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FORGIVE US OUR DEBTS: THE GREAT RECESSION OF 2008-09

Thomas N. Edmonds, Western Michigan University
Leo J. Stevenson, Western Michigan University
Judith Swisher, Western Michigan University

ABSTRACT

This research analyzes bankruptcies, mortgages past due and foreclosures from 1999 – 2009 and finds that bankruptcy filings, mortgages past due, and foreclosures are all positively related to the unemployment rate and negatively related to the change in housing values. Results show that borrowers seek bankruptcy protection at greater rates in states with stronger lender garnishment laws and that states with shorter foreclosure timelines see higher rates of bankruptcy filings. Evidence also suggests that some borrowers engage in strategic default. After controlling for other variables, bankruptcy rates are lower in states in which a strong incentive to default strategically exists.

Key Words: bankruptcy, unemployment, mortgage foreclosure, mortgage default, strategic default.

INTRODUCTION

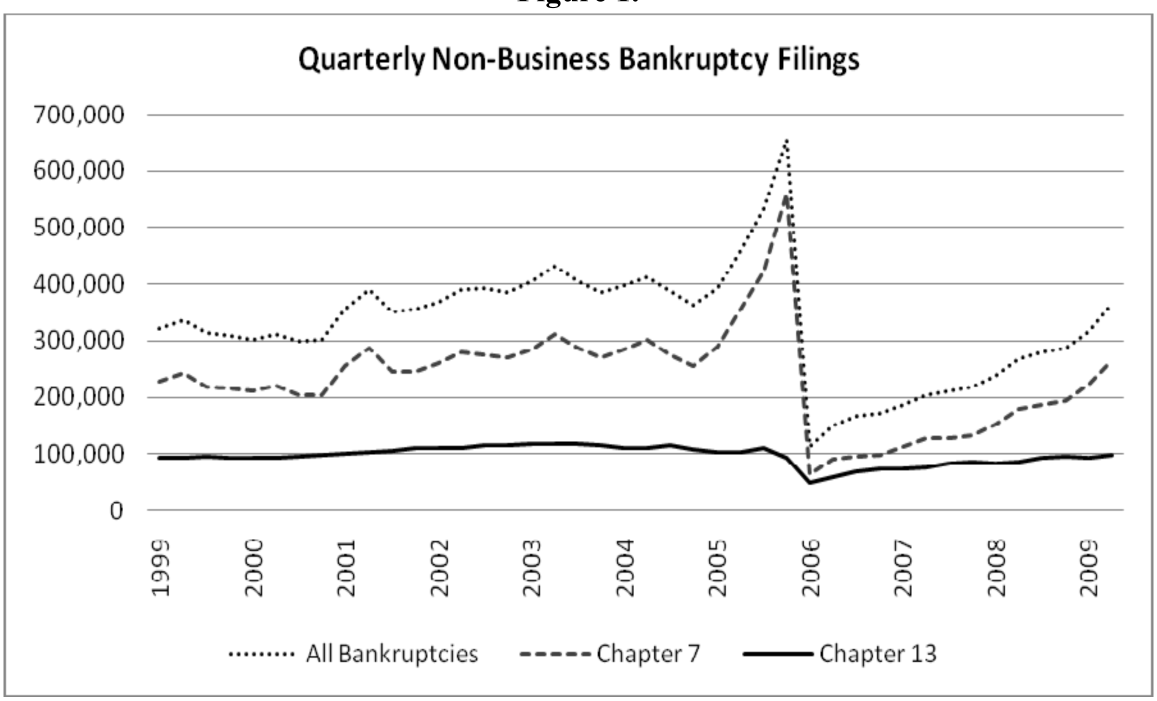
The Great Recession of 2008-09 has taken a toll on American households. The economic turmoil, which included a loss in investment and retirement wealth, falling housing values, and widespread job loss, has led to an increase in personal bankruptcy filings. The New York Times reported that in March 2010 there were 158,000 personal bankruptcy filings, the largest monthly number since the Bankruptcy Abuse and Consumer Protection Act of 2005 took effect on October 20, 2005 (Wilson, 2010). In addition, mortgage delinquencies and foreclosures have reached new highs according to the Mortgage Bankers Association (Kemp, 2010). Strategic defaults, in which underwater homeowners who can afford to make their mortgage payments default by choice, have generated heated debate in both the popular press and in academia (see, for example, Lowenstein, 2010; Haggerty and Timiraos, 2009; White, 2010).

The increasingly common failure of consumers to fulfill financial contracts is an indication of the difficult financial situations in which they find themselves. Widespread mortgage defaults put downward pressure on housing values, further exacerbating the problem and creating a downward spiral. The ramifications of widespread default and bankruptcy for our financial system are serious at another level as well. Lenders are facing losses, leading to lower stock prices for financial institutions. Loans that were securitized are generating losses for pension funds and other investors. The resulting weak consumer confidence leads to lower consumer spending and concern about a possible double dip recession (Mackenzie, 2010). Thus both the social and the economic implications of widespread bankruptcy and default are important. Our research examines bankruptcies and foreclosures in light of the economic stress associated with the Great Recession of 2008-09. Our analysis also sheds some light on strategic default.

US CONSUMER BANKRUPTCY

Historically, US law has taken the perspective that bankruptcy provides a fresh start to a debtor who, because of bad luck or unfortunate circumstances, is unable to meet his financial obligations. The US Bankruptcy Code allows for two main forms of consumer bankruptcy, Chapter 7 and Chapter 13. Under Chapter 7, most prior debts can be discharged without a commitment to repay from future earnings, provided the debtor relinquishes all non-exempt assets. Chapter 13 requires a filer to repay a portion of his debts over a set period (generally five years) in exchange for retaining non-exempt assets. Under Chapter 7, filers can choose either federal or state law to determine the allowable homestead exemption. The federal exemption is $15,000, but state exemptions vary greatly from zero to the unlimited exemptions of Florida and Texas.

Figure 1.



Source: US Courts Bankruptcy Statistics

Following an increase in the number of consumer bankruptcy filings, the Bankruptcy Abuse and Consumer Protection Act of 2005 raised the fees to file, imposed credit counseling on most filers, and added the requirement that Chapter 7 filers satisfy an income test. To file Chapter 7 after implementation of the 2005 Act, a debtor must generally have income less than the median in his state, considering household size. The intent of the 2005 Act was to prevent abuse of the bankruptcy process by debtors who have the ability to repay but choose not to do so.

Figure 1 shows that Chapter 7 has traditionally been favored over Chapter 13 among filers, with Chapter 7 filings making up around 70% of total non-business filings prior to 2005. Following the April 20, 2005 passage of the 2005 Act, both the number and the portion of Chapter 7 filings surged, peaking in the fourth quarter of 2005 at 560,654 filings or 86% of the total, as consumers rushed to file prior to the October 20, 2005 implementation of the Act. In 2006, both the number and the portion of Chapter 7 filings fell, in part because the rush of filers in 2005 essentially "borrowed" from those who would otherwise have filed in 2006. Since then, the number of bankruptcy filings has increased steadily, and the portion of Chapter 7 filings relative to total filings has also risen. In 2009, the number of Chapter 7 filings again exceeded 70% of total filings.

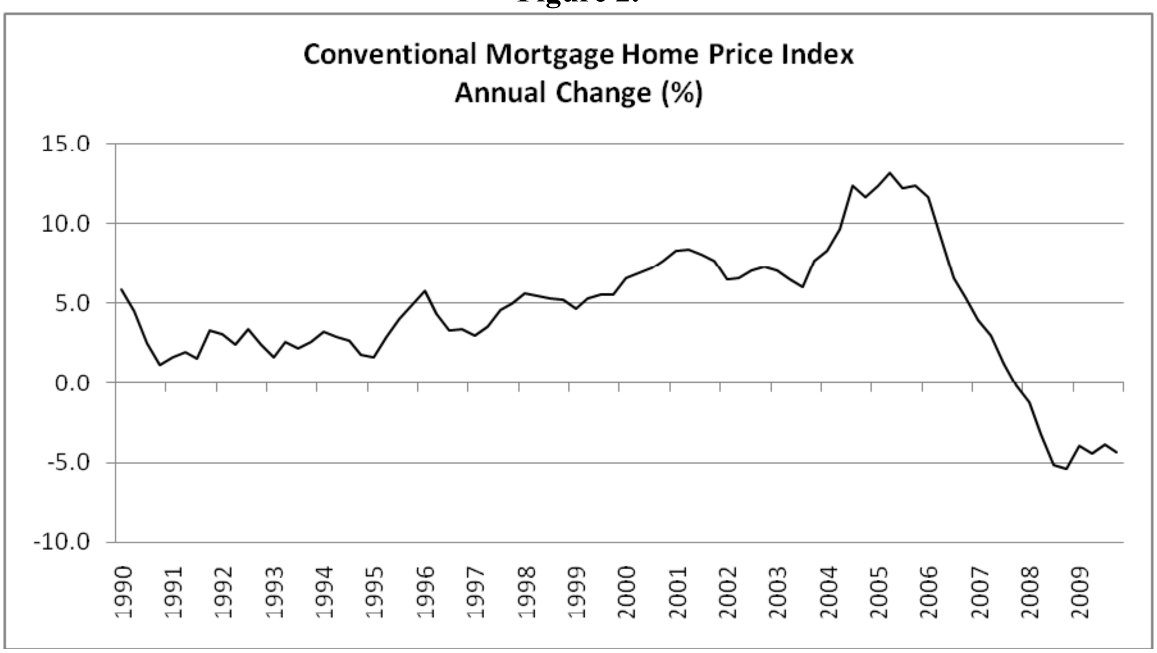
Factors that affect bankruptcy filings have been studied by researchers. Lefgren and McIntyre (2009) use zip-code-level bankruptcy data to study the differences in bankruptcy patterns across states. They find that differences in allowed exemption levels and garnishment restrictions are significant in explaining some of the variation across states. Their results also suggest that age plays a role. Individuals in their late 20's are most likely to file, while those between ages 30 and 49 are least likely to file bankruptcy.

