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JOURNAL OF LEGAL, ETHICAL AND REGULATORY ISSUES

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JOURNAL OF LEGAL, ETHICAL AND REGULATORY ISSUES

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THE BEST OF BOTH WORLDS: DO BELOW MARKET LEASES OR SALES AFTER EMINENT DOMAIN CREATE A TAXABLE ACCESSION TO WEALTH?

Valrie Chambers, Texas A & M University-Corpus Christi
Brian Elzweig, Texas A & M University-Corpus Christi

ABSTRACT

In June, 2005, the Supreme Court in Kelo v. City of New London[1] upheld the taking of property by eminent domain for the furtherance of economic development. The court however, did not address an ancillary but possibly material tax consequence: if a private party then subsequently receives a lease or ownership interest of land from a local or state government at less than fair market value, do they incur accession to wealth under either Generally Accepted Accounting Principles ("GAAP") or the Internal Revenue Code? If not, should they?

INTRODUCTION

In June, 2005, the Supreme Court in *Kelo v. City of New London*[2] upheld the taking of property by eminent domain for the furtherance of economic development. Under the plan originally approved by the City of New London, Connecticut, land taken by eminent domain would be divided into seven parcels of land. Some parcels would be subdivided, developed and re-sold, and while litigation was pending before the Supreme Court, the New London Development Corporation ("NLDC") was negotiating a lease on other parcels to be developed in accordance with the development plan, at the rate of $1/year for 99 years. Justice Thomas, voicing one of the dissenting opinions, demonstrates the historical trend toward more frequent eminent domain foreclosures for broader reasons. The court however, did not address an ancillary but possibly material tax consequence: if a private party then subsequently receives a lease or ownership interest of land from a local or state government at less than fair market value, do they incur accession to wealth under either Generally Accepted Accounting Principles ("GAAP") or the Internal Revenue Code?

The rest of the article is organized as follows: first comes a synopsis of the New London case followed by the economic effects of real property purchases from municipalities and a discussion of real property leased from municipalities. Then the article is concluded.

THE *KELO* DECISION

The economy of the city of New London ("New London") declined and New London was consequently designated by the state of Connecticut in 1990 as a "distressed municipality" and targeted for revitalization. The NLDC, a private, non-profit entity was charged with formulating a revitalization plan, which was funded in January 1988. The following month, Pfizer, Inc. announced the building of a research facility adjacent to the revitalization area. After several community meetings, NLDC submitted a plan comprised of seven different parcels to state agencies to develop 90 acres of the revitalization area in May 1988. The state agencies studied the project's consequences against six alternative proposals. Ultimately, the state's Office of Planning and Management accepted the NLDC's proposal. The first parcel of land in the NLDC project was designated for a waterfront conference hotel with marinas and a small urban restaurant and shopping village, originating at a pedestrian riverwalk. Parcel 2 was designated for 80 new residences with a walkway to the adjoining state park. Parcel 3 was abutted the Pfizer facility, and was designated as research and development office space. Parcel 4 supports the adjacent state park and/or marina, and the remaining parcels provide land for office and retail spaces and parking. The plan was approved by the city council in January 2000, and the NLDC was authorized to execute the plan. The NLDC successfully negotiated with most of the individual land owners in the revitalization area, but negotiations with the nine petitioners failed. The NLDC then initiated condemnation proceedings, which is the root of this case.

The petitioners were led by Susette Kelo, who had purchased her waterfront property in 1997. Another petitioner, Wilhelmina Dery was born in her house in 1918, and lived there her entire life, the last 60 years of which her husband Charles has lived with her. In all, the nine petitioners held 15 properties in parcels 3 and 4. Ten of the 15 properties were occupied by the owner or owner's family member(s); five were investment properties. None of the properties were alleged to be in poor condition; rather they were condemned solely to further the execution of the development plan. Petitioners sued to stop condemnation in the New London Superior Court in December 2000, claiming in part that the condemnation would violate the "public use" restriction of the Fifth Amendment to the Constitution. The court restrained NLDC from taking the eleven properties in Parcel 4, but denied relief for the four properties in Parcel 3. Both sides appealed this verdict to the Supreme Court of Connecticut; the court found, over dissent, that all the condemnations were valid because an economic development project is a "public use" in the "public interest." Dissenting justices desired that the New London first adduce "clear and convincing evidence" that economic benefits would result from the taking of the lands. The decision was appealed to the U.S. Supreme Court, who granted Certiorari.[3]

The Supreme Court (in a 5-4 split-decision) affirmed this condemnation just as it has the condemnation of private lands under eminent domain for other justifications.[4] Constitutionally, the exercise of condemnation under eminent domain requires payment to the private land holder "just compensation" for the individual parcel.[5] In some cases, the sum of the amounts paid for the individual parcels could be less than the fair market value of one larger contiguous lot.

While the litigation was in the lower court, NLDC announced that it was negotiating the lease of some parcels to private developers. Lease terms provided that the private developers would develop the land according to the development plan in exchange for a 99-year lease on the land at the rental rate of $1 per year. The city was presumably willing to offer the bargain rate because the city would gain taxes from increased employment and increased property values. While the condemnation has an economic effect on the land owner and the governmental entity, it is the economic effect to the subsequent private developers that is the focus of the paper.

ISSUES FOLLOWING THE *KELO* DECISION

The *Kelo* decision was reviled by many. The Court held that the while the Constitution would prohibit using eminent domain to confer a private benefit on a particular party, when the taking is part of a "'carefully considered development plan,' the *public use* requirement of the Fifth Amendment would be satisfied."[6] Most citizens of the United States felt that the Court's interpretation of a taking for a public use was overbroad.[7] By 2006 legislation was considered in 46 states to respond to the Court's opinion.[8] The legislation generally falls into one of the following categories, imposing greater restriction on what is allowable as a taking, many of which may have tax implications of their own:

- *Prohibiting eminent domain for economic development purposes, to generate tax revenue, or to transfer private property to another private entity.*

- *Defining what constitutes "public use," generally the possession, occupation or enjoyment of the property by the public at large, public agencies or public utilities.*

- *Restricting eminent domain to blighted properties and redefining what constitutes blight to emphasize detriment to public health or safety.*

- *Requiring greater public notice, more public hearings, negotiation in good faith with landowners and approval by elected governing bodies.*

- *Requiring compensation greater than fair market value where property condemned is the principal residence.*

- *Placing a moratorium on eminent domain for economic development.*

- *Establishing legislative study committees or stakeholder task forces to study and report back to legislature with findings.*[9]

The extent that any of this new legislation will be enforced depends on the individual state and its enforcement procedures. However, the desired effect is to limit the amount of eminent domain transactions where the beneficiary is a private party.

Financing eminent domain purchases is proving to be controversial in some areas like Chicago, USA. Rather than finance purchases through the general budget, some municipalities opt for Tax Increment Financing Entities (TIF entities or TIFEs). When a tax increment financing district (area that will pay for the purchase) is created, the property tax valuation attributed to existing tax revenue items is frozen, with tax revenues resulting from the increase in property tax valuations going to pay off the amount borrowed for property acquisition. This leaves pre-existing budgets (e.g. for schools and county) with no additional revenues to offset rising operating costs, leading to proposals for tax rate increases. The cash raised from increased valuations in the tax increment financing district are often "off-budget" items. The effect in Chicago is that "[f]rom [Chicago Mayor] Daley's standpoint, the beauty of the program is that other taxing bodies do the heavy lifting while he controls the cash. And because TIF funds aren't included in the city's annual budget or broken down on tax bills, he can act like they don't exist." Per the Cook County clerk, these funds have gone from $2 million in property taxes for the sole TIF in 1986, to over $200 million by 2002, making them the second largest amount of tax revenue in Cook County.[10]

Another issue that arises is whether or not the best use of the property will be used. It is asserted that weaker property rights lower incentives to make the best use of property which limits economic growth.[11] It can become a sort of self-fulfilling prophecy. The fear that the property may be taken from an individual may cause the individual not to develop it to its fullest potential. This in turn causes the property to be more likely to be in a position to be taken, since it may be considered to be blighted or not put to its s best use.

Further, there is a question of valuation. Government appraisers consistently undervalue property when it is to be taken for eminent domain.[12] This is obviously in the interest of the government, in that they would have to pay less for a condemned piece of land. Of course the valuation of the land can have an impact on the fair market value when it comes to the beneficiary deciding a tax basis for the property they have acquired.

Note that the eminent domain issue is distinguished from corporate strategy where a state or local rebate or abatement of regular tax liability is provided in exchange for a company's promise to establish, maintain or improve its presence in the community. A discussion of this issue is found in the Coordinated Issue Paper on State and Local Location Tax Incentives dated 5/23/08,[13] in which the IRS has ruled the abatement to essentially be a discount on state and local tax expense.

ECONOMIC EFFECTS TO PRIVATE PARTIES OF RECEIVING EMINENT DOMAIN PROPERTY – IS THERE A POSSIBLE ACCESSION TO WEALTH?

Where property is sold or leased to a private party at fair market value, no accession to wealth would occur to the private party.[14] However, if the property is resold or leased at bargain price (including donated property, with a "bargain price" of $0), then the private party gains the rights to property use with an artificially lower cost basis or lesser lease expense. The difference between the fair market value and the bargain purchase amount arguably constitutes accession to wealth for federal income tax purposes. Where the contract is structured as a bargain lease, then the lease would be treated as a purchase for tax purposes if most of the benefits and burdens of ownership fell on the lessee rather than the lessor.[15] Therefore, the substance of the transaction affects the answer to the accession of wealth question.

Purchase Treatment

The bargain purchase element of a sale is either an accession to wealth at the time the property is transferred to the private party, or delayed until that property is subsequently sold. Accession to wealth would be recognized at the time of purchase, resulting in a low basis of the property, or, under the second alternative, taxes on the bargain purchase element would then result when this property is subsequently sold (presumably at fair market value), because the private party is subtracting the lower cost basis resulting in a higher gain. The economic effect of the deferral of taxes can be material. As shown in the first numerical column of Table 1, a tax deferral of 39 ½ years would reduce the present value of the tax burden by 97.7% over having to pay the taxes at the time the property was received. (See Table 1 for example.)

Table 1: Cash Flow and Present Value Effects of Tax on Accession to Wealth

	Land Treated as Sold	Land Treated as Leased and Held
Highest Use FMV	$200,000,000.00	$ 24,000,000.00/year
Governmental Contract Price	(4,000,000.00)	(1.00) /year
Accession to Wealth	$196,000,000.00	$ 23,999,999.00 /year
Tax @ 35%	(68,600,000.00)	(8,399,999.65)/year
Present Value of Tax if Deferred 39 1/2 years	1,589,692.23	
Tax on Lump Sum Present Value of Accession		($83,993,291.43)
Present Value of Tax Payments over 99 years		$83,993,291.43
Present Value Difference in Tax Liability	$ (67,010,307.77)	$0.00 *
Percent Reduction in Present Value	97.7%	0.0%

Table 1: Cash Flow and Present Value Effects of Tax on Accession to Wealth	
Land Sale Assumptions	
♦	*The city assembles 100- ¼ acre lots at an average of $10,000/lot; some lots are ocean-side.*
♦	*Assume that the resultant unified oceanside property is zoned commercial and valued at $200,000/acre. ($100,000/oceanside lot @ 2 lots/acre, from real estate advertisements in the Corpus Christi, TX area.)*
♦	*Tax rate, whether for short-term or long-term capital gains is 35%.*
♦	*Estimated useful life for depreciation of non-residential real estate is 39 1/2 years.*
Land Lease Assumptions	
♦	*The city leases land at 1% of FMV of the sales price/month; the tax rate for ordinary income is 35%.*The tax on the lump sum present value (PV) of accession equals the PV of the tax payments over 99 years; only cash flow differs.*

If the property were subsequently exchanged for like-kind property instead of sold, the gain would be deferred until the sale of the second property.[16] On exchanged property, a tax could be deferred until the present value on the bargain purchase element was near zero. For example, if the property described in Table 1 were exchanged in 75 years, and the second property sold 75 years after that, the present value of the taxes on the gain would fall to $42.41, which is a loss of $68,599,957.59, or nearly all of the present value of the tax revenue. The potential for lost tax revenue makes the federal income tax treatment of a bargain purchase an important tax issue, and may also carry with it lost state tax revenue.

Where property is bought or exchanged at fair market value, and subsequently sold at a gain or loss, the gain realized on the sale or exchange of property is generally includible in taxable income in the year the property is sold.[17] However, where the property is received at a discounted value, an immediate economic gain equal to the amount of the discount results, raising the basis for determining gain in a subsequent sale.

The Internal Revenue Code Section that defines income is IRC §61. That section reads, in part, "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived."[18] This Code section interprets income broadly, with the purpose to comprehensively tax income except where exemptions exist. Clarifying the broadness of this code section, Reg. §1.61-3 (Gross income derived from business) says that income includes "any income from investments and from incidental or outside operations or sources."[19] Similar regulations indicate that income comes in multiple forms: e.g. improvements to leased property may constitute rental income,[20] discharge of indebtedness or purchase by a debtor of his obligation at less than face value may constitute income to debtor,[21] and receipt of an option transferred for less than its fair market value may constitute compensation income in the amount of discount.[22]

Commissioner v. Glenshaw Glass Co.[23] sets out a test to determine whether an item constitutes income. Specifically, there must exist "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[24] Generally, the term "income" is used to reflect whether the recipient has "economic gain" consistent with *United States v. Gotcher.*[25] For example, in *Milenbach et al. v. Commissioner,*[26] the tax court held that loan amounts received from the Los Angeles Memorial Coliseum Commission were taxable income when received because they were to be repaid from revenue received from the leasing of luxury suites, but such repayment was not unconditional. In *James W. and Laura Keith v. Commissioner*,[27] a taxpayer who sold residential real estate contract-for-deed[28] was required to claim the entire amount of the gain in the year the contract was signed, not throughout the contract term or at the transfer of title.

The term "complete dominion" is clarified in *Bailey v. Commissioner.*[29] The court held that where a city's urban renewal agency contracted for façade rehabilitation, chose the construction contractor, negotiated the terms of the contract, and paid the contractor directly for the work, the property's new façade was not income to the petitioner because the petitioner lacked complete dominion over the façade. In this case, the petitioner was not permitted to alter the façade in any way without prior written approval from the city. However, where taxpayers were reimbursed by the government for construction expenditures or repairs, these payments were held to be income to the recipient because they had unfettered use of the funds.[30] In *Crystal Lake Cemetery Association v. U.S.* ,[31] money received from a not-for-profit trust was taxable when withdrawn and used in a for-profit venture. In this case, there were broad and vague restrictions on the uses of the cash, which gave the recipient dominion over these funds. The taxpayer then used the funds, receiving "much more in the way of an economic benefit than an amount equal to the fair rental value…." However, to the extent capital is considered contributed by a non-shareholder (e.g. municipality) to the corporation after June 22, 1954, no income is recognized under Section 118(a), and the corporation's basis in the property is zero[32] creating a book-tax difference on the corporate tax return. For example, in *Brown Shoe Co. v. Commissioner,* [33] civic groups transferred cash and other property to induce the taxpayer to enhance and operate facilities in their community. These payments were ruled non-taxable contributions to capital. Motivation is key, though. In *United States v. Chicago, Burlington & Quincy Railroad Co.*,[34] the government made payments to the taxpayer to fund highway safety improvements and maintenance that would protect non-railroad travelers and the citizenry in general. The Court held that these payments were not contributions to capital. More recently, in *United States v. Coastal Utilities, Inc.*,[35] the eleventh circuit upheld that government-sponsored universal support payments that were tied to the taxpayer's revenue requirement for expansion (which factored in the taxpayers, expenses, taxes and return on investment) were supplemental taxable income, not a contribution to capital. GAAP provides guidance on how donated revenue should be recognized for book purposes.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES TREATMENT OF PURCHASED OR GIFTED PROPERTY

Normally, for-profit companies engage in an exchange: both giving and taking something of value at an arms-length, fair market value price. Occasionally, companies receive a contribution (e.g. land, building, use of facilities or forgiveness of debt) from non-owners in a nonreciprocal transfer. While an exchange of property would rightfully be accounted for using the cost principle, where property is donated to a for-profit entity, "a departure from the cost principle seems justified; the only costs incurred (legal fees and other relatively minor expenditures) are not reasonable basis of accounting for the assets acquired. To record nothing is to ignore the economic realities of an increase in wealth and assets. Therefore, companies use the fair value of the asset to establish its value on the books" (Kieso, Weygandt and Warfield, 2006, p. 449).

Accordingly, when a company receives a contribution from non-owners, the company would record the contribution it received (as a debit), and record the credit as revenue in the period(s) that the contribution is received. Kieso, Weygandt and Warfield (2006) go on to offer this example, "to attract new industry a city may offer land, but the receiving enterprise may incur additional costs in the future (e.g., transportation or higher state income taxes) because the location is not the most desirable…. The FASB's position[36] is that in general, companies should recognize contributions receive as revenues in the period received" in the amount of the fair market value of the assets receive. "To illustrate, Max Wayer Meat Packing, Inc. has recently accepted a donation of land with a fair value of $150,000 from the Memphis Industrial Development Corp. In return Max Wayer Meat Packing promises to build a packing plant in Memphis. Max Wayer's entry is:

Land	150,000	
Contribution Revenue		150,000"

While treatment of a donation is relatively clear, what would happen in the event of a sale at bargain prices? Historically, a bargain purchase is treated as part sale, part other transaction (e.g. salary) generating that sale. The IRS offers the following example (Pub. 551; http://www.irs.gov/publications/p551/ar02.html#d0e1418, retrieved 11/8/06):

> A bargain purchase is a purchase of an item for less than its FMV. If, as compensation for services, you purchase goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV (your purchase price plus the amount you include in income).

Thus, explicit GAAP treatment provides for immediate recognition of income, unlike the Code.

Some Leases Treated As Purchases

Under GAAP, leases are divided into either operating (ordinary) leases or capital leases (for which the lessee treats the leased property as purchased for the lease term). Kieso, Weygandt and Warfield (2006) states that a company "should capitalize a lease that transfers substantially all of the benefits and risks of property ownership, provided the lease is noncancelable"[37] and it meets one of the four capitalization criteria set forth in FASB Statement No. 13.[38] These criteria are: 1) Lease transfers ownership of the property to the lessee at the end of the lease term, 2) Lease contains a bargain purchase option, which is an option to purchase the property at an exercise price that is so low compared to the fair market value of that property that exercise of the option is reasonably assured, 3) Lease term $\geq$75% or more of the estimated economic life of the leased property, or 4) Present value of the minimum lease payments (excluding executory costs) $\geq$90% of the fair market value of the property leased.

This structure has arguably resulted in abuses to provide the benefits of ownership (in substance) to the lessee while maintaining the form of an operating lease (e.g. FMV of lease comes in at 89.9% of FMV in numbers disproportionate to those found in the natural business environment). Consequently, per Robert Herz, Chairman of the FASB board, the FASB "will likely look at ways to account for the right to use an asset" (Reilly, 2006, C3) and account for leases on more of a substance over form basis. The International Accounting Standards Board is also re-examining treatment of leases. Similarly, for federal tax purposes, the benefits and burdens of ownership tests are examined so that leases are treated according to their substance over form.[39]

Where the it is determined that for tax purposes the lessee has most of the benefits and burdens of ownership, then the lease is treated as being owned by the lessee. The benefits and burdens test examine eight factors: "1) whether legal title passes; 2) how the parties treat the transaction; 3) whether an equity was acquired in the property; 4) whether the contract created an obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; 5) whether the right of possession is vested in the purchaser; 6) which party pays the property taxes; 7) which party bears the risk of loss or damage to the property, and 8) which party receives the profits from the operation and sale of the property."[40] For example, in *Coulter Electronics v. Commissioner*,[41] the Tax Court attributed ownership to the lessee because the lessor had limited loss exposure and the lessee had the obligation to correct lease defaults. Revenue Ruling 68-590[42] provides an example where a corporation "sold" a project to a political subdivision at cost, then leased it back at a nominal cost, with an option to repurchase the project. The corporation agreed to pay taxes, insurance, operating costs and maintenance on the property. Because the corporation and not the subdivision stood to gain, the sale/leaseback was deemed a financing arrangement for the corporation; the corporation had exhibited the benefits and burdens of ownership. Based on the Supreme Court discussion in the *Kelo* case, tests 5, 6, 7, and 8 appear to be in the NLDC development lease, and could potentially cause the lease to be classified as a sale for tax purposes.[43] However, what are the effects if the lessee's contract fails the benefits and burdens of ownership test and is construed strictly as a lease?

By Lease

In general, Adam Smith identified several characteristics of a "good" tax, including taxes that embrace horizontal equity – treating all persons in a similar economic situation similarly.[44] For the lease term, a for-profit company which has a materially smaller lease payment (operating expense) has a competitive advantage over those entering the area that pay fair market value to purchase or lease the land. Taxing a gain on the bargain element would seem to be consistent with a good tax when examined from an economic perspective.

More specifically, the first step in determining tax treatment then is to analyze the transaction between the local government and the for-profit entity to determine if, *in substance*, the transaction is a donation, bargain purchase or operating lease.

Where the benefits and burdens of ownership test has been met by the lessee or substantial intangible lease rights exist (e.g. that allow the right to property to be retained or sold or sublet at lessee's option). There are two possible accounting treatments for this lease. Conceptually, either 1) record income in the amount of the difference between the net present value of the fair market value of lease payments over the lease term and the net present value of the bargain lease payments at the signing of the lease, or 2) the difference between bargain lease payments and fair market value of lease payments is income in each tax period but is simultaneously off-set by expense each period. The first solution does cause a tax difference at lease signing, and would seem to be most appropriate especially where lease rights are in themselves a valuable intangible, (for example, there is value in the right to profit from a subsequent lease transfer or sub-letting). In this treatment, ordinary income in the amount of the intangible lease rights is created at lease signing, offset by an intangible asset account such as "lease rights." These rights are then amortized over the lease term, with any remaining lease rights being reconciled or closed out at the time of lease transfer, if before the end of the lease term.

The second option produces no immediate tax effect on the signing of the lease and an accounting that for tax purposes can be ignored in favor on the simpler, lower lease payment deductions[45] (that result in higher net taxable income in each period). The lessee would have no tax basis in the leased asset. Buildings erected and other improvements added to the property are depreciated without regard to the lease term.[46] In the *Kelo* case, the portion of the land leased for $1/year has the effect of artificially lowering the operating costs of the leased land, resulting in higher taxable income over the 99-year lease term, which is arguably consistent with the taxing of subsidy payments in the *Coastal* case, above.

Where the lease term is for an extensive period of time, the deferral period can be substantial. (On a 99-year lease, for example, the pro-rated recovery time averages 49 ½ years versus ½ year if recognized at lease signing.) However, where the lease rights themselves have no transferable value, the present value of tax collected is roughly the same when collected up front as when resulting in higher profits taxed over the lease term. (See numerical column 2 of Table 1.) In a very short-term lease, whether to tax at the time the transfer of property (or lease rights), or to tax at the time the property is subsequently sold (or throughout the lease term) may not be financially material at all because any lost tax on accession to wealth reverses within one-to-two tax years.

If lease rights are subsequently sold before the end of the lease term, those rights would be taxable proceeds (with no lease basis) treated as a capital gain in the year of transfer of those rights.

The risk in this strategy is that under Code §61, the government might determine that these rights should have been recognized at the signing of the lease, consistent with the first alternative, resulting in a higher present value of taxes to the government, coupled with penalties and interest. Such rights would be intangibles. However, an examination of IRC §197 indicates that many interests in land are specifically excluded from tax intangibles,[47] as is an interest as a lessee: "Section 197 intangibles do not include any interest as a lessee under an existing lease of tangible real or personal property….If an interest as a lessee under a lease of tangible property is acquired in a transaction with any other intangible property, a portion of the total purchase price may be allocable to the interest as a lessee based on all of the relevant facts and circumstances."[48] Paragraph (c)(13) also excludes rights under contracts granted by a governmental unit acquired in the ordinary course of business with a duration of less than 15 years. Thus, if such intangible rights do exist legally, they are not recognized for federal income tax purposes.

Recognition of Liabilities

While the municipality aggregates land through eminent domain from several previous holders, the private recipients who will be developing that land may agree to share the financing risk. FASB's Emerging Issues Task Force addresses whether a private company should recognize an obligation for any part of a municipality's TIFE debt. Usually, all of the debt is issued by the TIFE to be financed from future taxes or user fees. For EITF 91-10, the Task Force reached a consensus that if the new owner is responsible for a fixed or determinable amount for a fixed or determinable period, the property owner should recognize a liability for the tax or special assessment. Further, a contingent liability would exist if any of the following three factors are present:

- *The company must satisfy any shortfall in the annual debt service obligations.*
- *There is a pledge of company assets.*
- *The company provides a letter of credit in support of some or all of the TIFE debt or provides other credit enhancements.*[49]

CONCLUSION

If the transaction is a donation of property, GAAP and §362 are inconsistent on whether accession to wealth has occurred. Under GAAP, the revenue is recorded when property is received; the tax basis is fair market value of the property at the time of purchase. The tax basis in the property is the fair market value of the property at time of purchase.

Where a bargain purchase has occurred, the difference between the fair market value and bargain purchase price is a donation which is an accession of wealth when property is received for GAAP. The tax basis in the property is then elevated to the fair market value of the property at time of purchase. However, for tax purposes, this contribution or bargain purchase element is not currently taxed, resulting in a book tax difference and a material federal tax break for recipient corporations (and revenue loss for the federal government).

Where a lease exists, no accession to wealth is incurred at the acquisition of the leased property, whether or not the burdens and benefits of ownership test are met. Subsequent sale or subletting of a lease at fair market value may result in a capital gain at the time of sale/sublet.

ENDNOTES

1 *Kelo v. City of New London*, 545 U.S. 469, 125 S. Ct. 2655, 162 L. Ed. 2d 439 (2005).

2 *Ibid.*

3 *Id.* at 545 U.S. 472.

4 See for example: *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229, 104 S. Ct. 2321, 81 L.Ed. 2d 186 (1984), where fee title was transferred for compensation to lessees to reduce the concentration of land ownership; *Berman v. Parker*, 348 U.S. 26, 75 S.Ct. 98, 99 L.Ed. 27 (1954), where public use was upheld in a plan to redevelop a blighted area of Washington D.C.; *Fallbrook Irrigation Dist. V. Bradley*, 164 U.S. 112, 17 S. Ct. 56, 41 L. Ed. 369 (1896), where property was condemned for construction of an irrigation ditch for public use.

5 U.S. Const. amend. V and U.S. Const. amend IV.

6 Donald Sanders, Bruce McClung & Patricia Pattison, *Post* Kelo *Legislation: Big Development's Self-Inflicted Wound?*, 17 Southern Law Journal (Vol. 1) 62, 66 (2007), *citing* Kelo, 65 U.S. at 478 (emphasis supplied).

7 *Id.* at 65.

8 National Conference of State Legislatures, State Legislative Response to Kelo, Annual Meeting 2006 http://www.ncsl.org/programs/natres/annualmtgupdate06.htm, retrieved 8/27/08.

9 *Id.*

10 Joravsky, B. (2007). Cook County Clerk David Orr Reveals – Nay, Publicizes – that TIFs Sucked Up More than $500 Million in Property Taxes Last Year. The Chicago Reader. http://www.chicagoreader.com/features/stories/theworks/071122/, retrieved 8/19/08.

11 Sanders, et al, supra note 3, at 68.

12 *Id.* at 70.

[13] See also IRC Sec. 118 Abuse Directive #4 and Rev. Rul. 79-315, 1979-2 C.B. 27. Essentially, the IRS' position is that a state or local tax abatement, credit, deduction, rate reduction or exemption that is applied against current or future tax liabilities reduces that particular tax expense. Essentially it functions like a sales discount or coupon, not as income with a corresponding higher tax expense. The eminent domain issue on the other hand involves the one time transfer of property initially from a state or local government independent of what taxes, if any, are charged on an ongoing basis.

[14] The fair market value of the assembled land may arguably be greater than the sum of the fair market values of the individual parcels. At this point, the condemning government then has a possible problem in defending the individual values paid to the original owners, especially if they're not in line with previous property tax assessment values. Where property is assembled by a governmental unit specifically for a private party at a profit to the governmental unit, questions of unrelated business income might also arise, but these problems are outside the scope of this article.

[15] See for example *Grodt & McKay Realty, Inc. v. Commissioner* [CCH Dec. 38,472], 77 T.C. 1221, 1237-38 (1981) and cases cited therein.

[16] IRC §1031. All IRC references are to the Internal Revenue Code of 1986, as amended. Note that IRC §1031 exchanges are a frequent and growing tax-deferral technique. Per a Wall Street Journal (2007) report, taxpayers filed more than 338,500 forms that deferred more than $73.6 billion in like-kind exchanges for 2004, which is double that reported five years earlier.

[17] Reg. §1.61-6(a).

[18] IRC §61(a).

[19] Reg. §1.61-3(a).

[20] Reg. §1.61-8(c).

[21] Reg. §1.61-12(a).

[22] Reg. §1.61-15(a).

[23] *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 75 S. Ct. 473, 477, 99 L.Ed. 483 (1955).

[24] Id. at 348 U.S. 431.

[25] *United States v. Gotcher* [68-2 USTC ¶9546], 5 Cir., 1968, 401 F. 2d 118.

[26] *Sheldon R. and Phyllis Milenbach, et al. v. Commissioner,* TC [CCH Dec. 51,266].

[27] *James W. and Laura Keith v. Commissioner,* TC [CCH Dec. 54,169], (Dec. 28, 2000).

[28] A contract for deed sale is one where a buyer obtains possession of real estate but does not receive the title to the property until/unless he or she has satisfied all terms of the contract including full payment.

29 *James Bailey v. Commissioner*, TC [Dec. 43,924], May 18, 1987.

30 See *Baboquivari Cattle Co. v. Commisioner* [43-1 USTC ¶9385], 135 F.2d 114 (9th Cir. 1943), *affg.* [Dec. 12,558] 47 B.T.A. 129 (1942); *Lykes Bros. S.S. Co. v. Commissioner* [42-1 USTC ¶9355], 126 F.2d 725 (5th Cir. 1942), affg. [Dec. 11,399] 42 B.T.A. 1395 (1940); *Dubay v. Commissioner* [Dec. 36,375(M)], T.C. Memo. 1979-418; *Harding v. Commissioner* [Dec. 20,215(M)], T.C. Memo. 1970-179; *Driscoll v. Commissioner,* T.C. Memo. 1944-021, *affd.* in part and *revd.* in part on unrelated issues [45-1 USTC ¶9184] 147 F.2d 493 (5th Cir. 1945).

31 *Crystal Lake Cemetery Association v. U.S.* [US-CT-APP-8, 69-2 USTC ¶9545].

32 §362(c)(1). See in particular §1.118-1.

33 339 U.S. 583, 70 S. Ct. 820, 94L.Ed. 1081 (1950).

