doing with respect to protecting the records they are creating, how they are being used and by who, how they are being stored, and when and how to effectively destroy them.

From an employee relations prospective, remember the potential debilitating affects on employee morale, productivity, and potential turnover that can occur when employees' personal information is compromised and used in identity theft. An emerging new employee benefit that some organizations are offering is identity theft services to both educate employees about protecting their identity and helping them to restore their identity and credit when they fall victim to this rapidly increasing crime (Gurchiek, 2005). The cost of these benefits for employers can be quite low according to Gurchiek, and she sites one estimate that the "price for employers can be as low as 75 cents per employee per year. Gurchiek also reports that these services can cut down on lost productivity, give employees piece of mind, and according to Mark Pribish, and executive with Aon Risk Services Inc., "can mitigate the risk and impact of class- action lawsuits" (Gurchiek, 2005, p. 32). Employers that want to minimize their exposure to litigation and potential damage awards and minimize the negative impact on employee morale and productivity can not simply pay lip service to this issue. A top down approach with genuine commitment of resources to effectively protect employee personnel information is necessary.

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PEER TO PEER FILE SHARING, COPYRIGHT, AND GROKSTER

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ABSTRACT

Music and entertainment media lovers widely use copying services offered on the internet to download and otherwise copy songs and movies. Those who engage in the practice are often committing copyright infringement. The entertainment industry wants to stop the practice, hoping to maximize its profits on its copyrights in the works. Pursuing suits against each individual copier is too expensive. So the entertainment industry has pursued the internet service providers for enabling the copiers to illegally copy works. The entertainment industry bases its claim against the internet service providers forms of indirect copyright liability that are judicially created and recognized. They are not written in the copyright statute.

First, this article explains the concept of peer to peer file sharing. Second, it reviews the judicial opinions that have created and applied the doctrines that involve indirect copyright liability. Third, it summarizes the Supreme Court's recent case involving indirect copyright infringement liability for service providers who enable others to illegally copy entertainment works. Finally, the article explains the effect of the decisions on copyright law policy.

INTRODUCTION

Music and entertainment media lovers widely use copying services offered on the internet to download and otherwise copy songs and movies. Those who engage in the practice are often committing copyright infringement. The entertainment industry wants to stop the practice, hoping to maximize its profits on its copyrights in the works. Pursuing suits against each individual copier is too expensive. So the entertainment industry has pursued the internet service providers for enabling the copiers to illegally copy works. The entertainment industry bases its claim against the internet service providers on forms of indirect copyright liability that are judicially created and recognized. They are not written in the copyright statute. In 2005, the Supreme Court decided its third copyright case to consider imposing indirect liability for others' wrongful copying.

The first case is *Kalem Co. v. Harper Brothers*, [*Kalem*] where in 1911 the Court recognized that one who causes another to commit copyright infringement by advertising is also liable for infringement. [*Kalem*, 62] The second case is *Sony Corp. of America v. Universal City Studios, Inc.* [*Sony*] where in 1984 the Court acknowledged indirect liability for copyright infringement, but limited its application. The Court decided that contributory infringement is actionable. Then the

Court adopted patent law’s staple article of commerce doctrine to deny liability for contributory infringement if the product is capable of substantial noninfringing activity. The third case is *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.* [*Grokster*], where in 2005 the Court extended indirect liability for copyright infringement by adopting another patent doctrine, the inducement theory, to impose liability on marketers of peer to peer file sharing software.

Before the Supreme Court's decision in *Grokster*, two circuit courts, the Ninth and the Seventh, had interpreted and applied *Kalem*'s and *Sony*'s jusicial law on indirect liability for copyright infringement. The Ninth Circuit in *A & M Records, Inc. v. Napster, Inc.* [*Napster*], had given internet service providers an opportunity to avoid contributory copyright liability by recognizing *Sony's* limitations on contributory liability. The Ninth Circuit found Napster contributorily liable for copyright infringement. The Ninth Circuit also considered *Grokster* before it was reviewed by the Supreme Court. Grokster provided a service that lacked a central server and did not actively participate in connecting the provider with the copier. So the Ninth Circuit found that Grokster was not liable for contributory copyright infringement. The Seventh Circuit, however, had a different interpretation of *Sony* which resulted in finding contributory copyright infringement under similar factual circumstances in *In re Aimster Copyright Litigation* [*Aimster*].

First, this article explains the concept of peer to peer file sharing. Second, it reviews the judicial opinions that have created and applied the doctrines that involve indirect copyright liability. Third, it summarizes the Supreme Court's recent case involving indirect copyright infringement liability for service providers who enable others to illegally copy entertainment works. Finally, the article explains the effect of the decisions on copyright law policy.

COPYRIGHT INFRINGEMENT AND PEER TO PEER FILE SHARING

Copyright gives the owner of an original work of authorship an exclusive right to make and market copies of its work. The copyright's goal is to promote creation and dissemination of original works. It is believed that enabling an owner of a work to reap a financial reward from marketing copies of the work will promote the progress of science and useful arts. The courts have sought to achieve a balance between promoting technological progress through innovative internet services and thwarting creative activity through failure to adequately protect the exclusive right to make and market copies of the work. Courts do not always agree on where to draw the lines. That has happened with peer to peer file sharing systems. The courts have considered the balance between the competing interests inherent in copyright. One one side is the right of the owner to exclude others from access to the work unless payment is made for access. On the other side is the interest of society in having access to intellectual property for the public good.

One who copies a copyrighted work is liable for copyright infringement. There are exceptions to this rule, so the copyright owner's right is not as exclusive as it appears. Copyright is protected by federal statute. Courts interpret statutes. Courts apply common law concepts to statutory law problems and have done so in copyright law.

Courts now hold some defendants liable for copyright infringement even though the defendant did not illegally copy the copyrighted work. Those who enable others to infringe copyright may be liable on the basis of contributory copyright infringement and vicarious liability for another's copyright infringement.

Copyright was created in reaction to a technological invention that made copying another's original work of authorship easy. That first invention was the printing press. Since that time there have been numerous new technologies that have enabled copiers to more easily infringe the copyright of the owner of the work. A recent enabling technology is internet services that provide programs that enable internet users to download and copy works. Copying is commonly performed on musical and video works.

The entertainment industry has pursued suits against individuals for direct copying. It is felt that the illegal copying is of such a large scale that individual suits against each copier are too burdensome for the copyright owner. So the industry has sued the providers of the copying services for their role in inducing or enabling the individual copying.

Since peer to peer file sharing is a new technology, its possible uses for the good of society are barely being realized. It is agreed that peer to peer file sharing technology holds much promise for facilitation of communication for far more than song and movie copying. The music and movie industries would like to have the services prohibited. Those who see future noninfringing uses of the services would like to have the opportunity for innovative growth. It is not good policy to hinder or prevent technology that is going to be widely used throughout the world, possibly for noninfringing uses.

Napster actively participated in illegal music copying by operating a central server that received requests, found owners of the requested music, and transferred the music to the requester. Therefore it presumably had actual knowledge of specific infringing uses. Therefore it was liable for contributory and vicarious copyright infringement. Technology was quickly developed to eliminate the central server that was the cause of Napster's liability. After Napster was stopped from its activity, numerous other internet sites developed technology that enabled music copiers to download music files. The newer systems used two main strategies. The first was locating overseas where it was hoped the U.S. courts could not have jurisdiction. The second was eliminating the use of a central server that received requests and found links to providers. [*Grokster*,] The use of the central server was found to be the main factor in Napster's liability due to its actively engaging in encouraging others to illegally copy. Grokster eliminated the central server and thought it would be immune from liability.

HISTORY OF PEER TO PEER FILE SHARING JUDICIAL OPINIONS

Three internet file sharing cases led to the Supreme Court's decision to review the Ninth Circuit's opinion in *Grokster*. They are *Napster*, *Aimster*, and the Ninth Circuit's opinion in *Grokster*. All three cases interpreted the doctrines created in *Sony*: contributory copyright

infringement, vicarious copyright infringement, and the staple article of commerce doctrine. The courts that have applied *Sony* to cases involving technology that enables direct copyright infringement have become sophisticated in their understanding and articulation of the theories of indirect liability.

First, in 2001 the Ninth Circuit found Napster liable for contributory and vicarious forms of copyright infringement. The internet operator maintained a central server accessible by both musical works providers and copiers. It enabled individuals to download music files that the Napster server maintained access to. Both forms of vicarious copyright infringement require that the technology enable an underlying act of direct infringement. Contributory liability attaches when the defendant also knows of the infringement and materially contributes to it. Vicarious liability results when the defendant directly financially benefits from the infringement. It must also have the right and ability to control the infringer's actions. [*Napster*]

Second, in 2003, the Seventh Circuit in *Aimster* differed from the Ninth Circuit's interpretation of *Sony* when it considered a similar factual situation to *Napster*. First, the Seventh Circuit said Sony's recognition of no liability if the instrument that enables infringement is capable of substantial noninfringing uses meant more actual use than the Ninth Circuit had been requiring. Second, the court pointed out the difference in a machine versus a service. Sony provided a machine through sales. It had no control over the use of the machine once sold. Internet providers sell a service and do have an ability to control the uses of the service through monitoring and maintenance. Third, the court thought that there is no need for the peer to peer file sharing provider to actually know of specific infringing uses to be liable for contributory copyright infringement. In comparison, the Ninth Circuit had implied that actual knowledge would be a prerequisite of contributory copyright infringement liability. Indeed that was the basis for the Ninth Circuit's decision in *Grokster*.

Third, the Ninth Circuit considered Grokster's file sharing methods and determined that Grokster's peer to peer network was not contributorily or vicariously infringing, although the network users probably were engaging in direct copyright infringement. The court said that the service had no actual knowledge of infringement by the users, which it said is a requirement of indirect liability.

The stage was set for the Supreme Court to review the law since two circuits were in conflict over the law on indirect liability for copyright infringement.

THE SUPREME COURT'S GROKSTER OPINIONS

The Supreme Court actually published three opinions. The first opinion was unanimous. It chose to remand *Grokster* to the lower court. The second opinion was authored by Justice Ginsburg and joined by two other justices. The third opinion was authored by Justice Breyer and joined by two other justices. The second and third opinions disagreed with one another.

Unanimous Opinion

The unanimous opinion cited evidence that tended to place Grokster closer to Napster than what the Ninth Circuit did. The lower courts found the intent of the network operators was irrelevant if there was not actual participation in the illegal copying activity. In *Napster* it was clear that the operator actively participated in helping users illegally download music and video files. Grokster did not use servers to intercept search requests, nor did the content enter a central server.

The Supreme Court's concern over the marketer of the service that enables infringement is similar to Judge Posner's differing opinion in *Aimster*. Rather than disagree with the Ninth Circuit's interpretations of *Sony*'s theories of indirect liability for copyright infringement, the Supreme Court overlaid the indirect liability analysis with a new inquiry based on patent law's inducement theory.

The inducement theory requires that the inducer intend to cause infringement, that there is distribution of a device used for infringigement, and that there is actual infringement by users of the device. [*Grokster*] The inducement theory is not in the patent statute, but is a judicial doctrine. The unanimous court stated the issue as "under what circumstances the distributor of a product capable of both lawful and unlawful use is liable for acts of copyright infringement by third parties using the product." [*Grokster*] It decided "that one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties." [*Grokster*] That rule will be interpreted by future courts considering indirect liability for copyright infringement.

The Court continued from *Sony*, which had said that if the defendant had knowledge of infringing uses of the technology, then it could be held indirectly liable. The Court added that even without actual knowledge of specific acts of infringement, a defendant could be liable for indirect infringement if it actively induced infringement. "Thus, where evidence goes beyond a product's characteristics or the knowledge that it may be put to infringing uses, and shows statements or actions directed to promoting infringement, *Sony*'s staple-article rule will not preclude liability." The Court found three facts that caused it concern about inducing others to copy. First, the defendants publicly stated that the objective of using the programs was to copy copyrighted works. Second, the defendants did not develop safeguards or deterrents to deter infringing activity. Third, the defendants profited from the activity by selling advertising.