HOME VALUES, MORTGAGES PAST DUE, AND FORECLOSURES

Zillow.com reports that 23.3% of single-family homes with mortgages have negative equity (Paoli, 2010). Borrowers who are underwater on their mortgages are often trapped in their homes and unable to sell them. Archer and Smith (2010) study a sample of mortgages from 20 counties in Florida and argue that borrowers are making a rational choice to default and "put" the house to the lender if the equity is zero or negative. They find evidence that "euphoria" can exist among buyers much like the "irrational exuberance" in the stock market that Alan Greenspan referenced. Their results also suggest the recent increase in defaults could be attributed in part to weaker underwriting standards due to lender "euphoria." Archer and Smith conclude that when recent market performance has been strong, both buyers and lenders tend to extrapolate that performance into the future and take on more risk as a result. Kohn and Bryant (2010) study the housing market and find evidence consistent with the idea of "euphoria". They conclude that both borrowers and lenders played a role in fueling the housing bubble.

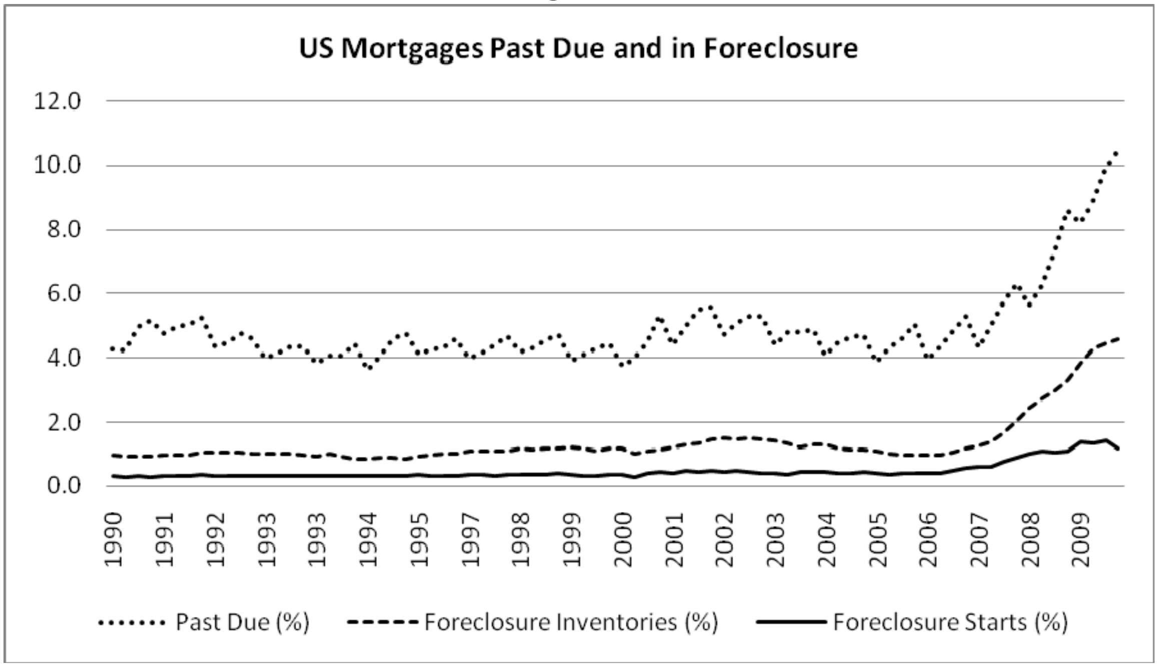
The large decline in housing values has contributed to the financial problems facing consumers. The drop in home values is unprecedented in recent history in terms of its depth and breadth. Housing values hit a low in March 2009, at about the level of 2003 values (Boesel, 2009). From the peak in April 2006 to the trough, the drop in values nationally was about 34%. Figure 2 shows the change in housing values based on Freddie Mac's Conventional Mortgage Home Price Index (CMHPI). The drop in housing values reached over 5% annually on a national basis during the last half of 2008. For some states and regions, the fall in housing values has been much more extreme. In September 2009, Nevada showed a year-over-year drop in housing values of 25.5% based on an index constructed by First American Core Logic (August 19, 2009). Other regions suffered similar declines in home values. The Case-Shiller home price indices for 2007 reflect year-over-year declines in 17 of 20 major metropolitan areas, with double digit declines in 8 areas (Associated Press, 2008). While one quarter or one year drops are significant, the cumulative effect can be devastating for the home owner with drops over several years approaching a 50% decline in some areas. Such large drops in housing values could easily wipe out the owner's entire equity, plus some. Thus, falling housing values added to the financial distress of American consumers who are also suffering from job losses, pay cuts, and forced furlough days (Belkin, 2009).

Figure 2.



Source: Freddie Mac

Figure 3.



Source: Mortgage Bankers Association

Guiso, Sapienza, and Zingales (2009) conduct a survey that studies borrowers' attitudes toward default. Their results suggest that 26% of current defaults are "strategic" rather than a result of the borrower's inability to repay. They find that no borrowers would default due to an equity shortfall of 10% or less. They also find that the propensity to strategically default increases at an increasing rate 1) as the size of the negative equity grows, and 2) with a higher frequency of foreclosures in the area. Their results also suggest that in areas where defaults are common, the social stigma associated with default is reduced. Figure 3 shows the percentage of mortgages in foreclosure across the US has surged since 2007.

Ghent and Kudlyak (2010) study the factors that play a role in the decisions of borrowers to default. They argue that a state's time line to foreclosure and garnishment restrictions should affect mortgage defaults. When the foreclosure process of a state involves a longer timeline to foreclosure, borrowers benefit in that they effectively receive free rent for that time period. They argue that states that allow greater levels of garnishment should have fewer defaults, since borrowers would anticipate less benefit from default. Ghent and Kudlyak analyze individual mortgage level data and find that in states with no lender recourse, the probability of default is higher than in recourse states. Their analysis controls for state unemployment levels.

UNEMPLOYMENT

As a result of the Great Recession, consumers have been hit with layoffs, furloughs, pay cuts, and job losses (Goodman and Healy, 2009; Rampell, 2009). Unemployment surged during 2008 and 2009 and remains stubbornly high in spite of government efforts to stimulate the economy (see Figure 4). In a June 2 economic release, the US Bureau of Labor Statistics reports that the number of long-term unemployed (jobless for 27 weeks or longer) was unchanged in May 2010 at 6.8 million people, or 46.0% of all unemployed. As has been the case with recent recessions, unemployment continued to increase following the end of the Great Recession. Companies remain reluctant to hire new workers until there is strong evidence of persistent growth (Reich, 2010; Wessel, 2010). Smith (2010) reports that bankruptcy filings surged 14% during the first half of 2010. The prolonged financial stress under which consumers find themselves suggests that foreclosures and bankruptcies will continue to rise due to the inability of consumers to meet their financial obligations.

Figure 4.

Source: Bureau of Labor Statistics and National Bureau of Economic Research

DATA DESCRIPTION

We analyze bankruptcies from 1999 to 2009 using data obtained from the US Courts web site. The data provide information on the number and type of quarterly non-business bankruptcy filings per court district within each state. District numbers are summed to obtain the number of quarterly state filings. To control for differences in population across states, we calculate bankruptcies per 1,000 people for each state, using annual US Census Bureau population data. Table 1 shows that, on average, states had 1.116 filings per population of 1,000 over the time period from 1999 to 2009. The maximum rate of filings was 4.436 and the minimum was 0.134. If the third and fourth quarters of 2005 and the first quarter of 2006 are excluded to eliminate the large run up in filings prior to the 2005 Act and the large drop following its implementation, the average and maximum rates are somewhat lower for total filings and for Chapter 7 filings.

Data on mortgages past due, foreclosure starts, and foreclosure inventories is obtained from the National Delinquency Survey by the Mortgage Bankers Association. The average quarterly statewide percentage of mortgages past due is 5.003%, but the rate varies widely across the states. The maximum quarterly percentage past due is 24.630% for Louisiana in the third quarter of 2005, which is the quarter during which Hurricane Katrina struck New Orleans. The average percentages of quarterly state foreclosure starts and foreclosure inventories are 0.517% and 1.472%, respectively. The maximum percentage of foreclosure starts of 3.760% belongs to Nevada (Q3 2009) and the foreclosure inventory maximum of 13.440% belongs to Florida (Q4 2009), both states that have been hit hard by the drop in housing values.

Table 1. Descriptive Statistics

Variable	Mean	Std. Dev.	Min.	Max.
Ch 7 Filings Per 1,000 Population	0.823	0.437	0.068	3.902
Excluding 2005 Q3, 2005 Q4, & 2006 Q1	0.794	0.368	0.098	2.211
Ch 13 Filings Per 1,000 Population	0.293	0.265	0.011	1.491
Excluding 2005 Q3, 2005 Q4, & 2006 Q1	0.296	0.267	0.011	1.491
Total Filings Per 1,000 Population	1.116	0.563	0.134	4.436
Excluding 2005 Q3, 2005 Q4, & 2006 Q1	1.090	0.508	0.194	3.054
Mortgages Past Due (%)	5.003	2.149	1.560	24.630
Foreclosure Starts (%)	0.517	0.336	0.090	3.760
Foreclosure Inventories (%)	1.472	1.070	0.170	13.440
Lagged Quarterly Unemployment Rate (%)	4.990	1.596	1.633	14.100
1-Year Change in Housing Prices (%)	5.272	6.288	-23.621	38.019
Garnish	1.098	0.891	0.000	2.000
Foreclosure Timeline	0.627	0.484	0.000	1.000
Recourse	0.804	0.397	0.000	1.000

State unemployment data are retrieved from the Bureau of Labor Statistics web site. For our analysis, we use data that are not seasonally adjusted, since bankruptcies, mortgages past due and foreclosures might have a seasonal component. The average quarterly state unemployment rate is 4.99%, with the maximum quarterly unemployment rate of 14.1% attributed to Michigan during the third quarter of 2009. Michigan has suffered with high unemployment during the Great Recession due to its heavy dependence on manufacturing, and especially the auto industry.