34 412 U.S. 401, 93 S. Ct. 2169, 37 L. Ed. 2d 30 (1973).

35 514 F. 3d 1184 (11th Cir. 2008), *per curium aff'g* 483 F. Supp 2d. 1232 (S. D. Ga. 2007). The Eleventh Circuit substituted the Southern District of Georgia opinion for their own.

36 "Accounting for Contributions Received and Contributions Made, "*Statement of Financial Accounting Standards No. 116* (Norwalk, Conn: FASB, 1993). The scope of this standard excludes transfers of assets from governmental units to business enterprises. However, we believe that the basic requirements should hold also for these types of contributions. Therefore, companies should record all assets at fair value and all credits as revenue." Kieso, Weygandt and Warfield, 2006.

37 *Ibid,* p. 1092.

38 *FASB Statement No. 13* (Stamford, Conn.: FASB 1980, ¶7).

39 Disguised sales, while pertinent to the discussion, are a separate, lengthy topic outside the scope of this paper.

40 *Grodt and McKay Realty, Inc. v. Commissioner*, [CCH Dec. 38,472], 77 T.C. at 1237-1238. See also Rev. Rul. 2005-74. Additional tests for sale vs. lease of equipment can be found in Rev. Rul. 55-540 and Rev. Proc. 2001-29. For a discussion of sale v. lease transactions being reclassified, see *Osterreich v. Commissioner*, 226 F.2d 798 (1955) where a bargain purchase option creates a capital lease for tax purposes and *Larsen v. Commissioner*, 89 T.C. 1229, 1267 (1987).

41 *Coulter Electronics v. Commissioner,* T.C. Memo 1990-186.

42 C.B. 66.

43 The Supreme Court case is silent as to whether or not NLDC had contracted with the resort developers to provide the developers with a bargain purchase option at the end of the lease term. However, it is reasonable to assume that a bargain purchase option provision is a possibility, because otherwise the municipality would receive improved land at the end of the lease term that could be re-sold or subdivided and be an investment gain on land that would potentially be unrelated business income to that municipality.

[44] Smith, A, (1776). *Wealth of Nations* . For further discussion on good tax characteristics, see *Individual Taxation, 2006 Ed.* By James Pratt and William N. Kulsrud, Thompson Publishing, 2006, Chapter 1.

[45] §162. See in particular, §162(a)(3). See also Reg. §1.162-11(a).

[46] IRC §168(i)(8).

[47] IRC §197(c) (3).

[48] IRC §197(c)(8)(ii).

[49] Emerging Issues Task Force Abstracts, No. 91-10, Accounting for Special Assessments and Tax Increment Financing Entities (TIFEs), page 2.

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DID COMMERCIAL BANKS CLOSE BRANCHES IN LOW-INCOME NEIGHBORHOODS IN RESPONSE TO THE CRA? IMPLICATIONS FOR UNDERSTANDING THE 2007-2008 FINANCIAL CRISIS

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ABSTRACT

The role of the Community Reinvestment Act (CRA) as a causal factor in the financial crisis remains unresolved. This research attempts to empirically determine whether the CRA played a role in the crisis by unintentionally encouraging large commercial banks to close branches and avoid CRA requirements. The results indicate that following the 1995 revision to the CRA, large commercial banks increasingly closed branches in low-income neighborhoods. This may have made banks' performance stronger and given the false appearance that CRA institutions were not a significant factor in the 2007 – 2008 financial crisis.

INTRODUCTION

Many Americans were caught off guard by the magnitude of the financial crisis that began quietly in 2007 and in earnest in the fall of 2008. Indeed, the crisis surprised even those who were assumed to be in the know; regulators, government officials, and leaders of financial intermediaries. With surprise came confusion as the nation began asking "how did this happen?" There seems to have emerged two general perspectives on the cause of the latest financial crisis. One perspective focuses blame on deregulation while the second perspective finds culpability in regulators, regulations, and government enterprises. Since the first perspective finds fault in not enough regulation and the second perspective finds fault in too much regulation, the perspective that finds the most support amongst law makers will undoubtedly shape the future of banking and finance. Consequently, the stakes in this discussion are extremely high.

While both perspectives on the crisis are outlined in detail below, this paper focuses on a narrow segment of the second perspective. Within the school of thought that too much regulation is to blame, many scholars offer the possibility that the Community Reinvestment Act (CRA) contributed to the crisis. Essentially, the CRA encourages commercial banks to provide credit to all the residents of their local area. Many scholars have interpreted the CRA to be a mandate for commercial banks to extend credit to borrowers who would otherwise not qualify for commercial bank loans. If the CRA pushed bankers to make high risk mortgages that they would not have made in absence of the regulation, the theory is that this contributed to the run up of subprime mortgages and, consequently, contributed to the crisis. In the weeks and months after the height of the crisis, scholars pointed out this culpability on the part of the CRA. Quickly, scholars, particularly from the Federal Reserve who regulate CRA institutions, produced evidence that the CRA was not at fault.

The disagreement over the role of the CRA is not easily resolved. Because there is no comprehensive data on CRA loan performance, one cannot know with certainty how those loans impacted the health of commercial banks.[1] In 1999, Congress passed the Gramm-Leach-Bliley Act which, among other things, directed the Federal Reserve Board of Governors to study the impact of the CRA on the performance and profitability of bank credit. Using the results from survey data, the Board found that CRA lending increased substantially to low-income borrowers during the 1990s (Avery et al., 2000). Further, large bank survey respondents admitted that many do not track CRA-related lending separated from general lending so it is difficult to reach conclusions on the impact of CRA lending on bank profit (Avery et al., 2000). Finally, large bank respondents indicated that mortgage and refinancing credit was less profitable and had similar or higher delinquency rates than non CRA mortgage and refinancing credit (Avery et al., 2000). Indeed, Avery et al. (2000) report that approximately 63 percent of the large bankers noted that CRA mortgage and refinance lending was less profitable than overall lending in this area. Thus, data on the profitability and performance on CRA credit is limited but certainly suggests that it hurts large bank profitability.

While the data on the performance of CRA loans is limited, there is comprehensive data on agreements that banks entered to meet CRA standards.[2] Some of these agreements are to keep open branches in low-income neighborhoods. If banks are entering agreements not to close branches, how many branches are actually closed in low-income neighborhoods? How many were closed in the years prior to the crisis? If the number is substantial, does this mean that banks exited these pools of high risk borrowers in an attempt to avoid the CRA? If so, does this compromise the position of the Federal Reserve who maintains that CRA institutions performed well throughout the crisis? Perhaps they performed well because they had shed much of the CRA burden prior to the crisis. This paper aims at answering these questions and, in the process, furthering the discussion of what caused the financial crisis that surprised the nation, and the world.

EXISTING 2007 - 2008 CRISIS LITERATURE

During times of crisis and uncertainty, it is natural to look for answers. Regulators, scholars, financial experts, and government officials are all seeking to understand what caused the first financial crisis of the twenty-first century. This section of the paper details two perspectives that are offered as explanations of the crisis.

The first perspective considers how deregulation led to the crisis. Gilani (2009) argues that financial institutions were able to successfully lobby and buy away bank regulation established during the Great Depression. Gilani uses a rather broad brush to paint all regulatory changes in banking since the savings and loan crisis as deregulation but it is not clear how those changes are tied to the crisis. In contrast, Davidson (2008) specifically identifies the Glass-Steagall provisions from the Banking Act of 1933 as a contributing factor in the crisis. Davidson argues that, in 1999, when the Glass-Steagall provisions were deregulated this set the stage for the securitization of noncommercial mortgage loans and thus contributed to the housing bubble. Government officials such as House Speaker Pelosi also blame deregulation: "the Bush Administration's eight long years of failed deregulation policies have resulted in our nation's largest bailout ever…" (Litvan and Faler, 2008). Becker et al. (2009) offer a scenario in which the failure of government to intervene and a failure of deregulation policies explain the impetus for the crisis. Finally, Krugman (2009) offers the possibility that the 1982 Garn-St. Germain Depository Institutions Act, a congressional deregulation of the thrift industry, expanded access to mortgage debt and in doing so paved the way for the real estate bubble in the early part of the twenty-first century.

The second perspective finds fault in the failure of regulators and in too much regulation. Both of these viewpoints are considered below.

In terms of regulator fault, the majority of this literature focuses on monetary policy in the years prior to 2008. More specifically, White (2008), Gramm (2009), Taylor (2009a and 2009b), and O'Driscoll (2009) discuss how the low and negative interest rates maintained by the Federal Reserve during the twenty-first century created an explosive borrowing environment. At the end of 2000, the Federal Reserve's discount rate was 6 percent with a targeted federal funds rate of 6.5 percent (Federal Reserve Bank of New York, 2009). By the end of the following year, the discount rate sat at 1.25 percent with the targeted federal funds rate at 1.75 percent (Federal Reserve Bank of New York, 2009). These rates remained low between 2002 and 2004 but steadily rose in 2005. In 2006, the discount rate exceeded the 2000 level at 6.25 percent and by the end of 2007, the discount rate was at 5.25 percent (Federal Reserve Bank of New York, 2009). Thus, during the first five years of this century, the low short term interest rates made for cheap borrowed funds thereby contributing to the home buying spree in the years leading up to the crisis. Greenspan (2009) defends the policy that he led by arguing on two fronts: that the Federal Reserve controls short term interest rates and not the long term mortgage rates; and that tremendous growth in global savings pushed interest rates so low. The discussion of the role of monetary policy as a contributing factor in the crisis is ongoing.[3]

This perspective also blames regulators of government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, for creating a robust demand for high risk mortgages. The GSEs operate under a mandate from Congress to make housing affordable to all Americans. To do so, these enterprises purchased a substantial amount of both prime and subprime mortgage that originated at mortgage brokers and commercial banks. According to the agency that regulates the GSEs, the Office of Federal Housing Enterprise Oversight (2007), the two agencies owned 40 percent of all single family mortgages at the end of the second quarter of 2007. Wallison and Calomiris (2008, 7), using data from GSE publications, estimate that as much as 40 percent of the mortgages purchased by Freddie and Fannie between 2005 and 2007 were subprime. According to many scholars, including Taylor (2009), White (2008), Wallison (2008), Wallison and Calomiris (2008), Weicher (2008), Jacoby (2008), Henderson (2009), Levin (2009) and others, without this growing demand for these high risk mortgages, the originators would have had a greater incentive to worry about repayment and, perhaps, would have been more cautious in their lending. That is, had Fannie and Freddie not been standing ready to purchase these subprime mortgages from their originator, the originator may not have extended such risky loans.

Three regulatory developments have also been blamed for contributing to the financial crisis; Housing and Urban Development (HUD) policy, Federal Housing Administration (FHA) policy, and the Community Reinvestment Act. White (2008) explains how the FHA policy of decreasing required down payments contributed to the higher number of high risk mortgages. Conventional borrowing often requires 20 percent down for the best interest rates but by 2004, the FHA required 3 percent down payments. According to White (2008), HUD began cracking down on mortgage brokers who declined a higher percentage of minority applicants so lenders began relaxing their income and down-payment standards. This would contribute to the ease at which mortgage credit was extended early in this century. The Community Reinvestment Act requires that commercial banks, particularly large institutions in urban settings, consider extending credit to all potential borrowers; even to low-income and high risk borrowers. This perspective argues that this regulation forced banks into making high risk mortgage loans and, in the process, contributed to the run-up of subprime mortgages (see, for example, Henderson, 2009, Wallison and Calomiris, 2008, Wallison, 2008, Gramm, 2009, Ely, 2009, Levin, 2009, or Husock, 2008).

The real emphasis of the second perspective tends to be on monetary policy, the GSEs, and on the CRA. The issues of monetary policy and the GSEs fall under the rubric of regulator failure while the CRA falls under regulation failure. This paper focuses on the possibility that regulation failed and, to do so, considers the role of the CRA in the financial crisis. This section of the paper does two things: first, it provides a brief history of the CRA and also explains how the CRA functions; second, it details the existing debate in the literature regarding whether or not the CRA had a hand in creating the recent financial crisis.

The Community Reinvestment Act was passed into law in 1977. The act requires federally insured commercial banks and thrifts to extend credit to the community they serve. Specifically, the act, according to its critics, compels these institutions to extend loans to low-income households. Reflecting on the CRA, Federal Reserve Chairman Ben Bernanke recently observed that "The obligation of financial institutions to serve their communities was seen as a *quid pro quo* for privileges such as the protection afforded by federal deposit insurance and access to the Federal Reserve's Discount Window." (Bernanke, 2007). In the early years of the CRA, it did not function uniformly and there was often confusion about what the institutions were suppose to be doing to comply with the act. Revision to the act in 1995 gave more teeth to the legislation and made clear to institutions what was expected and the consequences of not performing accordingly. More specifically, the 1995 revisions divided institutions into two classifications. Large institutions were those with $250 million or more in assets and small institutions were all others. Since the 1995 revision, the CRA has changed the size definition of the institutions. As of December 22, 2009, a small institution has assets of less than $1.098 billion for either of the prior two years and a large institution is defined as one with assets of at least $1.098 billion for both of the previous two years.[4] The large banks have different reporting requirements than small banks. Annual data on CRA loans, which includes small business, small farm, community development, and mortgage loans, must be reported by the large institutions and this data is public information. Small banks are exempt from the reporting.

Regulators examine and analyze the CRA lending record of the bank and use this analysis to assign a CRA rating to each institution.[5] The ratings are either "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance". Taylor and Silver (2008) provide the percentage of banks earning each rating for the years 1990-2007. For this entire time frame, 16.3 percent of the ratings were outstanding, 79.5 percent were satisfactory, 3.8 percent needed to improve and 0.4 percent fell into the substantial noncompliance rating. Lending records are public information for large institutions (see Avery et al., 2005b), though the CRA ratings are public information for all sized institutions. While the public nature of the rating may compel banks to extend low-income loans, perhaps more important in this respect is what regulators do with the rating. Regulators are required to consider the institution's CRA record and rating when the institution applies for a new branch, merger, or acquisition. Given that 1994 ushered in a new era of more freedom for banks to branch, merge, and acquire other banks with the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act, tying a bank's ability to pursue these activities to its CRA record and rating provides significant incentive for banks to comply with the CRA lending provisions.

Many scholars contend that the CRA is culpable in the most recent financial crisis because of this incentive to extend loans to low-income applicants. This perspective argues that the CRA forces banks to make low-income and consequently, high-risk loans that would not otherwise be made which, in the end, compromised prudent risk taking (see, for example, Gramm, 2009, White, 2008, Wallison and Calomiris, 2008, Wallison, 2009, Levin, 2009, or Husock, 2008). Gunther (1999) emphasizes the tradeoff created by the CRA between compliance with the regulation and the safety and soundness required by alternative requirements. More specifically, the objective of the CRA is to enhance credit while other regulation, capital requirements, for example, constrains risk-taking. Gunther illustrates this conflict in regulation by arguing that the CAMEL rating system is at odds with the CRA regulation. CAMEL, which was put into place in 1979 by federal regulatory agencies, requires that banks' be evaluated in terms of their capital adequacy, asset quality, management, earnings, and liquidity generate a safety and soundness rating. The CRA generates a rating for banks regarding their extension of credit to the local community. Gunther's (1999) empirical analysis of these two opposing regulations finds that bank behavior, such as aggressive lending, improves the CRA rating but hurts the safety and soundness (CAMEL) ratings. As Gunther (1999) reports the: ". . . evidence suggests that increases in the proportion of home-purchase mortgage volume extended to borrowers in low-income neighborhoods raise the chances of a problem CAMEL rating. The findings cast doubt on the typical claim made by CRA advocates that lending in low-income neighborhoods is relatively innocuous in terms of financial safety and soundness."

The CRA is seen as a clear mandate to relax lending standards. Indeed, Wallison and Calomiris (2008) argue that this relaxation of lending standards spread to other credit markets, including the HUD standards mentioned previously. White (2008) admits that it is likely that a small share of the subprime mortgages made in the years leading up to the crisis were from CRA loans. Nonetheless, he argues the CRA bears responsibility for any increase in defaults that originated with CRA lending. Evidence prior to 2000 and the significant increase in home prices indicate that CRA loans had higher losses and higher cost than regular mortgage loans (Avery et al., 2000). It is expected that the substantial rise in home prices between 2000 and 2007 would stifle losses and defaults on CRA lending during these pre-crisis years. Finally, White (2008) indicates many institutions, in attempt to meet CRA standards, purchased mortgage-backed securities that were largely backed by subprime mortgages which increased the banks' risk exposure.

Other scholars, many from the Federal Reserve, defend the CRA and provide evidence that the CRA is not responsible for contributing to the financial crisis. Laderman and Reid (2008) compare the performance of loans made by CRA institutions with those made by mortgage banks to determine if there are differences in foreclosure rates between these two originators. Using a unique dataset for metropolitan areas in California between January 2004 and the end of 2006, the authors find that loans made by the mortgage bank were more likely to end in foreclosure. Based on this finding, the authors conclude that CRA loans performed better leading up to the crisis that non CRA loans. Kroszner (2008) also provides evidence that CRA lending did not contribute to the crisis. Using data from 2005 and 2006, Kroszner (2008) and his Federal Reserve staff find that CRA lending represented a small portion, 6 percent, of total high-priced loans to low-income borrowers. Further, in response to concerns raised by White outlined in the previous paragraph, Kroszner (2008) indicates that less than 2 percent of mortgaged backed securities that meet CRA standards were purchased by CRA institutions between 2005 and 2006. The statistical evidence leads Kroszner (2008) to argue that the CRA is not responsible for the financial crisis. Canner and Bhutta (2008), also with the Federal Reserve, contend that since there have been no substantive changes to the CRA since 1995 and because the current crisis is the result of poor performing mortgage loans made between 2004 and 2007, it is difficult to link the CRA to the crisis. Using data from the Home Mortgage Disclosure Act, these authors find that two-thirds of all mortgage loans are not CRA related and that only ten percent of all loans are lower-income loans made by banks (i.e., are CRA related). Finally, Canner and Bhutta (2008) reiterate the point made by Kroszner (2008) regarding the statistic that CRA institutions made only 6 percent of the total high-priced loans to low-income borrowers in 2006. The Chair of the FDIC also argues the CRA did not contribute to the crisis citing the statistic that only 1 in 4 high priced first mortgages were made by CRA institutions between 2004 and 2006 (Blair, 2008).

Commercial banks open and close branches for many different reasons. Avery et al. (2000) analyze changes in the number of bank offices between 1975 and 1995 and observe the general trend of a reduced number of banking institutions with an increased number of branches. The expansion of branching, they find, is the result of several factors. First, the authors determine that population growth increases the need for branch offices. Second, as banks were allowed to establish intrastate branches through legislative changes, the number of branches increased. This may be to serve more of the population, to diversify their balance sheets and reduce risk, among other motivating factors. Further, the authors discuss other possibilities for the change in the number of bank offices including increased competition from non-banks and technological developments that change the cost structure of banking and also the demand for branch services. Finally, Avery et al. (2000) find that merger and acquisition activity and bank failures are generally unrelated to commercial bank branch activity.

This paper argues that another reason banks may close a branch is because the congressional mandates of the CRA may significantly either increase risk at a branch and/or reduce the profitability of much of its lending. The possibility that bank profitability is compromised by the CRA is not a new idea. Indeed, White (1993, 14) clearly indicated that either the CRA was redundant since banks would make the loans mandated by the CRA without the mandate, i.e. they are profitable loans, or banks would comply with the CRA regulation and make up the difference on those loans elsewhere: "In essence, either it (the CRA) is redundant, because serving the local community is profitable anyway, or it requires a cross-subsidy, with above-normal profits from other services subsidizing the losses from the unprofitable service to the local community. In this latter case, the fresh winds of financial services competition are increasingly erasing any above-normal profits that might be earned on other services." White (1993) also indicates that the obligations of the CRA may cause banks to exit unprofitable markets by closing branches. In terms of the CRA's impact on risk taking, as mentioned earlier in this paper, Gunther (1999) finds empirical evidence that the type of lending that will improve a CRA rating will, at the same time, reduce a banks' safety and soundness rating.

In contrast, Avery et al. (2000) comments that since the CRA rankings include a service test, the act is unlikely to affect branching activity. The service test requires regulators evaluate a banks' record of opening and closing branches particularly in low-income areas. A bank with a record of closing branches in low-income areas would score lower on this portion of the service test component of a CRA examination. However, the CRA regulation, at the same time, does not require that banks expand branches or operate unprofitable branches. Consequently, if the CRA mandates reduced the profitability of mortgage lending, and the evidence from the Federal Reserve Board of Governors (2000) is that it did, banks would have an incentive to limit these types of loans. Closing a branch would be one way to accomplish this and the branch could be closed with the banker attributing the closure to the burden of the CRA.

Avery et al. (2000) recognize the possibility that banks, because of the CRA, would be motivated to close branches in low-income neighborhoods. Their work finds that between 1975 and 1995, there was a 21 percent decline in the number of branch offices in low-income neighborhoods. They find this despite an increase in the number of branches across all neighborhoods. According to the authors, this is partially explained by a reduction in the population in low-income areas; they find that the per-capita decline in the number of branches was 6.4 percent over the twenty year period. Finally, they argue that many low-income areas (defined by zip code) include business districts which may have had more branches initially and so the decline was a natural response.

Like Avery et al. (2000) we recognize that banks close and open branch offices for many reasons. As mentioned earlier in this paper, many scholars are concerned that the CRA provides the wrong incentive for bankers when it comes to extending credit to low-income areas. Further, it is well known that bankers enter agreements with community groups to not close branches in low-income areas. These community agreements are made to improve community goodwill and to improve part of the banks' CRA rating. It seems natural to ask if, absent the agreement, the banks would close certain bank offices? This work is a departure from that in Avery et al. (2000), the other scholarly work that considers changes in the number of branch offices, in two important ways. First, our sample expands from 1972 through 2008 and so it captures changes in the number of branches through a longer time frame. This sample includes important interstate branching legislation as well as the financial crisis. Second, Avery et al. (2000) do not utilize statistical techniques in their analysis. In contrast, this paper uses regression techniques to offer a different set of findings that may contribute to understanding why banks close branch units and the role this may, or may not, have played in the financial crisis.

We are left with two sides to the CRA story: those who argue that CRA regulation is culpable in the crisis and those who argue it is not. For scholars and observers who find the CRA responsible, even if only for a small portion of the increase in subprime lending, the agency and its regulators must take ownership for its contribution to the crisis. Defenders of the CRA rely on statistical evidence to indicate that CRA loans were a small amount of total subprime lending which, from their perspective, exonerates the CRA and its regulators. This paper attempts to shed more light on the discussion by providing one possible framework to empirically analyze the CRA's role in the crisis.

CRA AND BRANCH CLOSURES: EMPIRICAL ANALYSIS

The hypothesis tested here is that CRA institutions closed branches in low-income areas in the years prior to, and including, the build-up of subprime lending and that this contributed to their stronger overall performance. If the statistical evidence supports this hypothesis, it may suggest that one reason CRA institutions performed well during the crisis was because they had eliminated the riskier CRA obligations prior to the crisis. Another way to think about this research is it asks if the crisis would have been even worse had banks not closed these branches in low-income neighborhoods. This is important to understanding the most recent crisis because the CRA institutions' regulator, the Federal Reserve, has recently used the strong performance record of CRA institutions as evidence that the CRA was not culpable in the crisis. Further, the Obama administration is calling for the Federal Reserve to have more regulatory power over financial firms moving forward (Pulizzi and Paletta , 2009). Consequently, it is important to understand the role of the CRA in the crisis.

This research utilizes a unique and newly constructed data set to address several issues regarding branch closures, the CRA, and the financial crisis. First, a model is constructed to test whether banks closed branches, particularly low-income branches, in response to the CRA revisions of 1995. Secondly, the impact of any closures on bank performance is examined. The focus is on large commercial banks since they are subject to the most critical review under the CRA.[6] To the author's knowledge, this is the first paper to test these relationships and to identify branch closures according to economic demographics.[7] The research begins by reducing all 50 states to a more manageable sample of states. To do so, the authors determined which states housed the largest metropolitan statistical areas (MSAs), as defined by the U.S. Census Bureau in the country. The top sixteen MSAs in 2008 include twenty states. Since most large banks have a presence in these large MSAs, it seems reasonable that using these twenty states as our sample would capture most large commercial banks.[8] At year end 2008, there were 519 large commercial banks in the United States and our sample includes 299, or 57.6 percent, of these banks.[9]

Once the state sample is determined, all large banks (those with assets in excess of $1 billion) headquartered within these states are identified at the FDIC's Institutional Directory. Balance sheet and financial data for each bank is also found at the FDIC's Institutional Directory. The FDIC identifies all of the branches, branch locations, and any branch closures for each institution, quarterly, back to 1972 and through 2008.[10] To determine if the branch closure is in a low-income neighborhood, the U.S. Census Bureau publishes per capita personal income data for most zip codes in the United States.[11] Existing CRA research (see, for example, Kroszner, 2008) or Bostic et al., 2005) define low-income to be a zip code tract in which per capita personal income is less than 80 percent of the per capita personal income for the MSA in which the zip code is located. Consequently, per capita personal income MSA data is required from the Bureau of Economic Analysis (BEA). In the end, the sample contains 299 banks from nineteen states and the balance sheet, financial, and branch closure data for each bank, in each quarter, for the period 1972 to 2008. In addition, the sample contains the income status for the area in which the branch closure is located (see the Appendix for all data definitions and sources). All balance sheet, financial, and income data are expressed in 1999:Q3 dollars.

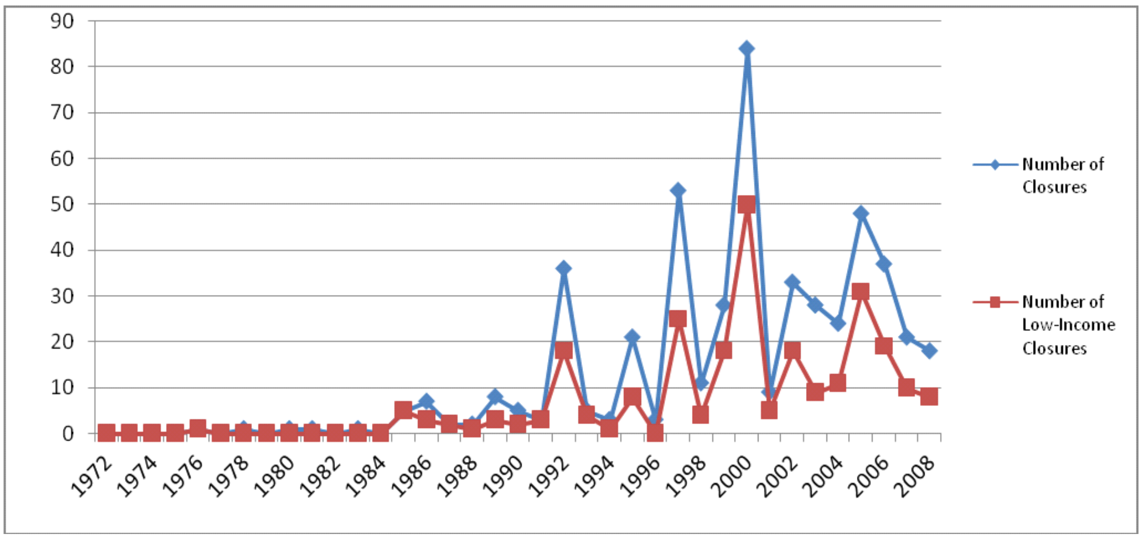
Table 1: Branch Closures and Low-Income Branch Closures at Large CRA Commercial Banks Between 1972 and 2008.

State	Number of Large Commercial Banks	Number of Branch Closures	Number of Closures in Low-Income Neighborhoods	Percent Closed in Low-Income Neighborhoods
AZ	2	0	0	0%
CA	49	134	67	50%
DE	9	23	10	43.4%
FL	18	12	5	41.6%
GA	17	17	9	52.9%
IL	39	21	11	52.3%
IN	13	9	4	44.4%
MA	7	4	1	25%
MD	6	6	4	66.6%
MI	10	24	8	33.3%
MN	3	6	1	16.6%
NJ	9	5	1	20%
NY	28	37	23	62%
PA	20	120	80	66.6%
TX	32	49	16	32.6%
VA	15	2	0	0%
WA	12	19	9	47.3%
WI	5	9	3	33.3%
WV	5	17	7	41.1%
TOTAL	299	514	259	

Table 1 contains the findings of the data analysis on branch closures for the 299 banks in our sample. It indicates that 514 branches were closed by these banks between 1972 and 2008. Of these, 259 or 50.3 percent were in low-income neighborhoods. At the low end, Arizona and Virginia had no low-income branch closures and in Minnesota only one branch in six closures was in a low-income neighborhood. At the high end, in Maryland, New York, and Pennsylvania large bankers closed more that 60 percent of their branches in low-income neighborhoods. From almost any angle, it is striking that over half of all of these closures are in low-income neighborhoods.

Since the CRA was altered in 1995 to give banks greater incentive to lend in low-income neighborhoods, it is expected that banks would have a greater incentive to avoid the regulation after 1995. A simple comparison of the mean number of total closures and low-income closures before and after 1995 (allowing for unequal variances) indicates that the number of branch closures and the number of low-income branch closures are significantly higher after 1995 (t=2.93 and t=2.35 for total and low-income closures, significant at 1% and 5%, respectively). A non-parametric Wilcoxon rank sum test also confirms that closures and low-income closures are higher after 1995 (z= 4.8 and z=2.97 for total closures and low-income closures, respectively, significant at 1%). Finally, a graph of the branch closure and low-income branch closure data paints a similar picture (see figure 1). Taken together, these simple descriptive statistics suggest that banks increasingly closed branches in low-income neighborhoods following the revision to the CRA.

Figure 1: Number of Branch and Low-Income Branch Closures by Large Commercial Banks Between 1972 and 2008.



In addition to the 1995 CRA revision, other regulatory change during this time frame must also be considered. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (IBBEA) removed legal barriers to interstate *banking* but left it to each state to determine the extent of interstate *branching*. Following the 1994 act, all states kept in place some form of branching barrier so it seems unlikely that the increase in branch closures comes primarily from the 1994 regulatory change (Johnson and Rice, 2007). Further, the changes from the IBBEA were effective in the middle of 1997 and so does not account for the jump in branch closures beginning in 1995. Ultimately, it seems plausible that large commercial banks increased their branch closures, half in low-income neighborhoods, at the same time that the CRA was strengthened.