Justice Ginsburg's Opinion

Justice Ginsburg was joined by the Chief Justice and Justice Kennedy. She believed the Ninth Circuit misunderstood and misapplied *Sony*. She said that at least summary judgment for Grokster was inappropriate. She found there were issues of fact for possibly engaging in active inducement of copyright and/or for contributory infringement based on the distribution of the software products. The two categories overlap, but address different behaviors also.

Justice Ginsburg reviewed the *Sony* Court's reasoning and its findings based on the evidence. She said that the Ninth Circuit erred three years ago in *A&M Records, Inc. v. Napster, Inc.*, when it held that "if substantial noninfringing use was shown, the copyright owner would be required to show that the defendant had reasonable knowledge of specific infringing files." [*Grokster*] Justice Ginsburg disagrees with the Ninth Circuit's application of the standard in *Sony* that said there is not contributory infringement if the product used to infringe is capable of substantial noninfringing uses. Her interpretation, like the Seventh Circuit in *Aimster*, requires that the defendant show actual noninfringing uses of the product.

Justice Breyer's Opinion

Justice Breyer agreed with the Court that actively inducing others to commit copyright infringement is grounds for contributory copyright infringement. He also agreed that the Supreme Court did not need to reexamine *Sony*.

Having said this, he indicated that the lower courts did correctly interpret and apply *Sony*. So why did he feel the need to support and delve so deeply into the facts in *Sony*? He believed Justice Ginsburg indicated that the lower courts misinterpreted *Sony*. She did indeed strongly indicate that *Sony* has been misread. So Justice Breyer reviewed the case in its factual details, just to show that by comparison, if anything, Grokster looks better that did Sony in the VCR uses.

Justice Breyer found three factual parallels. First, in *Sony*, the Court considered the copyright liability of a company that did not itself illegally copy protected material, but rather sold a machine that could be used to copy. The same is true in *Grokster*, except there is a service rather than a machine. Second, Sony knew many VCR owners would use the machine for unauthorized copying. So did Grokster. But that fact in Sony was insufficient to make Sony itself an infringer. Court ultimately held that Sony was not liable for its customers' acts of infringement. Third, in *Sony* evidence showed that roughly 9% of all VCR recordings were noninfringing uses. In *Grokster* the evidence showed just slightly more noninfringing use percentage wise.

There are two caveats to the above. First, the amount of copying engaged in by Grokster users is much larger than was confronted by the Court in *Sony*. Second, In *Sony* the Court found that a large percentage of users use the machine for time shifting which the Court decided was not an infringing activity. The Court did not think most of the music copying by Grokster users was noninfringing.

Comparing the facts in *Sony* to the facts in *Grokster*, Justice Breyer concluded that the evidence showed that Grokster has uses that are capable of substantial or noninfringing uses. Justice Breyer believed that more lawful uses for peer to peer file sharing would develop so long as peer to peer file sharing sites were permitted to operate.

He said the *Grokster* facts satisfy the *Sony* standard, so the issue is whether the Court should change the *Sony* standard to be stricter. He presented a three point inquiry. (1) Has *Sony* been effective to promote development of new technology? (2) If so, would modification of *Sony*

weaken that desirable protection? (3) If so, would applying new copyright-related benefits to owners of works outweigh any weakening of *Sony*? This inquiry has an economic and social basis. It is forward looking. It asks if the policy is based on protecting the status quo when change is desirable. Justice Breyer then answered the three questions. (1) *Sony*'s rule has given authors an "assurance that they will be shielded from copyright liability as they bring valuable new technologies to market." (2) Strict interpretation of the *Sony* rule would cause a "chill of technological development." (3) New copyright-related benefits do not outweigh "technology-related loss." [*Grokster*,] Justice Breyer pointed out that although *Grokster* involved music sharing, other uses of peer to peer file sharing would also suffer from a narrow interpretation of *Sony*. He recognized other solutions for the copyright holder to be protected even while others are protecting their activities by suing.

ANALYSIS AND CONCLUSION

"[C]ourts continue the struggle to balance public rights of access to copyrighted works with the copyright owners' interests in reaping just rewards for creative labors." [Grokster,] Whether the Suprme Court is swinging more toward protecting the rights of the copyright holder will be examined by the lower courts in the next few years.

The Supreme Court remanded *Grokster* for the lower courts to reconsider. At this time the district court has not redecided. Often it is predictable what the lower courts will do on remand after studying a Supreme Court decision. But it is not predictable in this case. The unanimous opinion skirted interpretation of *Sony*, simply choosing to invite application of a second patent doctrine not previously adopted into copyright law. The Justice Ginsburg decision called for a rereading, a reinterpretation, of *Sony* by the Ninth Circuit. The Justice Breyer decision indicated that the Ninth Circuit applied *Sony* precisely as it was meant to be interpreted. Under his scheme of the law, the lower courts would be applying the new Supreme Court decision on the inducement doctrine.

The Supreme Court added patent law's inducement theory to considerations in copyright involving indirect liability. When one reviews the facts and findings in the trial court in *Sony*, as Justice Breyer did, it is difficult to distinguish between the inducement done by Sony in its advertising of the Betamax and its training of sales personnel to demonstrate how to copy and store copies of television programs and televised movies, and the inducement done by the defendants in *Grokster*. So one cannot predict how the lower court may decide the applicability of the inducement theory in Grokster's case.

There is a distinction between *Sony* and *Grokster* in regards to the item that was being distributed. Sony's VCR is a machine that Sony sold and did not continue to control its use. Grokster's program is an intangible software program that Grokster continually participated in running and reaping financial benefits from. It continued to interact with its users. Sony did not do that. This may have been in the minds of the justices when they perceived Grokster as being more actively engaged in promoting infringing uses of its product than was Sony. The Court said that

Sony's advertising and training induced consumers to buy the VCR to record favorite shows and to build a library of recorded programs, but that these uses may be fair. Those are the same types of copying that Grokster was enabling its users to do. Why is recording a TV show and saving it a fair use and not illegal, while recording a song and saving it is infringing use? Should the courts consider whether copying musical works for private use may be a fair use?

The Supreme Court's unanimous opinion in *Grokster* did not resolve the differing views of base requirements for vicarious and contributory copyright infringement. Justice Ginsburg did address these issues. She agreed with the Seventh Circuit and Judge Posner. Justice Breyer did address these issues. He agreed with the Ninth Circuit in both *Napster* and *Grokster*. Since the unanimous opinion did not find either with the Ninth Circuit or with the Seventh Circuit, practitioners and scholars are left to ponder the issue. But at times the decision will not have to be made, since they can apply the most recent interpretations of the newly recognized inducement theory.

The Court acknowledged that MGM argued those two theories and lost in the lower courts. The Court said it would not consider the merits of the two theories of copyright liability: contributory infringement and vicarious liability for copyright infringement. It chose instead to incorporate the inducement theory into copyright law. But the Court did look at *Sony*, because it is the most recent time the Supreme Court has addressed secondary liability in copyright law. It also admitted that MGM had based its claim against Grokster on the *Sony* opinion and adoption of secondary liability theories into the copyright law.

Justice Ginsburg's explanation complains about the evidence the Ninth Circuit relied on in *Grokster* to show that it met *Sony's* standard. She did not compare the actual facts and evidence before the Court in *Sony* with the actual facts and evidence before the Ninth Circuit in *Grokster*. This was, however, done by Justice Breyer in his concurring opinion that disagreed with Justice Ginsburg's concurring opinion. So we have one unanimous opinion and two concurring opinions that agree with the unanimous opinion, but disagree with one another. This will prove quite difficult for the lower courts who must revisit the case on remand. Justice Ginsburg did indeed spend pages reviewing the evidence relied on by the Ninth Circuit in *Grokster*. She was persuaded that when the primary use is infringing, the court should not grant summary judgment. She did not mention that in *Sony* the primary use of the VCR was certainly infringing also. She suggested that the Ninth Circuit should revisit it if it does not find liability on the inducement theory.

But consider that a VCR is only good for copying and playing videocassettes. Grokster's peer to peer file sharing is capable of more that simply copying. It is a communication device among internet users. It does not have to be used for copying music or movies. It can actually be used for discourse.

Sony could have been held liable on an inducement theory also, but the Court was predisposed to allow the technology. Now the Court is tired of allowing infringing technology. This was a problem with copy machines, even with printing presses. So we are back to the original

copyright problem of stopping a technology simply because it is used to infringe copyright. We know Grokster is capable of substantially noninfringing uses.

The Supreme Court's unanimous opinion would reinterpret *Sony* to lower the threshold for imposing liability for contributory infringement. If this is the case, there is likely to be a deluge of contributory infringement cases against numerous internet server systems. Justice Breyer mentioned that a good thing about *Sony* is that there have been very few contributory infringement copyright cases dealing with the newer technologies that make copying simple. The lower courts will continue to struggle as technology continues to change at breakneck speeds and the copyright law attempts to address the parameters of protection.

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ATTORNEY ADS AND CONSUMER PURCHASE INTENTIONS: THE EFFECTS OF CERTIFICATION CLAIMS AND SEX OF SOURCE

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ABSTRACT

An experiment was conducted using a mock-up of print advertisements for attorneys. A sample of 309 consumers viewed the ads. The independent variables were attorney certification credentials and attorney sex. The dependent variable was consumer purchase intentions. Results indicated a main effect for certification credentials. That is, the positive wording (board certified) and negative wording (not board certified) of attorney board certification credentials in a print ad significantly influenced subjects' purchase intentions. A significant main effect was also found for the sex of the attorney as subjects indicated greater intentions to patronize the female attorney than the male attorney. Additional analysis of the data based on the sex of the subjects suggested that females were concerned with certification credentials much more when the advertising attorney was male. Implications for public policy and advertising practices are discussed and directions for future research are suggested.

Key Words: *Attorney, consumer purchase intentions, advertising, services marketing, sex, board certification.*

ATTORNEY ADS AND CONSUMER PURCHASE INTENTIONS: THE EFFECTS OF CERTIFICATION CLAIMS AND SEX OF SOURCE

Consider the following scenario: while at a stop light, your vehicle is rear ended by another driver. Your vehicle is severely damaged and you sustain serious injuries requiring on-going medical treatments. The subsequent police investigation of the accident reveals that the other driver was under the influence of alcohol and had no insurance on his vehicle. Faced with voluminous medical bills and a plethora of legal issues, you consult the local yellow pages in search of an attorney. Among the myriad advertisements for legal services, you notice that some ads feature statements that read, "Not Certified by the State Board of Legal Specialization," while others proclaim, "Certified by the State Board of Legal Specialization." How does such information influence your

decision on which attorney to contact? Such a question warrants further investigation because nearly one quarter of states require that certification statements be included when attorneys advertise their specialization.

To consumers searching for legal services, board certification statements in attorney advertisements may be confusing and/or misleading. Because such purchases are often highly involving, consumers of professional services (e.g., legal counsel) have a greater need for purchase decision criteria (Hill, Garner, and Hanna 1992). Yet, consumers typically do not have a well developed set of evaluative criteria for legal services due to purchase infrequency (Hill and Neeley, 1988). In light of possible confusion and an under-developed decision criteria for legal services among consumers, the disclaimer that a lawyer is "Not Board Certified" is thought by some attorneys to adversely influence consumers' purchase intentions (Kilbourne, 1990; Texas Bar Journal, 1998).

Now consider another situation relevant to how consumers may perceive attorneys in their search for legal representation. In your search for legal counsel, you examine a number of advertisements, each of which contains photographs of the attorneys from each firm. The photographs appear quite similar, depicting attorneys in professional attire and posed in an office setting. A difference one may note while perusing the ads is that some of the ad photos depict female attorneys while other photos show male attorneys. From this situation, a key question arises, that is, would the sex of the attorney be an influencing factor among consumers seeking the legal services and if so, how?