Belsie (2010) notes that until May 2010, Michigan had the dubious distinction of having the nation's highest unemployment rate for four years.

The Conventional Mortgage Home Price Index (CMHPI) from Freddie Mac is used to calculate the 1-year change in housing prices by state. The index is based on repeat sales of houses with mortgages that were purchased or securitized by Freddie Mac or Fannie Mae. The mortgages are not insured by the Federal Housing Administration or the Veterans Administration and must not exceed the conforming loan limit that is determined annually based on a Federal Housing Board Survey. For example, the maximum conforming loan limit in 2009 was $417,000, with the exception of mortgages originated in Alaska, Hawaii, Guam and the US Virgin Islands, where it is $625,500. The average state 1-year change in housing prices is 5.28% from 1999 to 2009. However, the range is large reflecting both the housing boom and bust. Both the largest 1-year housing price increase and price drop occurred in Nevada. The third quarter of 2004 saw an increase of 38.019% compared to a year earlier and the fourth quarter of 2008 shows a decline of 23.621% compared to a year earlier.

Table 2. Summary of State Foreclosure and Bankruptcy Laws

State	Garnishment Restrictions	Judicial or Non-Judicial Foreclosure	Optimum Foreclosure Timeline	Recourse Classification
Alabama	Federal	NJ	49-74	Recourse
Alaska	$602.50/week	NJ	108-111	Non-Recourse
Arizona	Federal	NJ	115	Non-Recourse
Arkansas	Federal	NJ	90	Recourse
California	Federal	NJ	120	Non-Recourse
Colorado	Federal	NJ	173	Recourse
Connecticut	$206/week	J strict	160	Recourse
Delaware	85% of DI	J	200-300	Recourse
Dist. of Columbia	Federal	NJ	48	Recourse
Florida	100% of DI	J	150	Recourse
Georgia	Federal	NJ	48	Recourse
Hawaii	80% of DI	NJ/J	195/320	Recourse
Idaho	Federal	NJ	150	Recourse
Illinois	85% of DI	J	345	Recourse
Indiana	Federal	J	266	Recourse
Iowa	$206/week	J	180	Non-Recourse
Kansas	Federal	J	230	Recourse
Kentucky	Federal	J	198	Recourse
Louisiana	Federal	J executory /J non-executory	209/269	Recourse
Maryland	Federal	J	46	Recourse

Table 2. Continued

State	Garnishment Restrictions	Judicial or Non-Judicial Foreclosure	Optimum Foreclosure Timeline	Recourse Classification
Massachusetts	Federal	J	75	Recourse
Michigan	$206/week	NJ	360*	Recourse
Minnesota	$206/week	NJ	270-280**	Non-Recourse
Mississippi	Federal	NJ	90	Recourse
Missouri	90% of DI	NJ	61-65	Recourse
Montana	Federal	NJ	163	Non-Recourse
Nebraska	85% of DI	NJ/J	121/176	Recourse
Nevada	Federal	NJ	116	Recourse
New Hampshire	$257/week	NJ	75	Recourse
New Jersey	90% of DI	J	295	Recourse
New Mexico	$206/week	J	225	Recourse
New York	90% of DI	J/J/NJ	445/299/355	Recourse***
North Carolina	100% of DI	NJ	120	Non-Recourse/ Recourse****
North Dakota	$206/week	J	150	Non-Recourse
Ohio	Federal	J	217	Recourse
Oklahoma	Federal	NJ	201	Recourse
Oregon	$206/week	NJ	160	Recourse
Pennsylvania	100% of DI	J	300	Recourse
Rhode Island	Federal	NJ	74	Recourse
South Carolina	100% of DI	J	180	Recourse
South Dakota	80% of DI	J	340	Recourse
Tennessee	Federal	NJ	50-55	Recourse
Texas	100% of DI	NJ	35-60/80-180	Recourse
Utah	6-month limit	NJ	139	Recourse
Vermont	85% of DI	J	275	Recourse
Virginia	Federal	NJ	60	Recourse
Washington	$294/week	NJ	140-150	Non-Recourse
West Virginia	80% of DI	NJ	120	Recourse
Wisconsin	80% of DI	J	315	Non-Recourse
Wyoming	Federal	NJ	180	Recourse

* The non-judicial foreclosure optimally takes 60 days; however, after that the redemption period begins to run, typically for 6 months. Estimated time for completion for uncontested foreclosure without eviction action is 12 months.

** The sale in non-judicial foreclosure can generally be held within 90 days; however, there are substantial redemption rights in Minnesota. Thus, including the redemption period, the optimum timeframe for non-judicial foreclosure is 270-280 days.

***NYC: J / outside NYC: J / outside NYC: NJ.

**** Non-recourse for purchase mortgages, recourse for others.

Like Lefgren and McIntyre (2009), we consider state garnishment laws in our analysis. Information on state garnishment laws are obtained from Lefgren and McIntyre and Fair Debt Collection.Com. Garnishment laws are assigned a value of 0, 1, or 2, with 0 providing the most protection to borrowers and 2 allowing lenders greatest access to borrower income. Table 1 shows the mean value is 1.122.

We use data included in Ghent and Kudlyak (2010) from the National Mortgage Servicer's Directory, 21st Edition (2004) on a mortgage servicer's optimum timeline for foreclosures. A dummy variable is created, with optimum timelines less than 185 days assigned a 1, 0 otherwise. Thus values of 0 are more favorable to borrowers and values of 1 are more favorable to lenders. Also like Ghent and Kudlyak, we include a variable to indicate whether a state allows the lender recourse in a foreclosure if the outstanding mortgage balance is not satisfied by the sale of the collateral. The recourse variable is assigned a value of 1 for states than allow lenders recourse, and 0 for non-recourse states. Table 2 summarizes information on garnishment, optimum foreclosure timeline, and recourse.

HYPOTHESES

Bankruptcy filings, mortgages past due, and foreclosures are affected by many of the same variables. Borrowers who file bankruptcy have typically fallen behind on their payments and foreclosure proceedings have often been initiated. As prior researchers have shown (see, for example, Evans and Lewis, 2008; Ghent and Kudlyak, 2010), the unemployment rate is positively related to both bankruptcy filings and mortgage defaults.

The change in housing prices is expected to negatively affect bankruptcy filings and mortgage defaults. As housing prices fall, borrowers are reluctant or unable to sell their homes. In many cases, after a drop in value, the mortgages are underwater, trapping borrowers in homes they might no longer be able to afford. Thus changes in housing prices will be negatively related to bankruptcy filings. A second variable that addresses housing prices is the big drop dummy variable that is equal to 1 if the 1-year drop in housing prices is worse than 10%, otherwise 0. A positive estimate for this variable indicates that defaults and bankruptcies occur at a higher rate with a large drop in housing prices.

Three variables take into account the state regulatory environment and the relative advantage given to lenders or borrowers. First, the garnish variable is a proxy for the ability of lenders to garnish the wages of borrowers who default. Garnish is a dummy variable that can take on a value of 0, 1, or 2. Higher levels of the variable represent stronger rights of lenders to collect unpaid debts. Other things equal, we hypothesize that garnish will be positively associated with bankruptcy filings, since borrowers will seek the protection provided by bankruptcy rather than simply default. The relation of garnish to mortgages past due and foreclosures is uncertain, since consumers who file bankruptcy generally default before filing.

Next, the timeline required for lenders to complete the foreclosure process is considered. Timeline is a dummy variable that is equal to 0 or 1, with 1 indicating a relatively short time required for a lender to foreclose. A longer timeline benefits the borrower, since the borrower effectively receives free rent during the process. We hypothesize a positive relation between timeline and bankruptcy filings, because a short time to foreclosure would make bankruptcy relatively more attractive than foreclosure.

The last regulatory variable is recourse, which represents the ability of lenders to recourse in the case of default. This variable is particularly relevant for mortgages that are underwater. Traditionally lenders could sell the collateral for a sufficiently large amount that recourse was less important. With the large drop in housing prices, recourse has taken on new importance. Recourse is a dummy variable that has a value of 0 for states with no recourse and 1 for states with recourse. With recourse, we hypothesize that borrowers would favor bankruptcy over informal default. This would be particularly true in the case of negative equity. The expected relation between recourse and bankruptcy is positive. The relation with default is uncertain since borrowers who file bankruptcy generally default.

Finally, we include two control variables in the bankruptcy analyses. To control for the large drop in bankruptcy filings due the 2005 Act, a postreg dummy variable is included. Second, a trend variable is included to control for the general upward trend in bankruptcy filings, particularly Chapter 7 and total filings. The expected relation between the variables and bankruptcy filings, mortgages past due, and foreclosures is summarized in Table 3.