To analyze the impact of the CRA on branch closures more closely, an equation is estimated in which the dependent variable is the number of branch closures. A Tobit model is appropriate given that the dependent variable has a large number of zero values corresponding to when bank i closed no branches in time t:

$$BRANCHCLOSURE_{i,t} = \beta_1 CRA95_t + \beta_2 ROA_{i,t-1} + \beta_3 INTERESTRATE_t + \beta_4 INCOME_{j,t} + \beta_5 REALESTATE_{i,t} + \beta_6 MERGER_{i,t-1} + \beta_7 STATE_j + \beta_8 YEAR_t + \mu \quad (1)$$

In Equation (1) $BRANCHCLOSURE_{i,t}$ is either the total number of branch closures in non-low-income or low-income neighborhoods by bank i at time t. To explain the number of closures, eight independent variables are included. CRA95 is a dummy variable equal to one after 1995 and is included to capture the change in closures after 1995. Since the 1995 revision to the act made it more onerous for bank noncompliance with the lending requirements, we expect that banks will have closed more branches after 1995 than before.[12]

$ROA_{i,t-1}$ and $MERGER_{i,t-1}$ are the one quarter lag of the real return on assets and a dummy variable equal to one if bank i was involved in a merger in the previous quarter.[13] It is expected that one reason banks close branches is because those branches are harmful to bank profits. Consequently, we expect ROA to have a negative impact on branch closures. Bank mergers may make certain branches redundant, therefore we expect a bank involved in a merger to have increased closures.

In addition, given that the 2007-2008 financial crisis was driven, in part, by the over extension of high risk mortgage loans, the closure model considers the ratio of real net loans secured by real estate to the average total real estate loans ($REALESTATE_{i,t}$) at each bank in the sample. Remaining variables account for general economic conditions and state and time specific effects. $INTERESTRATE_t$ is the prime rate at time t. $INCOME_{j,t}$ is the real personal income for state j (where bank i is located) at time t. Finally, $STATE_j$ and $YEAR_t$ control for state specific and time specific effects. For brevity, the coefficients on $STATE_j$ and $YEAR_t$ are not reported below.

Table 2 reports the results from the Tobit regression given by Equation (1). Confirming the comparison of means and non-parametric tests described above, the number of closed branches increases significantly after 1995, ceteris paribus.[14] This is consistent with the hypothesis that large commercial bankers responded to the 1995 revision to the CRA by closing branches to avoid making loans to low-income clients. Since the earlier data (see table 1) shows that over half of all branch closures were in low-income neighborhoods, these regression results also suggest the possibility that, had all these branches not been closed after 1995, the financial crisis could have been worse. That is, had banks not responded to the CRA by closing branches generally, and those in low-income neighborhoods more specifically, it is possible that banks would have made loans to low-income depositors to meet CRA requirements between 1995 and the crisis. This incentive to comply with CRA requirements is particularly strong for large commercial banks because they can be denied the right to merge or acquire a new bank or new branch if their CRA performance is not satisfactory.

Thus, bankers perhaps felt they could either comply with CRA requirements and extend low-income loans or they could close the low-income branches. Not closing the low-income branches could have made large banks more vulnerable to the instability brought about by the plunging home prices and crisis of 2007 – 2008.

Table 2: Branch Closure Regression Results: Tobit Estimation[a]		
	Low-Income Branch Closures[b]	Number of Branch Closures
CRA95	11.109** (2.45)	7.238** (2.43)
ROA_{t-1}	-4.876 (1.09)	-2.582 (0.50)
INTERESTRATE	0.0343 (0.21)	0.0953 (0.60)
Log INCOME	-6.465** (2.28)	-3.153* (1.86)
REALESTATE	0.2063* (1.81)	0.2045 (1.48)
$MERGER_{t-1}$	2.007*** (3.85)	2.691*** (4.39)
STATE	Yes	Yes
YEAR	Yes	Yes
N	19,637	19,637
Psuedo R^2	0.059	0.048

[a] Absolute value of the t-statistic in parentheses. A *,**,*** represent significance at the 10, 5, and 1 percent level, respectively. Sample is from 1990-2008 due to small number of closures prior to 1990. [b]This regression excludes AZ and VA since there were no low-income branch closure in those states.

The other estimated coefficients from the Tobit model are consistent with expectations. Improvement in bank performance (ROA) reduces closures, though not significantly so. Increases in income reduce closures while an increased reliance on real estate loans and merger activity increases the number of branch closures.

The above analysis demonstrates an increase in branch closures, particularly in low-income neighborhoods, after 1995. This is true controlling for both bank performance and merger activity. Why, then, the increase in closures? Did they in turn improve bank performance? To examine this issue an empirical model that attempts to explain large bank performance prior to and during the most recent financial crisis with the primary explanatory variables being closed branches in non-low-income and low-income neighborhoods is estimated. This model is found in equation 2. Following Nippani and Green (2002), four performance ratios are analyzed: 1) the return on assets;

2) the return on equity; 3) the net interest margin; and 4) the loan loss ratio. Separately, all four measures are labeled as $PERFORMANCE_{i,t+2}$ in equation (2) below where i represents the commercial bank in the sample, and t represents the quarter and year. Performance is measured 2 quarters after the branch closures to allow time for any impact of branch closures to take effect and to minimize possible simultaneity bias due to the potential endogeneity of the number of closures. Examining performance one, three, or four quarters after the closings did not significantly change the results reported below.

$$PERFORMANCE_{i,t+2} = \beta_0 + \beta_1 NONLOWINCLOSURES_{i,t} + \beta_2 LOWINCCLOSURES_{i,t} + \beta_3 CLOSURE_i + \beta_3 REALESTATE_{i,t} + \beta_4 INCOME_{j,t} + \beta_5 INTERESTRATE_t + \beta_6 MERGER_{i,t} + \beta_7 STATE_j + \beta_8 YEAR_t + \mu \qquad (2)$$

Three of the independent variables in equation (2) control for branch closure activity. First, $NONLOWINCLOSURES_{i,t}$ is the number of branches closed by each large bank i in time period t that were not located in a low-income neighborhood. In theory, a bank would close a branch if it was not performing well or if it did not fit into the overall model the banker was operating. From this perspective, it is expected that branch closures will improve bank performance. Second, $LOWINCCLOSURES_{i,t}$ is the number of low-income branches closed by each large bank. It is expected that a closure in a low-income neighborhood would also improve bank performance, particularly given the CRA requirements. Third, $CLOSURE_i$ is a dummy variable equal to one if bank i ever closed a branch, zero otherwise. $CLOSURE_i$ is included to control for any differences (e.g., management quality) that may exist between banks that closed one or more branches and banks that never closed a branch throughout the sample period.

As in the closure regression, the performance model has four general independent variables that may be important in explaining bank performance. First, the log of real state personal income ($INCOME_{j,t}$) controls for the macroeconomic performance of each state. If the economic health of the state is strong, it is expected that banks perform better. Second, the prime rate ($INTERESTRATE_t$) controls for fluctuations in interest rates which impact bank profitability and risk taking. Third, $REALESTATE_{i,t}$, the ratio of real net loans secured by real estate to the average total real estate loans, may positively or negatively influence bank performance. While mortgage loans are certainly high risk, they can also contribute significantly to bank profits. Common sense suggests that $REALESTATE_{i,t}$ will positively impact $PERFORMANCE_{i,t+2}$ in the stable real estate years but perhaps negatively impact $PERFORMANCE_{i,t+2}$ once the real estate market experienced falling prices and increased instability. Fourth, $MERGER_{i,t}$ is a dummy variable equal to one if bank i was involved in a merger at time t. It is expected that mergers will increase bank performance, either through increased efficiency or market power. $STATE_j$ and $YEAR_t$ control for state and time effects.

Table 3: Performance Regression Results: OLS Estimation[a]				
	Bank Performance Measures			
	Real Return on Assets	Real Return on Equity	Real Net Interest Margin	Log Real Loan Losses
NONLOWINCCLOSURES	0.0024** (1.99)	0.0140 (1.31)	0.0037*** (4.22)	0.1222 (1.52)
LOWINCCLOSURES	-0.0017** (2.06)	-0.0088 (1.25)	-0.0005 (0.63)	0.0959* (1.74)
CLOSURE	0.0004 (0.93)	0.0404*** (8.61)	-0.0010*** (5.67)	0.7773*** (44.75)
INCOME	0.0150*** (6.09)	0.1285*** (4.51)	-0.0328*** (20.75)	1.377*** (12.06)
INTERESTRATE	0.0003 (0.84)	0.0021 (0.52)	-0.00007 (0.56)	-0.0181 (1.06)
REALESTATE	-0.0034*** (9.08)	-0.0403*** (3.20)	-0.0006*** (4.18)	0.2838*** (16.71)
MERGER	0.001* (1.80)	0.0285*** (4.76)	0.0004 (1.28)	0.9109*** (26.82)
STATE	Yes	Yes	Yes	Yes
YEAR	Yes	Yes	Yes	Yes
N	25,450	25,450	25,450	25,445
R^2	0.076	0.063	0.100	0.534

[a]Absolute value of the t-statistic in parentheses. A *,**,and *** represent significance at the 10, 5, and 1 percent level, respectively. See the Appendix for complete variable definition and data sources.

Table 3 contains the regression results for the performance model.[15] In terms of the branch closure variables, the results indicate that when the large banks closed branches in non-low-income neighborhoods, both the real return on assets and the real net interest margin statistically improved. This is as expected since it is anticipated that banks close branches that are poor performers. The coefficients on the real return on equity and the log of real loan losses are not statistically significant. The estimated coefficients on $LOWINCCLOSURES_{i,t}$, defined as the number of branch closures that occur in low-income neighborhoods, provides the impact when a closure is in a low-income area. The only statistically significant results are for the real return on assets and the log of real loan loss. Interestingly, closing low-income branches reduces bank performance according to these measures. However, while statistically significant, the economic impact of closures is very small. For example, the average real return on assets over the sample is 0.037. Closing a low-income branch would reduce this by 0.0017 to 0.0353. Similarly, the average for the log of real loan losses is 7.776, so the increase resulting from a low-income closure, 0.096, is economically small. Therefore, from an economic standpoint, closing a low-income branch has little effect on bank performance. For that matter, a comparison of the coefficients on NONLOWINCLOSURES yields similar conclusions. The average real net interest margin is 0.0266, making the increase of 0.0037 from closing a non-low-income bank economically small.

While some of these results are unexpected, data limitations may be part of the reason. More specifically, the FDIC closure data indicates branch closures for branches located in the state in which the bank is headquartered. The data omits closures outside of the banks' home state. Consequently, our data captures some, but not all, branch closures and may therefore be a conservative estimate. It is also possible that banks closed low-income branches *before* they became a financial burden due to CRA requirements. That is, it is possible that low-income branches were performing at an acceptable level but bankers, anticipating how these branches would perform after the 1995 CRA revision, decided to close them. Under this scenario, closing the branch would not impact bank performance; it was closed *before* it became a drain on profit.

CLOSURE_i, the control for whether the bank ever closed a branch, is statistically significant in three of the four regressions, suggesting that banks that have ever closed a branch have different performance levels than those never closing a branch. The direction of that difference, however, is ambiguous as banks that closed branches have a higher real return on equity, but lower real net interest margin and larger loan losses. Regardless, the results suggest that it is important to account for banks that made decisions to close a branch versus those that did not.

In terms of the remaining estimation results, $\text{INCOME}_{j,t}$, is statistically significant in all four regressions and largely suggests that higher real income in the state in which the large bank is headquartered improves bank profit but slightly reduces the banks' net interest margin. Fluctuations in the prime rate (INTERESTRATE_t) are statistically insignificant. All four measure of bank performance deteriorated with an increase in the ratio of net loans secured by real estate to average total real estate loans ($\text{REALESTATE}_{i,t}$). Clearly, real estate loans hurt bank performance at the large banks in our sample. Finally, mergers generally improved bank performance with the exception of loan losses which are unexpectedly positive. However, the impact of being involved in a merger, much like branch closures, is economically small.

Existing research from the Federal Reserve argues that since such a small portion, 6 percent, of mortgage loans went to low-income borrowers, the CRA could not be responsible for the financial crisis. This research asks if perhaps the reason that so few loans came from CRA institutions is because commercial banks closed branches in low-income neighborhoods to avoid the CRA in the years before the crisis. The empirical analysis suggests that may be what happened. Large commercial banks did close branches and one half of all closures were in low-income neighborhoods. Further, the results of the Tobit model indicate that closures increased significantly following the strengthening of the CRA in 1995 even when controlling for merger activity, bank performance, and general economic conditions. It is possible that the reason CRA loans were such a small portion of total low-income mortgage loans made in the height of the real estate run up is because of decisions made to close these branches. From this perspective, it is not as easy to exonerate the CRA in the financial crisis.

The initial reform plan from the Department of the Treasury acknowledges a debate over the role of the CRA in the financial crisis (Department of the Treasury, June 17, 2009, 67). Siding with the Federal Reserve, the Treasury recommends rigorous application of the CRA moving forward. Is this sound policy? This research indicates that perhaps the CRA had the unintended consequence of encouraging banks to close branches in low-income neighborhoods. It is possible that these closures disguised the true impact of the CRA on the financial crisis. Had these branches not been closed, it is possible that the CRA institutions would have made high priced mortgage loans to high risk borrowers in these low-income neighborhoods. Once home prices began falling and adjustable mortgage rates began rising, these problem loans would have been revealed. Ultimately, the crisis could have been even worse.

Of course, correlation does not equate to causation. The increase in closures after 1995 may have some other root cause, such as the IBBEA in 1994. However, neither the CRA nor IBBEA had the closure of low-income branches as an objective. Moreover, it does not appear that bank performance, merger activity, or economic conditions were a primary driver of these closures. Therefore, it is conceivable that banks closed these branches to avoid CRA regulation. Given this, perhaps policy makers need to be more careful about CRA regulation and application as they seek resolution to the financial crisis.

ENDNOTES

1 Data for determining the profitability of CRA loans is extremely limited and perhaps non-existent. Avery at al. (2005a) indicate that survey data from the Board of Governors in 2000 may lend some insight but the survey fails to ask which loans were made as a result of the CRA.

2 All CRA commitments may be found at: http://www.ncrc.org/images/stories/whatWeDo_promote/cra_commitments_07.pdf. This is the internet site of the National Community Reinvestment Coalition.

3 Several scholars weigh in on the role of monetary policy in the crisis at an online symposium of the *Wall Street Journal* (March 27, 2009) which can be found at http://online.wsj.com/article/SB123811225716453243.html.

4 This data and the history of changes to the CRA institutional size definitions may be found at http://www.ffiec.gov/cra/examinations.htm.

5 Four regulatory bodies conduct CRA examinations: The Federal Reserve Board, the Office of Thrift Supervision, The Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

[6] Large banks are the appropriate sample of commercial banks because they account for over 70 percent of all CRA lending (Federal Reserve Board of Governors, 2000).

[7] Avery et al. (2000) analyze branch closures across demographics but do not subject the data to econometric analysis.

[8] An alternative method for determining the state sample would be to determine the largest commercial banks in the country, and then use the twenty states that house those banks. However, it seems likely that bank headquarter locations may be a function of regulatory and tax advantages of certain states and not where the bank is doing much of its business. Nonetheless, this approach produces a bank sample with significant overlap as the sample used in this research. The twenty states in this research sample are NY, NJ, PA, CA, IL, IN, WI, TX, DE, MD, FL, VA, WV, GA, MA, NH, MI, AZ, WA, and MN. However, NH does not house any large banks (over $1 billion in assets) so it falls out of the sample, leaving nineteen states. Data collection created significant time constraints which is why the sample does not include all states.

[9] This appears to be a reasonable sample. As a point of comparison, the Federal Reserve Board of Governors (2000) survey data contains 114 large commercial banks.

[10] The FDIC's research department generated the quarterly branch data back to 1972 for the authors.

[11] This data is available across the sample of banks for the year 1999.

[12] A difference-in-difference model, which is frequently used to compare a treatment (low-income branches) and control group (non-low-income branches) over time is not estimated here due to the lack of complete branch specific data. Specifically, since our primary focus is on those branches that closed, we only have zip code level income data for those branches that were closed, not all branches that a bank operates.

[13] ROA and MERGER are lagged one quarter to avoid any possible simultaneity bias between branch closures and bank performance and merger activity and branch closures since they influence each other. Lagging these variables more than one quarter did not change the results.

[14] To control for the possibility that branch closures were a response to the general change in the number of branches in the market, the regression is also run with the total number of branches for each state for the 1994-2008 period (the period for which data is available). The results indicate that the number of branches have no bearing on the decision to close a branch.

[15] The regression is also run with the total number of branches in each state for the 1994-2008 sample period to control for the possibility that the number of branches may impact bank performance. The results indicate that the number of branches is statistically significant and improves bank performance.

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Appendix: Data Sources and Definitions		
Variable	Source	Definition/Notes
Real Return on Assets (ROA)	www2.fdic.gov/idasp	Ratio of real undivided profit to total real assets
Real Return on Equity	www2.fdic.gov/idasp	Ratio of real undivided profits to total real equity capital
Real Net Interest Margin	www2.fdic.gov/idasp	Ratio of the difference in real interest income and interest expense to real earning assets
Log of Real Loan Losses	www2.fdic.gov/idasp	Log of the ratio of total real loan losses to total loans
Mortgage Loans (REALESTATE)	www2.fdic/gov/idasp	Ratio of net loans secured by real estate to average total real estate loans.
Branch Closures in Low-Income Neighborhoods (LOWINCCLOSURE)	http://www.bea.gov/regional/reis/drill.cfm http://factfinder.census.gov/home/saff/main.html?lang=en	Zip code per capita personal income is from the U.S. Census and per capita personal income for the MSA in which the closure was located is from the BEA.
Number of Branch Closures not in Low-Income Neighborhoods (NONLOWINCLOSURES) =1 if the bank closed a branch (CLOSURE)	http://www2.FDIC.gov/sod http://www2.FDIC.gov/sod	The number of branches not in low-income neighborhoods closed by each large bank in the sample. A control variable = 1 if the large bank closed a branch; =0 if the large bank never closed a branch.
Log of Real State Personal Income (INCOME)	www.bea.gov/regional/sqpi	Natural log of real state personal income for all states in the sample.
Prime Rate (INTERESTRATE)	http://www.federalreserve.gov/release/h15/data/Monthly/H15_PRIME_NA.txt	Monthly prime rate data that was converted to quarterly averages.
Merger Activity (MERGER)	www2.fdic/gov/idasp	Dummy variable equal to one if the large bank was involved in a merger at time t.
Regulatory control for the Community Reinvestment Act Revision (CRA95)	NA	A control variable = 1 if the year is 1995 - 2008; = 0 if year is 1972 - 1994.

COMPLYING WITH THE FAIR LABOR STANDARDS ACT (FLSA): A CONTINUING LEGAL CHALLENGE FOR EMPLOYERS

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ABSTRACT

Complying with the Fair Labor Standards Act (FLSA) continues to be a challenge for employers. In Fiscal Year (FY) 2008, the U.S. Depart of Labor's Wage and Hour Division (WHD) recouped back wages totaling $185,287,827 for 228,645 workers. While this amount is down from the $220,613,703 recouped in FY 2007, it still represents a 40 percent increase over the FY 2001 amount. Since FY 2001, WHD has recouped more than $1.4 billion in back wages for over two million workers (DOL News Release, 2009). Back wages associated with overtime violations accounted for 88 percent of all FLSA back wages collected and 93 percent of all workers due FLSA back wages (DOL Results Page, 2009). In addition to the back wages recouped by the federal government, employers in a variety of industries all across the United States have over the last ten years been staggered by large settlements awarded to employees in class action litigation estimated to be as high as $319 million in 2007 and even higher in 2008 (Seyfarth Shaw (2008). The purpose of this paper is to examine the nature of the challenges employers have faced in recent years with respect to FLSA compliance and what organizations can do to facilitate compliance with the FLSA.

INTRODUCTION

Complying with the Fair Labor Standards Act (FLSA) continues to be a challenge for employers. In Fiscal Year (FY) 2008, the U.S. Depart of Labor's Wage and Hour Division (WHD) recouped back wages totaling $185,287,827 for 228,645 workers. While this amount is down from the $220,613,703 recouped in FY 2007, it still represents a 40 percent increase over the FY 2001 amount. Since FY 2001, WHD has recouped more than $1.4 billion in back wages for over two million workers (DOL News Release, 2009). Back wages associated with overtime violations accounted for 88 percent of all FLSA back wages collected and 93 percent of all workers due FLSA back wages (DOL Results Page, 2009). The amount of back wages recouped and the number of employees receiving those wages have increased dramatically since 2001 (See Table 1).

Table 1: WHD Enforcement Statistics		
	Back Wages	# of Emp.
FY 2001	$131,954,657	216,647
FY2002	$175,640,492	263,593
FY2003	$212,537,554	342,358
FY2004	$196,664,146	288,296
FY2005	$166,005,014	241,379
FY2006	$171,955,533	246,874
FY2007	$220,613,703	341,624
FY2008	$185,287,827	228,645
Source: DOL Results Page, 2009. (# of Emp. = Number of Employees Receiving Back Wages)		

In addition to the back wages recouped by the federal government, employers in a variety of industries all across the United States have over the last ten years been staggered by large settlements awarded to employees in class action litigation estimated to be as high as $319 million in 2007 and even higher in 2008 (Seyfarth Shaw (2008). On December 23, 2008, Wal-Mart Stores Inc. announced that it was settling 63 wage and hour lawsuits in 43 states that would cost the company between $352 and $640 million "depending on the amount of claims that are submitted by class members"(Smith, 2008). Wal-Mart has been a prime target for this type of litigation in recent years and had suffered a number of adverse court decisions (Table 2).

Table 2: Recent Settlements and Jury Verdicts		
Company	Issue	Amount*
Wal-Mart Stores	Variety of issues	$352-640
Wal-Mart Stores & Sam's Club (MN)	Off the clock work	$54.2
Wal-Mart Stores Inc.	Bonuses & improper overtime calculations	$33.5
Albertson's Inc	Off the clock work and denial of overtime	$53.0
IBM Corporation	Failure to pay overtime	$65.0
Staples, Inc.	Misclassification and overtime	$38.0
Family Dollar Store	Overtime - store managers	$35.0
UBS	Overtime	$89.0
Morgan Stanley	Overtime	$42.5
Electronic Arts	Overtime	$15.6
Sears, Roebuck and Co.	Overtime	$15.0
*All amounts are in millions Source: (Jern and Politzer, 2008), (Smith, 2008), & (Mersol, 2008), (Holland, John M, 2007).		

The purpose of this paper is to examine the nature of the challenges employers have faced in recent years with respect to FLSA compliance and what organizations can do to facilitate compliance with the FLSA.

BACKGROUND

The Fair Labor Standards Act of 1938, as amended, provides for minimum standards for both wages and overtime entitlement, and spells out administrative procedures by which covered work time must be compensated. Also included in the FLSA are provisions related to child labor, equal pay, and portal-to-portal activities (U.S. Office of Personnel Management, 2009). The FLSA covers over 130 million American workers and applies to all employees who work for employers that have an annual dollar volume of sales or business of at least $500,000. Individuals are also covered "even when there is no enterprise coverage, if their work regularly involves them in commerce between States (interstate commerce)" (Fact Sheet #14, 2009). The Wage and Hour Division was created with the enactment of the FLSA and its staff is responsible for the administration and enforcement of a wide variety of laws that "collectively cover virtually all private and State and local government employment (Wage and Hour Division, 2009).

Table 3: Laws Enforced by the Wage and Hour Division
Fair Labor Standards Act
Government Contracts labor standards statutes
Migrant and Seasonal Agricultural Workers Protection Act
Employee Polygraph Protection Act
Family Medical Leave Act
Immigration Reform and Control Act of 1866
Source: Wage and Hour Division (2009).

Enacted by a Congress attempting to pull the United States out of the Great Depression, the FLSA is one of the oldest of the many federal statutes that impact human resource decision making (Falcone, 2008). In addition to the basic problems associated with the Great Depression, the FLSA was enacted in what was primarily an "industrial and agricultural economy" where "it was fairly clear who was nonexempt and who was exempt" from the overtime provisions of the FLSA (Russell, 2008). Russell, in remarks made at BLR's Second Annual National Employment Law Update in October of 2008 went on to say that "in today's workplace, those lines are blurred, and HR managers are stuck with sorting out the rules" (Russell, 2008). Additionally, "in a society that's increasingly dependent on technology", employees working in what is often described as the virtual workplace, monitoring and controlling employees work time has become increasingly difficult (Coie, 2008).

While the U.S. Department of Labor's (DOL) 2004 "controversial" revisions of regulations on exemptions from overtime requirements were designed to up date and facilitate employer compliance with the regulations, the challenge associated with the regulatory burden associated with FLSA compliance does not appear to have been mitigated (Lechner, 2005). The DOL made changes in all three components associated with the white-collar regulations: the salary level test; the salary basis test; and the duties tests. According to Lechner, the most significant changes include:

> *the salary level test has been changed to increase the minimum compensation level for exempt employees and to provide a more lenient standard for certain "highly compensated" employees; the salary basis test has been revised to allow salary deductions for full-day disciplinary suspensions, to expand the "window of correction" provision and to provide a "safe harbor" for employers who, among other things, have a "clearly communicated policy" prohibiting improper salary deductions; and the duties tests have been combined to eliminate the separate "long" and "short tests and to require exempt executives to have meaningful input into hiring, firing, promotion, or similar employment decisions* (Lechner, 2005).

According to current DOL regulations, to obtain the white-collar exemption the employee must be compensated on a salary basis of at least $455.00 per week. The salary level had been $155 a week for executives and administrative employees and $170 a week for professional. A so called "short test" was $250 per week. Paul Kersey cited a 2000 General Accounting Office study by Cynthia Fagnoni that noted that inflation had eroded the salary levels in the DOL regulations to the extent that they applied to the overwhelming majority of employees instead of the higher salaried workers that they were originally designed to apply to (Kersey, 2004). Under the duties test for the executive exemption,

> *the employee must be managing the enterprise, or managing a customarily recognized department or subdivision of the enterprise; must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent; and must have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees must be given particular weight* (Fact Sheet # 17, 2009).

In 2007 and 2008, the WHD collected nearly $29 million for over 21,000 employees as a result of violations of the Overtime Security regulations and the violation cited in the greatest number of cases was one in which the employees did not meet the duties test required for exempt executive employees (DOL Results Page, 2009).

For an employee to qualify for the administrative employee exemption, the duties test requires that

> *the employee's primary duty must be the performance of office or non-manual work directly related to the management or general business of the employer of the employer's customers; and that the employee's primary duty includes the exercise of discretion and independent judgment with respect to matters of significance* (Fact Sheet # 17, 2009).

While cited in fewer cases, violations in 2008 of failure to meet the duties test for administratively exempt employees resulted in $600,000 more in back wages for 300 more employees that those cases involving administrative employees (DOL Results Page, 2009).

While a number of critics protested that the 2004 revisions would lead to many blue collar workers losing their ability to earn overtime, the revisions concerning highly compensated employees is important. Under the 2004 revisions,

> *highly compensated employees performing office or non-manual work and paid total annual compensation of $100,000 or more (which must include at least $455 per week paid on a salary or fee basis) are exempt from the FLSA if they customarily and regularly perform at least one of the duties of an exempt executive, administrative or professional employee* (Fact Sheet # 17, 2009).

The DOL has noted that these exemptions apply only to "white collar" employees who meet the salary and duties tests set forth in the Part 541 regulations (DOL Results Page, 2009). The exemptions…

> *do not apply to manual laborers or other "blue collar" workers who perform work involving repetitive operations with their hands, physical skill and energy. Further, FLSA-covered, non-management employees in production, maintenance, construction and similar occupations, such as carpenters, electricians, mechanics, plumbers, iron workers, craftsmen, operating engineers, longshoremen, construction workers and laborers are entitled to minimum wage and overtime premium pay under the FLSA, and are not exempt under the Part 541 regulations no matter how highly paid they might be* (DOL Results Page, 2009).

CHALLENGES

The expanding list of FLSA compliance issues that have challenged employers is long with no let up on the horizon. Described by one prominent employment law attorney as "becoming a cottage industry" in some locations, the staggering dollar amounts being paid out in jury verdicts, settlements, and WHD back wage recoveries, are supplying the motivation (Baker, 2007). Class-action litigation has become increasingly popular with plaintiffs' attorneys and Jerry Maatman, a prominent attorney involved in workplace litigation issues, noted that "wage and hour class actions are like low-hanging fruit for plaintiffs attorneys" (Deschenaux, 2008). These challenges are being faced by a wide variety of employers all across the United States. Low-wage industries including hospitality, retailing, construction and manufacturing and high-wage industries, including financial services, technology, and communications have all been targeted (Jern and Politzer, 2008). While California has been described as "ground zero" for these types of claims, all across the country employers and management attorneys are becoming increasingly aware of increased interest in this type of litigation (Baker, 2007).

Table 4: Compliance Issues
Meal & rest break
Off the clock work claims
Misclassifying non-exempt as exempt
Improper tip pooling

Table 5: States with paid rest period requirements
California
Colorado
Illinois
Kentucky
Minnesota
Nevada
Oregon
Washington
Source: U.S. Department of Labor, Employment Standards Administration (2009).

Litigation involving meal and rest break regulations has been very costly for employers in recent years. Under the FLSA, employers are not required to provide lunch or coffee breaks. FLSA regulations do require that bona fide meal periods (typically lasting at least 30 minutes) are not work time and are not compensable. Short breaks (usually lasting about 5 to 20 minutes) are compensable work hours and should be considered in determining if overtime was worked (U.S. Department of

Labor, 2009). The rational associated with breaks is that they are common industry practice and are designed to promote the efficiency of the employee. Meal periods are considered bona fide if the employee is completely relieved from duty for the purpose of eating regular meals. The employee is not relieved if he/she is required to perform any duties, whether active or inactive, while eating (Fact Sheet # 22, 2009). The bulk of the compliance problems for employers with regard to meal and rest breaks are not with the federal regulations but, with the variety of state laws that exist in this area. Eight states, for example, require employers to provide paid rest periods (see Table 5).

The general requirement in all but the state of Illinois is that employers are required to provide a paid 10-minute rest period for each 4-hour work period. The Illinois regulations apply to hotel room attendants and requires that those persons who clean or put guest rooms in order in a hotel or other establishment licensed for transient occupancy, shall receive a minimum of two 15-minute paid rest breaks in each workday in which they work at least seven hours (U.S. Department of Labor, Employment Standards Administration (2009)*. Twenty-one states have regulations with meal period requirements for adults with 35 states having separate provisions requiring meal periods specifically for minors. None of them require paid meal periods but the regulations do provide a wide variety of time frames and situations where the meal periods may be taken. For example, in California a 30 minute meal period is required after 5 hours of work, except when the workday will be completed in 6 hours or less. After 6 hours of work, the meal period must be 30 minutes and not more that 1 hour. In New York, a 1 hour noon-day period is specified. A 30 minute noonday period is required for employees who work shifts of more than 6 hours that extend over the noon day meal period. An additional 20 minutes between 5 p.m. and 7 p.m. for those employed on a shift starting before 11 a.m. and continuing after 7 p.m. (U.S. Department of Labor, Employment Standards Administration (2009)**. For employers with multi-state operations, the variety in regulations makes it difficult to develop consistent policies for their organizations. Wal-Mart problems in this area cost the company over $250 million from two jury verdicts entered against it in break cases in California in 2005 and Pennsylvania in 2006 (Deschenaux, 2007). In California, "if an hourly employee fails to get a rest break, he or she is entitled to an extra hour's pay... if the employee also does not receive a lunch break, he or she is due another hour's pay" and, if a large number of employees missed breaks, the employees may be able to recover up to four years of back pay for those missed breaks (Descchenaux, 2007).