This study considers both of the above situations, where attorney certification credentials and attorney sex appear as components of attorney advertising. Therefore, the purpose of this study is to answer the questions, "What are the effects, if any, of advertising certification claims and the sex of the source on consumers' intentions to patronize an attorney?" Here, these two possible decision criteria (certification and sex) are examined as independent variables that consumers may consider when they view attorney ads.

Attorney board certification and attorney sex represent specific types of two evaluative criteria (a professional qualification and a personal characteristic) that have been linked in the literature as potential antecedents of purchase intentions for legal services (Kilbourne, 1990; Lang and Marks, 1980; Rhode, 2001). Further, attorney certification and the sex of the attorney both represent potential biases to consumers. For example, the wording of professional qualifications was empirically found to influence consumer perceptions (Kilbourne, 1990). Also, sex has influenced perceptions of attorneys such as the negative stereotype bias of women attorneys, given the legal profession's history of being a male-dominated profession (Rhode, 2001).

ATTORNEY ADVERTISING LITERATURE

The attorney advertising stream of research began shortly after attorney advertisements were legalized in the 1977 landmark case of Bates v. State Bar of Arizona. Much of the work assessed

how an attorney's professional qualifications and the personal characteristic, sex, affected consumers' attitudes and purchase intentions. Each of those evaluative criteria is discussed in more detail below.

ATTORNEY PROFESSIONAL QUALIFICATIONS

Lang and Marks (1980) found that customers' purchase intentions for legal services were significantly affected by attorney advertisements that included the attorney's professional qualifications (including specialization, law school degree affiliation, class rank, and professional affiliations), factual information (i.e., the implications from not seeking legal aid), and a fee schedule. Smith and Meyer (1980) identified 18 criteria, including area of lawyer specialty, years in practice, and law school attended that consumers used to select an attorney. Kilbourne (1990) examined consumer attitudes of attorney ability and ethics in print ads. He found that the inclusion of a statement indicating that the advertising attorney was either "board certified" or "not board certified" by the state board of legal specialization significantly influenced subjects' attitude regarding the advertising attorney's ethics and ability.

A major motivation and implication to include attorney board certification as a professional qualification is because in the U.S., nearly 25% of the states use attorney board certification as a benchmark for professional excellence. To become Board Certified within an area of law, an attorney must meet a number of requirements including a minimum level of experience, continuing education, peer reviews, and passing a written examination (Texas Board of Legal Specialization, 2000). In addition, twelve states have adopted state-wide certification programs to promote public access to legal services and improve attorney competence (Kilpatrick 1997). Among those states that have adopted certification programs, attorneys must specify their certification status (i.e., Board Certified or Not Board Certified) when they advertise an area of specialization (Wallace and McKelvery, 1987).

Critics of this program assert that using the term Board Certified does not guarantee quality service, and requiring attorneys to state they are Not Board Certified could mislead the public into believing such attorneys are either un-licensed or inexperienced (Texas Bar Journal, 1998). The certification/non-certification statements were intended to be affirmative disclosures. That is, such requirements were created to objectively inform the public. Yet such claims may be interpreted by consumers as either a disclaimer (i.e., negative bias) for those attorneys who label themselves Not Board Certified or as a positive bias for those attorneys who are labeled Board Certified (Jacoby et al. 1982; Kilbourne, 1990). Instead of informing consumers, these required advertising claims may either confuse or mislead consumers. Consequently, the question arises, "How does such information influence consumer purchase intentions?" Impression Formation Theory appears to offer insight to answering this question.

IMPRESSION FORMATION THEORY

Heider (1958) found that when we form an impression of another, we tend to focus on that person's behavior or other readily available information. In a similar vein, when consumers look at the images of people in an advertisement, they may seek to form an impression, even though the quantity of information in an ad may be somewhat limited or vague (Kanouse and Hanson, 1972). Impression Formation Theory is particularly relevant to this study because as Kilbourne (1990) noted, the attorney-client relationship facilitated by the ad involves the consumer forming an impression about a service provider who will likely render a highly personal and important service. Similar to the Kilbourne (1990) study, the current experiment uses an attorney advertisement as the initial cue from which subjects will form their attitudes and intentions to purchase legal services.

Central to Impression Formation Theory are positivity and negativity bias. People tend to succumb to a positivity bias when forming their evaluations of specific individuals. For example, one who belongs to an unfavorable reference group such as attorneys (Romano, 2005; Trebbi, Hayes, and Walker, 1999) tends to be evaluated more positively when assessed on an individual basis (Sears, 1983). Because attorney ads tend to promote individuals rather than lawyers in general (Kilbourne, 1990), a positivity bias is possible.

Conversely, a negativity bias may occur when either an extreme or negative attributes exist. Research indicates that extreme or negative characteristics tend to be more heavily weighed when impressions are being made (Fiske, 1980; Reeder and Coovert, 1986). Negative information may completely negate any individual-based positivity bias. Further, negative information attracts more attention than positive information when both forms of information are comparable in magnitude (Fiske, 1980). For this study, information that an attorney is not board certified would then likely be given more weight as the consumer forms an impression of the attorney.

Morwitz and Fitzsimons (2004) noted the impact of positivity and negativity bias when measuring individual's purchase intentions. Their results revealed that individuals tend to choose options toward which they hold positive and accessible attitudes and are less likely to choose those options that they have negative and accessible attitudes toward. Such results are particularly relevant to the current study given the dependent variable is purchase intentions.

In additional support of the positivity and negativity bias during impression formation, Kilbourne (1990) found empirical evidence that a positive affirmative disclosure had the effect of significantly influencing consumers' attitudes of attorney abilities and ethics, while a negative affirmative disclosure negatively influenced attitudes. Using the logic of Impression Formation Theory and Kilbourne (1990), the following hypothesis was developed:

H1: Consumers will have stronger purchase intentions for a Board Certified attorney than for a Not Board Certified attorney.

ATTORNEY SEX

In addition to professional qualifications, other studies have examined the personal characteristic, attorney sex, as in influence on consumers' perception of attorney advertising. A number of studies suggest that the provider's sex is a salient component of the service situation that affects most customers' perceptions of their service quality and the service provider (Humphreys and Kasulis, 1981; Hahn and Clayton, 1996; Fischer, Gainer, and Bristor, 1997; Kay and Hagan, 1998; Trebbi, Hayes, and Walker, 1999; Hull and Nelson, 2000; Rhode, 2001). Simply put, one's sex is an inescapable factor present any time human labor is involved with serving customers.

While there is no consensus on which attorney sex is most preferred, there appears to be a significant body of research that favors men. For example, there is empirical evidence that in general, for tasks involving analysis and reasoning, males are perceived to be more competent than females. People tend to stereotype men as being more assertive, analytical, exact, and having better reasoning or problem solving skills than women (Deaux and Kite, 1993). The preference of men over women attorneys is also predicated on the well established tendency for an occupation (e.g., attorneys) that has been dominated by one sex (e.g., men) to be characterized as being a better fit for individuals of that sex (Basow, 1992; Mackie, Hamilton, Susskind, and Rosselli, 1996). Stern et al. (1993) suggest that like individuals, all services have masculine, feminine, or neutral sex-typed images. The legal field, which has historically consisted primarily of men and is approximately 70% male (Rhode, 2001), is likely to have a masculine sex-typed image, which may in turn facilitate a negative gender bias against women or in favor of men (Kay and Hagan, 1998; Rhode, 2001).

In the legal arena, gender bias is well documented. For example, research shows that female attorneys are thought to have significantly less assertiveness and aggressiveness in comparison to men (Carter, 2000) and that of the estimated 202,308 female lawyers in the U.S., between two thirds and three quarters report experiencing gender bias (Rhode, 2001). MacCorquodale and Jansen (1993) surveyed 112 lawyers and identified evidence of gender bias. They found women were more likely than men to report hearing sexist jokes and remarks, to be referred to by their first names, to be asked if they are lawyers, and to receive compliments based on appearance rather than achievements.

Interestingly, the gender bias against women may come from other women. Hodgson and Pryor (1984) found evidence that female attorneys were less preferred by women. Subjects read a mock court case about a breaking and entering crime, then listened to an audio tape of closing arguments. Half of the subjects heard a male defendant and the other half heard a female defendant. Women subjects rated the female attorney significantly less intelligent, less friendly, less pleasant, less capable, less of an expert, and less experienced than the male attorney. Men rated the male and female attorney about the same with no significant differences.

Swenson (1992) studied male and female attorneys who mediated child custody disputes. Clients of female attorneys were more likely to respond negatively after failing to settle. Female attorneys were found to have spent more time and effort and presented the mediation services more

favorably to their female clients who failed to settle, compared to their non-settling male clients. No significant differences were reported among male attorneys.

Finally, Hahn and Clayton (1996) found that consumers exhibited a preference for male versus female attorneys. In an experiment simulating a trial for assault-and-robbery, the researchers found that respondents rated male defense attorneys as more successful in gaining an acquittal than were female attorneys. The research also showed that male subjects rated male attorneys as being more successful and that female subject rated female attorneys as more successful.

While the literature suggests a general consumer preference for male attorneys, there is evidence that in some cases, female attorneys are perceived more favorably. This preference of women over men attorneys seems largely based on the evidence that women are perceived as outsiders to a field that has an unsavory reputation. Consequently, women may be considered more trusted or ethical than their male counterparts. Evidence of such was found in a survey by Starr and Stone (1992), where women attorneys were considered more interested in justice, guided more by ethical considerations, demonstrated more concern toward their clients, and were trusted more. In addition, women are often perceived as being more imaginative, intuitive, perceptive, verbally skilled, and creative (Cejka and Eagly, 1999). Similarly, women attorneys are believed to use more participatory styles (Eagly, 1995), have more empathy, and possess better people skills (Carter, 2000).

Villemur and Hyde (1983) manipulated sex of the attorney in an experiment that used audio taped testimonies and attorney summaries with slides of a mock rape trial. Results of the study showed that subjects indicated a higher acquittal rate under the female defense attorney condition (71%) than under the male defense attorney condition (49%). Villemur and Hyde (1983) explained the findings by the "talking platypus" phenomenon (Abramson, Goldberg, Greenberg, and Abramson, 1977), where jurors became so impressed that a woman was a competent defense lawyer that her performance was over-inflated relative to the male defense lawyer.