Table 3. Expected Relation of Variables to Bankruptcy Filings, Mortgages Past Due, and Foreclosures

Variable	Ch 7	Ch 13	Total	Past Due	Forecl. Starts	Forecl. Inv.
Lagged Unemployment Rate	+	+	+	+	+	+
1-Year Change in Housing Prices	-	-	-	-	-	-
Big Drop Dummy	+	+	+	+	+	+
Garnish Dummy	+	+	+	?	?	?
Timeline Dummy	+	+	+	-	-	-
Recourse Dummy	+	+	+	?	?	?
Postreg Dummy	-	-	-	na	na	na
Trend	+	?	+	na	na	na

EMPIRICAL ANALYSIS

We examine bankruptcy filings, mortgages past due, and foreclosures using ordinary least squares (OLS) regression analysis, with T-statistics and statistical significance determined using heteroscedasticity consistent standard errors. Like Evans and Lewis (2008), we drop data for the third and fourth quarter of 2005 and the first quarter of 2006 due to the large changes in bankruptcy filings surrounding the implementation of the 2005 Act. We estimate the following model.

$$\text{BankruptcyRate} = \beta_0 + \beta_1\text{Unempl} + \beta_2\text{ChgHousing Prc} + \beta_3\text{Garnish} + \beta_4\text{Timeline} + \beta_5\text{Recourse} + \beta_6\text{Postreg} + \beta_7\text{Trend} \quad (1)$$

Results show that bankruptcy filing rates are positively related to the unemployment rate as expected. The negative and significant estimated coefficients for the 1-year change in housing prices provide evidence that borrowers are seeking bankruptcy protection because of the drop in housing values. The positive and significant estimate for the garnish dummy variable suggests that borrowers seek bankruptcy protection at greater rates in states with stronger lender garnishment laws than in those with garnishment restrictions that protect borrowers. The positive and significant estimates for timeline indicate that in states with short timelines for foreclosure, borrowers are more likely to file bankruptcy than in states with long timelines. The recourse dummy variable has a positive and significant estimated coefficient, as expected. Our results show that in states that allow recourse to the lender, bankruptcy rates are higher. The postreg variable results are as expected, with lower bankruptcy filings following implementation of the 2005 Act. The trend variable shows evidence of positive trends in Chapter 7 and total filings, but the estimated coefficient for Chapter 13 filings is not significantly different from zero.

Table 4. Bankruptcy Regression Results

	Ch 7		Ch 13		Total	
Variable	Est.	T-stat.	Est.	T-stat.	Est.	T-stat.
Intercept	0.483*	17.64	-0.004*	-0.19	0.478*	12.29
Lagged Unempl Rate	0.038*	9.00	0.022*	6.62	0.060*	10.71
1-Yr Chg in Housing Prc	-0.017*	-14.02	-0.007*	-8.47	-0.024*	-14.37
Garnish	0.117*	19.31	0.074*	13.16	0.191*	22.02
Timeline	0.062*	5.48	0.026	2.87	0.088*	7.02
Recourse	0.102*	7.71	0.199*	21.00	0.301*	18.40
Postreg	-0.864*	-35.15	-0.149*	-6.10	-1.014*	-29.74
Trend	0.055*	15.64	0.004	1.17	0.059*	12.48
Adj R-Square	0.596		0.217		0.577	
F-Value	440.540*		83.740*		408.700*	

* Indicates statistical significance at the 0.01 level or better.

One objective of this research is to provide insight on strategic defaults. We modify model (1) to determine whether evidence suggests borrowers who can afford to make their payments are choosing to default. A strategic default variable is constructed to represent borrowers who would have the greatest incentive to default strategically. The strategic default variable is based on strong garnishment restrictions, no recourse for lenders, and a 1-year housing price drop of greater than 10%. The strategic default variable has a value of 0 for states that have weaker garnishment restrictions or that allow lenders recourse. For states with strong garnishment restrictions and no recourse, the strategic default variable equals the absolute value of the price drop only if the drop is greater than 10%, 0 otherwise. A negative coefficient would be consistent with borrowers engaging in strategic default. However, Chapter 13 filings are not expected to be significantly related to the strategic default variable, since Chapter 13 provides for debt restructuring rather than discharge. The following model is estimated using OLS regression analysis.

$$\text{BankruptcyRate} = \beta_0 + \beta_1\text{Unempl} + \beta_2\text{ChgHousing Prc} + \beta_3\text{Timeline} + \beta_4\text{StrategicDefault} + \beta_5\text{Postreg} + \beta_6\text{Trend} \quad (2)$$

Results, which are provided in Table 5, provide evidence of strategic default. The estimated coefficient for the strategic default variable is negative and significant, providing evidence of fewer bankruptcy filings when strategic default is most beneficial to borrowers. These results suggest that strategic default occurs when borrowers have large negative equity in their homes and state laws provide protection from recourse and garnishment. As expected, results are stronger for the Chapter 7 and total models than for Chapter 13, both in terms of the size of the estimated coefficients and the statistical significance.

Table 5. Strategic Default Regression Results

	Ch 7		Ch 13		Total	
	Est.	T-stat.	Est.	T-stat.	Est.	T-stat.
Intercept	0.646*	23.08	0.198*	9.05	0.842*	21.90
Lagged Unempl Rate	0.046*	9.84	0.028*	7.31	0.074*	11.15
1-Yr Chg in Housing Prc	-0.017*	-12.41	-0.006*	-7.05	-0.023*	-12.20
Timeline	0.085*	6.60	0.044*	4.25	0.128*	7.59
Strategic Default	-0.160*	-3.80	-0.096**	-2.44	-0.257*	-4.32
Postreg	-0.846*	-31.43	-0.134*	-4.97	-0.981*	-24.60
Trend	0.052*	13.54	0.002	0.44	0.054*	9.56
Adj R-Square	0.506		0.072		0.415	
F-Value	357.74*		27.86*		247.72*	

* Indicates statistical significance at the 0.01 level or better; ** at the 0.05 level or better.

We next examine mortgages past due and foreclosures. We estimate the following model using OLS regression analysis, also substituting foreclosure starts and foreclosure inventories for mortgages past due as the dependent variable.

$$\text{MortgagesPastDue} = \beta_0 + \beta_1\text{Unempl} + \beta_2\text{ChgHousing Prc} + \beta_3\text{Recourse} + \beta_4\text{Timeline} \quad (3)$$

Results, reported in Table 6, are generally consistent with expectations. Unemployment is positively and significantly related to mortgages past due, foreclosure starts, and foreclosure inventories. The estimated coefficients for the change in housing prices are negative and significant for all three regressions, providing evidence that more borrowers default when housing prices have fallen. The recourse estimate is positive and significant, even though a lender's ability to recourse would be expected to discourage default and encourage bankruptcy. However, borrowers who are in the process of filing bankruptcy generally default on their mortgages. Timeline is negative and significant as expected for mortgages past due and foreclosure inventories, suggesting that shorter timelines to foreclose reduce mortgage defaults. Overall, these results show that borrowers are under pressure in today's difficult economic environment.

Table 6. Past Due and Foreclosure Regression Results

	Mortgages Past Due		Foreclosure Starts		Foreclosure Inv.	
Variable	Est.	T-stat.	Est.	T-stat.	Est.	T-stat.
Intercept	2.476*	16.45	0.278*	11.34	0.480*	5.37
Lagged Unempl Rate	0.571*	21.59	0.066*	14.77	0.241*	13.88
1-Yr Chg in Housing Prc	-0.130*	-24.17	-0.032*	-19.96	-0.090*	-19.78
Recourse	0.974*	14.67	0.093*	7.85	0.426*	13.32
Timeline	-0.667*	-9.36	0.005	0.53	-0.125*	-3.91
Adj R-Square	0.505		0.604		0.572	
F-Value	573.92*		856.23*		749.46*	

* Indicates statistical significance at the 0.01 level or better

CONCLUSION

This research analyzes bankruptcies and mortgage defaults in light of the Great Recession of 2008-09. Bankruptcies and mortgage defaults have surged as consumers face high unemployment and falling housing prices. Results of our analysis show that bankruptcies, mortgages past due, and foreclosures are significantly related to unemployment and housing values. Evidence suggests that borrowers are defaulting on their mortgages and seeking protection because of the drop in housing values. Results also suggest that borrowers seek bankruptcy protection at greater rates in states with stronger lender garnishment laws than in states with garnishment restrictions that protect borrowers. We find that in states with short timelines for foreclosure borrowers are more likely to file bankruptcy than in states with long timelines. Our results also show that in states that allow recourse to the lender, bankruptcy rates are higher. We also find evidence suggesting that borrowers are engaging in strategic default.

Results of this research have important policy implications, but also provide evidence of the human suffering that has resulted from the Great Recession.

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SHOULD THE NONPROFIT ORGANIZATION'S MISSION DRIVE THE TAX DEDUCTIBILITY OF CONTRIBUTIONS?

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ABSTRACT

This paper discusses the potential impact on nonprofit organizations if the tax deductibility of charitable contributions made to organizations that do not benefit the poor was reduced or even eliminated.

INTRODUCTION

These are not the best of times for nonprofit organizations as they face multiple challenges from federal, state and local governments. First, the tax-exempt status of nonprofit organizations is being challenged by state and local governments as they seek alternative revenue streams to balance gaping budget deficits. Such actions include attempts to repeal property tax exemptions, charging nonprofits payments in lieu of taxes, and instituting user fees for services such as police and fire. The second is even more troubling since it is based on a simple proposal made by a former Labor Secretary that could revolutionize the tax treatment of charitable contributions if adopted by the federal government. The basic premise is that only charitable contributions made to institutions that help the poor would receive a full tax deduction. (Frank, 2007).

This is a more restrictive definition of charity than is currently found in the Internal Revenue Service (IRC) and discussed later in the paper. Gifts to institutions that do not benefit the poor would be deducted at reduced values. By reducing the tax deductibility of charitable contributions, the proposal would result in an increase in the tax revenue collected by the federal government.

With the nation's economy slowly recovering from a recession, the federal government is also exploring revenue sources that could plug its deficit without increasing the tax burden of the citizenry. This deficit was partially created through the passage of a $787 billion stimulus package intended to increase spending during the recent recession.