Off-the clock violations, according to Lisa Schreter, have three root causes: "fundamental misconceptions regarding what constitutes compensable working time, inadequate or improper recordkeeping practices, and supervisory misconduct" (Schreter, 2006). In addition, “ many of the decisions about overtime, break time, meal time, and hours of work are made by low-level supervisors who don’t know the rules and act on instinct” (HRDaily Advisor, 2008. A key to avoiding problems in this area according to Schreter is employers developing an understanding of what constitutes compensable working time under the FLSA. The FLSA does not define "hours worked" but it does define the term "employ" to mean "to suffer or permit to work" (Schreter, 2006). Schreter, citing the U.S. Supreme Court's 1944 decision in Tennessee Coal, Iron & Railroad Co. v.

Muscoda Local No. 123, notes that the FLSA requires that employees must be paid for all time spent in "physical or mental exertion (whether burdensome or not) controlled or required by the employer and pursued necessarily and primarily for the benefit of the employer" (Schreter, 2006). Schreter goes on to point out that the DOL regulations are also clear on management's responsibility for controlling the work environment and that it is "management's duty to control and see that the work is not performed if it does not want it to be performed" and that employers "cannot simply sit back and accept the benefits of work that is performed without compensating employees for their work" (Schreter, 2006). It is, according to Schreter, "management's legal duty to control the hours employees work through a combination of clear policies and vigorous enforcement, including appropriate disciplinary action" and employers that attempt to avoid paying for unauthorized overtime without clearly communicated policies and consistent enforcement will have a great deal of difficulty defending simple policy statements stating that only pre-approved overtime will be paid. Work preformed before clocking in and after clocking-out must also be dealt with in a similar fashion (Schreter, 2006). In 2005, the U.S. Supreme Court in IBP v. Alvarez decided that employers "must pay employees not only for their principal activities but also for preliminary activities at the beginning of the day and postliminary activities at the end of the day, as long as the preliminary and postliminary activities are integral to the employees' principal activities" (Segal, 2007). In the IBP v. Alvarez decision, the Supreme Court agreed with the District Court decision that the donning and doffing of protective gear that was unique to the jobs at issue were compensable under the FLSA because they were integral and indispensable to the work of the employees who wore such equipment. Additionally, the walking time between the locker room and the production floor was also compensable because it occurred during the workday (IBP v. Alvarez, 2005).

The number of claims alleging employee misclassification as exempt or not exempt from overtime pay under the FLSA has increased "a whopping 77 percent during the first half of the decade" according to a report Diane Cadrain (Cadrain, 2008). According to Cadrain, a wide variety of employees have been misclassified including insurance adjusters, assistant managers in stores and restaurants, pharmaceutical salespeople, and loan originators in the financial services industry (Cadrain, 2008). The misclassification problem is in part fueled by a number of widely held misconceptions associated with the FLSA's overtime regulations. The use of job titles, normally considered irrelevant in determining if someone's job is exempt or non-exempt from the overtime provisions, is a reoccurring theme expressed by too many individuals responsible for making these types of decisions. The use of the terms "manager", "assistant manager", "supervisor", "team leader", "administrative assistant", and "independent contractor" have in recent years been subject to legal challenges that have resulted in employers paying dearly for this mistake. Other common misconceptions, according to Steve Bruce, are "we pay everyone in the office on a salary basis" or we don't have to pay overtime because we pay salaries" (Bruce, 2008). A recent example of how these misconceptions can lead to an expensive costly situation can be seen in a recent 11th U.S. Court of Appeals decision.

The 11th U.S. Circuit Court of Appeals recently up-held a $35 million jury verdict against Family Dollar Stores for "store managers" who were misclassified as exempt under the DOL's executive exemption regulations (Morgan v. Family Dollar Stores, 2008). In the case, evidence presented by the plaintiff's attorneys showed that the store managers, who were salaried employees, spent up to 90% of their time performing manual labor such as unloading trucks, stocking shelves, and cleaning parking lots, floors and bathrooms (Morgan v. Family Dollar Stores, 2008). In addition, the evidence showed that the Family Dollar Store managers had no traditional managerial discretion, such as making hiring and firing decisions (Morgan v. Family Dollar Stores, 2008). Testimony by Family Dollar Executives at trial also revealed that the organization had never done a study concerning the duties of the store managers in relation to whether they should be exempt or non-exempt for overtime purposes (Morgan v. Family Dollar Stores, 2008). The response to one question in particular posed to one Family Dollar Executive is especially telling. The question from the plaintiff's attorney was "you said every store' manager is considered exempt. And when you said "every", you meant regardless of store size, number of employees, whether it's rural or urban, no matter what its profits, no matter what anything; you just said they're all exempt, didn't you? The executive replied, "All of our store managers are salaried, yes, sir, in every one" (Morgan v. Family Dollar Stores, 2008). Just because you call someone a manager and pay them on a salary basis does not satisfy the DOL executive exemption. The Appeals Court cited DOL guidelines that individuals should spend at least 50% of their time on exempt work. Evidence at trial indicated that Family Dollar Store managers spent only 10 to 20% of their time performing exempt work (Morgan v. Family Dollar Stores, 2008). These facts, plus testimony that Family Dollar had never studied what store managers actually did on a day-to-day basis supported the jury's verdict (Morgan v. Family Dollar Stores, 2008).

Improper tip pooling has also become a very expensive problem for a number of organizations. Taco Bell, Pizza Hut, California Pizza Kitchen, and Starbucks are among the many organizations that have had problems in this area (Baker, 2007). A California Superior court awarded $105 million to Starbucks Baristas in a tip sharing dispute (Bajaj, 2008). Baristas make coffee and serve customers and also are responsible for directing other employees, setting schedules and doing other managerial work. According to Bajaj, "if the verdict is upheld, the damages will be shared by about 100,000former and current baristas who worked at stores in California since 2000 (Bajaj, 2008). This case was brought under California law and the rules created by the California authorities provide that "tips can be pooled and shared among workers but restaurant owners or their agents, who are typically construed to mean managers and supervisors, cannot share in the money (Bajaj, 2008).

FACILITATING FLSA COMPLIANCE

The general suggestions in the literature with respect to FLSA compliance mirror those associated with most anti-discrimination laws and regulations. Start with clearly stated and communicated compensation policy and procedures. Whether employers want to restrict or require overtime, regulate break or meal periods, or require employees to properly document hours worked, they have a great deal of latitude if they develop policies within the bounds of the FLSA and DOL Guidelines, effectively communicate them, and consistently apply them. Next, education and training of decision makers and vigilant monitoring and enforcement of policies by supervisors with respect to what is compensable time is critical. Lower level supervisors must be educated as to FLSA Basics:

- ♦ Comp-time is not an option in the private sector.
- ♦ Do not pressure employees to work off the clock work.
- ♦ Do not allow employees to volunteer to work off the clock.
- ♦ Do not ignore employees working unauthorized overtime.
- ♦ Do not assign employees work during meal periods.
- ♦ Employees can be disciplined for working unapproved overtime.

Supervisors must understand that it is their responsibility to enforce policies on overtime in a fair and consistent manner. When supervisors see unauthorized overtime work being performed, they must intervene and apply appropriate discipline when necessary (Falcone, 2008). The time worked must be paid for, and working unauthorized overtime must be discouraged in the future. Once lower level supervisors are educated and trained, they must also be monitored and evaluated as to the effectiveness of their enforcement of policies in this area.

For employers making more extensive use of the virtual office, compliance with FLSA regulations can be even more difficult. As more and more employers distribute PDAs, cell phones and laptops to nonexempt employees, employers must remember that "if a nonexempt employee uses these devices, it could create an obligation to pay for the time spent using the device and for other time that otherwise would not be compensable" (Feldman, 2007). Keys for compliance in this area include making sure "that nonexempt employees accurately record all hours worked so they can be paid for this time" (Feldman, 2008).

Tammy McCutchen, a former DOL administrator involved in enforcing the FLSA, recommends that employers adopt procedures employed by employers to comply with Title VII of the 1964 Civil Rights Act (Cadrain, 20008). McCutchen goes on to note "with FLSA actions now outstripping Title VII actions in the federal courts, proactive steps under the FLSA make sense in the current climate". McCutchen says a compliance program should include:

- ♦ A toll-free number for employee questions and complaints.
- ♦ A process for investigating complaints.
- ♦ A policy on overtime work.
- ♦ A payroll integrity policy for actions such as falsifying time records and working off the clock (Cadrain, 2008).

These types of “good faith efforts” can not only facilitate employer compliance with the FLSA, but may mitigate and reduce the likelihood of double damages and three years of back pay being awarded (Cadrain, 2008).

One final recommendation to facilitate FLSA compliance includes auditing job classifications. The focus of these audits should be to make sure positions are accurately classified and payroll practices include record-keeping “to ensure retention of appropriate documents to substantiate classification and payroll practices” (Jern & Politzer, 2008). The auditing suggestion is not without its pitfalls. Schreter notes, with the ever increasing number of FLSA and state wage and hour claims, many employers “have rushed to audit their compensation practices, often discovering violations. Employers then struggle to remedy any violations without prematurely alerting employees and triggering the type of lawsuit the audit was designed to prevent” (Schreter, 2008). A controversial solution to this situation advocated by Schreter is to enter into a voluntary compliance agreement with the DOL. Schreter notes two “important advantages” associated with a voluntary compliance agreement:

- The DOL can negotiate a valid release of affected employees’ claims. An employer cannot.
- The DOL will generally only seek to recover two years of back wages instead of three years and it will not seek liquidated damages, attorneys’ fees or interest. In private litigation, a plaintiffs’ attorney will ordinarily pursue a willful violation and three years of back wages, an equal amount in liquidated damages and attorneys’ fees (Schreter, 2008).

These agreements with the DOL cannot be used to resolve FLSA claims already in litigation or identified in a DOL investigation. Resource that the DOL makes available to employers include a National Call Center for telephone assistance, e-mail responses to employer questions and the interactive First Step employment Law Advisors. The DOL has also adopted the Confidentiality Protocol for compliance Assistance “to alleviate any concerns that an employer might become the target of an enforcement action after contacting the DOL for compliance assistance and materials (Schreter, 2008). The availability of voluntary compliance agreements is not un-restricted, and the DOL will examine the employer’s compliance history, whether the employer has worked cooperatively with the DOL in the past, are they currently involved in FLSA litigation, the nature of the alleged violations and whether the employer has taken adequate steps to ensure similar violations will not occur in the future (Schreter, 2008). The DOL’s Compliance Assistance web portal (http://www.dol.gov/compliance/) is designed to provide workers, businesses, and others with the knowledge and tools they need to understand their rights and responsibilities under DOL’s rules.

Compliance with FLSA and the various state regulations can be a challenging expensive undertaking. There are no short cuts or quick fixes. Education and training of decisions makers and auditing of your compensation policies and procedures are essential for organizations serious about reducing their exposure to the expensive legal consequences of not complying with the FLSA.

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FAIR PRESENTATION---AN ETHICAL PERSPECTIVE ON FAIR VALUE ACCOUNTING PURSUANT TO THE SEC STUDY ON MARK-TO-MARKET ACCOUNTING

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ABSTRACT

Fair value accounting has received a significant amount of blame as the cause of the current financial crisis. Fair value accounting does not cause illiquidity or volatility in financial markets. Banks, rather than accounting, caused the existing crisis, ultimately through bad lending decisions and inadequate risk management. Accounting rules are designed to reveal the full extent of losses and future risks. This transparency would enable banks, regulators, and government to identify specific sources of the crisis and take steps toward recovery and future prevention. Shooting the accounting messenger is not a solution to the problem. Perhaps confusion exists regarding the conflict between transparency and financial stability. Transparency is an objective of accounting standards. Long term stability is best achieved by restoring investor confidence in financial markets and assets. Transparent accounting standards and sound auditing provide support for that confidence. Evidence from the recently released SEC study on mark-to-market accounting supports fair value as the most relevant measurement attribute for financial instruments. Suspension of fair value in favor of alternative cost-based measures would mask losses in value, mislead investors, and diminish investor confidence. From an ethical perspective, accounting has a responsibility to see that financial statements are fairly presented---reflect economic reality. Accountants and auditors are ethical detectives holding businesses to ethical standards of honesty, completeness, neutrality, and representational faithfulness. Accountants and auditors are bound by their professional code of conduct to protect the public interest. So grounded, accounting is the provider of one of the essential checks and balances on commerce.

INTRODUCTION

Recently, there has been considerable media coverage on the subject of fair value accounting. While some commentators applaud the use of fair value accounting as a positive factor in promptly revealing the values of financial assets in today's troubled credit markets, others decry the use of fair value accounting as a negative factor exacerbating the problems in the credit markets.

Over the past 18 months, what some viewed as a subprime mortgage crisis has spread to the global economy. The National Bureau of Economic Research announced that the United States has been in a recession since December 2007 and is expected to "likely be the longest, and possibly one of the deepest, since WWII."

Some posit that the fair value accounting standards have contributed to or exacerbated the crisis in this illiquid market by requiring asset write downs below their underlying or intrinsic economic values. Critics assert that these write downs have triggered a downward market spiral, causing diminished investor confidence, further losses in value, and lessened liquidity. Fair value supporters counter that fair value reporting enhances transparency and, therefore, investor confidence. They argue that suspension of fair value reporting would decrease transparency, thereby, leading to greater uncertainty and instability in the market.

Our paper examines the current economic tsunami as it relates to fair value reporting and explores the role of accounting and auditing from an ethical perspective. We believe that accounting is applied ethics, and accountants and auditors are the gatekeepers of business ethics. Contemporary ethical models are applied to the accounting profession. Results of the recently released SEC study on mark-to-market accounting are considered and fair value reporting rules are evaluated from an ethical perspective.

THE FINANCIAL REPORTING FRAMEWORK AND BACKGROUND INFORMATION ON FAIR VALUE ACCOUNTING

SFAC No. 1 states that the objective of financial reporting is to provide information to investors and creditors that are useful in decision-making. SFAC No. 2 states that the two primary qualitative characteristics that provide decision-utility are relevance and reliability, with secondary qualities of comparability and consistency. Financial information is also used in prudential oversight. According to the Basel Committee on Banking Supervision, prudential oversight is to foster safety, soundness, and financial stability.

Under current U.S. GAAP, items on the balance sheet are measured using a mixed-attribute model. This model calls for carrying some assets and liabilities at historical cost, some at fair value, and some at other bases, such as lower-of-cost-or-fair-value. GAAP rules governing appropriate measurement attributes for specific accounts hark back to conceptual framework theory relating choice of measurement attribute to promoting relevance, reliability, and comparability so as to maximize decision utility. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands fair value measurement disclosures. One objective of SFAS No. 157 is to improve consistency and comparability of fair value measurements. Fair value is defined as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" [SFAS No. 157]. Thus, fair value is an exchange price, an exit price. FASB concluded that an exit price objective is appropriate since it embodies current expectations about future inflows associated with the asset and future outflows associated with the liability from the market participant perspective. Continued use of current (fair) values is consistent with FASB's and the IASB's conceptual preference for the primacy of the balance sheet over the income statement. Fair value represents measurements related to the present. Historical cost represents measurements relating to the past.

Current GAAP requirements for fair value measurement of select assets and liabilities hark back to the banking and Savings & Loan crisis of the 1980s. At that time, many financial institutions were paying higher interest on deposits than they were earning on long-term fixed-rate mortgage loans. The historical cost model, the prevailing measurement attribute under GAAP at that time, masked the problem by recognizing losses gradually through negative net interest income. The current value of the institutions' assets was less than the current value of the liabilities, effectively making the institutions insolvent. The historical cost model obscured the problem due to the requirement of carrying assets at inflated cost figures. Therefore, transparency was greatly diminished.

Existing fair value and mark-to-market requirements were developed over several decades to address specific market events or conditions as noted above. These standards were the result of an extensive due process, and their elimination could erode investor confidence in financial reporting, contributing to greater market instability. Mark-to-market accounting standards apply only for select financial instruments and derivatives held for grading purposes. Mark-to-market rules, therefore, apply to a minority of investments/assets. For the SEC study, 22% of bank, 3% of insurance company, and 1% of credit institution assets are marked-to-market. On 70% of the overall study sample, adoption of SFAS No. 157 fair value rules had no impact, and no issuers had an impact over 5% of equity.

SEC roundtable discussions of fair value accounting and auditing standards reflected that "investors indicated fair value is the most relevant attribute for financial instruments in the current market environment." Participants considered historical cost to be more reliable, but less relevant and less comparable. They argued that while fair value is not precise or as objective (not as reliable), it is the most relevant measurement attribute, increasing transparency and consistency in financial reporting. Many panelists stated that they did not believe that fair value accounting caused or contributed to the current global economic crisis. They asserted that accounting information reports economic activity; it does not cause it.

THE SEC STUDY ON MARK-TO-MARKET ACCOUNTING

The EESA (Emergency Economic Stabilization Act), passed into law on October 3, 2008, mandated a study on mark-to-market accounting to be conducted by the SEC in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. Events and causal factors leading up to the Congressional call for this study were assertions that fair value accounting, along with SFAS No. 157 guidance on measuring fair value, contributed to instability in our financial markets. Critics alleged that such instability resulted from inappropriate write-downs in the value of investments held by financial institutions---write-downs that did not reflect underlying, intrinsic economic values of the securities in an inactive, illiquid, or irrational market. Correlation between U.S. GAAP reporting and regulatory requirements of financial institutions could, in their view, lead to failure of financial institutions, broader negative impact on prices and markets, and further financial instability.

However, other market participants, notably investors, stated that fair value accounting enhances transparency of financial statement information to the public. Investors, therefore, called for adherence to fair value reporting as vital in times of financial stress in the marketplace. Suspension of fair value reporting would, in their view, weaken investor confidence due to lessened transparency and thus, result in even greater market instability. According to these participants, the current financial market instability is a result of poor lending decisions, inadequate risk management, and regulatory inadequacy---not accounting standards.

The SEC study considered all viewpoints concerning the effects of fair value accounting on financial markets. Roundtable discussions and extensive research provide the foundation for the SEC study conclusions. The study focused on the usefulness of fair value accounting to investors, the potential market behavior effects of fair value accounting, challenges in applying fair value measurements, potential improvements in current standards, and auditor assurance with regard to fair values. For many years, accounting standards have required measurement of financial instruments on a financial institution's balance sheet at fair value. Losses or gains on trading securities (carried on the balance sheet at fair value) are reflected in income and retained earnings in accordance with U.S. GAAP and generally recognized in regulatory capital. For available-for-sale securities (measured at fair value on the balance sheet), changes in fair value are generally reported in equity (accumulated other comprehensive income) and bypass the income statement, unless an impairment has occurred.

As noted in the study, most challenges to fair value accounting revolve around four main concerns, addressed below. First, that fair value accounting measurements are unreliable in the absence of quoted market prices, leading to lack of reliability and comparability of financial statements. The body of academic research supports survey results from the SEC study supporting the relevance of fair value information to investors. Most previous academic studies examine whether stock prices are associated with reported fair values and fair value disclosures. Results indicate a positive correlation between business entity's stock prices and reported fair values and disclosures for financial instruments. Song, ET. Al [2008] test the value relevance of SFAS No. 157's Fair Value Hierarchy and find that Level 1 and 2 fair value measurements are value relevant to investors, but Level 3 estimates are less value relevant. Ryan [2008] also found that investors view fair value measurements to be relevant. Though comparability concerns were also raised in the context of fair value accounting in the absence of quoted market prices, a similar case can be made for historical cost which results in identical assets measured at different values reflecting different purchase prices.

A second concern is increased income statement volatility resulting from fair value write-up/write-downs. While prior research does indicate increased volatility in income and regulatory capital under fair value accounting, increased income volatility under fair value may be a proxy for market risk, reflecting underlying economic risks.

Third, concern exists about the inconsistency of valuing some assets and liabilities at a current exit price and assuming a going concern doctrine for measuring other assets and liabilities. FASB will address this and other issues in its measurement component of the Conceptual Framework project. Fourth, does fair value understate the underlying (intrinsic) economic value of financial instruments in depressed markets? Significant concerns have been raised concerning whether fair value accounting induced pro-cyclical downward pressure in asset prices, causing security prices and asset values to fall below true inherent values. Write-downs caused by fair value rules may compel some financial institutions to sell securities in illiquid markets in order to comply with regulatory capital requirements. To address this issue, one must separate the effects of regulatory capital standards from accounting standards. Many study participants expressed the view that pro-cyclicality concerns arise from the use of financial reporting results for regulatory capital purposes. Regulatory capital standards relate to capital adequacy for financial institutions. Accounting standards promote fair and accurate financial reporting for use by investors in the efficient allocation of scarce capital resources.

SFAS No. 157's objective is to provide transparent, unbiased information about value. GAAP is designed to primarily serve the information needs of external users who must rely on information provided by management. Regulatory capital requirements, which relate to oversight objectives of regulatory agencies, are outside the purposes and objectives of financial reporting and accounting standards. The SEC study results conclude that pro-cyclicality arises from deleveraging market effects, an economic decision.

Key findings from the SEC study note that investor generally believe fair value accounting increases financial reporting transparency and facilitates better investment decision-making. The report also observes that fair value accounting did not appear to play a meaningful role in bank failures in 2008. The report indicates that U.S. bank failures appeared to be the result of growing probable credit losses, concerns about asset quality, and in certain cases, eroding lender and investor confidence.

After considering the available evidence gained from roundtable discussions, surveys of market participants, and the body of academic research on the value relevance of fair value accounting, the SEC determined that the suspension of fair value, returning to historical cost measurements, would adversely impact debt and equity security valuation. Withholding current (fair) value information would introduce greater uncertainty, information asymmetry among market participants, and further lessen market liquidity. In our currently depressed markets, suspending fair value would result in removing useful information from investors at a time of great uncertainty and risk, when it is needed most. Also, suspending fair value rules would not relieve companies from recognizing impairment losses.

The SEC study concluded that: (1) fair value measurements were used to measure a minority of financial institutions' assets and liabilities; (2) fair value accounting did not appear to play a significant role in 2008 bank failures; (3) investors support fair value measurement as providing the most transparent financial reporting of investments and, therefore, the greatest decision-making utility as well as the most efficient allocation of scarce capital resources; and (4) suspension of fair value accounting and a return to historical cost-based measurement would increase investor uncertainty---suspension of SFAS No. 157 would result in inconsistent and conflicting fair value measurements.

The study warned that suspension of fair value accounting "would be akin to shooting the messenger and hiding from capital providers the true economic condition of a financial institution." SEC recommendations deriving from the study included improvements to existing practice in accounting for impairments and the development of additional guidance for determining fair value of investments in inactive markets, including situations where market prices are not readily available.

CONTEMPORARY ETHICAL MODELS

Over the years, several theoretical models have emerged for explaining ethical behavior. A brief description follows.

Utilitarianism

Many ethicists hold that the fairness of an action can best be determined by its results or consequences. If the consequences are good, the action or decision is considered good. The Utilitarian principle is, therefore, a consequential principle or teleological principle. This approach asserts that we should "… strive to make decisions that optimize the greatest possible good… for the greatest number of people…" [Epstein and Spalding, 1993]. The attractiveness of utilitarianism is that it proposes a standard outside of self-interest by which to judge the value of a course of action and forces the decision-maker to consider the general welfare. A cost-benefit analysis is an example of utilitarian thinking. Utilitarianism forces us to consider an action in the context of its impact on stakeholders.

Using this reasoning may lead to the problematic argument that the end justifies the means. The sheer numbers of stakeholders affected by the decisions of a single accountant make prediction of the consequences for each one impossible. Ultimately, the individual is faced with the issue of determining what the greatest good for the greatest number is. Using this principle, it is very difficult to formulate rules to guide decision making.

Pragmatism (Egoism)

In this model, only the good for the decision maker need be considered. However, this system has great potential for conflict and, therefore, is not a functional basis for developing ethical standards. As an example, businesses seek to maximize profit and minimize cost. The individual accountant, who prepares/audits the financial statements reflecting these accounts, has an individual goal of maximizing utility. Only by coincidence would the two goals result in the same desired action. Further, it is improbable that the good of the company or the accountant would always serve the needs of the larger community of stakeholders.

Egoism is the normative ethical position that moral agents should act in their own self-interest. Economic theory implies that when faced with a choice between ethics and self-interest, the latter will prevail. Both Adam Smith and John Bares Clark indicate that a strong sense of ethics is necessary for capitalism to overcome the inherent greed motivated by self-interest. Clark considers religion as the ethical base and prescribes the morally superior person as the solution [Everett, 1946].

Religion

The religious model relies on the guidance of a supreme being, God, who sets standards of right and wrong. The Judeo-Christian ethic provides moral imperatives such as: be honest, do good to others, respect human life, respect the property of others, and so forth. Although multi-national firms and a global marketplace may encompass operations in areas of the world not governed by Judeo-Christian principles, religion does provide the broadest basis that society has for an ethical framework as well as justification for ethical acts such as fair labor practices, environmental responsibility, and workplace safety.

Deontology

Deontological theories focus on duties. This ethical approach focuses on the action and ignores the consequences. An accountant has a moral duty to present fairly (honestly, completely, without bias) the financial statements of a company. The accountant is bound by his/her duty to adhere to the AICPA Professional Code of Conduct as well as personal ethical values. Stakeholders expect accountants and auditors to follow this ethical code and, therefore, assume a fair and representationally faithful set of books as a result.

One disadvantage of the deontological model is that it provides no framework for continuous evaluation of what is “best.” There are still gray areas in accounting---topics for which no accounting principles have been promulgated or for which accounting standards may need to be revised. Fallible human beings promulgate fallible accounting standards. Accountants and auditors have a duty to the profession to follow GAAP and GAAS, even though existing GAAP in some cases may be inadequate. GAAP is procedural, and if less than fair, can be changed. However, input for or against changing existing accounting standards is most often self-serving (based on egoism). Suspension of fair value accounting, which masks the true value of financial assets/liabilities, has been called for heavily in the banking industry. Avoiding asset write-downs and losses in the short-term may allow banks to meet regulatory capital requirements and report higher earnings, but could lead to nasty surprises for investors in the future. Ethics should provide the ultimate guidance to accountants. The ethical standard is fairness (honesty, freedom from bias).

Hermeneutical Model

This ethical model portrays the accountant as an agent giving an account. Schweiker [1993] claims that "…a hermeneutical and ethical examination of the activity of giving an account as basic to understanding the moral dimension of accounting practice and research." In this ethical perspective, the relationship between the accountant and the accounting records/financial statements involves a higher ethical imperative than the economic imperative of profit maximization and self-interest. According to Schweiker, giving an account equates to giving the corporation a "moral identity." Thus, the accountant's act of giving an account exposes the amoral world to ethical accountability. Schweiker posits that accounting gives identity to the "we" in the Socratic ethical question, "how should we live?" when the *we* is the corporation. The accountant provides answers to questions regarding how the corporation "can and must live in relation to others and themselves" [Schweiker, 1993].

Giving an account provides identity. The corporation, known to others through the financial statements, is a member of a moral community similar to an individual. In giving an account, the corporation subjects itself to a universal means of discourse to examine itself, and to be examined, through the fiduciary agent, the accountant or auditor. Ergo, the accountant becomes the soul or moral conscience for the corporation. Giving an account provides a snapshot, a temporal identity, of the corporation's actions and makes them accountable for those actions to the larger community. The accountant is professionally and ethically bound to faithfully render the corporation's identity.

Communitarian Model

The communitarian perspective harks back to the early Greek philosopher, Aristotle [1980]. This approach argues that ethical considerations emerge from within a particular community and considers universal ethical imperatives suspicious. While the deontological aspects of accounting are clear, as explained above, strong communitarian influences can also be identified in the process by which GAAP in the U.S. has emerged. Prior to the stock market crash of 1929, accounting principles were not explicit, were internally inconsistent, and not universally enforced. The significance of this is that accounting principles for properly financial statement reporting emerged from within the community itself. Thus, GAAP emerged through a process of exchange between firms and government. GAAP was codified, became more internally consistent through this communitarian system of due process for standard setting, and financial statements became more comparable. Financial statement relevance and reliability were enhanced, making them more useful for decision making by external users. Communitarian principles can also be observed in regard to international accounting standard setting, which is also influenced by the community served.

The Investors Technical Advisory Committee (ITAC) has expressed concern regarding calls for suspension of fair value accounting by banking and insurance lobbyists, politicians, and others recently in the media. According to ITAC, the critical tenet of independent private sector accounting standard setting empowered by an extensive, public due process system prioritizing investor needs could be impaired, thereby, diminishing investor confidence in financial reporting. ITAC strongly supports fair value accounting and suggests that financial reporting would be significantly improved if fair value was the measurement attribute for all financial instruments.

ETHICS AND FAIR VALUE ACCOUNTING

Accounting plays a key role in the economic and social progress of a nation. Stakeholders, such as investors, creditors, and others, rely on the integrity of accounting information in corporate financial statements. Ethics is a critical element of the accounting profession, as evidenced by the profession's time-honored commitment to serve the public interest. Francis [1990] states that accounting is a discipline which is thoroughly ethical in nature. Dolfsma [2006] asserts that accounting is applied ethics.

In 1494, the Italian, Luca Pacioli, was the first to bring out a book where the principles of double-entry bookkeeping were explained. This double-entry bookkeeping system provided internal controls for consistency. One reason for starting to keep accounts was a moral one: to be able to know and keep track of which individuals and organizations were due how much [de Wal, 1927]. Accountants could be perceived as minding the rights that different parties have toward others, drawing on deontological ethical considerations. The Dutch East India Company [de Boer, 1957] was the first to regularly prepare public financial reports and also the first "firm where ownership and management were separated," leading to a control struggle wherein moral arguments played a significant role. Accountants' fiduciary responsibilities involve not only tracking rights and obligations to various stakeholders, but also extend to maintaining accountability for integrity of funds---insuring that money is spent for its intended purpose. Again, this suggests the moral overtones of accounting.

The responsibility of the auditor is to recognize the ethical dilemmas their clients may face and detect whether the client has behaved unethically. The auditor must serve as an ethical detective. Post-Enron reforms have gone a long way toward restoring investor confidence in auditors and the audit profession's alignment with investors. Capital markets thrive when investors have confidence in them. Like law, auditing is a gatekeeper profession in our corporate governance system. Accounting and auditing as a profession are not only repositories of financial expertise, but also cultures of ethical responsibility. At the heart of the major professions---medicine, law, and accounting---is a dedication to serving their clients and upholding high standards of technical competency and moral integrity. The ultimate objective is to serve the public interest/good.