In summary, the evidence regarding consumer preferences of male versus female attorneys is somewhat mixed. Yet, given the substantial evidence of a negative gender bias against women in the legal profession, the following hypothesis is offered:

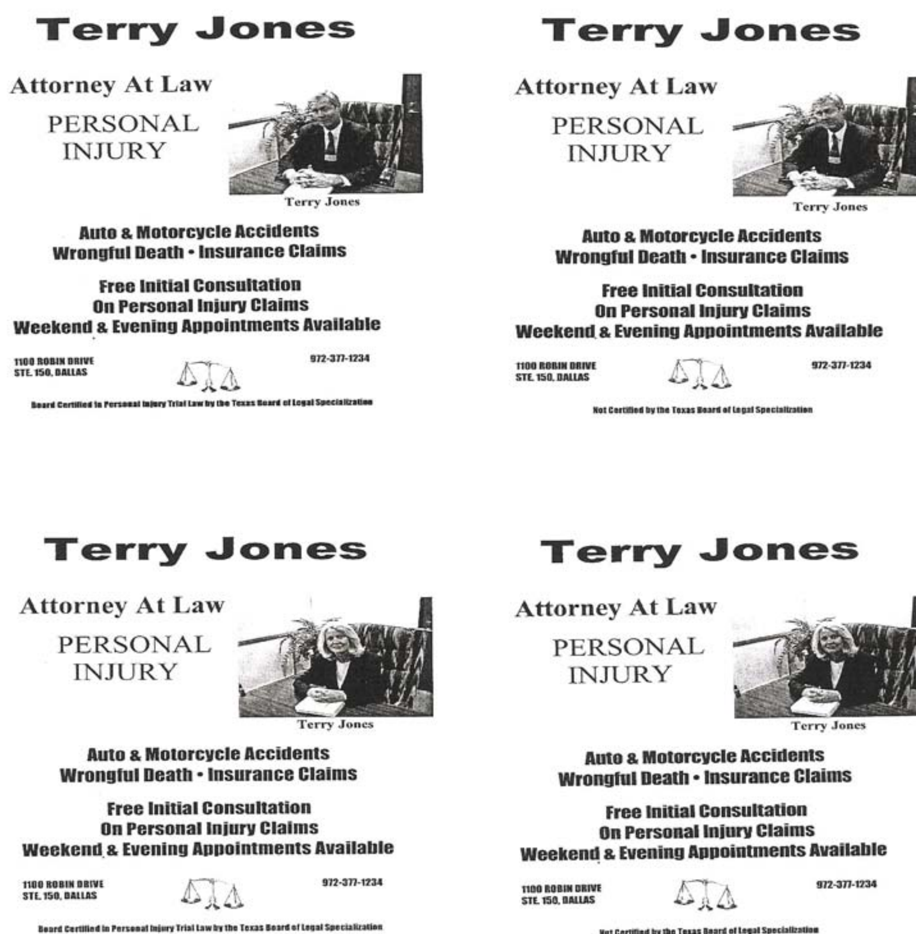
H2: Consumers will have stronger purchase intentions for a male attorney than for a female attorney.

THE EXPERIMENT

The experiment used a mock-up of a yellow pages attorney ad. The ad manipulated the sex of the attorney and his/her certification credentials. The experiment used a 2 X 2 full-factorial design with two levels for sex (male/female) and two levels for certification credentials, where a statement declared the attorney to be either "Board Certified in Personal Injury Trial Law by the Texas Board of Legal Specialization" or "Not Certified by the Texas Board of Legal Specialization."

The name of the attorney was sex-neutral, “Terry Jones.” The ad copy included the following captions: “Attorney At Law,” and “specialization in personal injury for auto and motorcycle accidents, wrongful death, or insurance claims.” Other information in the ad included: “free consultation on personal injury claims,” “weekend and evening appointments available,” an address, and a phone number. A 2 ½ " by 3 ½ " color picture of the attorney was also included. Both the male and female attorneys wore gray business suits and were depicted seated in the same position at a table in an office. Each attorney was approximately the same age (50 years old) and had a similar facial expression. Figure 1 contains mock ups of the ads used in the experiment.

Figure 1
Mock Ups of Ads



The relatively few extant studies of attorney advertising have included dependent variables such as intention to purchase or perceived attorney ability/ethics. Because the goal of most attorneys' advertising is to create selective demand for consumers to use their legal services, purchase intentions to use a specific attorney are included as the dependent variable in the current study. Further, purchase intention represents a measurable outcome from the effects of advertising and because it serves as a reasonable surrogate/antecedent for the purchase decision. Purchase intentions were measured using three items, each with a five-point Likert Scale including the anchors "Very Unlikely" =1 and "Very Likely" =5. The range for the summed items is 3 - 15. The three item scale yielded a Cronbach Alpha of .900. Table 1 contains a list of the items with item-total correlations.

Table 1: Purchase Intentions Scale Items

Item-to-total correlations	
.789	1. If you needed an attorney for a personal injury, what is the likelihood that you would visit the attorney in the advertisement for a consultation?
.865	2. If you needed an attorney for a personal injury, what is the likelihood that you would use the attorney in the advertisement?
.725	3. What is the likelihood that you would recommend this attorney to a friend who needed an attorney for a personal injury?

The experimental materials were pre-tested with 60 subjects. In the pretest, subjects offered feedback on the realism of the ads used, the time allotted to view the ads, the appearance of the attorneys depicted in the ads, and subject hypothesis guessing. Pre-test subjects indicated the ads were realistic, that 15 seconds was sufficient and appropriate time for viewing the ad, that there was nothing unusual or distracting about either attorney, the depicted attorneys were similar in professional and personal characteristics, and that they did not know what was being tested.

The sample was non-probabilistic. A total of 309 subjects were recruited for this experiment. The data were collected in individual's homes or places of work. The subjects consisted of a convenience sample from the general populace of a southwestern U. S. city of approximately 70,000 people. Subjects were shown an advertisement for an attorney and asked to examine the advertisement. Subjects received one of the four mock-up attorney ads and were allowed to examine it for 15 seconds, after which the ad was removed and the survey portion of the study was administered. Based on pre-tests of the mock-up materials, 15 seconds was determined to be sufficient for an individual viewing a yellow page ad to study the picture of the attorney and carefully read through the detailed information in the ad. Print advertising materials used in other studies employed similar times, ranging from 10 seconds (e.g., Barrett, 1985) to 20 seconds (e.g., Forehand and Deshpande, 2001), depending on the amount of information contained in the print ads.

Subjects' ages ranged from 18 to 81 with a median age of 35; median household income was $25,000, and 73% had at least some college education. The sample was 41% male and 56% female; and distribution by race was: 67% Caucasian, 15% African-American, 5% Asian-American, 6% Hispanic, and 6% other. In addition, 49.8% of the subjects had used an attorney, 74.4% had heard of attorney board certification, 47% correctly described what board certification meant, and 50.2% rated board certification as "Very Important."

ANALYSIS

The main effects for the study are hypothesized in H1 and H2, where H1 is a main effect for the board certification factor while H2 is a main effect for the attorney sex factor. These hypotheses were tested with ANOVA and the results relating to the hypotheses are presented as Table 2.

Table 2: Summary of Means and ANOVA

Dependent Variable: Purchase Intentions					
Attorney Sex	Board Certified	Mean	Std. Dev.	n	
Female	Not Certified	7.21	3.57	76	
	Certified	7.91	3.55	79	
	Total	7.56	3.56	155	
Male	Not Certified	6.06	3.24	77	
	Certified	7.40	3.60	77	
	Total	6.73	3.48	154	
Total	Not Certified	6.63	3.44	153	
	Certified	7.66	3.57	156	
	Total	7.15	3.54	309	
Dependent Variable: Purchase Intentions					
Source	Type III Sum Sq	df	Mean Square	F-value	p-value
Attorney Sex	52.84	1	52.84	4.32	.038
Board Certified	80.23	1	80.23	6.56	.011
Attorney Sex *	7.83	1	7.83	.640	.424
Board Certified					
Error	3730.20	305	12.23	-	-
Total	19678.85	309	-	-	-

Purchase intentions were measured via a three-item scale using a five-point Likert scale with endpoints of 1 (very unlikely) to 5 (very likely). Respondent purchase intentions could range from a low of 3 to a high of 15. H1 was supported. Subjects indicated significantly stronger purchase intentions (F=6.56; p<.011) for the Board Certified attorney (x=7.56) than the Not Board Certified attorney (x=6.73). However, H2 was not supported. Rather, the results suggested the reverse of H2. Instead of preferring the male attorney, subjects exhibited a significant purchase preference (F=4.32; p< .038) for the female attorney (x=7.65) over the male attorney (x=6.63).

Sex of the Research Subjects

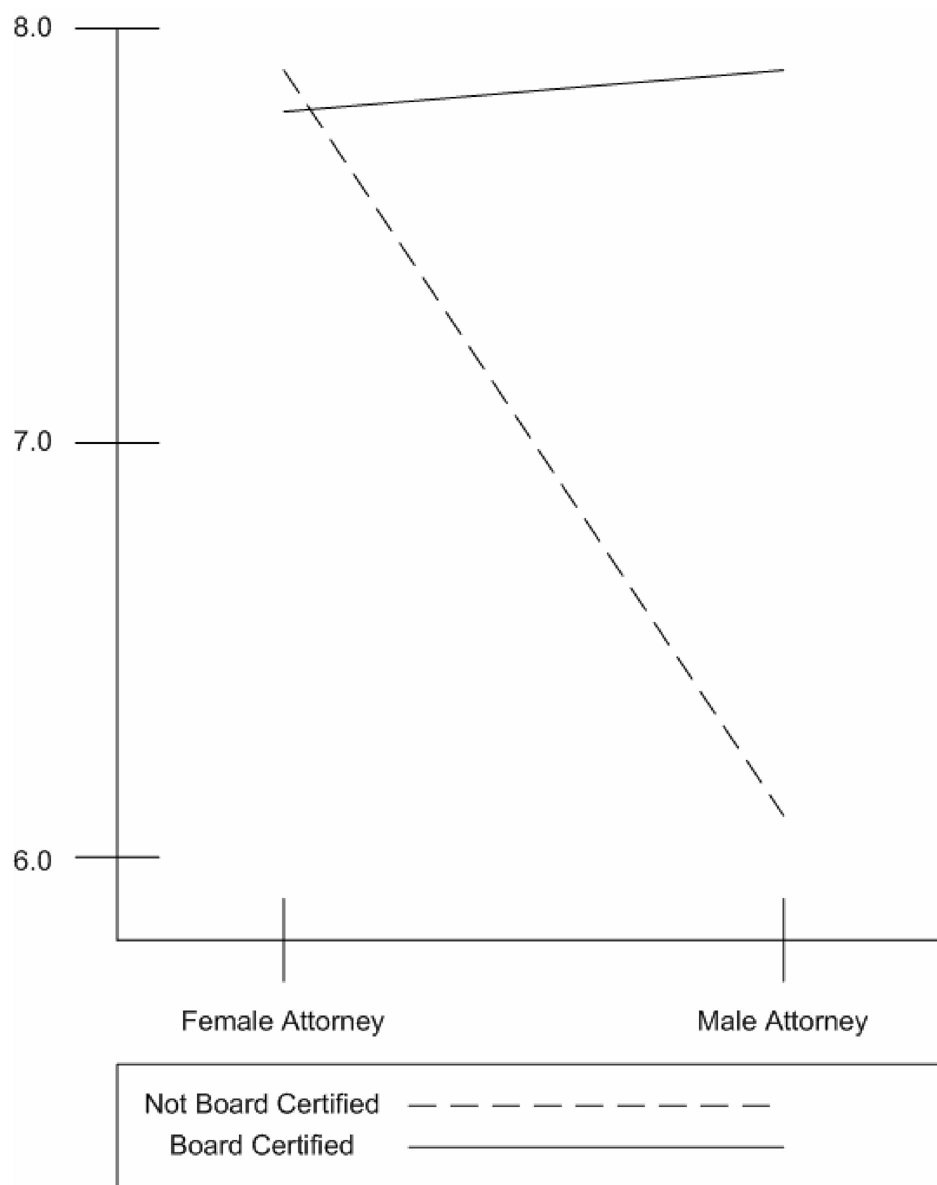
In addition to the research variables discussed previously and the hypotheses stated and tested above, some prior research suggested that there may be some influence of the sex of the consumer on attitudes toward attorneys (e.g., Hodgson and Pryor, 1984). However, prior research did not appear sufficient to support the a priori statement of research hypotheses regarding the influence of the sex of the subjects on the variables of interest in this study, and no effort was made in the experiment to control for any sampling error regarding the sex of the subjects. Nonetheless, additional analysis of the data to explore the relationships among the sex of the subjects and the primary research variables of interest was conducted.