The Senate Finance Committee (SFC) has taken a leading role in identifying new revenue sources. It contacted the 136 wealthiest colleges and universities to obtain detailed information on how they raise tuition, provide financial aids and manage and spend their endowment. The committee is also interested in the endowment-related bonuses paid to college presidents and endowment managers (Arenson, 2008). In addition, the SFC is looking at nonprofit hospitals and could require them to maintain a minimum level of charitable activity as well as limit charges to the uninsured and indigent patients. Hospitals could be subject to an excise tax for failing to meet these requirements (Baucus, 2009)

A move to reduce the tax deductibility of charitable contributions is already gaining traction. In an attempt to identify new revenue sources, The White House is proposing a reduction in the tax deductibility of charitable contributions made by higher income families by up to 20% (Lacayo, 2009). The National Committee for Responsive Philanthropy is even suggesting that foundations spend half of their grant dollars to help poor neighborhoods and minorities. This suggestion is receiving support from a member of Congress and various charitable leaders (Wilhelm, 2009). Could the proposal to reduce the tax deductibility of charitable contributions made to organizations that do not benefit the poor be far behind?

These events raise some additional questions. For instance, what type of charitable organization helps the poor? Does a religious organization qualify as helping the poor? What about a college or university that provides free tuition to low income students? Does a disaster relief organization such as the American Red Cross benefit the poor? What about a hospital that provides free health care to the under privilege? Should the deductibility of charitable contributions made to these organizations be reduced? We will explore the answers to these questions in the paper by first discussing non-profit organizations in general, the current tax treatment of charitable contributions and the potential impact on individuals and non-profit organizations if restrictions are placed on contributions that do not benefit the poor.

NON PROFIT ORGANIZATIONS

Non-profit organizations (NPOs) generally receive a significant portion of their funding or operating budget from contributions* (*Other primary income sources are endowment income; grants from corporations and government; tuition; fees; and ticket sales.), and provide goods or services to the citizenry without a profit motive. NPOs represent a large and varied group of organizations including hospitals, colleges and universities, libraries, museums, religious organizations and trade associations. The trade off for providing such goods and services is that non profit organizations receive tax exemption under more than 25 classifications of the IRC.

The most common NPOs are charitable organizations which are exempt from taxation under IRC Section 501(c)(3). Private foundations and public charities are the two main types of charitable organizations included within the code's definition. The difference between the two organizations is that private foundations receive support from a small number of individuals or corporations and exist to provide grants to public charities. One well established private foundation is the Bill & Melinda Gates Foundation with approximately $27 billion in endowment assets as of April 1, 2009. Public charities are funded, operated, and monitored by the public at large rather than by a limited number of donors. Such well established organizations as the Boys Scouts of America, the American Red Cross and the Salvation Army, are all public charities.

The IRC considers the following types of organizations as public charities - charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. The code further defines charitable to include relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.

The IRS reported 1,855,067 tax exempt organizations at the end of the September 2008 fiscal year. The vast majority (64%) represented religious, charitable and similar organizations (IRS, 2008; Williams, 2009). However, the number of people employed within the non-profit sector is not easily quantified but is clearly in the millions. As an example, the arts and culture sector employed approximately 5.7 million individuals as of December 31, 2008 (Spector, 2009a).

Non-profit organizations, except virtually all religious organizations, file annual reports with the IRS using Form 990 (for large tax exempt organizations, generally with gross receipts of $25,000 or more), or Form 990N (for small tax exempt organizations, generally with gross receipts of $25,000 or less). The Giving USA Foundation reported that Americans gave $307.7 billion in charitable donations and pledges in 2008 (Wasley, 2009). Organizations that provide services to the needy received approximately 9% of the total donations (Strom, 2008).

What effect would disallowing certain charitable donations have on nonprofit organizations whose mission does not include 'helping the poor'? To answer this question, we looked at the ten largest charities based on total revenue* (*Includes public, private and government support, plus other income such as endowment income(loss)) and the ten largest charities based on donations (both for fiscal year 2009) to determine if helping the poor (the proposed restrictive definition of charity) was included in their mission or comparable statements. This information is provided in Appendices 1 and 2 respectively. The top ten charities include organizations across a broad range of categories including health and medical, domestic and international needs, education, and youth.

Based on our review of the mission statements of the organizations listed in Appendices 1 and 2, only three organizations includes helping the poor as part of their mission statements. Therefore, charitable contributions made to these organizations (Food for the Poor, Feed the Children and World Vision) would continue to be fully deductible since their mission statements currently complies with the 'proposed' restrictive definition of charity. Many of the remaining organizations such as The Mayo Clinic and The American Cancer Society are well known and established institutions providing such services as medical and health care to all segments of society including the poor. However, since the organizations' mission statements do not include language such as helping the poor, charitable contributions made to them would no longer be fully deductible under a more restrictive definition of charity. In other words, only the 9% of the charitable contributions made in 2009 as noted above, would be fully deductible, assuming that providing services to the needy and poor are synonymous.

CURRENT TAX TREATMENT OF CHARITABLE CONTRIBUTIONS

Individual donors are the main funding source for non-profit organizations providing approximately 80% of charitable contributions; hence the tax treatment of their contributions is our primary focus. Individual taxpayers can receive a charitable contribution deduction by making a gift to a Sec 501(c)(3) organization (and certain other exempt organizations). As defined earlier, this generally means charitable, scientific, educational or literary organizations.

Deducted amounts include cash, property and out-of-pocket expenses incurred to perform volunteer work. The full value of these donations is generally deductible on Form 1040 Schedule A, subject to certain income limitations (the individual's adjusted gross income). Excess contributions are carried forward to five years. Other contributions such as gifts to political organizations, cost of tuition, country club memberships and gifts to chamber of commerce are not deductible.

DISALLOWED CHARITABLE CONTRIBUTIONS

Impact on Individual Donors

NPOs and governments have implicitly agreed that NPOs could avoid taxation in exchange for providing certain goods and services to society. These goods and services might be performed by all levels of governments if NPOs did not exist. However, the relationship between NPOs and government could change if gifts made to charitable organizations that do not support the poor are reduced. Full deduction of contributions would only be available for the 9% of charitable organizations that helps the needy.

We believe that any change in the current treatment of charitable contributions could have a negative impact on NPOs since most would no longer qualify as tax exempt under the new restrictive language. One immediate impact of the reduction of charity deductions is a corresponding reduction in contributions received from middle and high income donors since donations will no longer be fully deductible. According to the 2000 Social Capital Community Benchmark Survey, households with income below $20,000, already contribute the highest percentage of their income (4.6%) to charity than any other income group (Brooks, 2008).

However, the largest donor group is the wealthiest 3% of Americans who supply approximately two-thirds of all household charity in the US (Farrell, 2008).

Clearly, the working poor as they are known do not currently benefit from the tax deductibility of charitable contributions since most are below the income level needed to qualify for itemization. Their income will not change under the "proposed' legislation so their charitable contributions would continue to be nondeductible. One reason for the working poor's loyalty is their motivation – they generally belong to religious organizations and believe they have a moral obligation to give to charity. We believe that middle income tax-payer's motivation is driven by the tax deductibility of the charitable contributions. Therefore, their contributions would fall if deductions are limited based on the mission of the receiving nonprofit organization.

Our position is that higher income taxpayers are motivated to give to charity because of the tax deductibility of their charitable contributions. In addition to motivation, high net worth individuals' charity contributions are impacted by economic factors and the current decline in the world's economic activity is having a negative impact on their generosity. A recent poll of 439 high net worth families noted that 73% of the respondents felt a significant adverse impact from the current economic environment (Farrell, 2008). Furthermore, economists estimate that a 10% income decline would cause a 4-8% drop in giving (Fisman, 2008).

However, Pogrebin (2008) cautions that affluent individuals donate more from assets than from income so their contributions are less vulnerable to an economic downturn. Therefore, while the donations may continue, the values of such donations might decrease if the assets have experienced a severe market decline. Consequently, we expect a decrease in the level of giving if the tax treatment of charitable contributions is limited based on the mission of the non-profit organizations.

Brooks (2006) noted that regardless of income levels, individuals might also be motivated to give based on two-key value system. The first is based on the role that government should play in citizen's lives. Individuals holding this view believe that the government should do more to reduce income differences between the rich and the poor. The second view is based on individual's family lifestyle. This view simply suggests that couples are more likely to give to charity than single individuals.

Impact on Nonprofit Organizations

Since NPOs receive a significant portion of their operating income from charitable contributions any reduction in donations could have a tremendous impact on operating budgets and the services provided to society. This is already happening to nonprofit organizations especially in the arts and cultural sector. Facing declining donations, orchestras, opera houses, theater troupes, and dance companies are cutting salaries, jobs and programs; or have simply collapsed (Lacayo, 2009). One estimate is that approximately 10% or 10,000 arts organizations are at risk of folding due to declining donations (Spector, 2009b).

A few examples will illustrate the current plight of arts and cultural organizations. The Baltimore Opera Company filed for Chapter 11 bankruptcy in December 2008 after 50 years of operations citing declining donations. The Connecticut Opera Company ceased operations in February 2009 after 67 season due to declining donations, while The Opera Orchestra of New York cancelled the remainder of its 2008-09 season also due to declining donations. Even the nation's largest and wealthiest art museum, The Metropolitan Museum, has reduced staff by 10% citing a shrinking income source from its endowment.

The above examples offer a glimpse into the potential impact on nonprofit organizations if the deductibility of charitable contributions is restricted based on the mission of the recipient organization. Clearly, NPOs will need to react if the movement to restrict the tax deductibility of charitable contributions to organizations whose mission do not benefit the poor gains traction. They might simply change their mission statement, reduce services, charge a fee for services rendered or cease operations.

A move to change mission statements will be an attractive option for some NPOs. NPOs could simply incorporate language into their mission statements suggesting that they are providing services to the poor and so, become compliant with the legislation. Other NPOs will respond to the reduction in their chief funding sources by reducing operating budgets which would require a reduction and/or elimination of services or the implementation of a fee for services provided, albeit at a reduced rate than the private sector. The public (especially the needy) will be impacted since it may no longer receive expected services or may have to pay for services that were previously provided without a charge.