A significant trend toward ethics improvements is the impetus for enhanced transparency. Corporate transparency refers to a quality or state in which activities, practices, processes, decisions, and financial reporting become open and visible to public scrutiny. Opacity, the opposite of transparency, describes a condition where activities, decisions, and financial reporting remain obscure (hidden) from public stakeholder review. Stakeholders want to know the reality of what is occurring within business organizations. Recent scandals such as WorldCom and Enron have exerted greater public pressure for transparency in financial reporting and greater independence in auditing. The Sarbanes-Oxley Act of 2002 mandates greater transparency and independence. Transparency leads to accountability. Increasingly, companies are realizing the internal benefits of transparency as an ethical practice. Pagano and Pagano in their book *The Transparency Edge: How Credibility Can Make or Break You in Business*, promote a transparent management approach. In their view, a "what you see is what you get" code of conduct will enhance a company's credibility in the marketplace, build loyalty, and enable the company to gain the trust and confidence of stakeholders. Tapscott and Ticoll in their book, *The Naked Corporation: How the Age of Transparency Will Revolutionize Business*, direct companies to "undress for success." They argue that corporate transparency is inevitable, not optional. As companies become more open in their reporting practices, the public and other stakeholders will come to have greater confidence in them because of the greater disclosure (more will be exposed to view).

Transparency implies openness, communication, and accountability. It is the construct of removing all barriers to, facilitating free and easy public access. Relevant meanings include: very clear, easily understood, candid, and frank. The best definition of transparency in business is financial statements of high quality. A complex, opaque financial report gives no idea about the true risks and real fundamentals of the company. High-profile cases involving financial opacity, such as Enron and Tyco, demonstrate how managers employ fuzzy financials and complex business structures to hide unpleasant news. Lack of transparency often means nasty surprises ahead.

Transparency pays according to Robert Eccles, author of "Building Public Trust---The Value Reporting Revolution." Eccles shows that companies with fuller disclosure gain more investor trust. Relevant, reliable information equates to less risk to investors and a lower cost of capital, translating into higher valuations. Key findings indicate that companies who share key metrics and performance indicators with investors are more valuable than companies who keep information to themselves. Transparency makes analysis easier and, therefore, lowers investor risk. Transparency is assurance.

Fair value accounting, according to the SEC study, provides greater transparency to investors and therefore, greater value relevance. Fair value accounting requirements have existed for a number of years. Only recently, when market values necessitate write-downs have preparers questioned the relevance of these measurements. When bull markets existed, no one objected to fair value rules. As suggested by the SEC study findings, fair value accounting has increased the quality and relevance of financial reporting for investors. Investors have indicated that fair value provides more relevant information, reflecting current economic reality that should not be replaced by other alternative accounting measures, such as historical cost. Investor confidence is reinforced by providing transparency relating to the underlying asset value of their investments; removing that information would lead to greater uncertainty and greater instability in the financial markets.

"Suspending mark-to-market accounting, in essence, suspends reality," asserts Beth Brooke, global vice chair at Ernst & Young LLP. Accounting firms argue that such a change would deceive investors about troubled loan values and the value of mortgage-backed assets. Ultimately, the point of fair value accounting is to provide accurate information to investors---companies should account for their assets at their real values. Goldman Sachs Group Inc. CEO, Lloyd Blankfein, upheld mark-to-market accounting and argued that it should be even more rigorous. Goldman, which has largely avoided the current financial crisis, cites adherence to fair value accounting rules as "a key contributor to our decision to reduce risk relatively early." He states that if financial institutions had properly valued their positions/commitments at the outset, they could have substantially reduced their risk exposure.

Fair value accounting has received a significant amount of blame as the cause of the current financial crisis, not least by politicians. Fair value accounting does not cause illiquidity or volatility in financial markets, but makes it more transparent to market participants. Banks, rather than accounting, caused the existing crisis, ultimately through bad lending decisions. Politicians, lobbyists, and media representatives may not understand the operation of the capital markets and accounting's key role in resource allocation decisions within those markets. The danger is in their power to interfere in accounting rules, which should be free from outside pressure. Politicians and other naysayers misunderstanding may be deliberate, since changing the rules may serve to cover up the extent of the problem, without solving it. Accounting rules are designed to reveal the full extent of losses and future risks. This transparency would allow banks, regulators, and governments to identify specific causes of the crisis and take steps toward recovery and future prevention. Bad loans, inadequate risk management, and overreliance on rating agencies were cited in the SEC study as causes of the crisis. Shooting the accounting messenger is not a solution to these problems. Perhaps there is confusion related to a conflict between transparency and financial instability. Transparency is an objective of accounting standards. Long term financial stability is best achieved by restoring investor confidence in financial markets and assets. Transparent accounting standards and sound auditing provide support for that confidence.

While fair value measures the effects of a transaction on an entity's financial statements, it does not drive underlying economic activity. Credit Suisse Group asserted, "In our view, mark-to-market accounting is not the problem; it is reflecting an economic reality--asset values are falling. The sooner accounting reflects those losses, the better. The real problem was overexposure to certain assets, poor risk management, misunderstood and mispriced risks and lots of leverage. We would prefer to see the financial statements reflect real economic volatility rather than a false sense of stability." Fair value accounting has been in application for 15 years. Despite upward/downward trends in the market, investors need the financial statements to reflect value relevant information. R.J. Chambers [1991] says, "We should speak…of the immorality of accounting; for it has been the quirks of accounting that have provided many of the opportunities for misdemeanors on the part of corporate officers; and corporate accounting does not do violence to the truth occasionally and trivially, but comprehensively, systematically and universally, annually and perennially." Chambers and other observers lament that business demands on accounting to 'bend the rules' have become extreme, and some have questioned the resolve of the accounting profession to respond effectively to the critical challenge such pressures induce. Chambers [1991] aligned ethics with commercial, legal, economic, financial, and social foundations. The ideas of equity and fair dealing are ethical or moral norms. They permeate almost everything that is done in communities that have outlawed willful appropriation, by some, of the properties, persons and rights of others. Equity, trustworthiness, and fair dealing do not relate to some morality higher than and beyond the bounds of commercial affairs. They are necessary conditions of continued, more or less harmonious collaboration between parties having diverse and in some respects opposing interests in property and power. They are implicit in all contracting, all legislative and judicial processes, all arbitration, and all collaboration [Dean, 2003]. Ethics relate to the prevalent tone of the accounting profession. So grounded, accounting is the provider of one of the essential checks and balances on commerce.

SUMMARY AND CONCLUSIONS

Fair value accounting transparently reflects, under current economic conditions, the value of a firm's assets and liabilities. Suspension of fair value accounting would result in a loss of information and investor confidence. Returning to alternative cost-based measures would mask losses in value and risks and mislead investors. Evidence from the SEC study on mark-to-market accounting supports fair value as the most relevant measurement attribute for financial instruments in the current market environment. Study findings expressed strong support for independent accounting standard setting, free from political or regulatory intervention. From an ethical perspective, accounting has a responsibility to require that financial statements 'present fairly' the financial condition and operating results of an entity. In other words, the financial statements should reflect reality. They should be clear and understandable (transparent), honest, unbiased, complete, and representationally faithful (reflect economic reality). Accountants and auditors are bound by their professional code of conduct to, first and foremost, protect the public interest. They serve as the moral conscience of their clients.

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DO I FEEL YOUR PAIN? MEDICAL MARIJUANA, THE WORKPLACE, AND FEDERALISM

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ABSTRACT

In 1996 California voters passed Proposition 215, also known as The Compassionate Use Act of 1996, which provides that a person who uses marijuana for medical purposes on a physician's recommendation shall not be subjected to criminal prosecution or sanction. Upon being hired by RagingWire Telecommunications, Gary Ross presented his doctor's written recommendation to use marijuana to alleviate pain he was suffering from as a result of injuries he sustained while serving in the United States Air Force. He then failed – quite naturally – a company required drug test and was subsequently fired, thus setting in motion the legal trek that ultimately led to the determinative ruling of the California Supreme Court.

HISTORY OF FEDERAL LAW AND CALIFORNIA'S COMPASSIONATE USE ACT

The Compassionate Use Act of 1996 (California Health & Safety Code, § 11362.5), voted on and approved by the California Voters (as Proposition 215), provides a person who uses marijuana for medical purposes on a physician's recommendation with a defense to certain state criminal charges involving the use and possession of the drug. Currently, twelve states have laws that allow patients to use medical marijuana (Medical Marijuana Laws Vary Among States). One of those state laws, California's Compassionate Use Act, created a federalism issue before the U.S. Supreme Court in the context of whether legal medical marijuana users (in a state authorizing such use) could be exempted from federal criminal prosecution under federal laws prohibiting the possession, use, and harvesting of cannabis (Gonzales v. Raich). In that case, two plaintiffs, Angel Raich and Diane Monson, suffered from a variety of serious medical conditions. Both women were prescribed marijuana after their doctors determined that it was the only available drug that provided them with effective treatment. Raich's physician went so far as to opine that forgoing cannabis treatments would cause Raich excruciating pain and could very well prove fatal (Id. at 7).

In 2002, county deputy sheriffs and agents from the federal Drug Enforcement Administration (DEA) came to Monson's home to investigate her use of marijuana. It was concluded that her use of marijuana was entirely lawful under California law. After a three hour standoff, the federal agents seized all six of her cannabis plants and destroyed them (Id.). Raich and Monson thereafter brought an action for injunctive and declaratory relief prohibiting the enforcement of the federal Controlled Substances Act (CSA) (84 Stat. 1242, 21 U.S. C. § 801 et seq). Both women sought exemption from prosecution for possessing, obtaining, or manufacturing cannabis for their personal medical use, arguing that such enforcement was a violation of the Commerce Clause, the Due Process Clause of the Fifth Amendment, the Ninth and Tenth Amendments, and the doctrine of medical necessity (Id. at 8).

The District Court denied the request for a preliminary injunction on the grounds that the Raich and Monson could not demonstrate a likelihood of success on the merits of their legal claims (Raich v. Ashcroft). The Ninth Circuit, in a divided opinion, reversed the District Court and ordered that the preliminary injunction be entered (Id.) The Ninth Circuit believed that Raich and Monson had shown a likelihood of success on the merits. Prior cases that had upheld the CSA in the face of Commerce Clause challenges were distinguished based on: (1) the "separate and distinct" class of activities" at issue in this case; and (2) the intrastate, noncommercial cultivation and possession of cannabis for personal medical purposes as recommended by a patient's physician pursuant to valid California state law (Id. at 1228). In 2004, the U.S. Supreme Court granted certiorari to hear the case. The majority opinion, written by Justice Stevens, framed the issue as follows:

> *The case is made difficult by respondents' strong arguments that they will suffer irreparable harm because, despite a congressional finding to the contrary, marijuana does have valid therapeutic purposes. The question before us, however, is not whether it is wise to enforce the statute in these circumstances; rather, it is whether Congress' power to regulate interstate markets for medicinal substances encompasses the portions of those markets that are supplied with drugs produced and consumed locally* (Gonzales at 3).

Raich and Monson did not argue that the CSA was an unconstitutional exercise of congressional authority. Their argument was simply that the CSA's categorical prohibition of the manufacture and possession of marijuana, as applied to the intrastate manufacture and possession of marijuana for medical purposes pursuant to California law, exceeded Congress' authority under the Commerce Clause.

The seminal case cited by the U.S. Supreme Court was Wickard v. Filburn. In that case, Filburn was a farmer who violated federal law by producing more wheat than permitted under the Agricultural Adjustment Act of 1938. He intended to use the excess wheat for his own farm rather than sell it in interstate commerce. Filburn argued that Congress could not regulate the production of wheat that was not intended for commerce, but rather for use on his own farm (Id. at 118). In a unanimous Supreme Court opinion, Filburn lost, with the Court holding that Filburn's own demand for wheat may be trivial but is not enough to remove him from the scope of regulation where, his contribution, taken together with that of many others similarly situated, is far from trivial (Id. at 127-128).

Raich and Monson argued that Wickard differed from their case as follows: (1) the Agricultural Adjustment Act, unlike the CSA, exempted small farming operations; (2) Wickard involved a "quintessential economic activity" – and they (Raich and Monson) do not sell marijuana; and (3) the Wickard record made clear that the aggregate production of wheat for use on farms had a significant impact on market prices (Gonzales at 9).

The Supreme Court rejected all three arguments. First, it was stated that the fact that Wickard's own use was trivial did not exempt him from the scope of federal regulation. What the Court ignored, however, was that under the Agricultural Adjustment Act in Wickard, small farming operations were exempted. No such exemption was available to Raich and Monson under the CSA, though they only harvested marijuana for their own personal, medical use. Second, in Wickard, the defendant grew wheat commercially, but also kept some of his harvest for his own personal use. As a commercial grower, he was clearly involved in interstate commerce. Raich and Monson were not engaged in any commercial production of marijuana.

Finally, in the Raich and Monson case, the Supreme Court conceded that the Wickard case established a causal connection between the production of what for local use and the market – and they stated that "we have before us findings by Congress to the same effect" (i.e., a causal connection between the production of marijuana for local use and the market)(Id. at 20-21). The Court went on to cite statistics showing that in 2000, American marijuana users spent $10.5 billion on the purchase of marijuana. It seems strange, to say the least, that the Court would compare the legal growing and harvesting of wheat with the illegal growing and harvesting of marijuana. Does the Court feel it can legitimately compare the interstate effects of **legally** harvested wheat with the interstate effects of illegally produced marijuana? In Wickard, the Court was concerned that the aggregate production of wheat for use on farms had a significant impact on market prices. Surely the Court is not similarly concerned that the aggregate production of marijuana for legal medical use will have a "significant impact on market prices."

The Court's final argument illustrated that even they realized the fallacy in their logic. The Court denied that they had to determine whether respondents' activities, taken as a whole, would substantially affect interstate commerce. Indeed, they opined that they only needed to decide whether a "rational basis" existed for their conclusion (Id. at 22) The Court further stated that "[G]iven the enforcement difficulties that attend distinguishing between marijuana cultivated locally and marijuana grown elsewhere, 21 U.S.C. § 801(5), and concerns about diversion into illicit channels, the Court has no difficulty concluding that Congress had a rational basis for believing that failure to regulate the intrastate manufacture and possession of marijuana would leave a gaping hole in the CSA" (Id. at 10). It is also true that there is an illegal market for the purchase of prescription drugs, but that has not prevented the regulation of prescription drugs. It is unclear, then, why the prescriptive use of marijuana could not be similarly regulated.

With regard to respondents' last two arguments – substantive due process and medical necessity, the Supreme Court declined to address them because those arguments were not addressed by the Court of Appeals. The opinion then suggests other avenues for relief, e.g., procedures for the reclassification of marijuana (currently a Schedule I drug) or use of the democratic process through lobbying Congress to change the law. The case was remanded for further proceedings consistent with the Court's decision. On remand to the Ninth Circuit Court of Appeals, the request for preliminary injunction was denied.

CALIFORNIA STATE EMPLOYMENT LAW AND THE COMPASSIONATE USE ACT

With the law now clear that federal criminal prosecution was still a possibility, even for those legally using marijuana, the only issue at the state level was the effect of California's Compassionate Use Act on California's state employment law.

Gary Ross' suffered injuries to his back while serving in the United States Air Force. He suffered debilitating pain for approximately a dozen years before his physician recommended that he use marijuana to treat his chronic pain. Ross applied for employment at RagingWire Telecommunications and was offered a job as a lead system administrator. RagingWire required a drug test as a condition of employment. Before taking the test, Ross gave the clinic that would administer the drug test a copy of his physician's recommendation for marijuana (Ross v. RagingWire Telecommunications). Ross took the drug test on September 14 and began working on September 17. On September 20, he was suspended for testing positive for tetrahydrocannabinol (THC), a chemical found in marijuana. Ross gave the human resources director a copy of his doctor's recommendation and was informed that they would call his physician and then advise them of their decision. On September 25, Ross was fired for using marijuana. According to Ross, despite his medical marijuana use, he had performed satisfactorily in his field with no complaints about his job performance.

Ross sued RagingWire, alleging violations of California's Fair Employment and Housing Act (FEHA) (California Government Code § 12940, subd.(a)), specifically, for discharging him because of his disability and failing to make reasonable accommodation. Moreover, Ross alleged that his employer terminated his employment in violation of public policy. RagingWire brought a demurrer, which was sustained by the trial court without leave to amend. The Court of Appeal affirmed the lower court and plaintiff's petition for review by the California Supreme Court was granted.

CALIFORNIA SUPREME COURT MAJORITY OPINION

The only issue before the California Supreme Court was whether Ross had stated at least one legitimate cause of action. Plaintiff argued that he had stated two causes of action: (1) violation of FEHA for his employer's refusal to accommodate his medical marijuana use at home; and (2) termination in violation of public policy. In support of his first cause of action under FEHA, plaintiff argued:

Just as it would violate the FEHA to fire an employee who uses insulin or Zoloft . . . it violates [the] statute to terminate an employee who uses a medicine deemed legal by the California electorate upon the recommendation of his physician . . . .

The Court rejected plaintiff's argument, stating that the Compassionate Use Act does not give marijuana the same status as any legal prescription drug. Marijuana will never be completely legal to use as long as the federal law still deems it illegal. Moreover, the Court interpreted the Compassionate Use Act as merely prohibiting criminal prosecution under two state statutes. "Nothing in the text or history of the Compassionate Use Act suggests the voters intended the measure to address the respective rights and obligations of employers and employees" (Id.)
Ross further argued that he had no intention to use marijuana at work. Pointing to legislation enacted after the Compassionate Use Act (Health & Saf. Code, § 11362.5), Ross argued that employers are required to accommodate employees' use of medical marijuana at home. The statute provides as follows:

Nothing in this article shall require any accommodation of any medical use of marijuana on the property or premises of any place of employment or during the hours of employment or on the property or premises of any jail, correctional facility, or other type of penal institution in which prisoners reside or persons under arrest are detained." (Id. at 930).

In fact, five present and former state legislators who authored the bill adding section 11362.785 to the Health and Safety Code stated they "believed that this statutory enactment clearly and sufficiently expressed [their] belief that the FEHA does require employers generally to accommodate off-duty, off-premises medical cannabis use by their employees, absent an undue hardship" (Id. at 931). The majority rejected this pronouncement, stating:

In construing a statute we do not consider the motives or understandings of individual legislators who cast their votes in favor of it. . . . Nor do we carve an exception to this principle simply because the legislator whose motives are proffered actually authored the bill in controversy . . . ; no guarantee can issue that those who supported his proposal shared his view of its compass (Id., citing California Teachers Assn. v. San Diego Community College Dist.)

Given that legislative intent is often utilized as one method of analyzing legislative enactments, this pronouncement by the Court calls into question how else could a court better discern legislative intent than to consider the intent of the bill's author and the intent of other legislators who voted for it? Nevertheless, based on the above, the Court concluded that plaintiff had no cause of action under FEHA based on his employer's refusal to accommodate his medical marijuana use at home. Clearly, such "circular illogic" should not stand. The very purpose of amendment of California's Health & Safety Code was to expressly provide that employers did not have to accommodate prescriptive marijuana use on the employment premises. The only possible need for such an amendment is the inescapable negative implication that employers could not penalize prescriptive use of marijuana during non-working hours at the employee's home. Even so, this is exactly what happened to Ross.

Ross' second cause of action was for termination in violation of public policy based on the Compassionate Use Act, FEHA, and the California Constitution's right to privacy clause (Article I, § 1). Without any meaningful analysis, the majority simply rejected out of hand the argument that the Compassionate Use Act and FEHA supported Ross' claim for wrongful termination, stating "[t]he Compassionate Use Act did not put defendant on notice that employers would thereafter be required under the FEHA to accommodate the use of marijuana" (Id. at 932).

A more credible way to consider the issue, however, is that the amendment to California's Health & Safety Code did in fact put defendant on notice that it did not have to accept an employee's use of medical marijuana on the employment premises. If the legislators had not expected employers to accommodate at home use of medical marijuana, there would be no need for the amendment. Moreover, as to the issue of violation of public policy, while it is true that it is illegal to use marijuana under federal law, it is not illegal to use marijuana, pursuant to a doctor's prescription, under California state law. The violation of public policy, therefore, would be the violation of California state law (i.e., the Compassionate Use Act), which would quite actually seem to be the relevant public policy when contemplating California state employment law statutes.

Ross' remaining argument was that an adult patient has the right to submit to lawful medical treatment, a right found in California's state constitution and the common law. Even so, the Court distinguished the cases cited by Ross, opining that they merely referred to a patient's right to refuse treatment. This, too, appears to be needlessly narrow-minded thinking in this sense: By effectively precluding Ross from his treatment of choice, the Court assumes a coercive posture by essentially directing Ross to an alternative method of treatment (i.e., one that he would otherwise refuse) that would not jeopardize his employability. Nevertheless, the Court failed to recognize its own complicity in coercing Ross into a form of pain management it preferred, and Ross' final argument was rejected by the Court.

THE DISSENTING OPINION

Justice Kennard concurred in the majority's opinion that plaintiff had no cause of action based on wrongful discharge in violation of public policy because, curiously, federal law prohibits marijuana possession. Such acquiescence by Kennard on this issue seems misplaced. If, after all, federal law were the relevant and controlling public policy, then arguably the entirety of California's medical marijuana law would be preempted. In other words, the explicit public policy in California is to permit the medical use of prescribed marijuana under certain circumstances and it is that very public policy of the state that should be recognized in the context of analyzing California state employment law. As for the remainder for the remainder of the majority opinion, Kennard stated:

> *In a decision conspicuously lacking in compassion . . . the majority holds that an employer may fire an employee for . . . marijuana use, even when it occurs during off-duty hours, does not affect the employee's job performance, does not impair the employer's legitimate business interests, and provides the only effective relief for the employee's chronic pain and muscle spasms. I disagree (Id. at 934).*

One of the stated purposes of the Compassionate Use Act is "to ensure that patients and their primary caregivers who obtain and use marijuana for medical purposes upon the recommendation of a physician are not subject to criminal prosecution or sanction" (California Health & Saf. Code, § 11362.5, subd. (b)(1)(B)). The majority opinion renders illusory the statute's promise to ensure patients are not subject to "sanction." Ross' options were to either continue the use of marijuana treatment and become unemployed or discontinue the treatment and try to endure the pain in order to remain employed (Id. at 936-937). In Justice Kennard's opinion, the voters who enacted the Compassionate Use Act could not have intended such a "cruel choice" (Id. at 937).

CALIFORNIA LEGISLATION INTRODUCED TO REVERSE EFFECT OF RAGINGWIRE

In 2008, California Assembly member Mark Leno (D-San Francisco) and several co-authors introduced AB 2279, a bill designed to protect the rights of hundreds of thousands of medical marijuana patients in California from employment discrimination (Americans for Safe Access). The bill left intact existing state law prohibiting medical marijuana consumption at the workplace and protected employers from liability by carving out an exception for safety-sensitive positions. AB 2279 prevented employers from discriminating against a legal medical marijuana patient and preserved the right of employers to take action against employees that came to work impaired or consumed medical marijuana at the workplace. After passing both the Assembly Judiciary and Labor Committees, AB 2279 was passed by the full California Assembly on May 28, 2008. The State Senate Judiciary Committee than passed the bill on June 24, 2008. It was passed by the full State Senate on August 20, 2008.

The California Chamber of Commerce opposed the bill, arguing that it "hurts employee safety and employers' right to maintain drug-free workplace policies and exposes employers to potential litigation by prohibiting employers from refusing to hire applicants or fire current workers who use medical marijuana." (Cal Chamber Requests Veto on Legislation Aimed at Diminishing Workplace Safety). On October 1, 2008, Governor Arnold Schwarzenegger vetoed AB 2279 (Id.)

CONCLUSION

The purpose of California's Compassionate Use Act was to alleviate the suffering of those in chronic pain for whom traditional drugs provided no relief. Unfortunately, the U.S. Supreme Court, the California Supreme Court, and the Governor of California have usurped that purpose. Those who are already suffering from chronic, and sometimes fatal illnesses, now must contend with possible federal prosecution and harassment, as well as the potential loss of employment. Since 1996, twelve states have passed medical marijuana laws (Governor Vetoes Medical Marijuana Bill; and Medical Marijuana Laws Vary Among States). In order to be effective, states must remove criminal penalties for those who use, possess and grow medical marijuana. Removal of state criminal penalties alone is, however, insufficient. Federal recognition and respect for such laws is required, as is protection for those who seek to gain or retain employment. Until such time, little compassion can be expected from these statutes, despite the best of intentions.

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MINIMUM PRICE MAINTENANCE AGREEMENTS AND THE PREMIUM PRICING STRATEGY

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ABSTRACT

There has been a significant amount of research in regard to Porter's general strategies. The research has shown that a differentiation strategy, if successfully implemented, can lead to a sustainable competitive advantage, as well as allowing the business to implement a premium pricing strategy. Much of this research, however, was conducted within the parameters of the stringent Sherman Antitrust Act, with good reason. For the past decade courts have uniformly refused to permit vertical price maintenance agreements on the grounds that they are conducive to cartels and are predisposed to exhibit anticompetitive effects. As a result, courts imposed a per se prohibition on vertical price maintenance agreements. The standard of review, however, recently changed with the Leegin decision issued in August, 2007. The holding in the Leegin case changed the standard of review from a per se violation to the more flexible rule of reason analysis. As a result, manufacturers and retailers have a greater likelihood of being able to enter into vertical price maintenance agreements, fostering an environment conducive to implementing a differentiation strategy as opposed to a cost leadership strategy.

INTRODUCTION

There has been a significant amount of research in regard to Porter's general strategies. The research has shown that a differentiation strategy, if successfully implemented, can lead to a sustainable competitive advantage, as well as allowing the business to implement a premium pricing strategy. Much of this research, however, was conducted with the perimeters of the stringent Sherman Antitrust Act, with good reason. For the past decade courts have uniformly refused to permit vertical price maintenance agreements on the grounds that they are conducive to cartels and are predisposed to exhibit anticompetitive effects. As a result, courts imposed a per se prohibition on price maintenance agreements. Under the per se standard, courts would invalidate any restraint in furtherance of a price maintenance agreement, without inquiring into the subject nature of the price maintenance agreement, or the actual effect of the alleged agreement.

In June, 2007, however, the United States Supreme Court issues its ruling in Leegin Creative Leather Products v. PSKS, Inc. (2001), overruling the well established body of precedence, abolishing the 96 year old prohibition on minimum price maintenance agreements. As a result, courts are now required to adjudicate alleged price maintenance agreements under the more flexible rule of reason, which requires courts to utilize a balancing test to ascertain whether the vertical price maintenance agreement violates the Sherman Act. Such a ruling is beneficial to smaller retailers and manufacturers as it permits them to differentiate their product on service, fostering an environment conducive to premium pricing. Moreover, it permits the small business to compete without the detrimental effects of the economies of scale, which is critical for low cost leaders.

Part II of this article will provide a comprehensive background of the legal history and development of the law pertaining to price maintenance agreements. This section will consist of a brief overview of the Sherman Antitrust Act as well as the legislative intent which assisted in establishing the scrutiny afforded to alleged violations. In addition, the concept and application of the two standards of review will be discussed.

Part III will distinguish between horizontal and vertical price maintenance agreements. In addition, this section will compare and contrast the judicial scrutiny afforded to the horizontal and vertical price maintenance agreements, respectively. Part IV will focus on the Leegin case and the material reasons for applying the rule of reason in lieu of the per se standard. Part V will discuss the practical application of the Leegin case. In particular, this section will discuss the benefits afforded to businesses that are pursuing brand image or premium pricing strategies, as well as providing small business owners with a viable strategy when competing against conglomerates or wholesalers who capitalize upon economies of scale.

SHERMAN ANTITRUST ACT

John Sherman was the architect, and leading advocate in favor of the Sherman Antitrust Act (Troesken, 2002). The origin from which he drew to advocate for the passage of the Sherman Act has been ardently debated (Troesken, 2002). The two predominate theories relate to which set of lobbyists were most instrumental in facilitating the enactment of the Sherman Act, small business owners or consumer protection groups (Troesken, 2002). While there is not a consensus on who the primary lobbyist was, what is known is that the Act is the most comprehensive consumer protection legislation. In addition, a significant amount of case law has been created in order to define the purview of the Act.

The Sherman Antitrust Act was passed in 1890 and serves as a powerful tool in permitting the government to regulate commerce and trade by prohibiting the use of restraints that are predominately anticompetitive in nature (Sherman Antitrust Act, 1890). The act is comprised of two significant provisions. Section 1 prohibits the use of all contracts that restrain trade (Sherman Antitrust Act, 1890). Section 2 proscribes the use of monopolies (Sherman Antitrust Act, 1890). While Section 2 is a central provision of the Act, it falls outside the purview of this article, which focuses on Section 1 of the Sherman Act.

While the language utilized in Section 1 prohibits all contracts that restrain trade, the courts have not strictly interpreted the legislative language (State Oil Co. v. Khan, 1997). Instead, the United States Supreme Court has held that the legislative intent only prohibits the use of unreasonable restraints (State Oil Co. v. Khan, 1997). As a result, the court has the duty of determining whether a restraint is reasonable (Denny's Mariana v. Renfro Prods., 1993). In making this determination, the court must decide whether the restraint will be scrutinized under the rule of reason standard or under the more stringent per se standard of review (Denny's Mariana v. Renfro Prods., 1993).

STANDARDS FOR EVALUATING RESTRAINTS OF TRADE

When faced with an agreement that appears to impose a restraint on trade, the courts have two standards at their disposal to determine whether the agreement amounts to an unreasonable restraint (Leegin Creative Prods., Inc. v. PSKS, Inc., 2007). The court must either use the rule of reason or per se standard of review to ascertain the reasonableness of the restraint. The standard that is used dependent upon the nature of the alleged restraint (Leegin Creative Prods., Inc. v. PSKS, Inc., 2007).

The rule of reason is the customary standard that is used to determine whether a restraint is unreasonable (Standard Oil Co. v. United States, 1911). The rule of reason is a flexible test that permits the court to consider a variety of factors when analyzing the restraint (Standard Oil Co. v. United States, 1911). The rule of reason incorporates a balancing test whereby each factor is afforded a weight (Continental T.V., Inc. v. GTE Sylvania Inc., 1977). The purpose of the balancing test is to ascertain whether the agreement has an interbrand or intrabrand effect (Leegin, 2007). In furtherance of determining the reasonableness of the contract, courts have enumerated four factors that should be incorporated within the balancing test (Chicago Board of Trade v. United States, 1918). The factors include (1) specific information about the business; (2) the nature and effect of the restraint; (3) the market power of the parties involved in the contract; (4) the reason for the restraint (Chicago Board of Trade, 1918).