To study the effects of the sex of the research subjects, an analysis was conducted where the responses from the men and women were analyzed separately. Of the 309 subjects interviewed, 10 could not be used because the interviewers had not indicated the subject's sex. Overall, both men and women preferred board certification (7.4 vs. 6.2 for men, 7.9 vs. 7.0 for women), both men and women prefer female attorneys (7.2 vs. 6.4 for men, 7.9 vs. 7.0 for women), and women subjects indicated a stronger intention to purchase attorneys' services than men (6.8 mean response for men vs. 7.5 for women), Table 3 contains descriptive statistics of the purchase intentions of the subjects' dissected by board certification of the attorney and sex of the attorney and dichotomized by the sex of the subject.

Further analysis suggests an additional relationship of interest in the data. As Figure 2 illustrates, women subjects seemed to be concerned with board certification very little when the advertising attorney is female (purchase intentions of 7.9 for the board certified female attorney vs. 7.9 for the non-board certified female attorney) and very much when the advertising attorney is male (7.9 for the board certified male attorney vs. 6.2 for the non-board certified male attorney). Given the explanatory, *ad hoc* nature of this analysis, discussion of the implications of these findings will be presented as suggestions for future research.

Table 3: Descriptive Statistics – By Sex of Subjects				
Dependent Variable: Purchase Intentions				
Results: Men				
Attorney Sex	Board Certified	Mean	Std. Dev	n.
Female	Not Certified	6.48	3.40	33
	Certified	7.94	3.18	34
	Total	7.22	3.34	37
Male	Not Certified	5.86	2.69	29
	Certified	6.90	3.45	31
	Total	6.40	3.13	60
Total	Not Certified	6.19	3.08	62
	Certified	7.44	3.33	65
	Total	6.83	3.26	127
Dependent Variable: Purchase Intentions				
Results: Women				
Attorney Sex	Board Certified	Mean	Std. Dev	n.
Female	Not Certified	7.94	3.73	39
	Certified	7.88	3.85	45
	Total	7.91	3.77	84
Male	Not Certified	6.15	3.13	44
	Certified	7.93	3.66	44
	Total	7.04	3.50	88
Total	Not Certified	7.00	3.52	83
	Certified	7.91	3.74	89
	Total	7.47	3.65	127

Figure 2
Plot of Women Subjects' Purchase Intentions



DISCUSSION AND IMPLICATIONS

This study focused on the effects of professional certification claims and the sex of the source on the purchase intentions of an attorney based on a print advertisement. Using Impression

Formation Theory, the hypotheses predicted that board certification statements and attorney sex would significantly influence subjects' intentions to use an attorney. Regarding the certification statements (H1), consumer purchase intentions were influenced by disclosure statements about attorney certification credentials. This finding supports Impression Formation Theory, where a negative and extreme attribute (Not Board Certified) was heavily weighed in forming an impression, while the positively worded affirmative disclosure (Board Certified) yielded a positive impression. This result bore a similarity to that of Kilbourne (1990), who found a positivity bias among subjects who were exposed to a positively stated disclosure (e.g., attorney is board certified) and a negativity bias for those who viewed a negatively stated disclosure (e.g., attorney is not board certified) on subjects' evaluations of attorney ability and ethics.

The hypothesis (H2) that subjects would prefer to use the male attorney over the female attorney was rejected. In fact, the data suggest that the female attorney was preferred over the male attorney. This result was inconsistent with the belief that because of men's traditionally strong presence in the legal field, the male attorney would be more preferred. Instead of consumers viewing women in the legal field akin to a "talking platypus" (e.g., Villemur and Hyde, 1983), this finding of a purchase intention preference for the services a female over a male attorney supports the work of Starr and Stone (1992). That is, a preference for women attorneys may be a result of their perceived superiority to their male counterparts in certain areas such as interest in justice, ethics, caring toward their clients, and trust. For example, there is a general belief perpetuated in the popular press that women are more altruistic and have more compassion for others than males (Gilligan, 1982), and our study appears to support such a notion.

This finding also contradicts the traditional stereotypes that women may be viewed more favorably than men only in domestic roles and female-dominated occupations (Cejka and Eagly, 1999). Women have long been believed to possess superior communal characteristics such as being gentler, kind, supportive, expressive, affectionate, and tactful (Deaux and Kite, 1993). However, these communal characteristics facilitated more positive evaluations of women (versus men) in traditionally feminine domains, not in neutral or task oriented-masculine domains (Swim, Borgida, Maruyama, and Myers, 1989). It may be that consumers view such communal characteristics as valuable in the (historically masculine) legal profession as well.

Our findings also deviate with Orth and Holancova (2004), who found empirical results suggesting that male and female consumers have significantly different responses to sex role portrayals in advertisements. Rather than men and women processing advertising differently as suggested by Wolin (2003), we found evidence of convergence with a general preference for the female attorney by both sexes.

In addition, the nature of the specialization in the advertisement may have influenced the subjects' preference. Specifically, the attorney's specialization was personal injury. It is possible that in comparison to a male attorney, a female attorney may have been perceived as more compassionate or empathetic with regard to a client's needs related to a personal injury.

The findings here suggest that the role of a woman attorney may benefit from a progressive portrayal. However, our conclusion contradicts the work of Milner and Higgs (2004) who found that advertising portrayals of women appear to be moving in a more stereotypical and traditional direction.

Finally, analysis of the influence of the sex of the subjects yielded what may be the most interesting findings in this study. Overall, the results appear to be influenced by the two differing views of males and females in this sample. Generally, females had stronger purchase intentions than males, both sexes preferred a board certified attorney over a non-certified attorney, and both sexes preferred a female attorney over a male attorney. Further analysis indicated that female subjects' preferences for certification were much stronger when the advertising attorney was male than when the advertising attorney was female. Male subjects' responses did not indicate such an influence. Additional comments about the significance of the sex of the subject will be provided as suggestions for future research.

Implications

The scope of this study's contributions extends well beyond the legal field. All forms of disclosures in advertising make some sort of claim and the way in which the presentation or claims are framed is critical to assessing how that information will be interpreted by its recipients. Therefore, the implications of this study reach well beyond just those states that impose mandatory disclosure of certification credentials, and may have relevance to any ad that makes an affirmative disclosure. For example, could a required warning label, intended to more fully disclose information and protect consumers, unintentionally act as a devise to dissuade potential consumers from buying or using the product?

The results of this study are significant for disclosures in advertising. How information is framed may create consumer biases that are unintended by the advertiser. For example, affirmative disclosures for attorney advertising have a dramatic impact on consumer purchase intentions. While the positive disclosure statements do not offer information about training or experience, the resulting bias effects indicates that the consumers make generalizations about the attorney's desirability. Public policy makers who have mandated attorney disclosures intended to offer decision-making information to consumers, not to disparage non-certified lawyers. Yet, the current policy appears to have unintended consequences. Public policy makers should reconsider how to protect consumers by informing them about the service offerings of attorneys without creating the unintended biases of negatively and positively worded advertising disclosures.

The impact of an affirmative disclosure was profound in attorney advertising.
A simple one line statement intended to more fully inform the public significantly impacted consumers' purchase preferences. When the negatively worded affirmative disclosure of not being board certified was included in the ad, the disclosure acted like a disclaimer, reducing consumers' purchase intentions, with particularly negative effects for the male attorney. It is almost as if being

not board certified was a scarlet letter for male attorneys. In reality, only a small percentage of attorneys are board certified. Perhaps attorneys need to better educate the public about what certification really means as numerous states continue to mandate their inclusion in advertising.

With regard to the unexpected results that the female attorney in the advertisement was preferred, this finding is particularly interesting. This result suggests that the traditional preference of men attorneys over women may have not only disappeared, but reversed itself. Women may be the beneficiaries of being perceived as new or non-traditional to the legal field. Relative to other occupational fields, the legal field has a longstanding poor reputation with the public (Trebbi et al. 1999). Therefore, as more women are expected to continue entering the legal field (Rhode 2001) and women become more accepted as in-group members, any perceptual advantages resulting from being distanced from this profession may diminish in the future.

LIMITATIONS AND FUTURE RESEARCH

Two limitations were identified in this study that could be addressed in future research. The first limitation concerns the sample. The subjects comprised a convenience sample from one state (Texas) that had mandated requirements for attorney advertising. Therefore, the results obtained from this study would be more generalizable had a probabilistic sample been obtained from multiple states with similar requirements for attorney ads.

Second, there was no control treatment in the experiment that omitted information about board certification. Because a major purpose of the study was to examine the unintended consequences of affirmative disclosure statements for attorneys advertising a legal specialization, comparisons were made only between ads containing board certified and non-board certified statements. However, future research should include a control group with no statement of board certification for comparison.

FUTURE RESEARCH

As a suggestion for future research in attorney advertising, scholars may consider expanding the focus of the consumer decision criteria to other personal characteristics. For example, the race and age of the attorney could be manipulated and compared according to the race and age of the subjects. Further, the type of attorney specialization in the experiment could be changed to something that may be less controversial than personal injury cases, such as a specialization in tax or estate planning.

In general, men and women exhibited the same preferences for both board certification and female attorneys. However, an interaction was suggested as women subjects seemed to be influenced by the certification of the male attorneys but not by the certification of the female attorneys. Thus, women may have had some expectation that the male attorney should be certified (e.g., mean response=7.9) and if not, the lack of such a credential may have suggested something

was wrong, or the quality of representation would be diminished (e.g., mean response=6.1). However, women subjects appeared to give the female attorney the benefit of the doubt if the female attorney was not board certified.

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MINIMIZING RISK OF TRANSFER PRICING AUDIT AND AWAKENING THE GIANT OF CORPORATE STEWARDSHIP: AN ETHICAL DECISION MAKING MODEL (EDMM) FOR MULTINATIONAL ENTERPRISE (MNE) TRANSFER PRICING

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ABSTRACT

This manuscript presents an ethical decision making model (EDMM) for transfer pricing (TP). The EDMM has been theoretically and empirically supported in the strategic management, marketing, and ethics literatures, but never applied in a TP context. The model is embedded into the realities and risks presented in TP literature to reveal shortcomings in the ethical reasoning styles of multinational enterprise (MNE) managers. One shortcoming reveals that TP programs have been managed with an overly dominant focus on cost/benefit-based reasoning (teleological), which seeks to minimize effective global tax rates and/or to avoid or effectively manage the risk of tax audits. Another shortcoming reveals that only partial consideration has been made of rule-based reasoning (deontological), which should not only attend to TP laws and regulation but to foundational values, moral laws and corporate responsibilities. These shortcomings have, in part, left low tax countries in a compromised position, voicing strong concerns over the socio-economic impacts that MNE activities are having on their country and culture, officially labeling the strategic use of TP as a 'restrictive business practice' (RBP), and calling for higher levels of corporate stewardship. The EDMM is thus brought into the TP arena and positioned as a tool for MNE managers to use when determining an appropriate and ethical TP.

INTRODUCTION

> *"The social and ecological effects of intra-firm trade need serious examination. Driven by economic growth and profit maximization, the TP practices of TNCs (transnational corporations) can impede sustainable development by depleting natural resources in host countries, with or without the consent of local politicians. It may be argued that this is just a sub-problem of secondary importance in wider international "green issues". To the contrary, the TP-FDI (foreign direct investment) interlinkage has produced a problem of prime importance that the coveted arm's length principle can totally eclipse. For many TNCs, natural resources are a key FDI determinant. An FDI company may strip a forest bare, or chemically pollute a main river and displace an entire community, yet pay little tax income to the host government through TP false accounting…The moral responsibility rests with all the parties…"* (Mehafdi, 2000).

In deed, TP-related business activities have left low tax countries with a mixed blessing; tax and employment-related gains set against a growing backdrop of economic, social, and political losses which have significantly and negatively impacted persons, publics, cultures, and formal governments. Damage done has been often irreparable on physical (depletion of natural resources faster than they can be replaced, environmental damage, health hazards), economic (employment realities such as wages being paid (e.g., paying employees less), increased poverty, increased national debt, loss of tax income), and psychological (national pride threats caused by differential employee pay, loss of trust in MNE and reputation) (Mehafdi, 2000; Zyglidopoulous, 2002).