An even more draconian measure is for NPOs to simply cease operations since they will not have the necessary funds to support their operations. As noted earlier, NPOs in the arts and cultural sector are already ceasing operations due to declining donations. The impact on the overall economy could be dramatic if the deductibility of charity contributions was restricted and NPOs experienced declining donations and ultimately ceased operations. For instance, 'defunct' NPOs means that less office space is required in buildings resulting in an increase in commercial real estate vacancy rates. As a result, the property owners' income will decrease if they are not able to lease the available spaces. A downsized or defunct NPO means that employees will be terminated resulting in an increase in the unemployment rate and a decrease in government revenues. Without this revenue, government will not be able to provide necessary services to its residents or may need to increase tax from other sources.

A downsized or dissolved NPO could also result in less environmental initiatives, no support for animal welfare, less support for places of worship, higher admissions fees at museums, higher tuition and fees at colleges and universities, just to name a few. This may have a ripple effect on governments since they might need to provide the services no longer offered by NPOs. Unfortunately, governments at all levels (local, state and federal) are facing their own budget challenges and may not be able to bridge the service gap created by the vanishing NPOs.

The ultimate "victim" is society at large which will no longer be able to enjoy the cultural, educational, religious and literary services once provided by NPOs.

CONCLUSION

The Internal Revenue Service and the US Congress are always exploring new ways to generate revenue for the Treasury. One potential revenue stream is the tax generated by reducing the deductibility of charitable contributions made to organizations that do not benefit the poor. However, one challenge of such measure is determining which organizations actually help the poor, in which case, contributions made to such organizations would continue to be fully tax deductible. As noted in our review of the mission statements of the largest non-profit organizations only three included 'helping the poor' or similar language as part of their mission statements. Therefore, only charitable contributions made to these organizations would receive a favorable tax treatment under a more restrictive definition of charity. However, the other organizations are well known institutions that provide services to all segments of society, including the poor. Since their mission statements do not include language such a "helping the poor," charitable contributions made to them would no longer be fully deductible.

We understand the need for the government to explore alternative approaches in order to increase tax revenue. However, we discourage the US Congress from embracing any proposal that might reduce the tax deductibility of charitable contributions without fully analyzing the impact of any such tax change. We do not believe that the additional tax revenue raised would be spent on the needs provided by charitable organizations that would be deprived of charitable contributions. We believe that the cost to society of any change in the current treatment of charitable contributions will be greater than any derived benefit. This is especially important in our current economic climate in which non-profit organizations are experiencing higher demand for services as displaced workers turn to them for assistance with such basic services as food, clothing and shelter. Other nonprofit organizations are already ceasing operations due to declining revenue.

It might be tempting for Congress to reduce the deductibility of charitable donations to organizations whose missions do not include helping the poor as a revenue generating mechanism. However, we suggest that no change be made until the cost/benefit of any proposal is fully analyzed.

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Appendix 1 – Top Ten Charities based on Total Revenue in 2009

Organization Name	Category	Total Revenue*	Mission **
Lutheran Services in America	Domestic needs	$16.61b	To create opportunities with people in thousands of communities throughout the United States and the Caribbean …and their over 300 health and human service organizations. Working neighbor to neighbor through services in health care, aging and disability supports, community development, housing, and child and family strengthening, these organizations together touch the lives of one in 50 Americans each year.
Mayo Clinic	Medical	$6.55b	To provide the best care to every patient every day through integrated clinical practice, education and research.
UPMC Group	Medical	$6.02b	To create a new economic future for western Pennsylvania – a future built on new ways of thinking about health care and sparked by leveraging the uniqueness of the integrated health enterprise. By exporting excellence nationally and internationally, and fueling the development of new businesses that emerge from UPMC's intellectual capital, core capabilities, and management expertise, UPMC will catalyze a regional economic renaissance. At the same time, UPMC will remain steadfastly committed to providing premier health care services to our region and contributing to this community.
YMCA	Youth	$5.69b	To put Christian principles into practice through programs that build healthy spirit, mind and body for all
The United Way of America	Domestic needs	$3.87b	To improve lives by mobilizing the caring power of communities
Catholic Charities USA	International needs	$3.83b	To provide service to people in need, to advocate for justice in social structures, and to call the entire church and other people of good will to do the same.
The ARC of the United States	Health	$3.60b	To promote and protect the human rights of people with intellectual and developmental disabilities and actively supports their full inclusion and participation in the community throughout their lifetimes.
Goodwill Industries	Domestic needs	$3.28b	To help people who are looking for work or better jobs so they can better provide for their families.
Cleveland Clinic	Health	$3.18b	To integrate world-class patient care with cutting edge research and physician education
The American Red Cross	Domestic needs	$3.00b	To provide relief to victims of disaster and help people prevent, prepare for and respond to emergencies

*Information on organization name and total revenue as noted by Barrett (2009)
**Obtained from each individual organization's website

Appendix 2 – Top Ten Charities based on Public Support (Donations) Received in 2009

Organization Name	Category	Donations Received*	Mission **
The United Way of America	Domestic needs	$4.03b	To improve lives by mobilizing the caring power of communities
Goodwill Industries	Domestic needs	$2.87b	See Appendix 1
The Salvation Army	Domestic needs	$1.88b	To preach the gospel of Jesus Christ and to meet human needs in His name without discrimination
Food for the Poor	International needs	$1.49m	To link the church of the First World with the church of the Third World in a manner that helps both the *materially poor* and the poor in spirit.
Feed the Children	Domestic needs	$1.18b	A Christian, international, nonprofit relief organization that delivers food, medicine, clothing and other necessities to individuals, children and families who lack these essentials due to famine, war, *poverty*, or natural disaster.
Brothers' Brother Foundation	International needs	$1.08b	Connecting People's Resources with People's Needs
AmeriCares Foundation	International needs	$$1.011b	To ensure that medicines, medical supplies and aid reaches individuals in need wherever they are, whenever they need it
American Cancer Society	Health	$1.008b	A community-based voluntary health organization dedicated to eliminating cancer as a major health problem by preventing cancer, saving lives, and diminishing suffering from cancer, through research, education, advocacy, and service.
YMCA	Youth	$935m	See Appendix 1
World Vision	International needs	$834m	To follow our Lord and Savior Jesus Christ in *working with the poor* and oppressed to promote human transformation, seek justice, and bear witness to the good news of the Kingdom of God.

*Information on organization name and public support received as noted by Barrett (2009)
** Obtained from each individual organization's website

EDUCATION POLICY AND SCHOOL SEGREGATION: A STUDY OF THE DENVER METROPOLITAN REGION

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ABSTRACT

This study examines the extent of segregation in low performing elementary schools in the Denver metropolitan area from 1984-2007. The combination of state school choice policies and the accountability requirements of The No Child Left Behind Act, have contributed to this segregation. In Colorado, parents have choices regarding what school they want their children to attend. The schools' ratings often influence the choices parents make. The ratings are primarily a reflection of student scores on standardized tests. The racial segregation of students in addition to school funding, and teacher stability, are just some of the issues associated with school choice.

INTRODUCTION

It is a popular belief in today's America that there are equal opportunities for educational attainment. It is, at the very least, assumed that the fundamental structure of our public education system provides a level playing field for all children, regardless of gender, race, or religion. However, beginning in the 1950s, racial segregation of metropolitan areas became more common as increasing numbers of white families began moving from inner-city urban areas to suburban areas. For white families, the decision to relocate has been based on a combination of push and pull factors. The pull factors include the attractiveness and amenities of the suburbs (less congestion, more green space, etc…) and perception of higher quality schools. The push factors include inner-city crime, racism and declining property values.

Property taxes provide the primary funding source for public education, therefore impoverished, economically depressed regions find it almost impossible to adequately fund public education at the level necessary to guarantee educational quality equal to that in more economically affluent areas. By the same token, school districts in economically depressed areas find it difficult to compete for high quality teachers and support staff. These facts seem to be either accepted or perhaps just ignored by school funding policies which seem to perpetuate the status quo for Americans in poverty.

Federal policy over the past decade has taken steps to employ standardized testing on a national level to ensure that the quality of intra-national public education be comparable. The No Child Left Behind Act (NCLB) of 2001 mandates the assessment of students in public schools in reading and mathematics. NCLB also requires that states provide parents of students in poor performing schools the option of enrolling their children in a different school. These mandates are based on the widely supported idea that schools need to be held accountable to the public for educational quality. Standardized testing has become the primary means of accessing school success and providing for school accountability.

Colorado educational policy addressed the issue of standards based education almost a decade earlier. In 1993, the Colorado legislature passed HB 93 – 1313. This law required the state to develop content standards in twelve subject areas and a procedure for assessing student achievement. The student assessment tool is called the Colorado Student Assessment Program (CSAP). The stated goals of CSAP are: 1) To determine the level at which Colorado students achieve the Colorado Model Content Standards, 2) To measure the progress of students over time, and 3) To add to the body of evidence to determine 3rd graders' literacy levels (Colorado Department of Education, Unit of Student Assessment).

Student performance on the tests are categorized as unsatisfactory, partially proficient, proficient, or advanced. The results of the tests are issued in state, district, school, and individual student reports. The reports provide data on the total and percentage of students who scored in each performance category as a whole and disaggregated based on various demographic variables such as gender and ethnicity. At the school level, CSAP scores are an important component of the School Accountability Report (SAR). The first SARs were issued in September 2001 and were based on the CSAP tests that were administered that spring (Colorado Department of Education, 2002). Schools are ranked on the basis of their students' scores on the CSAP tests. Schools are ranked as Unsatisfactory, Low, Average, High, or Excellent. In addition to the overall school ranking, the SAR includes other school level data such as safety and school environment, taxpayers' report, school history, and staff information.