If, after conducting a balancing test, the court determines that the agreement has a procompetitive effect, the contract will be upheld (Leegin, 2007). In contrast, if the agreement has an anticompetitive effect, it will be invalidated as a violation of the Sherman Antitrust Act (Leegin, 2007). While the rule of reason is the customary standard of review, some agreements are of the nature that they possess a strong probability that they will have anticompetitive effects (Leegin, 2007). These contracts are adjudicated under the per se standard (Leegin, 2007).

The per se standard is an unyielding test that invalidates contracts without delving into the subjective nature or effect of the agreement (Business Electronics Corp. v. Sharp Electronics Corp., 1988). These types of restraints are only used when the courts have previously scrutinized that type of restraint and have consistently found that those restraints have an anticompetitive effect (United States v. Sealy, Inc., 1967). The purpose is to promote judicial efficiency and consistency within the law (United States v. Socony-Vacumm Oil Co., 1940). When a form of restraint is reassigned under the per se standard, it will uniformly violate the Sherman Act.

TYPES OF RESTRAINTS

All violations of Section 1 of the Sherman Act involve a minimum of two parties to the contract. The level of scrutiny afforded to the restraint is dependent upon the respective parties' position on the supply chain. If both parties are on the same level of the supply chain, the agreement is classified a horizontal restraint (Leegin, 2007). If the parties are on different levels within the supply chain, the contract is considered a vertical restraint (Leegin, 2007).

A horizontal restraint occurs when at least two parties on the same market level enter into an agreement that restrains trade (Crane & Shovel Sales Corp. v. Bucyrus-Erie Co., 1988). The prototypical example is price fixing (Crane & Shovel Sales Corp., 1988). Price fixing involves an agreement between competitors to establish a set price (Crane & Shovel Sales Corp., 1988). This type of agreement permits the competitors to charge a heightened price by restricting competition (Denny's Mariana v. Renfro Prods., 1993).

When confronted with a horizontal restraint, courts scrutinize the agreements as per se violations (Leegin, 2007). The purpose for using the more stringent standard is that horizontal restraints are indicative of anticompetitive behavior and are at a heightened risk of cultivating a cartel (Leegin, 2007). As a result, horizontal restraints meet the criteria to be analyzed under the per se standard, invalidating such contracts without considering the subjective factors or actual effect of the agreement (Palmer, 1972).

A vertical restraint, in contrast, occurs when parties on different levels of the distribution chain enter into an agreement that restrains commerce (White Motor Co. v. United States, 1967). This would include a manufacturer and distributor, or a distributor and a retailer. Vertical restraints frequently consist of customer/geographical restraints and price fixing. Traditionally, geographical restraints were held under the per se standard on the basis that the lack of competition would have an anticompetitive effect by raising the cost of the goods sold (United States v. Arnold Schwinn & Co., 1967). However, in 1977, the courts acknowledged that geographical restraints can have procompetitive effects by encouraging businesses to invest sufficient capital to promote marketing and superior customer service, without the fear of being undercut by a free rider (Schwinn, 1967). A free rider is competitor that capitalizes on the marketing efforts of other businesses, and then sells the product at a discount (Leegin, 2007). The free riders able to sell the product at a discounted price as their expenses are lower (Leegin, 2007). As a result, courts now apply the rule of reason to vertical restrictions based upon geographical boundaries (Continental T.V., 1982).

Another form of vertical restraint is price fixing agreements. This occurs when a manufacturer sets a price by which the distributor or retailer must comply with (AAA Liquors, Inc. v. Joseph E. Seagram & Sons, Inc., 1982). These restraints were traditionally prohibited under the per se analysis as they were deemed inherently anticompetitive in nature (Khan v. State Oil Co., 1996). Vertical price fixing restraints consist of either vertical maximum price maintenance agreements or vertical minimum price maintenance agreements.

A vertical price maintenance agreement occurs when two parties at the same market level on the distribution chain agree to set a maximum price for which the product will be sold, thus constructing a price ceiling (USA Petroleum Co. v. Atlantic Richfield Co., 1992). Courts were initially skeptical of these types of contracts and treated them with the same per se standard used in the horizontal price fixing cases (Kiefer-Stewart Co., Joseph E. Seagram & Sons, Inc., 1951). The courts justified the use of the per se standard on the basis that the vertical price maintenance agreement can effectively serve as a minimum price maintenance agreement when the selling price of the product is near the maximum price (Albrecht v. Herald Co., 1968). In these instances retailers will have an incentive to forgo costly promotional activities in order to maximize their profit margin (Albrecht, 1968).

In 1997, the United States Supreme Court overruled its previous holdings, which resulted in analyzing maximum price maintenance agreements under the more flexible rule of reason criteria, as long as the agreement does not encourage predatory pricing (Khan, 1997). In their holding, the court acknowledged the counterintuitive logic of strictly prohibiting agreements what result in lower prices to the consumer (Khan, 1997). The court further conceded that competition based upon price often goes to the very essence of competition, and is often used strategically to increase market share (Khan, 1997).

Even as the courts permitted vertical maximum price maintenance agreements, they remained steadfast against vertical minimum price maintenance agreements, continuing to use the stringent per se standard (Khan, 1997). A minimum price maintenance agreement occurs when one party, such as a manufacturer, sets a minimum price at which another party, such as a distributor or retailer, can sell the item for (Khan, 1997). The United States Supreme Court traditionally prohibited theses agreements on the basis that they were anticompetitive and increased the cost of the product to the consumer (Miles Medical Co. v. John D. Park & Sons Co., 1911). Moreover, the courts held that such agreements restricted the ability of retailers to compete on the basis of price (Miles Medical Co., 1911). As a result, the courts utilized the per se standard in regard to vertical minimum price maintenance agreements (Miles Medical Co., 1911).

In June 2007, however, the United States Supreme Court overruled 96 years of precedence by switching the level of scrutiny from the rigid per se violation to the flexible rule of reason standard (Leegin, 2007). The explanation for altering the standard of review was that vertical minimum price maintenance agreements can promote interbrand competition in a couple different ways (Leegin, 2007). Interbrand competition is competition among manufacturers selling different brands of the same class of product (Leegin, 2007).

The first way that a vertical price maintenance agreement can promote interbrand competition is by reducing intrabrand competition which is competition among manufacturers selling the same brand (Leegin, 2007). Intrabrand competition can have an anticompetitive effect as it discourages retailers from making an appropriate infusion of capital to promote a product for fear of free riders (Leegin, 2007). Free riding occurs when a discounter competes on price, capitalizing upon the marketing efforts, expenses and value created by the efforts of other retailers (Leegin, 2007). The consumer then has the option of purchasing the product at a lower price from a discounter who can offer the product at a lower price (Leegin, 2007). This in turn serves as a disincentive to high-service retailers to make capital investments in order to promote the sale of a product, as they will lose to the discount seller (Leegin, 2007). The high-service retailer would then be forced to reduce the amount of services offered to the consumer in order to compete on price (Leegin, 2007). By incorporating a vertical minimum price maintenance agreement, the retailer is encouraged to invest in promotional efforts, as they are able to compete on the basis of services as opposed to price (Leegin, 2007).

The second advantage of the vertical minimum price maintenance agreement is that it facilitates market entry for new firms and brands (Leegin, 2007). This occurs as new manufacturers are able to position themselves within the market as they desire by incorporating a minimum price agreement (Leegin, 2007). The distributor and retailer are then provided with incentive to adequately invest in promotional efforts, as they are ensured a given profit margin on the sale of the product (Leegin, 2007). As a result, new manufacturers can encourage competent and aggressive retailers to actively promote their product to the consumer (Leegin, 2007).

MARKETING IMPLICATIONS

According to Porter, businesses can compete as the low cost leader, differentiate their product, or implement a focus strategy (Porter, 1980). The cost leadership strategy seeks to achieve marginal returns over competitors by driving all components of activities toward cost minimization (Prajogo, 2007). In order to become the cost leader, the business must have a large market share (Prajogo, 2007). When an organization has a large share of the market, they are able to capitalize on economies of scale by purchasing in bulk. In addition, they can then compete on marginal profit margins (Prajogo, 2007). In order to implement a low cost strategy the business will attempt to minimize costs, which includes a reduction in advertising and customer service, among other cost reduction techniques (Prajogo, 2007).

In order to counter this strategy, a small business can compete by differentiating their product. The principle of differentiation is based upon the premise that undifferentiated businesses will be restricted to competing for business constrained to marginal cost competition (Tirole, 1988). One way the small business owner can differentiate their product is through quality, such as enhanced customer service (Prajogo, 2007). When a business can successfully implement a differentiation strategy they are able to secure enduring business relationships with their customers (Prajogo, 2007). This provides a sustainable competitive advantage to the business. In addition, differentiation can also lead to premium pricing, thereby increasing the profit margin. While differentiation has always been a viable strategy, much of the current literature base states that premium pricing in markets with low differentiation is prima facie evidence of collusive behavior that violates the Sherman Act (Carlton and Perloff, 2000). While that was the case for the past decade, the Leegin case illustrates a change in the interpretation of the Sherman Act, whereby businesses will now be afforded more difrerence when analyzing whether vertical minimum price maintenance agreements are a violation of the Sherman Act (Leegin, 2007).

If courts begin permitting vertical price maintenance agreements, the incentive to pursue a focus or cost leader strategy will be minimized. While businesses can still compete based upon price by offering the lowest price permitted per the agreement, it will be difficult for a business to sustain that position as distributors and retailers will be assured of a sufficient profit margin to also sell at the minimum price. If the profit margin were not lucrative enough whereby a free rider could undercut them based upon economies of scale, the advantages generated by such an agreement would be deminimis, likely resulting in a violation of the Sherman Act. Instead, business will be moe likely to compete based upon differentiation through enhanced customer service and promotions in order to secure a higher share of the market.

In past studies it was confirmed that large discounters, such as Wal-Mart, have a substantial impact on the sales of small businesses when the discounter entered small towns, with one study showing that half of all the businesses with less than $1 million in annual sales were negatively impacted when Wal-Mart penetrated their market (Peterson and McGee, 2000). The adverse impact is particularly alarming with the high failure rates of small businesses. As a result, it is imperative that entrepreneurs implement a strategy designed to off set the advantages possessed by wholesalers. The Leegin holding may make it easier for entrepreneurs and small business owners to compete with conglomerates by thwarting large businesses attempts to capitalizing upon their superior bargaining power in relation to their suppliers as well as capitalizing upon economies of scale accomplished by purchasing in bulk, providing the wholesaler with a lower price on a per unit basis. Under the Leegin holding, manufacturers and retailers have a heightened chance of implementing a vertical minimum price maintenance agreement in order to promote a brand image, while incorporating a premium price. When retailers are assured of a minimum profit margin, they are provided with the opportunity to compete by distinguishing their products based upon an increase in customer service. While the minimum price maintenance agreement will shelter small business retailers from free riders, it will not shield them from all competition. Rather, wholesalers can still compete by selling competing goods at a discounted price (Leegin, 2007). These competing goods, manufactured by a different manufacturer, actually benefits the consumer by providing a choice between premium priced goods differentiated by an enhanced level of customer service versus low frills, low cost goods (Leegin, 2007). This choice was the premise of the Leegin holding, which was to promote interbrand competition at the expense of intrabrand competition (Leegin, 2007).

Moreover, the mere fact that a manufacturer and a retailer incorporate a minimum price maintenance agreement into their dealings does not necessarily prevent businesses from competing on price. The minimum price maintenance agreement merely establishes a price floor for the product, providing the retailer with a minimum profit margin for the sale of the product. The retailer, however, is permitted to sell the product over the minimum price. This could be warranted if the retailer can differentiate the product based upon enhanced customer service or marketing. In that case, another retailer may elect to focus on price, accepting the minimum guaranteed profit margin per the agreement.

While the vertical minimum price maintenance agreement is beneficial to the retailer, it also bestows attractive strategic advantages upon the manufacturer. First, the agreement can help a manufacturer achieve their brand image by establishing a premium price for the product, in an effort to connote quality. Absent a minimum price maintenance agreement, the manufacturer's efforts to promote and maintain a high end brand image would be thwarted by low service low cost free riders (Leegin, 2007).

Secondly, the vertical price maintenance agreement encourages the retailer to aggressively market the manufacturer's product, which sustains the brand image the manufacturer is attempting to denote. By establishing a minimum price, the retailer is guaranteed a specified profit margin, quelling the retailer's concern of being undercut by wholesalers. This mutually beneficial agreement benefits both the manufacturer and retailer, as it provides the manufacturer the increased marketing efforts of the retailer, thus adding to the brand image of the product (Leegin, 2007).

EXAMPLES

Just by walking down a store aisle containing hair shampoo it is easy to conclude that the market for hair shampoo is crowded. There are name-brand products, generic products, and many variations of each type of shampoo. The price of shampoo also varies dramatically between brands, types, and even locations of sale. By any standard this would seem to be a tough market in which to introduce a new product. While the Leegin decision cannot promise success, it does allow a new strategy to attempt success.

This example describes a manufacturer who develops and introduces a new line of shampoo to be sold through hair salons and barbershops. A minimum price maintenance agreement with distributors and/or retailers (the hair salons and barbershops) would require resale of each type of shampoo to be no less than a specified dollar amount (which could be adjustable pursuant to contract language by a specified percentage each year to account for inflation). In this example the manufacturer sets a minimum price of $2 as the retail price for a bottle of shampoo in its contract with distributors/retailers. The manufacturer would have set this price to cover its costs and profit margin, but also with the idea that it will sufficiently cover the cost and profit margin of retailers to allow for additional costs associated with the efforts of product differentiation. Retailers could sell the shampoo to their customers for any price above $2 per bottle and not have to worry that their competitor will be selling the same product for less than $2 per bottle. Each retailer could then decide how best to add value to the shampoo through customer service and marketing, knowing that as long as its total cost in each bottle of shampoo, plus its profit margin per bottle, was at or less than $2 it would never have to deal with price competition. This scenario may encourage more retailers to buy the product (providing it is a good product) and, thus, encourage the introduction of another brand of shampoo into the market place. A manufacturer's strategy of using minimum price maintenance agreements as in this example creates an incentive for interbrand competition.

In some ways, Wal-Mart is a free rider. It is a large enough retailer that it can and does buy products in bulk (including different brands of the same product), as well as being able to negotiate very favorable prices it will pay for products. This strategy, in turn, results in Wal-Mart being able to offer different brands of the same product at prices which are usually lower than most if not all competitor's prices (particularly when price competition is measured in a specific store's geographic market area). Wal-Mart has a successful strategy of offering products at low cost without needing to invest in the promotion of quality or of the specific characteristics of the products it sells. However, Wal-Mart does not own the market place.

There are manufacturers and distributors that do not do business with a national company like Wal-Mart. Regional and even local manufacturers and distributors may not have the capacity (or the desire) to sell to Wal-Mart and, instead, focus on other retailers. These other retailers are often local businesses with a single or relatively small number of stores or other sales outlets. Price competition with a store like Wal-Mart may not be a realistic part of a business strategy in this instance, but if the product is not sold in national (or even international) retailer's stores, minimum price maintenance agreements may yet be effective. A small retailer's direct competition will be other small retailers, although large retailers will remain as indirect competition through the sale of other brands of the same product. When small retailers know they no longer have to compete against each other on the basis of price alone, they will have the ability to focus on brand differentiation. Such efforts can also be effective in attracting customers away from the indirect competition, especially if the same product is not available through large retailers. Even if the product were to appear on Wal-Mart's shelves, however, the same minimum price maintenance agreement would have to be in effect for Wal-Mart. Wal-Mart may be able to sell at the minimum price described in the agreement, but if a small retailer is able to do this along with offering better customer service and marketing, the small retailer has the competitive advantage over Wal-Mart.

CONCLUSION

The Leegin holding, while changing an established body of legal precedence, will also have lasting implications for businesses attempting to develop a marketing and pricing strategy. The holding has the potential of evening the competition between small businesses and wholesalers as the competition to sell a specific item can be regulated to a differentiation strategy as opposed to being based on cost. By changing the method of competition away from price, small businesses which often focus on enhanced customer service are provided with a competitive advantage over the discounter.

By changing the analysis from the per se standard to the more flexible rule of reason, entrepreneur can become cautiously optimistic about developing new strategies in order to compete with large conglomerates. As long as the minimum price maintenance agreement is at a level high enough to encourage the retailer to aggressively market the product, companies will be compelled to compete by utilizing a differentiation strategy, as opposed to cost leadership.

While the United States Supreme Court has reversed an established body of case law, reverting back to the less stringent rule of reason, it is important to bear in mind, however, that a vertical price maintenance agreement may still violate the Sherman Act. The Leegin case, while colossal, only stands for the proposition that the court must consider the respective facts and subjective nature of each case as opposed to using the stringent per se standard of analysis. Moreover, even if the Leegin case does permit the vertical restraint, the entrepreneur must remain cognizant of the state antitrust laws, as the state law may diverge from the federal interpretation.

As previously stated, the Leegin case is a historical decision, overruling an established body of common law. This is an emerging area, leaving ample opportunity for future research. Future research should be directed at ascertaining how courts are interpreting vertical price maintenance agreements when applied under the rule of reason as opposed to the per se standard. Moreover, it will be important to analyze how the rule of reason analysis affects the small business from a strategic vantage point.

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ORGANIZATIONAL HOSTILITY TOWARD WHISTLEBLOWERS

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ABSTRACT

This paper examines hostile reactions toward whistleblowers who report violations of laws, rules, or regulations. This is an inherent organizational characteristic. We punish those who tell the truth if it causes embarrassment to the organization or exposes it to punishment. Some studies have tried to determine why members of organizations react in this manner. Others have suggested that the best way to avoid embarrassment by whistleblowers is to have a strong compliance program within the organization to react positively to such reports.

INTRODUCTION

There are various methods of discouraging those who wish to report an act that is a violation of a law, a regulation, or a rule. The easiest way is to order them not to speak or make a statement. If the order is ignored the supervisor can make an example of the whistleblowers by taking adverse actions against them. These adverse actions are noted by others in similar positions as a warning not to take similar actions in the future.

RETALIATION

Lucia Paccione worked as a sales representative for Cephalon Inc., a drug manufacturer. She claimed she was fired for expressing her concerns to her immediate supervisor regarding the illegal off label marketing of drugs. Off label marketing is the selling of drugs for purposes not approved by the Food and Drug Administration (FDA). Despite the FDA's letter, sent to Cephalon in 2002, which warned the company not to continue to promote one of its drugs off label, the company continued to do so. Prosecutors contended in court papers filed against the company that it trained its sales personnel to disregard FDA restrictions and structured its sales quota and bonuses so that sales representatives could not reach their sales goals unless they sold the drugs for off label uses (Duffy, 2008) The company agreed to pay $375 million to settle False Claims Act claims by Medicaid and Medicare and pay $50 million in fines. In addition, it paid Ms. Paccione over $46 million. She in turn agreed to split the sum with three other whistleblowers (Duffy).

John Marti, the first assistant prosecutor for the U.S. Attorney in Minnesota, was demoted for reporting his boss, Rachel Paulose, for careless handling of classified homeland security reports. In retaliation, Paulose had Marti removed as her first assistant and demoted to Assistant U.S. Attorney. The Office of Special Counsel confirmed Paulose's actions and awarded Marti back pay, a lump sum payment and any negative references removed from his personnel records (Karnowski, 2008).

In 2006, the United States Supreme Court ruled that a public employee could be disciplined for doing his job. Richard Ceballos was a supervising deputy district attorney for the Los Angeles County District Attorney's Office. He had been employed there since 1989. He was a calendar deputy in the Pomona branch with some supervisory duties over other attorneys. In February 2000, a defense attorney asked him about incorrect descriptions in an affidavit used to obtain a search warrant. Ceballos claimed that it was normal for defense attorneys to ask calendar deputies to look into elements of pending cases. The defense attorney had already filed a motion to challenge the warrant.

After reviewing the affidavit and visiting the location described in the affidavit, Ceballos concluded the affidavit had made critical misrepresentations. What the affidavit described as a long driveway, Ceballos thought should have been described as a separate roadway. He also doubted the affiant's assertion that tire tracks led from a derelict truck to the premises to be searched because the surface of the roadway made it difficult to leave visible tire tracks (Garcetti, 1955).

After speaking by phone with the deputy sheriff who had applied for the warrant and not receiving an explanation with which he was comfortable, Ceballos informed his supervisors and prepared a memorandum in which he recommended dismissal of the case. Ignoring his recommendation, his supervisor proceeded with the case. At a hearing on the defense motion to challenge the warrant, Ceballos was called by the defense to testify as to his conclusions about the affidavit. The motion was denied.

Following these events, Ceballos claimed he was subject to retaliation by his employer. These actions included reassignment from calendar deputy to trial deputy, transfer to another courthouse, and denial of a promotion. He filed a grievance which was denied because he had not suffered any adverse action by his employer. He then sued in federal district court alleging his employer had violated his First and Fourteenth Amendment rights by retaliating against him based on his memorandum. In answer, his employer responded that all actions were due to staffing requirements and that his memo was not protected speech under the First Amendment. The district court granted the employer's motion for summary judgment concluding that Ceballos wrote the memorandum according to his employment duties which were not protected speech under the First Amendment. The Ninth Circuit Court of Appeals reversed holding that Ceballos's allegations of defects in the affidavit in his memorandum were protected speech under the First Amendment. By a 5-4 vote, the Supreme Court reversed the Ninth Circuit, holding that when public employees make statements arising under their official duties, the employees are not speaking as citizens for First

Amendment purposes and the Constitution does not protect their words from employer discipline (Garcetti, 1960).

On a 60 Minutes broadcast, Anderson Cooper interviewed Joe Darby, the soldier who turned in the pictures of prisoner abuse at Abu Ghraib. Mr. Darby was from Appalachia, where he joined the Army Reserves to become an MP. His local unit was sent to Iraq and assigned to Abu Ghraib. He discovered the pictures of prisoner abuse because one of his unit members gave him CDs on which they were stored. Darby decided he had to turn in the pictures, but he wanted to do it anonymously, because he knew a lot of his unit members would regard him "as being a stool pigeon or …a rat" (Cooper, 3). Even though he was promised confidentiality by a CID investigator, his name was broadcast nationwide when the Secretary of Defense, testifying before a Congressional committee, mentioned he was the source of the pictures of prisoner abuse. He did get support from his unit, but not back home in Cumberland, Maryland. There they felt he had betrayed his unit members. The commander of the local VFW post related what people were saying. "He was a rat. He was a traitor. He let his unit down…"(Cooper). Then the commander added his own belief. "I agree that his actions …were no good and borderline traitor…"(Cooper, 4). To prevent the soldiers in Iraq from retaliating against him, the military command sent Darby home early, ahead of his unit. However, when he arrived stateside, he was informed that the Army Reserve had done a security assessment of his home town and concluded it was not safe for him to return. Mrs. Darby received phone calls telling her Joe "was a dead man. That he was walking around with a bull's-eye on his head" (Cooper, 5). Both sides of their families have turned against them. They cannot go home and cannot say where they are currently living for their safety. (Cooper, 6-7).

Reporters for the Washington Post printed a story about the neglect of outpatient wounded soldiers at Walter Reed Army Medical Center. Even though top military officials at Walter Reed knew of the neglect from complaints of Congressmen, their spouses, wounded soldiers, and their families, no action was taken. Last October, a woman who had volunteered many times to help at Walter Reed with outpatients, brought the wife of then Defense Secretary Donald Rumsfeld to a weekly meeting at which wives, girlfriends, and mothers of soldiers exchanged stories and offered support. At the end of the meeting, Mrs. Rumsfeld asked one of the staff members whether she thought that the soldiers picked to meet her husband had been chosen to paint a rose colored picture of their time there. The answer was yes. When Walter Reed officials discovered that Mrs. Rumsfeld had secretly visited, they told the friend who had brought her that she was no longer welcomed at Walter Reed (Hull, 2). In February of this year, the wounded soldiers who had spoken to reporters were told that there would be early morning room inspections and that further contact with reporters was prohibited. Some soldiers viewed these actions as retaliation for speaking to the press (Hull, 3).

In 2007, the Supreme Court made it harder for whistleblowers to collect a share of the fines collected for fraud by government contractors. By a 6-2 vote, the Court ruled that James Stone, a retired engineer, could not collect anything for his role in exposing fraud at the Rocky Flats nuclear weapons facility northwest of Denver. Stone was not eligible to collect a fee from the $4.2 million fine for fraud because he was not the original source of the information that led to Rockwell

International being ordered to pay the fine (Sherman). The company, supported by defense, energy, and pharmaceutical interests, wanted the Court to restrict when a whistleblower can collect for suing on the government's behalf. The Bush administration supported Stone because it would encourage whistleblowers to uncover fraud against the government. The False Claims Act permits persons, acting on behalf of the government, to bring fraud suits against companies that have contracts with the government. If they win, they get to receive a percentage of what the contractor pays the government. The issue in the case was whether Stone provided the information that the jury used to find fraudulent claims filed by Rockwell. Stone claimed he was the original source. Rockwell said he could not have been because Stone was laid off a year before it began submitting false claims relating to meeting goals of treating low-level radioactive wastes at the former atomic weapons plant. The title of the case is Rockwell International v. U.S., ex rel Stone.

THEORIES

A number of studies have examined why organizations retaliate against whistleblowers. Shahinpoor and Matt note that today's working students in undergraduate business classes still find their bosses act just like feudal lords obsessed with maintaining their own order. They use a model that rewards conformity, obedience and loyalty to bosses, and avoiding blame. Questioning is seen as disloyal and insubordinate and dealt with hostily (Shahinpoor, 37).

Hassink, de Vries, and Bollen examined whistleblowing policies of European companies and compared them to national whistleblowing regulations similar to the United States Sarbanes-Oxley Act. They concluded that the policies at the corporate level seemed to be more effective (Hassink, 2007).

Monin, Sawyer, and Marquez examined the hostile reaction to whistleblowers. They did a series of studies involving college students. From their studies they concluded that reactions to whistleblowers fall into three categories. Uninvolved observers will be inspired, coworkers will be hostile because it calls into question their own obedient behavior or silence toward the wrongdoing, and coworkers not directly involved will be passive (Monin, 2008).

CONCLUSION

It is human nature to punish those who do not follow the crowd. We have done it since the beginning of recorded time. When we told our parents that our siblings were violating a rule, we were invariably told it was not nice to tell on others. The rule was implanted early in our psyches. The current Supreme Court seems to mirror that rule. The Court could easily have sided with Ceballos. The majority chose to ignore a great deal of evidence. It is interesting to note that this case was argued twice; once, while Justice O'Connor was on the bench, and a second time after Justice Alito replaced her. It looks like O'Connor had voted with the dissent and her replacement turned the minority opinion into the majority opinion. So the Court upholds punishing a deputy district attorney who does what the California Code of Professional Conduct for attorneys requires, i.e., that he disclose exculpatory evidence to the defendant. If he had not, he risked having his license to practice law suspended or revoked (Garcetti, 1962).

Joe Darby and his wife cannot return to Cumberland, Maryland, their birthplace and home of their parents and grandparents and cousins. Why? Because Joe Darby did what he was required to do. He reported a violation of duty by MPs guarding Iraqi prisoners at Abu Ghraib. Even though it involved only seven out of two hundred MPs from his unit, the townsfolk regarded him as the traitor, not the seven who violated the code of military conduct. They are the heroes who can return home after they get out of prison. But Joe Darby who testified for the prosecution at their trials cannot. He is the one under witness protection.

Mr. Stone provided the information which led to the government recovering $4.2 million dollars. His reward would have been a percentage of that amount. But the Court said he could not have it; thereby discouraging future whistleblowers. The current majority of the Court seems to follow the letter of the law, but not its spirit. It is probably because most of the members never held political office. They are not oriented to people, but rather to words. We seem to be entering a time when the Court will be more reluctant to help people. It will defer to the executive and legislative branches to do those tasks.

What can companies do to prevent whistleblower embarrassment? Implement a policy which reacts positively to internal reports of violations. Promulgate a compliance program which includes a corporate integrity program with periodic training for employees. Review and update the compliance program. Keep records of compliance audits, employee training, and disciplinary measures taken. Address problems when they arise rather than sweeping them under the table. If the company values the employee who reports a problem and acts on it, they are less likely to go outside the company to report it. Maintain good employee relations to avoid unhappy employees reporting to outside agencies (Sinatra, Jr. 2009).

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A MORAL IMPERATIVE – OVERCOMING BARRIERS TO ESTABLISHING AN MBA INFUSED WITH ETHICS

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ABSTRACT

Business schools have been trying for decades to educate ethical managers, but have often fallen short of expectations. The difficulty for many schools may lie in barriers that prevent the inclusion of ethics into the graduate business program.

This case study describes the development of an MBA program in a small Catholic college which emerged naturally infused with values. We propose that the barriers that often inhibit the creation of such a program can be overcome, if the program emerges from a value-laden culture. Results of this single case study are promising, finding that both faculty and students recognize the emphases placed on ethics two years later.

The question for further research is whether this experience is unique to a single institution, or whether all faith-based institutions have an advantage when trying to integrate ethics into an MBA curriculum. If faith-based institutions truly have the edge in developing ethics-infused graduate business programs, they could have an important competitive advantage in the MBA market.

INTRODUCTION

Business schools have been trying for decades to educate ethical managers. The results of their efforts, however, often fall short of their hopes. MBA students, despite their exposure to business ethics during graduate school, are still often perceived as unethical win-at any-cost corporate climbers. Critics of MBA programs argue that not only do most business schools neglect ethics in their curriculum, but they actually encourage a focus on short-term profits and the compulsion of graduates to go to any lengths to increase shareholder profits (Alsop, 2006; Giacalone and Thompson, 2006). In the post-Enron world, hiring businesses are questioning the values of these graduates, and recognize that their focus on profit above all else can lead to serious damage to corporate reputations (Roy and Roy, 2004). Critics contend that business schools can and must do more in bringing about positive ethical change (Adler, 2002). Business schools have responded to these demands for more ethical graduates by either adding ethics courses to their curriculum or attempting to integrate ethics throughout their curriculum. These often-expensive experiments, however, have proven challenging for institutions that struggle with already-crowded curriculum and faculty who are untrained or unwilling to change their approaches (Piper, 1993).

The purpose of this paper is to describe a success story: the development of an MBA program in a small Catholic college which somehow emerged naturally infused with values. The program's title (Innovation and Entrepreneurship) does not promote or even hint at its value-laden nature. The faculty, when developing the program, were not specifically instructed to focus on ethics in constructing their syllabi. The students were not informed upon entering the program that they were going to be exposed to ethics in all of their courses. Nevertheless, when surveyed, the faculty that developed the program all claimed that each of the courses they developed (including *Accounting* and *Quantitative Analysis*) have significant ethical components and over 70% of the students currently enrolled in the program claimed that there was a significant ethics component in *every* course they have taken in the MBA program. How did this happen? Why did Felician College, a small, Catholic, Franciscan college with an even smaller business division, succeed in developing an ethics-laden program that other much-larger and better funded colleges might aspire toward?