One by one, the political faces of low tax countries are crying out and essentially demanding that a more ethical reasoning process is used by MNEs when crafting TP programs. One such voice is that of Dr. Sulaiman, representing the Malaysia Ministry of Domestic Trade and Consumer Affairs, who identifies transfer pricing as a 'restrictive business practice (RBP)':

> *"The Malaysia Ministry of Domestic Trade and Consumer Affairs will emphasize fair trade practices (not restrictive business practices which strategically use transfer pricing) which seek to balance the interest of both business and consumers…this will be done independent of the WTO agenda and will take cognizance of the socio-economic development needs of the country" (Ruzki, 2002).*

The impact that a certain stakeholder (person or group) can have on managerial TP decisions will, in part, depend upon the perceived salience of their respective request(s). A reporting by Zyglidopoulous (2002) adds an interesting 'twist' to the paradigm within which MNEs process, respond to, or ignore low-tax country pleas from stakeholders such as Dr. Sulaiman.

> *"…stakeholder salience depends on the interplay of three potential stakeholder characteristics: power, legitimacy, and urgency. Where "power" is defined as "the probability that one actor within a social relationship would be in a position to carry out his own will despite resistance"…"legitimacy" is defined as "a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs, and definitions"…"urgency" defined as a situation that is time-intensive and critical… stakeholders possessing all three characteristics (power, legitimacy, and urgency) will have a high level of salience. Stakeholders possessing only two characteristics will have moderate levels of stakeholder salience, while, stakeholders with only one of these characteristics will have low levels of salience"* (Zyglidopoulous, 2002).

Feinschreiber (2001) holds that TP programs have had a multibillion dollar impact on corporations worldwide and calls for a global decision making paradigm to guide program development. This paradigm would globally contextualize TP and develop supporting documentation which would address the socio-economic issues existing amidst market share strategies. Because of the multiple layers of complexity and uncertainty involved in TP, many advocates of a 'global TP' paradigm have felt as if they were fighting an uphill battle (a case in point would be the 'average world price' - an ethical standard TP for all intra-firm trades worldwide

proposed by Paul, Pak & Zdanowicz, 1994). The benefits of an 'average world price' are purported to be; decreased tax avoidance activities, decreased money laundering through TP, increases accuracy of trade flow reporting, and assistance in helping MNEs know what is a 'fair' price.

This manuscript breaks from the traditional focus in the literature (which has been on systematizing an approach for determining a transfer price), and espouses instead a systematized ethical decision making process that can be applied to any TP situation. As such, this manuscript builds upon some of the prior work that has identified a need for ethical considerations in the TP process (Hansen, Crosser & Laufer, 1992; Bateman, Herndon & Fraedrich, 1997; Paul, Pak & Zdanowicz, 1994; Mehafdi, 2000). Following a systematized EDMM process will help to ensure that a comprehensive reasoning process has occurred and that both endogenous (firm-related) and exogenous (market or country related) variables, relevant to the TP situation at hand have been considered.

The impact, scope, and importance of TP are unbelievably pervasive. In 2005, an Earnst and Young Survey[1] found that among MNEs, over 90% identified TP as the most important item on their corporate tax director's agenda, 63% had undergone a TP audit within the past 3 years, and 34% indicated they had proactively restructured business operations (more frequently than in the past) to be able to implement TP strategies. Following are other notable highlights:

- *The IRS estimated that inflated or undervalued TPs resulted in $53bn (2001) in lost US taxes due (Houlder, 2005);*
- *The UK has tax losses of pounds 20bn per year from "novel tax planning" (Anonymous, 2002 July 23);*
- *In 2004, the IRS disputed over $8.4bn in tax revenue (Houlder, 2005); UK MNEs (85%) use tax avoidance scheme; expect to be challenged by authorities (Anonymous, 2002 July 23);*

In defense of the MNE, the struggle to maneuver transfer prices ethically is difficult, especially under the growing weight of tax burdens (imposed by multiple tax authorities, each one striving to grow their own country's tax base). But, one may ask, how 'low' or 'high' can an MNE go with an intra-firm price before the tax authorities cry "wolf!"? TP examples are shared in Table 1.

Table 1: Examples of Overvalued and Undervalued Goods Sold Intra-firm by Transfer Price per Unit

US Imports	Country of Origin	Type of Good	Transfer Price per Unit
	Australia	Lawnmower blades	$2,326
	Pakistan	Dish Towels	$153
	Japan	Tweezers	$4,896
	Czech Republic	Plastic Buckets	$973

Table 1: Examples of Overvalued and Undervalued Goods Sold Intra-firm by Transfer Price per Unit			
US Exports	France	ATM Machines	$97
	Israel	Missile Launchers	$52
	Germany	Clinical Thermometers	$.06
	Britain	Bus and Truck Radial Tires	$11.74
(Abrams, 2002)			

Strategic maneuvering of TP is a fluid process and is often reactive to tax authority initiatives, as empirical findings by Bartelsman & Beetsma (2003) suggest:

> *"The results for our baseline regression, as well as the variations we considered, suggest that income shifting is both statistically and economically significant: a back-of-the-envelop calculation for our baseline estimates indicate that at the margin more than 65% of the additional revenue resulting from a unilateral tax increase is lost because of income shifting"* Bartelsman & Beetsma, 2003).

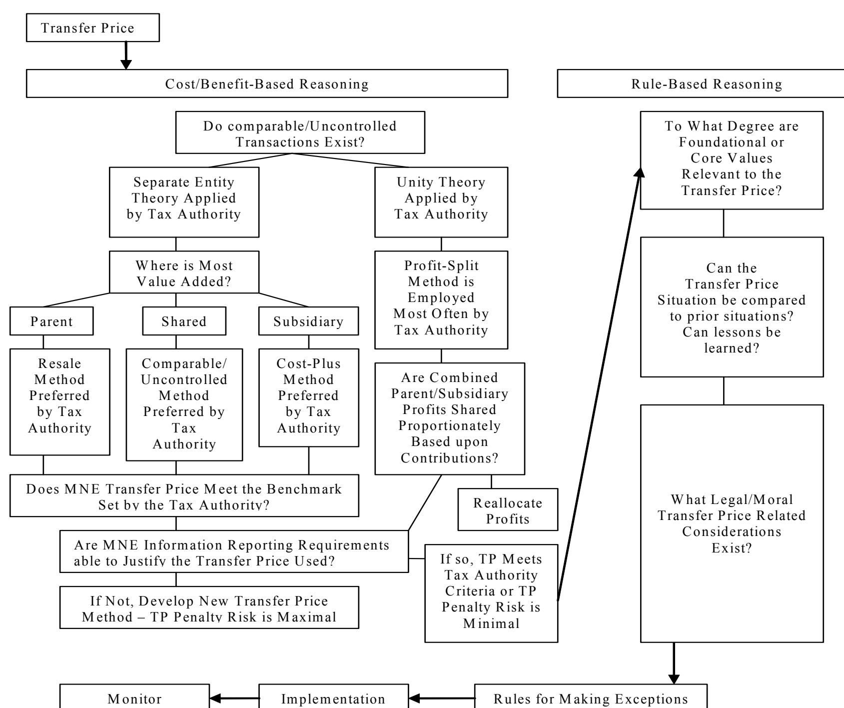
The literature is replete with accusations that TP is inappropriately, unethically, and strategically used a tool by MNEs to drive global profitability via the lowering of effective tax rates (Ward, 1993; Kaltenheuser, 1997; Gox, 2000; Clausing, 2002; Abrams, 2002; Associated Press, 2002 November 2; Simpson, 2002; Perera, et. al., 2003; United States GAO, 2004; Zdanowicz, 2004; de Boyrie, Pak & Zdanowicz, 2004). Amidst a sea of research, most would agree that there are some clear abuses, but there are also 'grey areas' for TP levels – grey areas are investigated by tax authorities who scourge through MNE documentation, and later deem the levels as 'appropriate'. Many law firms now specialize in being a 'one-stop-shop for MNE transfer pricing services'; from tax and legal strategies that develop plans and innovative solutions for reducing overall risk and optimizing worldwide tax positions, to identifying efficient TP opportunities to properly manage overall tax burdens in compliance with TP regulations. Third party assistance is also critical in preparing defenses for possible TP audits by tax authorities and gives MNEs a measure of security amidst dynamic complexities.

The purpose of this manuscript is to provide MNE managers involved in TP policy with a prescriptive EDMM or decision tool to help them undertake a more well-rounded justification and rationale behind their TP choice. The MNE manager should broaden his/her reasoning style to include value-based considerations such as corporate stewardship. The MNE manager has an opportunity to proactively build goodwill with governments in low tax countries and still prioritize considerations to minimize the risk of TP audit.

ETHICAL DECISION MAKING FRAMEWORK FOR TPMM

The EDMM presented in this manuscript has its roots in the strategic management, marketing, and ethics literatures. Its theoretical foundation began in the management literature and took the form of the Janus-Headed Model by Brady (1985, 1988 & 1990) which brought practical assumptions to teleological (or cost/benefit-based) reasoning and deontological (or rule-based) reasoning. From this point the model was embedded into the nomological network formed by the EDMMs found in the marketing and ethics literatures, resulting in a hybrid EDMM based upon practical assumptions (Bateman, Fraedrich & Iyer, 2003). The hybrid EDMM model has been empirically tested (outside of the TP arena) and found to have significant support for the model components. This manuscript adapts the hybrid EDMM and extends the cost/benefit-based reasoning component of the model with a tool to assess the TP audit risk. The TP risk assessment tool was developed by Fraedrich & Bateman (1996) and reflected the US Tax Authority preferences. The full EDMM applied to TP is presented below and applied to the TP arena in the sections that follow.

FIGURE: Ethical Decision Making Model for Transfer Price



Cost/Benefit-Based Reasoning: Assessing Audit Risk

The position of this manuscript is that TPs are typically set and managed by MNEs with an overly dominant focus on cost/benefit-based reasoning (e.g., focus on the left side of EDMM figure). However, this manuscript does not ignore the reality that assessing audit risk is the first rite of passage for the MNE manager, and so it is here that discussion of the EDMM begins. Risk determination, in general, is comprised of understanding how the tax authority may respond to possible courses of action taken by the MNE, along with likelihood and desirability of consequences. When the U.S. Tax Authority assesses the appropriateness of TP, the audit review process is guided by five main questions (see Figure).

> *"…if a TP audit occurs, the first question the tax authority asks is, "Do comparable/uncontrollable transactions exist?" If they do, the separate entity theory is applied (that is the subsidiary is treated as a separate and unique company) and the BALS (Basic Arms Length Standard) must be met. Before a reasonable BALS can be calculated, the tax authority must determine if the build of the value added is at the parent or subsidiary level. To what it determines as a "fair" TP benchmark for the BALS, the tax authority has a different "preferred" calculation method, depending on where the most value is added. For example, if the most value added is at the U.S. parent level and the subsidiary is in a lower tax country, the preferred method is the resale method. This ensures that the parent will not be selling to the subsidiary at below or near cost with the result of higher subsidiary profits, and ultimately lower effective tax rates for the MNE as a whole. If the MNE's TP policies in place meet the benchmark calculated by the IRS, the audit is concluded with no penalty. If the benchmark is not met, the MNE's TP records must meet tax authority information reporting requirements for the TP to be justified. Insufficient TP information reporting leaves the MNE at maximum risk for significant penalties, plus money and time spent on Tax Court appeals, stockholder loss of confidence, supplier and customer skepticism, loss of sales or profitability, and negative publicity. Tax authorities worldwide are forecasting a dramatic increase in the number of audits and the number and size of the penalties as they "crack down" on TP violations" (*Fraedrich and Bateman, 1996).