IMPORTANCE OF THE STUDY

We hypothesize that school choice policies in Colorado combined with school accountability reports and NCLB have resulted in increased school segregation. Our research examines this relationship by analyzing the percentage of white students in Denver metro area schools that are classified as "low-performing" elementary schools by the Colorado Department of Education.

In Colorado, parents have choices regarding what school they want their children to attend. The school's rating often influences the choice that parents make. The rating is mainly a reflection of student scores on standardized tests. School funding, teacher stability, and the potential segregation of students by race and/or socioeconomic status are just some of the possible consequences associated with school choice. Understanding the relationship between socioeconomic status and student performance will aid policymakers in evaluating the social impact and potential consequences of current education policies.

LITERATURE REVIEW

In the early 1950s, migration of white families combined with the absence of desegregation policies sustained the separated public education system in many metropolitan areas between whites and non-whites. The 1954 Supreme court decision in Brown vs. the Board of Education overturned the separate but equal clause of Plessy vs. Ferguson regarding public education. Regarding the unanimous court decision, Earl Warren wrote:

> We come then to the question presented: Does segregation of children in public schools solely on the basis of race, even though the physical facilities and other "tangible" factors may be equal, deprive the children of the minority group of equal educational opportunities? We believe that it does... ...We conclude that in the field of public education the doctrine of 'separate but equal' has no place. Separate educational facilities are inherently unequal (Brown v. Board, 1954).

In essence, the Brown decision put an end to mandatory segregation policies and paved the way for desegregation policies such as busing. However, the segregation of white and non-white students in public schools still exists.

According to a study by the Harvard Civil Rights project, much of the gains in school desegregation after the Brown v. Board of Education decision of 1954 have now been reversed. Although the trend of resegregation is national in scope, some of the more dramatic trends are occurring with blacks in the South and Latinos in the West. In the South, the percent of blacks who attend predominantly white schools went from zero percent in 1954 to 43 percent in 1988; in 2001 that figure dropped to 30%. For Latinos in western states, 58% attended predominately white schools in 1968; by 2001 only 20% attended predominately white schools (Orfield, 2001).

The physical relocation of white families from predominately non-white school districts to predominately white school districts will lead to greater school segregation, however, schools may become more segregated without a physical household relocation if a school district has an open enrollment policy. Study after study, in state after state, reveal that open enrollment has led to resegregation, because affluent families (in the absence of busing) are much more likely to afford increased transportation costs and are more likely to take advantage of open enrollment than poor families.

Focusing on the impact of students attending racially segregated schools and their performance on standardized tests, researchers in Florida found that students who attended black segregated schools scored lower than students who attended white segregated schools, however when controlling for other determinants of school-level performance, students who attended integrated schools did not score significantly lower than students in white segregated schools (Borman, McNulty Eitle, & Eitle 2004). The researchers also found that student enrollment stability and free lunch eligibility had a negative and significant relationship with the percent of a school's students passing a state standardized test in reading and math.

The majority of studies concerned with school characteristics and student performance are regional in scope. The most common characteristics examined include; teacher experience, student attendance, student enrollment stability, class size, and student socioeconomic status. According to an Ohio study, the factors that have the greatest impact on student achievement include student teacher ratios, teacher quality, student attendance, and student mobility (Carr, 2006). The research found that a higher ratio of students to full-time teachers was associated with higher student achievement; in addition, it also found that reducing class size by increasing the number of part-time teachers did not improve student performance. Regarding student mobility, schools that experience higher turnover rates have lower levels of student performance, even if the school has high attendance rates. Characteristics of the student body, such as the number of minority and economically disadvantaged students were negatively related to student performance.

Research involving New York City schools revealed that the poor performing schools, as measured by student test scores, were schools that served mainly economically disadvantaged and minority students (Stiefel, Schwartz, & Iatarola, 2000; Stiefel, Schwartz, & Iatarola, 2001). Schools with a higher percentage of non-white students and a higher percentage of students eligible for free lunch had lower test scores. These schools were also associated with low student attendance rates and teachers with limited teaching experience.

In a study of the determinants of student achievement in San Diego, researchers found that the most important determinant of students' gains in test scores was the individual student's classroom peer achievement (Betts, Zau, & Rice 2003). The authors contend that students are greatly influenced by the achievement levels of the students around them. Attendance rates were also an important influence on gains in students test scores and class size was important at the elementary but not middle or high school levels.

Aske and Corman (2008), identified that student attendance rates, the percent of students eligible for the free lunch program, student enrollment stability, student-teacher ratio, teacher absence, and the percent of teachers at the school with tenure were statistically significant in determining student performance on standardized tests.

They found that the free lunch variable (which reflects the relative poverty level within the school) was significant and negative in its relation to high student scores, indicating that as the percent of students eligible for the free lunch program increases, the percent of students proficient or advanced in reading, writing, math declined. This result is consistent with results identified in other studies across the nation (e.g., Carr, 2006; Betts et al, 2003; Borman et al, 2004; Goodwin et al, 2006; Stiefel et al, 2000).

In addition, Aske and Corman discuss minority membership data within their study. They did not include the membership variable within their regression because of the high correlation with the free lunch variable, especially for Hispanic and White membership. A correlation coefficient of 82.5% was identified between Hispanic membership and free lunch. The correlation coefficient between White membership and free lunch was -82.04%. They report that correlation was found between the poverty measurement and Black, American Indian, and Asian Pacific Islander membership categories as well, but not to the same degree

METHODOLOGY

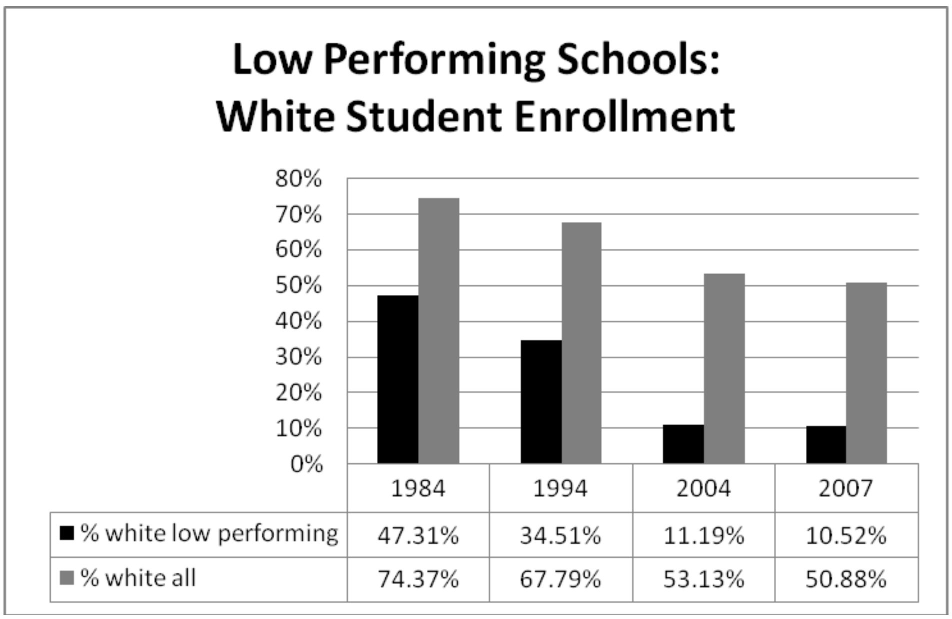
The purpose of this study is to demonstrate the extent of segregation of low performing elementary schools in the Denver metro region. The population of interest in this study consisted of elementary schools from Adams, Arapahoe, Denver, and Jefferson Counties. There are 82 schools that we have identified as consistently low performing schools throughout the 2001-2007 time period, indicating that these schools have been open continually and have received a low performance rating for each of these years. For this study, a school is determined as low performing based on the School Accountability Report (SAR) by the Colorado Department of Education.

SARs are issued annually, the reports rate the schools based on student performance on the Colorado Student Assessment Program (CSAP) standardized tests. The CSAP test was first administered in 1997 to 4th graders in the subject areas of reading and writing. In 2004, the test was administered to grades 3 – 10 in reading and writing, grades 5 – 10 in math and grade 8 in science. For elementary schools, CSAP scores are used to determine the school's overall academic performance. Based on these scores, schools are ranked as Unsatisfactory, Low, Average, High, or Excellent.

The extent of segregation within these low performing schools is examined by looking at the change in white student enrollment for these 82 schools from 1984 to 2007. For this analysis, the changing demographic characteristics within these counties are demonstrated by the change in white enrollment out of the counties' total school enrollment. In absolute terms, segregation is calculated as the change in the total number of white students enrolled. Relative segregation is demonstrated by the number of white students enrolled relative to the total number of students enrolled. This analysis is focused on a relative measurement of segregation; defining the degree of segregation by calculating the percent of total enrollment that is self-identified as white.

FINDINGS OF THE STUDY

The following graph depicts the change in the percent of white students in the four selected counties in the Denver Metropolitan Region compared to the percent of white students in low performing schools in 1984, 1994, 2004 and 2007. As discussed in the previous section, the demographic changes within the four counties are represented by the percent change in white student enrollment in all schools since 1984. In 1984, white students comprised 74.3% of the student population. By 2007, that percentage had fallen to 50.8%. a decrease of over 23 percentage points. The increasing segregation of non-white students in low performing schools is indicated by the more dramatic decrease in the percent of white students attending the schools identified as low performing during the same time period. In 1984, white students comprised 47.3% of the students in low performing schools. By 2007, this number had fallen to a mere 10.5% .



When calculating the percentage change between these statistics using the starting value as the base, this increase in segregation becomes even more evident. Using this approach, the change in overall white enrollment decreased by 31% whereas the change in white enrollment in low performing schools declined by 78%.