THE IMPORTANCE AND DIFFICULTY OF INCORPORATING ETHICS INTO MBA PROGRAMS

Business is often perceived as a game. The game analogy, though, can lead to some unpleasant ramifications. Games are won or lost. Games have limited and prescribed rules. Certain behaviors are tolerable in playing a game that might, in other social contexts, be unacceptable (Parks, 1993). And, sadly, the goal of the person engaged in the game is often to win at any cost. Nobody likes a loser. The focus is narrow and the stakes are high (Poytner, 1996).

Combine the game-like nature of business with the culture of self-interest and individualism that is inherent in our United States economic system and you have the recipe for unethical behavior. In reality, business school students may be at a greater risk of ethical lapses than other professional school students. Research has found that while business school students cheat at similar levels to students in other professional schools, their attitudes toward cheating are more permissive than the attitudes of their contemporaries (Klein, Levenburg, McKendall, and Mothersell, 2007). It could be hypothesized that the students attracted to business and seeking an MBA are more predisposed to this focus on self-interest, especially in terms of money-making (Parks, 1993). They like the game, and they want to win it. They enter MBA programs to equip themselves with the tools they need to compete.

Traditionally, MBA programs ignored this lethal combination of bright, aggressive students and a competitive, game-like business environment. MBA programs focused on the hard skills that would directly increase graduates' earning potential and students flocked to courses that they believed would make them more attractive to future employers (Alsop, 2007). The lessons of Enron, World-Com, and Arthur Anderson made it impossible for business schools to ignore the absence of ethics in their curricula any longer, though, and today most MBA programs acknowledge the importance of tempering their quantitative models with some focus on "softer skills" and character building. Piper (1993) explained that past overreliance on formal models "minimized the application of judgment and debate about values" (p. 3). Increasingly, academics realized that an MBA provides the framework by which future managers make decisions (Roy and Roy, 2004) and that business programs have a critical role to play in preparing their students to assume leadership roles in ethical and socially responsible businesses (Alsop, 2006). The quantitative thrust of the past needed to be expanded to include the new call for ethical understanding and reasoning abilities (Cohen and Burns, 2006).

As colleges and universities attempted to inject ethics into their MBA programs, though, they soon discovered that doing so was much more difficult than it appeared. During the early 1990s, a study at Harvard Business School identified common barriers that prevent the easy inclusion of ethics into most MBA programs (Gentile, 1993):

1. Difficulty in defining ethics
2. Lack of willingness to try to change students' value systems
3. Faculty's lack of confidence in their own value systems and/or their qualifications to teach ethics
4. The fear of "playing with a loaded gun" when discussing value systems in a classroom

How a small, resource-constrained Catholic college overcame these barriers and emerged with an ethics-laden graduate business program is the focus of this study.

THE FELICIAN COLLEGE EXPERIENCE

In 2004, the business faculty at Felician College were told that prospective applicants had been calling the admissions office inquiring about the availability of an MBA at the college. At that time, the division of business was only several years old (the business programs had existed as a department under Arts and Sciences since the early 1990s) and consisted of a 7-person faculty. The development of a graduate program in business was not a goal of the new division at that time, and seemed almost impossible to achieve. Felician College is a tuition-driven institution, though, and student demand is something that is taken very seriously. If prospective applicants were requesting a Felician College MBA, the tiny business division would have had a very difficult time persuading top administration that they were unable to create one (especially if they wished to preserve the respect of the institution). Therefore, in the summer of 2004 the division of business worked together to develop the theme and curriculum for their new program, which would be an MBA in Innovation and Entrepreneurship.

Felician College is a Catholic institution with a strong religious culture. The President, Vice President for Academic Affairs, and Dean of Students are all habited Sisters, so the Felician heritage of the college is visibly obvious. The Board of Trustees, as well, is heavily dominated by the members of the Felician order, and faculty members are carefully trained to respect and adhere to the religious mission of the college. Liturgies are held at least five times each academic year, crucifixes adorn each classroom, and posters articulating the Franciscan values are displayed throughout campus. Each faculty meeting starts with a 15-minute presentation on famous Franciscans, and each faculty member must attend an annual retreat. The last college strategic plan articulated religious identity as being as crucial as growth to the college's future. Anyone who spends any time on the Felician College campus quickly becomes aware that they are in a strong Catholic setting.

When the business faculty sat down to develop an MBA at the college, they never specifically stated the goal of infusing the program with values. Perhaps they didn't have to: there may be a certain homogeneity among Felician College faculty in terms of ethics. As the President states annually at her State of the College address, if any faculty members do not prescribe to the important Catholic mission of Felician College, they are encouraged to seek employment elsewhere. The faculty members who stay are comfortable with the religious identity of the college, and associate closely with the tenets of Franciscanism. Consequently, the 7-member team that created the MBA were, by default, willing and active participants in the religious culture of the college. They would not have been at Felician College if they had not been.

All courses in the MBA program were written by this full-time faculty team. The courses range from Innovation Management to Managerial Accounting and Managerial Finance. The surprise in the program does not rest in the curriculum, though: It lies in the fact that each of the courses, without prior discussion among the faculty developing them, wound up with a heavy ethics component.

OVERCOMING BARRIERS TO THE INCLUSION OF ETHICS AT FELICIAN

The difficulties articulated by Gentile in 1993 did not hold (or were easily overcome) when the Felician College faculty launched their MBA program. Felician College is mission driven, and that mission unequivocally is rooted in the values and principles of the Catholic Church. The acceptance of this mission by faculty made the inclusion of a strong ethics component into the MBA program both natural and comfortable. Each of the barriers Gentile identified were not formidable in the Felician College case.

At Felician College, the values and ethics of the instructor are presumed to reflect those of the institution. In effect, the faculty member gets to hide behind the values of St. Francis – regardless of whether these are truly the ethics by which he or she actually lives. The starting point is clear, and there is a model by which to frame the discussions. Ethical discussions are neither "vague" nor "nebulous" in this context: they are as clear cut as discussions of any other controversial topic. There is room for debate over interpretation, but no room for reestablishing the ethical groundwork. The faculty member is protected from the vulnerability of "revealing too much" by the college acceptance of a general, agreed-upon value base.

Difficulties in Defining Ethics

A key question when discussing ethics is "Whose ethics?" The recent focus on diversity and multiculturalism has made the identification of common values almost impossible and failure to get around this issue has derailed many attempts to teach ethics in secular institutions (Fukukawa and Shafer, 2007). On top of this is the fear that a discussion of ethics involves indoctrination. Parks (1993) described this fear as "the perception of ethics as a saboteur of the deeply cherished though spurious myth of value-neutral education" (p. 17).

Although many faculty members would prefer not to address issues of ethics in the classroom, it must be acknowledged that, even in their silence (or especially in their silence) they are teaching lessons on values during every class session. According to Piper (1993), management educators have always taught lessons in leadership, ethics, and corporate responsibility, even when they believe that they have avoided the topics. Students quickly pick up the value systems of their instructors, and faculty attempts to remain value-neutral invariably fail. "Omission of discourse is not value-neutral education. There is no such thing. Omission is a powerful, even if unintended, signal that these issues are unimportant" (Piper, 1993, p. 6).

At Felician College, the question of "Whose ethics?" need not be asked. The college subscribes wholeheartedly to the ethics of St. Francis of Assisi. His values, which include respect for all humankind, love and stewardship of nature, and love of God, are the core of the college mission and are posted prominently around campus. The faculty are taught the values and attend an annual retreat to contemplate the application of them in their professional lives. When beginning any ethical discussion at Felician College, faculty are armed with a strong and nonnegotiable starting point – the principles of Francis, as interpreted in modern Catholic Social Teaching.

Lack of Willingness to Change Students' Value Systems

Even if a universal ethics can be agreed upon, faculty in business programs still face reluctance to try to affect students' values. One reason for this resistance is the common belief that by the time students enroll in MBA programs it is too late to change their value systems. Conventional wisdom tends to equate value emergence with character formation, which is associated with early childhood. Parks (1993) called this assumption, which he traced to popular Freudian psychology, highly dangerous (p. 14). In its early experimentation with teaching graduate students business ethics, the Harvard Business School discovered that moral development can and does continue into adulthood, and the impact of value-based education introduced at the graduate level can have a significant impact (Parks, 1993). According to Piper (1993), students in their 20's are in a critical stage of their moral development, and their perceptions about capitalism, leadership, and appropriate resolution of ethical dilemmas can be molded appropriately in ethics-infused graduate programs (p. 5).

The second source of faculty resistance is the belief that ethics really cannot be taught at all. Despite the conclusions of Socrates 2,500 years ago, many faculty members still doubt whether ethics training really works (Cohen and Burns, 2006). In ethics courses, students invariably give the "correct" answers, often mouthing platitudes that they believe their professors want to hear (Gentile, 1993, p. 87). While students might be able to be taught to arrive at the socially responsible or ethically correct response when faced with a case in business school, how likely are they to carry this process with them into their careers?

According to Roy and Roy (2004), the students do develop transferable decision-making skills after exposure to graduate level ethics. Alsop (2006) agreed with this premise: The focus on moral decision-analysis in graduate programs is crucial to the development of ethical managers. The primary hindrance to managers making good, moral decisions is lack of experience in doing so (Poynter and Thomas, 1996) Case studies in graduate school can provide this experience before the students are faced with real-life ethical dilemmas.

The final source of faculty resistance to teaching ethics is more difficult to address. Business faculty, trained and educated in their fields, sometimes view discussions of ethics as "fluff," or distractions from the subject at hand. Lacking analytical models to apply, the faculty consider ethical discussions pointless, or "flat" (Gentile, 1993, p. 87). Students in functional courses (such as finance or strategy) may worsen this perception by acting as though an examination of ethics in class is a welcome break from quantitative analysis. Faculty therefore view ethics as "soft, idealistic, and even nebulous" (Gentile, 1993, p. 92). Why waste valuable classroom time on a topic that offers no clear conclusions and cannot be converted into a useable model? Roy and Roy (2004) perhaps offered the best rebuttal to this faculty resistance: Faculty should teach ethics because employers care. Because employers are looking for future managers well versed in ethics, the faculty member who refuses to introduce ethics into his or her curriculum does the students a disservice.

This barrier is irrelevant to the Felician College faculty. Indeed, part of the mission of the college is to do this very thing: change the value systems of students so that they graduate with "thinking hearts and understanding minds." Toward this end, all undergraduate students must take the Felician College core, which is comprised of four sequential courses infused with mission and leading to a service orientation. Students also are required to take two religious studies courses and two philosophy courses. Faculty are encouraged to get to know the "whole student" in their interactions with them, and to "recognize the face of God in every student who walks through the doors of the college." Changing value systems is what Felician College is all about, and faculty members either buy into this important component of the mission or leave the institution.

Faculty's Lack of Confidence in Their Own Value Systems and/or Their Qualifications to Teach Ethics

Gentile (1993) suggested that faculty resistance to teaching ethics may be rooted in their own insecurities. Faculty teaching in graduate programs are invariably experts in their fields. They have spent their lives polishing their trades, and take pride in their accomplishments. They walk into their classrooms confident that they are the experts in the topics addressed. Until, that is, the topic switches over to ethics. Suddenly the Ph.D. and publications in Finance, Economics, or Operations Research seem less relevant in deeming the instructor an expert, and the feeling of being in unfamiliar territory is an unpleasant one (to say the least).

Even faculty members who believe they are well enough versed in philosophy to teach ethics effectively may doubt their own value systems and resist opening themselves up to students who may find their values somehow lacking. Asking faculty members to teach ethics is asking them to move solidly out of their comfort zones, and share with students their deeply held personal beliefs (Alsop, 2006). The lack of universal ethics in non-faith-based institutions implies that there is no ethical "starting point" beyond the instructor's personal morality. Faculty are subject to the same embarrassment and vulnerabilities as students when discussing ethical issues, and fear that they might lose the respect of their classes if they share too much (Gentile, 2006, p. 88) It is no wonder that many faculty members in these institutions attempt to avoid discussions of ethics altogether.

Faculty at secular colleges feel vulnerable discussing ethics because of the degree of personal exposure they risk in order to do so. If the question "Whose values?" is left unanswered by the institution, the only logical response in the classroom is "those of the instructor." Therefore, a discussion of an ethical dilemma in non-faith-based institutions requires the pronouncement of the values and ethics of the faculty member.

The Fear of "Playing With a Loaded Gun" When Discussing Value Systems in a Classroom

When there is no agree-upon value system to start with, how does a faculty member begin a discussion of an ethical dilemma? Faculty are uncomfortable in situations where they do not have an analytical model to apply (Gentile, 2006, p. 89), and are hesitant to begin a discussion without the application of a set perspective. In the case of ethics, what perspective is that? How does the faculty member begin open, honest communication about ethics without leaving himself or herself open to criticism over personal beliefs? According to Fukukawa, Shafer, and Lee (2007), the discussion of ethics generally encroaches on subjects such as religion, politics, and personal career choices (p. 383). For obvious reasons, many faculty members view the introduction of these topics in class an invitation for heated, and at times unorganized, debate. If they can avoid the "loaded gun" by omitting the discussion of ethics and values in their classes, they are more than happy to do so.

When there is an accepted truth underlying discussions of ethics, the heat of the debate is diffused. Students (and faculty members) who do not share the beliefs of the Catholic church nonetheless recognize the primacy of these beliefs at the college, and engage in thoughtful debate about the applications of these values to real-life dilemmas – not debate about the values themselves. Felician values are explained to all students at orientation, and those students who cannot accept them self-select out of the institution. Those who enroll implicitly agree to respect the ethics of St. Francis as the groundwork for future debate.

RESEARCH METHODOLOGIES AND RESULTS

We based this investigation on a single case study design using the Felician College graduate business program as our main unit of analysis, and the ethical outcomes of individual courses as the subunits of analysis. We base our use of the single case design on the rationale that the Felician case is revelatory in nature in that it offers "an investigator … an opportunity to observe and analyze a phenomenon previously inaccessible to scientific investigation …" (Yin 2003, page 42).

Yin suggests that when determining which research strategy to use, an investigator must consider the amount of control an investigator has over events, the degree of focus on a contemporary versus historical set of events, and the type of research question being asked. Our examination of the emergence of Felician College's ethics-infused graduate business program in 2005, favors the use of a case study design.

Both investigators were involved in the implementation of this program and are characterized in what Yin describes as "participant-observers." Participant-observer status offered investigators an insider role that Merriam (1997) described as a requirement when conducting case study research. Nevertheless, investigators did not have direct, precise, and systematic control of events. Each of the 7-member full-time faculty team created all of the courses in the MBA program independently. Participant-observer status did however, offer full access to a full complement of evidence including program documents, artifacts, interviews with persons involved in the program's launch, and direct observation of events as they unfolded. In addition, one of the investigators no longer works at the institution and can thus offer an additional level of objectivity.

More importantly for determining our methodology however, is the type of research question we ask. Yin notes that research questions have both substance (i.e. What is the case about?) and form (i.e. Is the researcher asking a "who", "what", "where" "how", or "why" question?), and suggests that "What" questions favor survey strategies, while "How" and "Why" questions are explanatory and would lend themselves to the use of case studies. We have guided our research by the following questions:

**"How can the problems faced by other schools with infusing an MBA curriculum with ethics be overcome?"*

"Why did an ethic-laden curriculum emerge at Felician College?"

We propose that ethics can be infused into a graduate business curriculum naturally, if it emerges from a value-laden culture. To link the data to our proposition, we relied upon data from a combination of sources, and triangulated our evidence:

1. * Methodologies – Observations, qualitative interviews of graduates and faculty, documentation (e.g. syllabi), and a quantitative survey of students

2. Data – Evidence of an ethics-laden curriculum that was uncovered using one data collection technique was supported by other techniques

3. Use of Multiple Researchers

A survey distributed among the faculty who developed the program and courses uncovered an interesting and amusing statistic. Faculty were asked to respond to two statements: (1) *Which courses did you develop for the MBA program in Innovation and Entrepreneurship?,* and (2) *Of the courses you listed above, list the ones that contain significant ethics components.* In every case, the answers to the two questions were the same. Every faculty member – even those who had developed only *Accounting* or *Finance* courses – believed that every course that he or she created had a significant ethics component. This belief is borne out by reviewing the syllabi for the program. Of the fifteen courses that make up the MBA, nine reference an ethics component in the course objectives, four dedicate at least one full week's discussion to ethics, and one is a stand-alone ethics course. Only four courses in the program do not specifically mention ethics on their syllabi.

Students recognize this emphasis as well. A student survey showed that 90% of the current MBA students agreed or strongly agreed that the college's Felician/Franciscan heritage came through clearly in the program's curriculum and 86% believed that it was obvious the Felician College faculty cares deeply about teaching ethics in the program.

OTHER COLLEGES' ATTEMPTS

Faced with business demand for graduates well versed in ethics, schools have typically chosen one of two routes. Most schools initially tried to introduce ethics into their curriculum through the introduction of a stand-alone ethics course. Duquesne, Carnegie Mellon, Dartmouth, LaSalle, Villanova, and Belmont universities have adopted this model, and all require their MBA students to take courses ranging in title from Managerial Environment to Applied Ethics (Roy and Roy, 2004). In total, 40% of the top-ranked U.S. business schools require a stand-alone corporate ethics course as part of their core MBA curricula (Navarro, 2008). Other institutions, such as Columbia, have taken the second, more integrated approach to ethics education. Columbia originally launched their ethics initiatives with a stand-alone course (*The Individual, Business, and Society: Tradeoffs, Choices, and Accountability*), but has recently changed this requirement. Instead of students taking a single graded ethics course, Columbia MBA faculty have been charged with weaving ethics into other required standard business courses (Alsop, 2006).

Research suggests that an integrated approach that reinforces ethical standards continuously throughout the curricula, as was implemented at Felician College, may be the better option. In a four-year study on the effects of ethics education on business students' ethical standards, Arlow and Ulrich found that immediately after taking a stand-alone ethics course some students' ethical standards rose initially, but shortly returned to their pre-course levels (1985). This integrated approach, while seen as the preferred option, must emerge from a value-laden organizational culture, though. In order to infuse ethics into a business curriculum, it must be observed at the top and embraced by the entire college community (Cohen and Burns, 2006). The lack of acceptance by the college community is often what causes well-intentioned ethics programs to fail.

CONCLUSIONS

The strong Catholic culture at Felician College created an environment in which the business faculty developed and launched a value-infused MBA program not because they were told to do so, but because doing so came naturally. The very real barriers to the creation of such a program, articulated by Piper, Gentile, and Parks (1993) did not apply in such an environment. Discussion of ethical issues comes naturally to faculty members who are reminded of their shared values at every college gathering, and they comfortably incorporated this discussion into every course in the MBA curriculum. Two years after the launch of the program, both the students and the faculty recognize the dominance of ethics in the curriculum, and both groups believe that the MBA program is enriched because of its inclusion.

The question for further research is whether the Felician College experience is unique to that single institution, or whether all faith-based colleges and universities have an advantage when trying to integrate ethics into an MBA curriculum. The topic is an important one: Research shows that ethics can be taught (Cohen and Burns, 2006; Piper, 1993; Roy and Roy, 2004) and that businesses have come to expect that students will emerge from MBA programs capable of making ethical decisions (Alsop, 2006; Hughes, 2006). In addition, research suggests that students at schools whose missions specifically reference ethical content have a higher ethical orientation than those of schools whose missions lack ethical statements (Davis, Ruhe, Lee, and Rajadhyaksha, 2007). If faith-based colleges and universities truly have the edge in developing ethics-infused graduate business programs, they could have an important competitive advantage in the MBA market.

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THE CHALLENGES AND OPPORTUNITIES OF INCORPORATING ACCOUNTING ETHICS INTO THE ACCOUNTING CURRICULUM

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ABSTRACT

It is critical that accounting educators prepare students to address issues, such as ethics, that they are likely to encounter in their careers. The accounting scandals of the 21st century have caused the public to criticize the ethical standards of the accounting profession. Accounting organizations have called for increased coverage of ethics in accounting curriculums. Yet, research shows that only minimal time is being spent on ethics in accounting courses. Numerous state boards of accountancy have adopted the 150-hour requirement to sit for the CPA exam; therefore making room for additional courses such as a separate accounting ethics course in the accounting curriculum. The National Association of State Boards of Accountancy's (NASBA) proposal to include a separate accounting course in the curriculum was not adopted by accounting educators. The authors still advocate that a separate accounting course in accounting ethics has merit. This paper discusses some of the challenges and opportunities surrounding the teaching of accounting ethics as part of the accounting curriculum.

Key Words: Accounting Education, Ethics

INTRODUCTION

The accounting scandals in the early 2000s have had a devastating effect on the reputation of the accounting profession. The public perceives the scandals as a lack of ethics in the profession. Who is to blame for this demise? Russell and Smith (2003) point their fingers at academia. They noted:

> *If we are looking for a primary contributing cause of corporate malfeasance at firms such as Enron, Equity Funding, WorldCom, Sunbeam, Arthur Andersen, and HealthSouth, we need to look no further than the classrooms of colleges and university accounting programs that have not significantly adapted their methods of*

> *instruction or approach to accounting and management education over the last 50-60 years* (p.1).

Since the Bedford Committee report was issued in 1986, the American Institute of Certified Public Accountants (AICPA), the American Accounting Association (AAA), the Accounting Education Change Commission (AECC), and the National Commission on Fraudulent Financial Reporting (NCFFR) have all called for increased ethics coverage in the classroom. Yet, even subsequent to the accounting scandals in the early 2000s, meaningful changes have not been made to incorporate ethics into the accounting curriculum (Blanthorne, Fisher & Kovar, 2007).

The National Association of State Boards of Accountancy (NASBA) made a proactive attempt to address the ongoing ethics deficiency in the accounting curriculum in its exposure draft of proposed changes to Rules 5-1 and 5-2 of the Uniform Accountancy Act. This exposure draft once again ignited discussion regarding ethics in the accounting curriculum and sparked much attention within the accounting profession, having received more responses than any other Uniform Accountancy Act exposure draft. A major proposal of the draft suggested that the 150-hour curriculum should emphasize ethical conduct and professional responsibilities of CPAs by requiring three credit hours of business ethics and three credit hours of accounting ethics. As a result of the comments received, the exposure draft was tabled by NASBA's Board of Directors and a task force was established to revisit alternative measures for consideration regarding the 150-hour education rules and exposure draft. After almost three years of discussion, the three additional hours of accounting ethics was not approved. While the draft received much criticism for imposing cost and restrictions on accounting programs, the cost of not increasing ethics in the accounting program may result in serious consequences for the profession.

Accounting programs should ensure that students have the rudimentary tools they need to succeed in the accounting profession. Accounting curricula, however, are being criticized for not focusing enough on values, ethics and integrity (Albrecht & Sack, 2000). Past incidents of unethical behavior in the accounting profession echo the need for ethics in accounting education. During the first few years of their careers, accountants can expect to face ethical challenges. How will they react if they have not been taught to handle such situations? Chan and Leung (2006) reported that students may have the ability to determine what is ethically right or wrong, but may fail to behave ethically due to an inability to identify ethical issues. Accounting educators must no longer argue that restrictions on programs, costs and the lack of resources prohibit a course in accounting ethics. Clearly, the most severe threat to the accounting profession deserves more attention (Bean & Bernardi, 2005).

Many accountancy programs continue to struggle with how to effectively include ethics into their curriculum. For instance, Blanthorne et al.'s (2007) study of accounting professors and their teaching of ethics reported that 98.1% favor its inclusion in at least some accounting courses. Although the favored approach was integration into other accounting courses, the time spent covering ethics was not optimal since it equated to less than one three-credit hour course (48 hours).

The concerns raised by accounting educators include who will teach ethics, how it will be taught, what topics should be covered and what teaching resources are available for use. The purpose of this paper is to examine some of the issues surrounding the teaching of ethics in accounting. We will explore who should teach accounting ethics and whether it should be taught as a single course or in multiple courses.

CHALLENGES SURROUNDING THE TEACHING OF ETHICS IN ACCOUNTING

The teaching of ethics in accounting often results in two areas of concerns: (1) Who should teach ethics? and (2) Should ethics be taught as a single course? We will explore these two challenges in this section.

Who Should Teach Ethics?

Questions have been raised by the academic community regarding who should teach ethics to accounting students. One school of thought suggests that accounting ethics be taught by accounting faculty. Callahan (1980) suggests that ethics can be effectively taught to accounting students if the instructor has knowledge of accounting and has personally experienced some of the ethical dilemmas facing accounting practitioners. This school of thought is closely aligned with the National Commission on Fraudulent Financial Reporting (NCFFR), also known as The Treadway Commission (1987), and the American Assembly of Collegiate School of Business' (AACSB) call for ethics to be taught in all accounting courses. Under the current mandates, all accounting instructors are responsible for covering accounting ethics in their respective accounting courses. AACSB's standards are flexible and ethics can be incorporated into existing courses or on a stand alone basis.

However, a major concern is whether accounting faculty can effectively teach ethics. Ethics is a subject that involves moral reasoning, moral development and moral issues. It is an area that is intertwined in the human actions of accountants but it is a subject that is very distinct from accounting. However, most accounting faculty who teach ethics in their courses do not have the necessary training to effectively teach this subject.. Additionally, anecdotal evidence suggests that there are only a few accounting faculty members who are interested in teaching accounting ethics. This lack of interest and lack of training among accounting faculty can result in minimal exposure to ethics in the individual accounting courses. Perhaps this is simply because professors are more comfortable focusing on their own areas of technical competence.

Faculty who are not adequately prepared to teach ethics will avoid the topic or only discuss it superficially (Owens, 1983). Cohen and Pant's (1989) survey of accounting department chairpersons at colleges and universities throughout the United States indicated that the respondents perceived that accounting faculty is relatively well qualified to teach ethics. On the other hand, a survey of accounting practitioners by Carver and King (1986) revealed that 52% of accounting practitioners do not believe that accounting faculty members are capable of addressing the ethical problems facing the accounting profession.

Another school of thought regarding who should teach ethics advocates that philosophers teach ethics to accounting students (Langenderfer and Rockness, 1989; Loeb, 1988; Klein, 1998; Lawson, 2002). Philosophers are trained in the subject matter and are interested in teaching it. The teaching of ethics to accounting students should involve more than just discussing ethical accounting cases and dilemmas. Klein (1998) argues that for any university or college to have anyone other than a philosopher as a "teacher of ethics would be nothing less than fraud" (p. 563). Also, if equal weight is given to the business discipline and to ethics, it would at best justify the need for a business faculty member to team-teach with a philosopher (Klein, 1998).

A team teaching approach would alleviate the weaknesses inherent in the individual disciplinary instruction. Philosophers are equipped to teach moral reasoning to students but not necessarily the ethical dilemmas facing the accounting profession. On the other hand, accounting faculty members are equipped to teach the ethical dilemmas of the accounting profession but not necessarily moral reasoning to the accounting students. This is the point of view of the accounting professors in the study by Blanthorne et al. (2007). In the absence of having faculty with major training in both areas, the most ideal format to use in teaching accounting students ethics is team teaching.

Team teaching would involve accounting students being taught ethics by a faculty member with major training in accounting and one with major training in ethics. This pedagogy broadens topic expertise and provides students with a better depiction of the cross-disciplinary professional environment. Although team teaching has been labeled as time consuming for faculty (May, 1980) and challenging to manage in a traditional university (Callahan, 1980), it has been effective in teaching business students (Ducoffe, Tromley & Tucker, 2006; Helms, Alvis & Willis, 2005; Loeb & Ostas, 2000; Wenger & Hornyak, 1999).

Furthermore, Lawson (2002) reported that 92.1% of the business faculty surveyed believed that ethics should be taught by a joint venture of schools and business. An effective teaching team would result in students not only being exposed to ethical situations facing accounting professionals but also obtaining moral reasoning skills to address these situations. Given the limited number of accounting faculty interested in teaching ethics, team teaching should be considered as a viable technique for teaching ethics to accounting students (Loeb, 1988). The university could provide monetary or other incentives to the team teachers to indicate its support for their efforts.

Should Ethics be taught as a Single Course?

Another controversy surrounding the teaching of ethics is whether it should be taught as a single course. This issue has long been debated. Over forty years ago, Grimstad (1964) questioned whether there was space to teach a separate course in accounting in a four-year curriculum. In the past, however, many educators were reluctant to expand ethics coverage due to lack of materials and a lack of space in an already full curriculum (Cohen & Pant, 1989; McNair & Milam, 1993; Tan & Chua, 2000).

Although the AACSB requires that ethics be covered in all accounting courses and the NCFFR Treadway Commission and the AAA Bedford Report have called for increased ethics in accounting curriculums, research shows that ethics coverage in accounting courses is minimal. Karnes and Sterner's (1988) survey of 281 accounting chairpersons revealed that only 8.5% of the schools realized the significant value of accounting ethics and had a separate course in accounting ethics. The remaining schools agreed that too little time was being spent on teaching accounting ethics in their programs but did not believe that a separate course in accounting ethics was needed.

Armstrong and Mintz's (1989) survey of 137 AACSB-accredited schools indicated that ten (7.3%) institutions had a separate course in accounting ethics. Nine of the institutions offered the course at the graduate level and the other institution offered the course to graduate and undergraduate accounting students. These results confirmed the prior study performed by Karnes and Sterner (1988)

Cohen and Pant's (1989) survey of 145 accounting department chairpersons revealed that only 40 percent of their schools offered a course in business ethics; only 18 percent of their schools required accounting students to take an ethics course; and among the schools that offered ethics as an elective, only 19 percent of the accounting majors chose to take the course.

Madison's (2001) survey of the 42 colleges and universities in the state of Ohio revealed how little time is being spent on teaching ethics. The researcher's findings ranged from a low of 0.90 average hours being spent on ethics in advanced financial accounting courses to a high of 2.24 average hours being spent on ethics in auditing courses. In total, students were exposed to an average of 9.55 hours of ethics in their entire undergraduate accounting program. This reveals that the time spent covering ethics in existing courses in the state of Ohio is insignificant.

A survey by Madison and Schmidt (2006) of 122 department chairpersons at the largest North American accountancy programs reveals that while ethics education has increased in the accounting curriculum, the chairpersons ideally want to apportion more time to ethics education. They further reported that more public institutions required a stand alone ethics course for accounting majors than private institutions (13.9% vs. 9.4%), and more non-accredited institutions required a stand alone ethics course than AACSB-accredited institutions (16.67 vs. 8.1%). A more recent study by Blanthorne et al. (2007) of accounting professors noted that while a large majority (95%) favored the inclusion of ethics in at least some standard accounting courses, only a minority (22.6%) favored a stand alone accounting ethics course. Furthermore, only a small minority (5%) actually teach such a stand alone accounting ethics course. Clearly, the opportunity exists to further increase the amount of accounting ethics coverage in colleges and universities especially in a stand alone ethics course.