As the description of this prescriptive cost/benefit-based reasoning component shows, the answer to each question puts the MNE at a critical juncture. Each of the five questions are listed below and applied to the risks and realities of the TP arena in the sections that follow. It should, however, be noted that some MNEs (before or after reasoning through this process) prefer still to 'roll the dice' in the hopes that the under-funded and under-staffed tax authority inadvertently or intentionally 'turns a blind eye'.

Do comparable/uncontrolled transactions exist?
Where is the most value added?
Are combined parent/subsidiary profits shared proportionately based upon contributions?
Does the MNE's TP meet the benchmark set by the tax authority?
Are the MNE's information reporting requirements able to justify the TP used?

Do comparable/uncontrolled transactions exist? Putting a corporate or governmental finger on what a 'reported' transfer price truly represents can seem like a 'smoke and mirror' exercise in futility. One reality in the TP arena is that an MNE will likely report two different transfer price levels for the same product, depending upon to whom the report is going to. Specifically, one transfer price is reported to the tax authority (strategically chosen to reduce tax liabilities) and yet another transfer price for the same product is reported to the trade authority (economically chosen to reduce import/export tax). Diewert, Alterman & Eden (2004) highlight this discrepancy in TP levels for the same product and recommend the discrepancy problem be eliminated by setting only one transfer price per product and, if possible, to base it on the ALS. The ALS is based upon real markets, tried and tested, and offers a single international standard for agreements between MNEs where contending governments are ensured their fair share of taxes and double taxation issues are minimized or avoided (Neighbour, 2002). Another reality in the TP arena is the difficulty in identifying comparable/uncontrolled transactions to benchmark against. There may be a similar product sold on the open market, but it may be traded at a different level within the channel or may have different apportionment ratios (between parent and foreign subsidiary) for its intangible costs (e.g., R&D, marketing, royalties, intellectual capital, or services). As Collas-Monsod (2000) pointed out when writing a rebuttal against accusations that TP is blatently taking place in the oil industry; authorities and accusers must be certain that apples-to-apples (rather than apples-to-oranges) comparisons are being used when benchmarking a transfer price. One research study, in particular, accepts the fact that a 'most similar comparable' may be the best a market has to offer the MNE manager, and has found a way to identify a market-driven (or acceptable ALS) transfer price using mathematical programming. Lakhal, Mida & Venkatadri (2003) analyze the degree of variation between a semi-finished industrial product's weighted attributes (such as size, weight, reliability, performance, etc.) and that of similar competitor product attributes. Their mathematical programming model ultimately finds a 'best fit' comparable product with supporting documentation justifying why the corresponding transfer price meets the ALS. The IRS says the right price is the market value, but for many component (semi-finished industrial) products, it is difficult to find a free market to be able to estimate the market-driven transfer price. According to Earnst & Young (2005) tax authorities are recognizing some of the difficulties that well-meaning MNEs are having in finding an exact comparable/uncontrolled transaction, and are liberalizing the definitions to consider the possibilities of extraordinary market conditions, inflation, special circumstances such as Arm's-Length Markups for Maquiladoras, life-cycle of the product, and use of multiple year data. It is believed that ALS is flexible enough to meet the new challenges imposed by electronic commerce and global trading (Neighbour, 2002).

Where is the most value added? MNEs try to strategically use TP so that the most value can be added in the low-tax countries. 'Value added' in this sense represents the 'difference' between inbound transfer price and outbound price (which may also be a transfer price if product is being sold in a semi-finished state). The 'difference' is a combination of the reported costs while adding the value and possibly an added margin. When an ALS transfer price is used, costs and margins are

accounted for in an equitable fashion and the price is benchmarked against fair market prices. However, MNEs have a tendency to 'push-the-envelop' by assigning overvalued costs to the product or service, by over-emphasizing the role of an intangible such as R&D or marketing, and/or by paying the fixed price per hour for services rendered but negotiating less time/usage for the project (keeping costs down but leaving the service provider with excess service capacity) (Perera, McKinnon & Harrison, 2003). When MNEs are suspected of such practices, they may fall under tax authority scrutiny. A case in point is SonoSite (world leader in hand-carried ultrasound) who strategically changed (with legal counsel) their TP strategies and assigned costs to reflect a planned marketing investment for the worldwide launch of their MicroMaxx system (Anonymous, 2005 July 28). These activities resulted in a reported second quarter loss in 2005, a US tax loss, and a subsequent tax benefit. The irony is that SonoSite's reported second quarter loss occurred concurrently with a 29% gain in reported revenue. The OECD (Organization for Economic Cooperation and Development) has found that this phenomenon is more than just an irony, but a disturbing trend for tax authorities – as tax rate increases, the use of TP increases, and MNE profits still go down. Another case in point is that of Glaxo SmithKline (a British pharmaceutical company) whose method of weighting the importance of intangible costs has pitted the US-IRS against the UK-IR (Inland Revenue). The IRS claims that royalties paid for R&D from the American subsidiary to the English parent were 'drastically' overvalued, and in turn that the value of U.S. advertising and other marketing efforts were 'drastically' undervalued; resulting in US taxes due. The IR is siding with Glaxo (Simpson, 2002). A final case in point is that of a major energy distributor and retailer in Australia (Government Trading Enterprise – GTE) who in the absence of a comparable transaction still went ahead with a cost-plus approach to setting inflated transfer prices for services rendered (including full overhead costs in addition to loaded profit margins). As a result, TP came under strong criticism from the service receivers as being unrealistic and the whole TP system was perceived as "unfair" and "silly" (Perera, McKinnon & Harrison, 2003). Eventually, the GTE commercialized, made each SBU its own profit-making entity, and successfully reintroduced TP using a clear ALS TP system. The valuation of intangibles (intellectual property, R&D, etc.) for tax purposes is a high priority for MNEs. Latest research by Field Fisher Waterhouse's Transfer Pricing Unit (2004) shows that the exploitation of intangibles by corporations is a primary factor for the wealth and growth of the world economy and no longer ancillary. TP experts recommend that MNEs identify and document all intangible assets. From a global perspective, the OECD guidelines express a strong preference for transactional-based methods of adding value (comparable/uncontrolled prices, resale prices, cost-plus) over profit-based methods (transactional net margin) because the transactional-based methods rely heavier on ALS (Sakurai, 2002).

Are combined parent/subsidiary profits shared proportionately based upon contributions? When no approximation of a comparable/uncontrolled transaction is possible or probable, MNEs should determine whether combined parent/subsidiary profits are shared proportionately based upon respective contributions. The OECD Transfer Price Guidelines (2005) suggest that Cost Contribution Arrangements (CCA) can be used by the MNE to pre-plan for the apportionment of

costs relative to contribution and profit and if done properly will meet the ALS. CCA's most commonly address the R&D area, but may also address the costs and risks of developing, producing, or obtaining any assets, services, or rights. Currently there is a lack of consensus amongst OECD member countries as to how profits should be attributed to a permanent establishment (PE). OECD is testing a working hypothesis in this area (to PEs of banks), hoping to establish a consensus on how to handle the attribution of profits to a PE. It should also be mentioned that there are situations where an MNE should avoid certain TP methods and tax authorities should respect the constraints placed upon MNEs who operate on very small margins. Sakurai (2002) suggests that foreign tax authorities should realize that the way Japanese MNEs operate is different from Western MNEs. For example, Japanese trading houses work on very small margins and if a TP method such as comparable profits method (CPM) is mandated for use, it will produce unfair outcomes; CPM compares the overall profitability of controlled and uncontrolled companies rather than the profitability of transactions.

Does the MNEs TP meet the benchmark set by the tax authority? TP litigation is the most visible sign that tax authorities do not believe that MNEs have met appropriate benchmarks (Houlder, 2005). The recent past has shown sharp increases in litigation to the tune of $8.4bn in 2004 disputed income. Tensions rise over the tax implications of international intra-firm transactions, which account for more 60% of world trade. MNEs are walking a tightrope; not wanting to pay more in taxes than they have to on the front end and hoping they don't get flagged for an audit by tax authorities on the back end. Audits are resulting in higher penalties (Feinschreiber, 2001) and back taxes owed. Auditors are not only looking at documentation for the year in question, but may review prior years as far back as they want to. Auditors may increase scrutiny on marketing, distribution, and R&D allocations. Examples of TP litigation between MNE and Tax Authority are shared in Table 2.

Table 2: Examples of TP Litigation between MNE and Tax Authority

MNE	Accuser	Alleged Claim	Result
Hallmark Mktg. Corp.	NY Division of Taxation	TP did not satisfy ALS	Court ruled in favor of MNE - 5th yr
Sony BMG	Japanese Tax Authority	TP avoided $40m in taxes	In process – 2nd yr
Motorola	US Tax Authority	$500m tax dispute	In process – 2nd yr
Glaxo SmithKline (Pharm.)	US/UK Tax Authorities	Undervalued TP for Mktg.	$7.8bn owed (tax and penalties) -3rd yr
Honda/Nissan (EU/UK)	UK Tax Authority	pds 716m overinflated losses	In process – 16 fiscal yrs in question
(Anonymous, 2006 February 23; Anonymous, 2005 August 5; Houlder, 2005; Plender, 2004)			

The UK-IR's TP inquiries are focused on cases where it appears that there is a significant risk that taxable profits might have been materially under-reported (Plender, 2004). Subsidiaries of Toyota have incurred tax losses of more than pounds 1bn in Great Britain, which can be offset against future trading profits only by agreement with the IR. The IR has questioned Toyota's TP policy back to its date of incorporation in 1990. Toyota's latest accounts say nothing about TP, but they point out that the availability of pounds 716m of losses to be offset against future trading profits is subject to agreement with the IR.

According to the U.S. General Accounting Office (GAO) (2002), an Advance Pricing Agreement (APA) can reduce the risk of litigation substantially. However, the presence of an APA does not preclude ongoing audit-related interactions between the MNE and the tax authority. For example, approximately 7% of IRS-reviewed APA reports over a span of four years were adjusted or considered for adjustment. The three most common reasons for an APA adjustment (meaning more tax was owed by the MNE) are: the MNE did not fully comply to the APA agreement, inappropriate costs were being charged, or certain income was not being reported. The IRS estimates the total value of these post-APA adjustments to be at least $132 million. However, most MNEs involved in a TP dispute with IRS have no APA in place. As of 2000, approximately 250 MNEs had participated in the IRS APA Program.

> *"The APA Program (one of the IRS pre-filing initiatives) is one of our most visible and successful customer service compliance initiatives (e.g., with a goal of promoting voluntary compliance), and timely processing of APA requests is crucial to the Program's continued success"* (comments from Charles O. Rossotti embedded in U.S. GAO, 2000).

MNEs are concerned that delays of up to two years in APA processing could result in retroactive adjustments to tax returns and increased uncertainty, as a result MNEs may avoid APAs in the future. Linklaters & Alliance (2002) recommend that MNEs cautiously consider going for an APA, as it may prove to be a way of self-selecting oneself for higher levels of scrutiny by tax authorities. To combat the delays in APA processing, the IRS has doubled APA professional staff and made adaptations to the annual report review process. The IRS still proposes that wherever possible, an APA should be concluded on a bilateral or multilateral basis between competent authorities through the mutual agreement procedure or the relevant treaty.

Are the MNEs information reporting requirements able to justify the TP used? Whether the MNEs information TP documentation is able to adequately make justifications to the tax authority is ultimately decided in the tax court, but the MNE manager will be more confident when the TP is set in compliance with tax authority standards. As noted above, the taxes and penalties owed by virtue of tax litigation can cost MNEs hundreds of millions if not billions of dollars. But on rare occasions, the tax court or the appeals court does end up ruling in favor of the MNE defendant. A case in point is a dispute between Hallmark Marketing Corporation and the state of New York (NY) that began in 2001 with an accusation that Hallmark's TP policies did not satisfy ALS, followed by a 2004 notice of deficiency which carried with it an additional liability for taxes and penalties.

(Anonymous, 2006 February 23). Hallmark aggressively disputed the allegation with the help of CRA International (a law firm specializing in TP) and provided documentation (economic and TP analysis). The NY court of appeals eventually ruled in favor of Hallmark. Another case in point is Swatch Group (watchmaker) who is responding to questions by tax authorities about its controversial TP practices (Simonian, 2004). Swatch is no doubt hoping for an ending similar to Hallmark's.

Rule-Based Reasoning: Laws, Values & Global Corporate Responsibility

After reasoning through the cost/benefit-based reasoning, the MNE manager should begin to consider the TP from another viewpoint. Brady (1990) defined this viewpoint as "…a retrospective look into the cultural heritage established by law, language, and tradition and assessing the relevance and adequacy of the store of knowledge to the issues at hand" (p 62). When a manager uses a practical rule-based reasoning (deontological) approach to TP, the following questions and issues should be considered.

To what degree are foundational or core values relevant to the TP?
Can the TP situation be compared to prior situations? Can lessons by learned?
What legal/moral TP-related considerations exist?

To what degree are foundational or core values are relevant to the transfer price? From a global perspective, the OECD's foundational value is to encourage countries to associate with the OECD initiatives and avail themselves to the OECD TP guidelines through multilateral seminars with participation from regional partners (Transfer Pricing Guidelines, 2005). From a supply chain perspective, MNEs value maximizing the performance of the supply chain (as a whole) and have found that TP can be used to help ensure adequate rewards for each participant (Gjerkrum, Shah & Papageorgiou, 2002; Lemein, 2005). From a corporate perspective, much of the TP literature has focused on the values manifested in internal performance evaluation, motivation, control, and generally, the aligning of interests within the decentralized firm (Alles & Datar, 1998). From a divisional perspective, if the ALS is met by the TP, there is perceived value by divisional managers to flush out inefficiencies and excesses in their costing structures. When foundational values in a corporation are violated via TP, the organizational culture will suffer. Few studies in the TP literature have looked at the impact of TP policies on the value place on corporate unity in the corporate culture.

"The inter-branch charging became a second class goal. Transfer pricing dollars were (seen as) a bit like monopoly money" (quote from an MNE manager as found in Perera, McKinnon & Harrison, 2003).

From a managerial perspective, a number of values have been empirically linked to moral reasoning by studies in ethics, management, marketing, and decision sciences literatures; justice, equality, freedom and property, caring, practicality and efficiency, work and activity, humanitarianism and moral orientation, success and achievement, equality, material comfort, patriotism, external conformity, rationality and measurement, cooperation, self determination, control, and responsibility. The MNE manager should consider these and other personal and corporate values as they relate to the effects that TP programs have on their ability to function effectively in the workplace.

Can the TP situation be compared to prior situations? Can lessons be learned? Some claim that 'experience is the best teacher' and along with that come 'lessons learned'. A review of the literature and public domain information reveals several key lessons that have been learned by MNEs about TP.

Lesson 1: *Transfer prices strategically communicate cost-based manufacturing information to marketing departments, so for marketing do to its job it needs to be clear on what the actual 'revenue less cost' figure is. When reported costs are an artificially inflated transfer price, marketing will have less leeway on the market-face side of the product price* (Alles & Datar, 1998).

Lesson 2: *Some MNEs decidedly choose to over-inflate labor time standards ('special quotes') to offset marketplace pressures; essentially building a cushion to protect some semblance of margin* (Ferreira & Merchant, 1985 as reported in Alles & Datar, 1998).

Lesson 3: *When dealing with a bilateral treaty conflict, have your local tax authority on your side. The US IRS is strongly considering formal litigation with UK Glaxo SmithKline (mentioned earlier) who had pharmaceutical drug sales in the U.S. of $29.5bn from 1989-1999; UK IR (Britain) stands behind Glaxo SmithKline asserting the US-UK Convention for the Avoidance of Double Taxation (IR has already collected tax from Glaxo SmithKline)* (Simpson, 2002).

Lesson 4: *TP programs impact corporate culture in either a negative or a positive way* (Perera, McKinnon & Harrison, 2003).

Lesson 5: Change agents or champions of TP are necessary to effectively introduce and/or manage a program (Perera, McKinnon & Harrison, 2003).

What legal/moral TP related considerations exist? From a moral reasoning perspective, the MNE manager must consider what drives the dynamic legal and moral context within which TP operates. Managers must take a retrospective look into the cultural heritage established by law, language, and tradition and assess the TP issues in that context. There is no united global approach to TP, however a number of TP researchers and experts are strong proponents of a systematic and predictable global approach to TP; their arguments rooted in the fact that rapid expansion of e-commerce and technology advancement has facilitated global economic integration. Sakurai (2002)

argues that cross-country management styles are synthesizing, necessitating a 'supranatural regulatory framework' that would bring more cross-country TP uniformity.

> *Given that transfer pricing is a highly complex and dynamic taxation area which involves multiple jurisdictions, an integration of rules and principles in the transfer pricing law at the global level would be prudent. While the OECD provides commonly accepted principles, it is evident from the present study that interpretations and applications of the principles are subject to national regulatory cultures. What is required more is a super-national regulator that provides precise translation of the OECD guidelines and makes more concrete arrangements. The OECD guidelines can be used as a basis of globally enacted rules that govern each tax jurisdiction. Picciotto (1992) argues that international coordination based on secret and bureaucratic administrative arrangements lacks political legitimacy. Thus, once rules are established at the global level, overarching principles are commonly recognized and integrated through the "superior regulatory conversations" at the regional level. Within regional economic forums such as the EU and NAFTA, superior regulatory conversations should take place in various forms between tax administrations from different jurisdictions and interactions between tax administrations and stakeholders (MNEs and tax and accounting groups). In this way, political legitimacy can be achieved. (Sakurai, 2002)*

Cross-country TP education is taking place to some degree by virtue of bilateral treaties and increased international cooperation. However, not all tax authorities are being labeled as desirable role models by other tax authorities. Lack of consistency among tax jurisdictions occurs on many dimensions. This creates uncertainties for the MNE and thus opportunities for non-compliance, opportunity for creative tax strategies, increases inter-jurisdictional competition. It should be noted that creative compliance is sometimes perfectly legal…sometimes not. The MNE manager should seek to understand the philosophical-cultural-practical implementation side of TP law. Table 3 profiles several country-related orientations relating to various legal and normative aspects of TP.

Table 3: Country-Related Orientations Relating to Various Legal and Normative Aspects of TP	
U.S.	Increasingly tough on TP of intangibles. Takes a legal and adversarial approach. The regulatory relationship in the U.S. is seen by MNEs as formal, distant, adversarial, rigid, rule-oriented, suspicious, and tense. Tax authorities have successfully resolved cases via the tax court. MNEs are more motivated by tax minimization. The adversarial legalism approach results in greater transparency and accountability is extremely expensive to implement, and by its very nature results in MNE creative income shifting strategies. Foreign subsidiaries are usually fairly independent from U.S. parents, but are expected to meet short term profitability goals. U.S. is alert to the fact that money laundering occurs in the form of transfer pricing. Recommend that MNEs keep contemporaneous documentation which describes business and organizational structure and justifies the TP method and type of comparable selected.

Table 3: Country-Related Orientations Relating to Various Legal and Normative Aspects of TP	
U.K.	Strikes deals with MNEs for fixed percentages of intangibles and/or profits to be counted 'taxable'. IR is repositioning itself in the mind of the MNE as a "champion for business" hoping cooperative deals upfront will offset the cost of behind-the-door tax avoidance strategies (costing the UK up to pnds 20bn each year). Launched a new kind of focus on how TP cases are treated. Established new procedures that have been well-received by MNEs; such as filing complaints, adding a mechanism for MNEs to question tax authority decisions, conducting MNE satisfaction surveys, running TP forums for MNE input, and inviting MNE participation in the IR's regulatory formation unit. The regulatory relationship in the U.K. is seen by MNEs as flexible, informal, encouraging of self-regulation, and cooperative. Tax authorities have successfully resolved cases via confidential negotiations with MNEs. U.K.'s 'softer than US' approach encourages MNE voluntary compliance, but suffers in transparency and accountability. Foreign subsidiaries are usually fairly independent from U.K. parents, but are expected to meet short term profitability goals. U.K. is alert to the fact that money laundering occurs in the form of transfer pricing.
Japan	Takes an informal and cooperative approach based upon hierarchical negotiation. The regulatory relationship in Japan is seen by MNEs as informal, close, cooperative, flexible and reciprocal. MNEs are less motivated by tax minimization and parent companies play an active role in subsidiary planning. MNEs have management policies that pursue longer term profits and put more emphasis on market expansion. Japanese 'softer than US' approach encourages MNE voluntary compliance, but suffers in transparency and accountability. Foreign subsidiaries of Japanese MNEs purpose to minimize profitability in the host country and to funnel profit back to the parent (essentially operating unit within a single entity).
China	Finding that the foreign MNEs who truly value local partners and the Chinese host government are using the market-based method of TP (ALS). The Chinese government encourages FDI and then seeks to keep the resulting capital in country. Provincial tax authorities comprise a nationwide taskforce of specialist teams keeping watchful of the TP strategies used by MNEs.
India	Demanding pre-notice of the nature of FDI (production investment) proposals by foreign MNEs including the role that TP will play.
(South China Post, 2001; Sakurai, 2002; Chan & Lo, 2004; The Hindu, 2004)	

The MNE manager must also consider their corporate stewardship role as it relates to TP. The social and ecological effects of cross-country trade are pervasive; depletion of natural resources, stripping forests bare, chemically polluting main rivers, health hazards, paying little tax to host governments through false TP accounting, increasing the host country's national debt, and breaching trust. Low-tax host countries call for consideration and value to be placed on these areas. There is an opportunity for the MNE to put a better foot forward in this area. One would question the ethics of an MNE who chooses to disregard these issues.

According to Brady (1990), the EDMM model components discussed thus far mark the beginning of a dynamic interactive reasoning process. With regards to the considerations involving TP, the MNE manager will most likely begin with the assessment of the TP risk posture and the

degree of audit exposure the corporation is likely to be facing. For the MNE manager reasoning through TP issues, the cost/benefit-based reasoning style is likely the most preferred. However, either cost/benefit-based or rule-based reasoning styles may be the preferred pattern and one or the other may guide the final decision. A 'flip-flop' between the two reasoning styles (left vs. right side of the Figure) should frequently occur until a decision is made. When a manager switches from one reasoning paradigm to the other, it is termed an 'exception' (to the present course of reasoning). The 'exception' represents the interaction effect between reasoning styles that are situation specific, and occur more frequently when the decision stakes are higher. Once the TP decision has been made, implementation occurs and the MNE continues to monitor the endogenous and exogenous environments for significant changes that may necessitate a change in the TP.

CONCLUSION

This manuscript has embedded an EDMM into the realities, risks, and opportunities faced by MNE managers in charge of the TP decision. MNE managers are encouraged to follow a systematic ethical reasoning process when evaluating the rational for a TP policy. Doing so will force them to consider not only the TP audit risk costs and the financial gains, but also to consider foundational values, prior experience, and cultural norms, processes, and host country 'personalities' as they relate to the TP decision. Managers are strongly encouraged to consider the role that corporate stewardship has in relation to the TP decision. The EDMM for TP is a decision tool to help MNE managers have a well-rounded justification and rationale behind their TP choice and in turn enrich the quality of TP documentation.

ENDNOTES

[1]. Ernst & Young 2005-2006 Global Transfer Pricing Surveys: Global Transfer Pricing Trends, Practices, and Analysis (November 2005). This biennial research is the largest and most authoritative survey of its kind and broader in scope than any similar previous research. Ernst & Young commissioned Consensus Research International to conduct interviews with 348 parent companies and 128 subsidiary corporations in 22 countries.

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