A stand alone accounting ethics course in the accounting curriculum can have multiple benefits. It will ensure that a substantial amount of time is spent on accounting ethics. Also, it will expose students to a deeper conceptual framework of moral reasoning and potential ethical situations in accounting. As noted in Fisher et al. (2007), the accounting ethics course should deliver a common body of knowledge consistent with the university's mission; ensure that students have the opportunity to use the language of ethics, are sensitive to ethical issues and improve ethical reasoning skills. The course should also prepare them for the moral terrain of the practical workplace realities.

Lawson (2002) reports that faculty in five New York colleges and universities believe that teaching ethics will have a positive impact on students' ability to perceive ethical issues when making business decisions. Teaching accounting ethics, therefore, can benefit students, the accounting profession and society. Furthermore, it will ensure that accounting programs are not educating technically proficient but shallow graduates, a concern articulated in Low et al. (2008).

OPPORTUNITIES TO INCREASE THE TEACHING OF ETHICS IN ACCOUNTING

The accounting scandals in the early 2000s and the current financial crisis should serve as the catalyst for change in the teaching of ethics in the accounting curriculum. In addition, the implementation of the 150-hour requirement for membership by the AICPA clearly provides the opportunity for colleges and universities to add additional courses, such as a separate accounting ethics course, to the curriculum. Currently the 150-hour rule is in effect in forty-four states (including Washington D.C.) and becomes effective in three additional states at future dates. The AICPA has not established any course requirements but has suggested that accounting educators use these additional hours to prepare students with the core competencies needed to become qualified practitioners. These core competencies include non technical skills (such as ethics), knowledge and technology.

As a result of the need for increased ethics following the accounting scandals of the early 2000s, the AICPA and the AAA called for increased instructional materials in accounting ethics. Accordingly, the AAA and others have published collections of ethical accounting cases. The American Accounting Association's Professionalism and Ethics Committee has developed forums to enhance instructors' teaching skills and course materials to encourage the teaching of accounting ethics. Also, publishing companies have increased the ethics coverage in textbooks and ethics videos have been created for classroom viewing and discussion. To assist educators who are developing a separate accounting ethics course, Thomas (2004) presents an annotated bibliography of resources available for teaching accounting ethics in a post-Enron era. The listing of materials includes an arsenal of books, academic and professional articles, essays and websites.

Opportunities also exist for accounting organizations to emphasis the importance of ethics in the curriculum. Armstrong and Mintz (1989) suggested that if governing accounting organizations are serious about the need for increased ethics in the classroom, they should consider changing the current CPA exam and/or state ethics exams to force schools to recognize the significance of ethics. During the past years, very little ethics has been included on the CPA exams.

While 35 state accountancy boards require an ethics exam before licensing, these exams are take-home exams that are given separate from the CPA Exam.

Governing agencies should continue to stress the importance of this topic and accounting curriculums must be restructured in order to meet the needs of the profession. In order to do this, additional time needs to be devoted to teaching accounting ethics. The best way to devote more time to the subject is to make it the focus of a separate course in accounting. Of course, AACSB could assist in this matter by strengthening its standards to encourage (not mandate) the teaching of ethics in a stand alone course.

Armstrong (1993) argued that asking whether ethics should be taught as a separate course or integrated into existing courses is synonymous with asking whether writing skills should be taught in a separate course or integrated into existing courses. The researcher responded that the answer should not be 'either/or' but rather 'both/ and.' Armstrong's (1993) study of 26 senior accounting students taking a separate course in accounting ethics at a state supported university revealed that the course may be effective in raising the level of moral development in students beyond the natural level of expectancy.

Ethics must no longer be seen as a subject that can be taught by anyone and in any accounting subject. Yes, it should be covered in every accounting course but it should also have its own place and focus in the accounting curriculum. A separate ethics course will equip accounting students with the knowledge, skills and expertise they need to be successful in today's business environment. Accounting educators can no longer afford to educate technically proficient but shallow graduates since this would be a disservice to society (Low et al., 2008). Also, students need to be introduced to in-depth ethical situations before they enter the profession so that the profession can continue to meet society's expectations in the most professional and ethical way (Helps, 1994).

RECOMMENDATIONS FOR IMPROVEMENT

An educational reform is needed in accounting. The concern about the level of unethical behavior in the accounting profession reflects the need for accounting programs to effectively prepare accounting students to handle ethical dilemmas in their accounting careers.

So what can be done to address accounting ethics education? Clearly, any decision on teaching accounting ethics and its placement in the accounting curriculum must be made by business school deans and/or accounting department heads. In the meantime, the authors propose two solutions to fill this vacuum.

First, we believe that accounting ethics should be taught as a stand-alone course. The effectiveness of a separate accounting ethics course was confirmed by Klimek and Wenell (2009). The researchers' study revealed that accounting students who took a separate ethics course scored higher on a Defining Issues Test-2 than students who did not take a separate ethics course.

As noted earlier in the paper, the movement of most states to the 150 hour educational requirement provides an opportunity for universities to add a stand alone accounting ethics course into the curriculum. This will provide accounting students with the opportunity to further discuss ethics prior to sitting for the CPA exam or before applying for their CPA licensure (depending on the individual state's educational and licensing requirement).

Ideally, educational tools should be developed to assist accounting educators in developing the course content for stand alone ethics courses. The proposed course suggested in Williams and Elson (2009) could serve as a springboard for other educational tools. Also, the Big Four accounting firms have developed ethics cases and other resources for use by faculty interested in expanding the teaching of ethics to accounting majors

Second, we believe that team teaching should be adopted to effectively teach accounting ethics. Team teaching has pitfalls since universities might be challenged to find educators who are willing and experienced to use this teaching method. Also, many universities have budgetary challenges and educators are working at capacity and cannot take on additional responsibilities. This is certainly the case at the authors' universities. However, since team teaching will increase educators' teaching loads, universities could offer financial and other incentives to educators willing to experiment with this approach. Research has shown (Ducoffe et al, 2006; Helms et al, 2005, among others) that team teaching is a very effective approach for teaching business students. There are many subject matter experts within the university environment such as business law, accounting and philosophy professors. This gives universities a talented and cross discipline field from which to select educators to team teach the accounting ethics course.

CONCLUSION AND OPPORTUNITIES FOR FUTURE RESEARCH

This paper reviewed the literature surrounding the amount of ethics coverage in accounting curricula and identified some of the controversies surrounding the teaching of ethics in accounting. Based on the literature, we have also discussed the need for increased coverage of accounting ethics and offered a few solutions for improving the teaching of accounting ethics in the accounting curriculum.

In an attempt to mitigate unethical behavior in the accounting profession, Alder (2002) noted that academia must restore and strengthen required ethics courses that have been slowly disappearing from many business school programs. Instead of arguing about whether to have a separate ethics course or to integrate ethics discussion into every course, do both! Undoubtedly, when ethics is integrated into existing courses, it inevitably gets lost in other accounting material. If accounting ethics is important to the accounting profession, then it should also be the focus of a separate course.

Clearly future empirical research is needed in accounting ethics to confirm some of the authors' positions. Future research should include surveys of the pedagogical methods used by universities to teach ethics in accounting. Research should also solicit feedback from graduating accounting students, entry-level accountants and managers to evaluate their preparation in dealing with ethical issues in the workplace. Empirical testing should also be performed on the effectiveness of teaching ethics as a separate course and the effectiveness of using a team teacher approach.

The business world has changed; the role of the accountant has changed; and accounting curricula must also change in order to prepare students for their future careers in accounting. The accounting profession has emphasized a need for ethics in accounting education. Accordingly, academia has a responsibility to meet the changing needs of the accounting profession, just as the accounting profession has a responsibility to meet the changing needs of society. Accounting educators must face the realities of the professional world and seek to improve them. Gray et al, (1994) sums it all up by noting that if there are ethical failures in accounting practice it is therefore probable that at least some of the responsibility must be laid at the door of the educators.

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HOW STUDENT PERCEPTIONS OF ETHICS CAN LEAD TO FUTURE BUSINESS BEHAVIOR

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ABSTRACT

Unethical business behavior of many "white collar" business professionals has made major headlines over the past years. One recent example is the misuse of funds on Wall Street such as the massive bonuses paid to employees of American Insurance Group (AIG). This and other ethical dilemmas are being discussed by teachers, parents, employers, and peers of students enrolled in business schools across the country. Opinions abound as to the ethics and morality of those involved. In fact, these very individuals who participate in misconduct have children that will most likely emulate their actions. What is the perception of students enrolled in business schools regarding this type of behavior and other ethical situations that arise? Can these students be influenced in a positive direction so that they can go into the business world with values that are "above reproach" and admirable by those whom they lead. The purpose of this paper is to conduct an analysis of three years of surveys from the Wall Street Journal Ethics Quiz that were given to business students at a small, southeastern public university. An analysis is then made as to whether or not those students' perceptions of sensitive ethical dilemmas have changed over time.

INTRODUCTION AND LITERATURE REVIEW

Of recent interest is the highly debated situation of American Insurance Group (AIG) and the $165 million in executive bonuses, mostly paid to London traders who created the massive losses that resulted in government bailout money of $170 billion given to AIG. Were the AIG bonuses "legal"? In reality the bonuses were only one tenth of one percent of the total bailout amount. Additionally, AIG claimed they were contractually obligated to pay the bonuses. A government mistake was that there was no consideration of the possibility of bonus payouts in the structuring of the bailout terms by Treasury Secretary, Tim Geithner. Therefore, the AIG bonuses were contractual and legal. However, the question arises as to how ethical the bonuses were, and should there be some obligation on the part of the recipients to repay the money (Reed, 2009)?

Our laws are a starting point for ethical conduct and are implemented in order for society to avoid extreme situations. In other words, obvious unethical behavior is any behavior that is illegal or blatant (offensive) misconduct (Kullberg, 1988). The question then arises as to "Is any type of behavior 'ethical' as long as it does not violate a law or a rule of one's profession" (Whittington-Pany, 2004)?

The word "ethics" is derived from the Greek word, *ethos*, meaning "customs", "conduct", or "character" (Northouse, 2007). For a formal definition of ethics, *Webster's New World Dictionary* (1995) defines the term as "the study of standards of conduct and moral judgment". Ethics are important to individuals because we are concerned with what leaders do and who they are—their conduct and character. Numerous theories exist as to how followers are motivated to follow their leader/employer. Teleological theories are those that stress the consequences of a leader's conduct, and they come from the Greek word "telos" meaning ends or purposes. When looking at consequences, two types of theories occur. The first type is Ethical Egoism and deals with an individual choosing an outcome that produces the greatest good for themselves, perhaps receiving a promotion if their division excels. The second type of teleological theory is Utilitarianism, which states that a leader will behave in a manner to create the greatest good for the greatest number of people. An example is when a part of a federal budget is allocated to preventing an illness through immunizations rather than all to a catastrophic illness. Close to Utilitarianism is Altruism, which is almost a total concern for others, such as was the case with Mother Teresa (Northouse, 2007).

These theories emphasize the consequences of the leader's behavior. In analyzing the actions of the AIG management, they acted in accordance with their self-interest, defined by Ethical Egoism, which falls under the teleological theory. The other subcategory to Teleological Theory was Utilitarianism, ultimately meaning to help the most people (Northouse, 2007). Under this method, management should have acted in a way to maximize "social benefits". In the AIG case, this did not occur as the consequences of the mismanagement of AIG were that people's jobs, investments, and security were affected by the decision making of management and traders receiving the bonus money.

As for conduct, there is a second category of theory that relates to "duty" and the actions of the persons. These theories are called Deontological Theories, which imply that the leader has a moral responsibility and obligation to do the right thing and should not infringe on the rights of others (Northouse, 2007). Clearly, the actions taken by AIG infringed on the rights of others by using taxpayer money for their personal use when it was not justified. While it is "right" to reward people for achievement and even preventing losses, it clearly "seems" wrong to reward people for incurring losses!

Various "model" business organizations gave their definition of ethics. The pharmaceutical company, Eli Lilly Company contends that to act ethically means: "No Lilly employees should do anything, or be expected to take any action that they would be ashamed to explain to their family or friends." Eastman Kodak, the manufacturer of cameras and film says that ethics is a policy by Kodak "which emphasizes that Kodak's business practices throughout the world are to be conducted in a manner which is above reproach." A manufacturer of aeronautical equipment, General Dynamics, defines ethics according to their ethics vice president as "telling the truth and being fair and doing no voluntary harm." One should not allow themselves to get into a position that compromises his/her judgment, such as when a supplier takes a buyer to lunch. EDS (Electronic Data Systems), the manufacturer of software asks "Would we want to do business with ourselves" (Abend, 1988)? Our definition of ethics is a system of morals which guides the behavior of an individual when confronted with doing right or wrong. If a person were put in a situation in which right and wrong were a bit unclear, how would they react, or which of several alternatives would they choose?

METHODOLOGY

This idea is the premise for this paper. How student perceptions of ethics lead to future business behavior? To help answer this question the authors used a sixteen question ethics quiz from *The Wall Street Journal* to survey business students in their spring classes at a small, southeastern, public university during spring 2006, 2008, and 2009. The questions ranged from giving and receiving gifts from clients/suppliers to usage of business supplies and internet while at work. Many people agree that personal ethics may vary or change from one individual to another, and most within society agree on what is generally ethical or unethical. However, the "grey" areas are most difficult to decide. Many of the questions asked in this survey are "grey" areas in which there is no clear cut right or wrong answer. Some may be answered by knowing the ethic's policy of the company involved, while others rely on the moral character of the individual making the decision. Nonetheless, these questions provide the opportunity to evaluate the students' perceptions of ethical issues as they are confronted with business ethical dilemmas.

From a captive population of 193 students, 157 responses were collected in spring 2009, providing a rate of return of 81.3%. These were measured against previous samples taken in 2006 and 2008. Additionally, the students were informed about the purpose of the study, and the voluntary nature of their participation. Proper research procedures were applied to assure the students' anonymity, the privacy of the information, and to avoid duplication in participation. Classificatory questions were used to be able to evaluate potential differences between the participants.

FINDINGS OF THE STUDY

Table I indicates the sample characteristics of the participants over the three year time frame. In regard to gender differences, there were similarities in the mix between the 2006 and 2008 data; however, the 2009 data indicates an increase in the female population. No conclusive explanation can be given for this increase without other data. The increase in the freshman population in spring 2009 is a result of one of the authors teaching two sections of an introductory to business class which was an elective for freshman. The authors chose to include the freshman class in order to progressively follow these students over their academic careers. The significant increase in the junior population in spring 2009 is deemed to be a result of the larger sophomore class of spring

2008 advancing. The decrease in the senior population of spring 2009 is indicative of the junior class of spring 2008 advancing. Without the 2007 demographic data, the analysis is incomplete; however, the lower enrollment in the junior class of 2008 could be a result of an increase in the SAT requirements for admission to this university which were implemented during that time frame and lowered in the following year. In regard to demographics concerning concentration, the "other" category resulted again as a consequence of one of the authors teaching the elective introductory to business course during that time.

Table I: Sample characteristics

Description	Gender			Classification			Concentration		
	Sp06	Sp08	Sp09	Sp06	Sp08	Sp09	Sp06	Sp08	Sp09
Male		54%	53%	48%					
Female	46%	47%	52%						
Freshmen				1%	4%	10%			
Sophomore				18%	26%	15%			
Junior				30%	15%	31%			
Senior				51%	55%	45%			
Accounting							16%	14%	18%
Economics/Finance							5%	7%	6%
Health Care Mgmt							15%	17%	21%
Mgmt/Mkt							64%	52%	45%
Other								10%	9%

Table 2: Student Responses

Questions	Sp06	Sp08	Sp09
	Answered Yes		
1. Is it wrong to use company e-mail for personal reasons?	55%	58%	51%
2. Is it wrong to use office equip. to help children or spouse to do schoolwork?	53%	61%	64%*
3. Is it wrong to play computer games on office equipment during the workday?	81%	85%	89%
4. Is it wrong to use office equipment to do internet shopping?	81%	82%	82%
5. Is it unethical to blame an error you made on a technological glitch?	83%	74%*	78%
6. Is it unethical to visit pornographic web sites using office equipment?	98%	97%	99%

7. What's the value at which a gift from a supplier or client becomes troubling? $25.00	20%	33%	47%
$50.00	24%	32%	44%
$100.00	15%**	38%	47%
8. Is a $50.00 gift to a boss unacceptable?	33%	43% *	40%
9. Is a $50.00 gift from the boss unacceptable?	23%	34% *	27%
10. Of gifts from suppliers: Is it OK to take a $200 pair of football tickets?	59%	44% *	42%*
11. Is it OK to take a $120 pair of theater tickets?	59%	47% *	41%*
12. Is it OK to take a $100 holiday food basket?	68%	55% *	56%*
13. Is it OK to take a $25 gift certificate?	83%	72% *	85%**
14. Can you accept a $75 prize won at a raffle at a supplier's conference?	95%	93%	92%
15. Due to on-the-job pressure, have you ever abused or lied about sick days?	45%	38%	53%**
16. Due to otj pressure, have you taken credit for someone else's work or idea?	6%	7%	4%
* significance difference from spring, 2006, .05 alpha			
** significance difference from spring, 2008, .05 alpha	n=197	n=138	n=157

Table 2 shows the responses of the students with regard to their answers to the ethics quiz. There is no significant difference between the students surveyed in 2006, 2008, and 2009 regarding items pertaining to internet usage and technology, with the exception of question number two and five. The percentage of respondents from 2009 was significantly different from those in 2006 regarding the use of office equipment in helping family members do homework. The 2009 students had a higher ethical view regarding using equipment in this way. The answer to question five favored the students who took the survey in 2006. The responses indicate a significant difference between 2006 and 2008 students. This was the only question that ethically favored the 2006 students. However, there were seven questions that had a significant difference in ethical responses regarding vendor, client, and employer relationships, which are items that are strenuously taught within the courses of the Department of Business. Fifteen percent of the 2009 students believe a gift of $25 was troublesome as compared to 24% for 2008 students. This difference in percentages was significant at the .05 level. The students surveyed in 2008 showed a significant difference from 2006 students in questions 8-13. The 2009 students showed a significant difference from 2006 students in questions 10-12. There was a significant difference in both receiving and giving gifts to a boss and receiving gifts from vendors. In comparison with 2006 students, those students surveyed in 2008 had higher ethical standards regarding giving a $50 gift to their boss, as well as receiving a $50 gift from their boss. Also, the 2008 students received significantly higher responses regarding receiving various gifts from vendors such as football tickets, theater tickets, holiday food baskets, and gift certificates.

Regarding questions 10-12, the 2009 students' responses along with the 2008 students' responses were significantly different from 2006 students. For question 13, the 2008 students' responses were significantly different from both 2006 and 2009. The 2008 students gave a more ethical response than both 2006 and 2009. Also, the percentages of 2009 students regarding the abuse or lying about sick days was significantly different than 2008. The 2008 students' responses were much more ethical regarding this issue. However, in question 14, "Can you accept a $75 prize won at a raffle at a supplier's conference?" the percentage is still high for all three groups, 95% for 2006, 93% for 2008, and 92% for 2009, indicating that the majority of the students believe this type of prize is acceptable.

The comparison of these three data sets indicate that the 2008 students are more aware of certain ethical issues, especially those associated with vendor, client, and employer relationships. However, the 2009 student surveys indicate a rather mixed result with some questions favoring ethical choices, while other questions actually having significant differences leaning in the other direction. One reason the results were mixed in 2009 may be due to the fact that a larger percentage of freshmen and a smaller percentage of seniors were included in the 2009 sample as compared to both 2006 and 2008. Also, the authors acknowledge the variation among students from semester to semester and year to year. Nevertheless, the authors believe that student ethical perception improves as a result of emphasizing ethics in business classes and the interaction that these students may have with their teachers (leaders).

In addition, in the analysis of Table II, it is noted that questions one through six are "technology" related questions while questions seven through fourteen pertain to accepting or giving gifts to clients, employers, or employees. The remaining two questions, numbers 15 and 16, are personal, virtue related questions. These last two questions would pertain more to an individual's character, while the first fourteen questions could be easily answered simply by knowing the employer's requirements for employees working in that environment. For example, a local accounting firm will not allow employees to use company computers for personal use. If they do so, they are immediately terminated. The purpose behind their decision to have this requirement is that the accounting firm does not want any compromise of the confidential information of their clients. Therefore, if this were the case, the students would answer "Yes" to the first six questions.

With the exceptions of question one "Is it wrong to use company e-mail for personal reasons?" and question five "Is it unethical to blame an error you made on a technological glitch?" all of the responses to the technology related questions increased, indicating a positive increase in ethical perceptions of students in this area. This increase could be attributed to the fact that a week of ethics was taught in one of the author's classes with many of these questions being discussed extensively. Additionally, ethics is an accreditation related goal for the department of business within this university and is discussed in other business classes with simulation questions administered as an assessment tool. The decline in the response to the e-mail question could be attributed to the fact that e-mail is a routinely used tool among students and checking its use is a normal activity during their day. The other questions relate more to office equipment and work-related incidences of which many of them have little or no current knowledge.

In an analysis of questions seven through fourteen, the authors again contend that information pertaining to company policies needs to be addressed. Since various companies have different standards on what constitutes an ethical violation, the employee needs to be certain that they fully understand company guidelines. In examining the concept of ethics within the work environment, one must realize that the dilemma of unethical behavior arises from relationships between individuals. In general, the "welfare" of an individual, and consequently, the work environment, is generally affected by an ethical choice being made. The business issues involved in these questions involve questions such as the value that a gift to or from an employee is considered unacceptable, as well questions of acceptability of gifts from suppliers. Even having a business lunch with a supplier could be a conflict of "independence" (Whittington-Pany, 2004).

Pertaining to the idea of "independence", which is avoiding a conflict of interest with another party, the author remembers a conversation with a business student who contended that his company would not even allow them to have a cup of coffee with a supplier, yet in many public relations departments, dining with a supplier is standard procedure. With that knowledge in mind, further analysis of these questions follow. Question seven is of much interest and reads "What is the value at which a gift from a supplier or client becomes troubling?" Choices were $25, $50, and $100 and at every year, the students indicated the $100 amount was most troubling. Clearly, if receiving a $100 gift from a supplier or client were troubling to this sampling of students, one could assume the significant amount of bonus money paid out would be even more disturbing to them.

Question eight and nine involve giving and receiving gifts to an employer. Both indicate an increase in ethical perception from spring 2006 until spring 2008, indicative of an increased awareness by the students which is hopefully attributable to increased teaching of ethics within the department. However, there is a decrease from spring 2008 until spring 2009 of 43% to 40% for question eight of giving a $50 gift to a boss and a decrease of 34% to 27% of receiving a $50 gift from a boss. A plausible explanation for this decrease could be that the $50.00 amount does not appear significant to the students. If this amount were increased, the author believes the responses would increase.

Questions 10-14 pertain to receiving gifts from suppliers. The wording of the questions asks if it is "OK" to receive these varying gifts, which range from a $200 pair of football tickets to a $25 gift certificate. The higher the response, the perception is that the students consider the gift to be acceptable. The highest responses were in spring 2006, indicating that students in 2008 and 2009 have been made more aware of ethical situations and what may or may not be acceptable. The differences in the answers between spring 2008 and 2009 are minimal. However, of interest in the analysis of these responses is that question 13 "Is it OK to take a $25 gift certificate?" has a higher response rate range of 72% in 2008 to 85% in 2009, indicating to the authors that this marginal dollar amount is not considered of great value to the students, thereby making it "OK" to accept. Additionally, the fact that the acceptance is a gift certificate rather than cash may not be viewed as a “bribe” by the students, which is the issue behind accepting any amount from a supplier. Likewise, question 14 reads “Can you accept a $75 prize won at a raffle at a supplier’s conference?” Although the response decreased from 95% in 2006 to 92% in 2009, this percentage still indicates a strong acceptance by the students. Raffles are not uncommon at conferences, and even the authors contend that the acceptance of a prize in this context would not constitute a bribe.

Questions 15 and 16 are indicative of an individual’s character. These questions were:”Due to on the job pressure, have you ever abused or lied about sick days?” and “Due to on the job pressure, have you ever taken credit for someone else’s work or idea?” It is interesting to note that with the first question there was a significant percentage increase from 2008 to 2009, from 38% to 53%, with spring 2006 falling between the two at 45%. A possible conclusion could be drawn as to the “truthfulness” or “honesty” of the spring 2009 students as 83 of 157 students answered “yes” to this question. The answer to question sixteen remained low within three percentage points between the higher (2008) and lower (2009) levels of the range. In fact only 6 of 157 students responded “yes” to this question in 2009, giving a 4% response compared to 6% in 2006 and 7% in 2008. Clearly, the ethical perceptions of students appeared to increase overall from 2006 to 2009, which is a positive premise in terms of future business leaders.

In analyzing the changes in responses from 2006 until 2009, the question arises as to whether or not this increase in positive responses means that it is possible to change and mold a person’s values over a period of time before those individuals become leaders in a corporation? Virtue Based Theories stress a person’s character and are elements of who a person is and his/her disposition. Based on the writing of Aristotle, these virtues are courage, temperance, generosity, self-control, sociability, modesty, fairness, and justice (Velasquez, 1992). At one time it was believed that these characteristics were innate; however, it is now believed that they can be learned (Kullberg, 1988). So, do leaders in education have an effect on students to mold and shape these values and consequently have an effect on future business leaders? Obviously the “leaders” within an educational environment are the teachers and administration. Are teachers influencing students in a positive way?

CONCLUSION

The progression of responses indicated that “yes”, ethics can be taught, and that instructors have an impact on the ethical values that students carry with them into the business world. Callahan (1982), questions the fact that perhaps there should be a “Code of Ethics” within higher education because of various poor teaching practices. He elaborates by emphasizing that “there are a few hundred thousand teachers in higher education, a few thousand different types of colleges and universities, and the fact that just about any and all kinds of human beings teach” (Callahan, 1982).

Ethical leadership is essential in organizations such as AIG, and that leadership is ultimately provided by universities such as the one surveyed. As professors at the college level, the authors are constantly striving to teach ethical values, which have been learned from family, peers, education, professional experience, and religious instruction. The concept of ethics continues to evolve over time. Theories in literature that support ethical leadership include one theory by Heifetz (1994), which advocates that a person must use authority to influence their people through conflicts and rapid change. The leader provides an environment in which followers feel trust and empathy. It is part of ethical theory because of the emphasis that is placed on the values of the worker, not because of the authoritative nature of the leader. James MacGregor Burns (1978) in his theory of Transformational Leadership attempts to motivate leaders to strive for higher standards of moral responsibility by emphasizing a follower's needs, values, and morals. Burns' theory is closely associated with Servant Leadership Theory by Robert Greenleaf (1970), which stresses even more emphasis on the needs of followers. Leaders under the Servant Leadership Theory should nurture followers and empathize with them. The followers would then be motivated by viewing the leader as a role model through his/her becoming a servant (Northouse, 2007). According to Stanley (2008), leaders who have ethical values which are irreproachable will motivate followers.

Will ethical leadership prevail within AIG, and what is to be done about the bonus money? Democratic Senator Chuck Schumer of New York has suggested that if the bonuses are not voluntarily returned, then they will be "taxed" back by Congress. However, a citizen named John Reed, in his writing of an internet commentary in 2009, indicated that this "taxing back" of the bonuses violates the Fifth Amendment which states that private property cannot be taken without just compensation. One could argue, though, that this "property" was initially public property that never should have been distributed to those private individuals in question. Another argument by Mr. Reed is that this "taxing back" could be considered a "bill of attainder" which is a law that declares someone guilty of a crime without benefit of trial. This bill of attainder would be considered unconstitutional under Article 1, Section 9, and Clause 3 of the United States Constitution. If he is, indeed, correct, then the money could not be taxed back (Reed, 2009).

Well, should the individuals who received the money feel an obligation to repay it? With this in mind, perhaps appealing to the morality of those involved would be the best approach to receiving back the money. In truth, 15 of 20 of the top bonus recipients did agree to return $50 million in bonuses. However, it seems unlikely that all of this money will be returned voluntarily as $80 million was paid to non Americans and is now out of jurisdiction (Clifford, 2009). Despite this fact, good may have come from the mistake of not providing specifications for the use of the bailout money in that the Federal government will be more careful with the terms of the agreement next time money is given out. The reality is that the public has not heard "the rest of the story", as the late radio commentator Paul Harvey would say. Perhaps interviews with some of these individuals would bring "to light" more understanding of the situation and the opinions of those receiving the bonus money.

Gino (2008) discussed how ethical lapses occur during negotiations because of stereotyping and giving favoritism to these within the same group as the individual or group granting the favor. This idea was paramount in the analysis of the student's perceptions in the *Wall Street Journal Quiz,* particularly in questions seven through fourteen involving the giving and receiving of money, gifts, and raffles. Avoiding any appearance of a "conflict of interest" between parties is necessary to obtain credibility within the business world. Perhaps this stereotyping occurred in the granting of the bailout money as the majority of those in government and business are generally "powerful" male figures. Gino further notes the idea that in negotiations, conflicts of interest are particularly ignored in the roles of law and banking, especially when audits are conducted. As she indicates "the most well-intentioned negotiators routinely and unconsciously commit ethical lapses and tolerate such lapses in others." In her article, she also mentions a Harvard Business School professor named Max Bazerman who contends that "Few professionals consciously set out to violate the law or their own moral standards." Additionally, he insists that structural changes must occur within organizations to further eliminate the chances of ethical lapses occurring (Gino, 2008).

As an educator striving to improve ethical perceptions among students, what are some suggestions for organizations and business departments for stressing ethics and enacting structural changes that can be lasting? Stanley (2008) gives suggestions in his article *Ethics in Action* as to implementing structural changes within in an organization. They are:

1) Adhere to a standard of conduct and be professional in one's actions at all time—which includes the appearance of being ethical.
2) Train employees properly and continue to reinforce that training through coaching of ethics.
3) Keep ethics policies simple and easy to understand—employees will appreciate that.
4) Be viewed as ethical, meaning a firm's actions must be ethical—not just words.
5) Provide a professional service, yet be fair and reasonable in transactions and pricing.
6) Recognize that even the best leaders at times will make mistakes—allow a second chance for individuals that inadvertently made an error.
7) Be honest, as this is essential in establishing a framework for business ethics.
8) Recognize that some business organizations are going to be unethical, and those practices should be questioned. If those unethical practices continue, the popular movement is to regulate the most "mundane" transactions.
9) Publish ethical business practices to act as a guide to others.
10) Maintain the emotional health of employees as it keeps them ethical. Unethical behavior is "highly stressful"

The above ten structural suggestions for businesses such as AIG can be useful within the classroom as well. Progressive teaching of ethics within departments of business and giving examples of poor ethical decisions such as the AIG bonus situation as a teaching tool enlightens students to the business world they are about to enter. As Stanley (2008), indicated, "an ethical person will not lie, cheat, steal, or tolerate anyone who does." Enhancing students' perceptions in these areas will go far in producing a more ethical business environment.

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