This evidence indicates that the change in nonwhite enrollment in low performing schools is not simply the result of demographic changes within the region. It is the authors' contention that the increased degree of segregation of the nonwhite students in low performing schools can be attributed in part to demographic changes, however, a more significant contributor is the deliberate choices made by white parents to enroll their children in schools that have not received a low performance rating. What directly affects this decision making process is not within the purview of this study, however the national education policy of NCLB and the pursuant state policies regarding accountability and school choice do seem to provide an impetus for their decisions. School choice has presented parents with enrollment options outside of their neighborhood schools and the mandates of school accountability in the form of school rankings have provided the parents with an indicator, although a narrow one, of school quality.

FURTHER CONSIDERATIONS

Students differ regarding their level of motivation, performance preference, and capacity to respond to increases in educational opportunity. The range of innate or preparatory ability is wide among students from diverse family and socioeconomic backgrounds. While programs such as “Head Start” have narrowed the preparatory gap, students from affluent backgrounds begin school with higher levels of preparedness and consequently perform better than students without those preparatory opportunities. In addition, students from families with higher levels of educational attainment and higher incomes tend to place higher values on educational opportunity. Therefore, socioeconomic status contributes significantly to a student’s motivation, performance preference, and ability to capitalize on increased educational opportunity.

Students with low motivation, low performance preference, and a lower propensity to capitalize on increases in opportunity do tend to respond to positive peer competitiveness (Betts, Zau, & Rice 2003). If then, through school choice, parents of students that generate positive peer effects pull them out of largely “ability heterogeneous” schools and enroll them in more “ability homogeneous” schools, the educational progress of the students left behind will stagnate. No amount of additional funding will evoke a significant change in performance capacity or behavior for those remaining in the absence of the positive peer effects. Therefore, as schools become more economically segregated, attitudinal gains may dissipate as the economically challenged feel further marginalized within society and therefore become increasingly disenfranchised.

We suggest that educational leaders and policy makers address this issue of segregation and its relationship to poverty, CSAP scores, and SARs when determining future policies.

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OMAHA UNILATERALLY CHANGES RETIREE'S BENEFITS – CONTRACT CLAUSE IMPLICATIONS

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ABSTRACT

Many cities in America are facing budget shortfalls in 2010.The mayor and city council in Omaha, Nebraska decided to unilaterally require retirees to pay a portion of their health insurance premiums, despite labor contracts requiring the city to pay the entire premium. The contract clause in the United States Constitution prohibits states (and cities) from interfering with the obligation of contract; however, this prohibition is not absolute. This paper examines whether or not Omaha can legally require retirees to pay a portion of the premium.

INTRODUCTION

When is a public-entity labor contract a final contract and when can a governmental party unilaterally change the terms of the contract? In spring 2010 this was a question that was of significant interest to many in Omaha, Nebraska. The city, in an effort to cut expenses, unilaterally changed the retirement health insurance benefits for its retirees and employees. What happens in Omaha may impact other parts of the country, as many cities are looking to reduce expenditures in these difficult economic times.

According to May 2010 projections Omaha was facing a budget shortfall of approximately $12.3 million (O'Brien, 2010c). As city leaders looked for belt-tightening measures, one proposal was to have civilian, police and fire retirees pay a portion of their health insurance premium and to collapse 34 different health plans into three plans. The city, as provided by various collective bargaining agreements (CBAs), was to pay 100% of the health insurance premium for approximately 84% of city retirees. The contracts also required that retired employees receive health coverage comparable to the coverage in effect at the time of their retirement (Mastre, 2010).

On Saturday, April 18, 2010, many city retirees received a letter from the City of Omaha informing them that they may be required to pay a portion of their health insurance premiums starting July 1, 2010 (Goodsell & O'Brien, 2010). The original proposed monthly premiums are listed in Table 1 below. These premium amounts were not agreed upon by the respective unions or the retirees; rather this was a unilateral move by the city. The city estimated that it would save

$6.75 million per year if retirees were required to pay these premiums (O'Brien, 2010b). This one measure would cover over half of the projected budget shortfall.

Table 1 Proposed Monthly Premiums To be Paid by City of Omaha Retirees			
Retirees from	Single	Single plus one	Family
Firefighters	$175	$420	$686
Police officers	$128	$307	$501
Civilians	$179	$430	$702
(Source: *OMAHA WORLD HERALD*, April 20, 2010)			

Omaha Mayor Jim Suttle, in response to reactions to the initial proposal, announced a revised plan on Monday, May 10, 2010. This revised plan would save the city an estimated $4.1 million per year and based an individual's monthly premium payment on the annual amount of pension paid. Table 2 below sets forth the second premium proposal (O'Brien, 2010d). The revised insurance premiums would only address about 33.3% of the projected budget shortfall.

Table 2 Revised Proposed Monthly Premiums To be Paid by City of Omaha Retirees			
Pension Amount	Single	Single plus one	Family
$60,000+	$124	$298	$487
$40,000-$59,999	$90	$215	$350
$20,000-$39,999	$60	$125	$165
$19,999 or less	$20	$50	$60
(Source: *OMAHA WORLD HERALD*, May 10, 2010)			

On April 20, 2010, Mayor Suttle released a public statement regarding the proposed change to the retirees' insurance benefit. The city, according to the mayor's statement, is self-insured regarding health care. He cited a 38% increase in the City's healthcare costs between 2007 and 2009. He blamed this on a 300% increase in retiree healthcare costs over the past decade. He also blamed some of the costs on the 34 different health plans that the city must maintain for retirees. The mayor justifies the proposed increase in premiums, in part, on other cities requiring retirees to pay some to all of the retirement health insurance premiums (City of Omaha, 2010a).

Some proponents of requiring retirees to pay a portion of the health insurance premiums, such as Mayor Suttle, argued that the city simply could not afford to continue to fully subsidize health insurance benefits for the retirees (O'Brien, 2010a). Other proponents argued that most governmental bodies require retirees to pay all or a significant proportion of the health insurance premium (O'Brien, 2010a). It was argued that city retirees should not get a free ride (Nabity, 2010). Another argument made to support the change was that the retirement model, pension and benefits, used by the city of Omaha was abandoned by the private sector decades ago because it was too expensive to maintain (Mastre, 2010).

On April 29, 2010, the Omaha City Personnel Board considered the plan to make retirees pay a portion of the insurance premium and collapse 34 plans into three plans. The Board unanimously rejected the proposal (O'Brien, 2010b). Under the Municipal Code of Omaha, the rejection did not end the proposal. The rejection simply required a super majority of the city council members to vote to approve the proposal (O'Brien, 2010e).

The next step in the adoption process, a city council public hearing on the proposed ordinance, was held on May 11, 2010 (O'Brien, 2010e). Richard O'Gara, Omaha Human Resources Director, made the presentation at the public hearing on behalf of the city. According to the presentation, in 2000 the city had 589 retirees. By 2009 the number of retirees had almost doubled to 1091 retirees. The per capita cost of healthcare has also increased over the past decade. The per capita cost regarding active employees increased approximately 90% from $5,875 to $11,055 per employee. Over the same period of time, the per capita cost for retirees has increased by approximately 117% from $7,869 to $17,111 per retiree. The city's presentation then set forth that most comparable cities, as selected by the city of Omaha, required retirees to pay a portion to all of the health insurance premium. Likewise, the city commented that 62% of the companies in Omaha had higher health insurance premiums for retirees than those first proposed by the mayor. Finally, the city claimed there will be several benefits collapsing the 34 retiree health plans into three plans. Those benefits included reduced claim processing, standardized benefits, fewer errors in transactions, better customer service and automated claim processing. The benefits of collapsing the 34 plans into three would result in a $750,000 per year savings according to the city. The increased premium payments by retirees as originally proposed would result in another $6 million savings per year (City of Omaha, 2010b).

At the public hearing eight other people spoke in support of the proposal. Many of the proponents of the ordinance voiced the private sector argument – private sector employees and retirees do not get free health insurance, so public sector employees and retirees should not get free health insurance (City of Omaha, 2010c). Other arguments presented by proponents included:

1) the changes need to be made to keep the city solvent;
2) the proposal did not go far enough and that the current insurance benefit for retirees was not fair to taxpayers or current city employees;

3) there is no integrity in a promise from politicians whose campaigns received money from the unions;
4) taxes were maxed out and should not be raised;
5) the city simply does not have the money to pay and therefore should not;
6) the unions paid for the exceptionally good retirement benefits by supporting political candidates and therefore the benefits do not need to be honored;
7) the health insurance benefit for retirees was a drain on the city with rising health care costs;
8) the union contracts were outrageous and were the result of union greed and city weakness; and
9) the citizens of Omaha did not approve those contracts (City of Omaha, 2010c).

Nineteen witnesses, Omaha retirees or representatives of the employees' unions, testified at the public hearing in opposition to the proposal. Opponents argued:

1) the city made promises to them when they were employed and that the city should not back out of those promises now;
2) the retirement health insurance benefit was part of the compensation they earned for working their jobs; it was not a free gift from the city;
3) the city has other expenditures that can be cut or revenue sources that can be tapped;
4) representatives of the city's Human Resources Department told them at retirement meetings that the retirement health insurance benefits could not be changed;
5) the retirees performed their obligations under the labor contracts, and the city is contractually bound to meet its obligations;
6) promissory estoppel (i.e., the legal doctrine that a party cannot fail to perform a promise when another party reasonably relied on that promise to their detriment) bars the city from refusing to pay 100% of the health insurance premium for the current retirees;
7) the Eighth Circuit Court of Appeals in an Arkansas case ruled a city could not eliminate paying health insurance premiums (City of Omaha, 2010c) ;
8) other options for funding the commitment exist;
9) the city is trying to place the deficit burden on retirees rather than a less politically advantageous solution of placing the burden on the general public;
10) the proposal violated the city charter.
11) The proposal would dishonor the city.
12) the unions first secured the retirement health insurance benefit in CBA negotiations, knowing that it would take away from the city's pot to fund pay raises (on occasion no pay raises were agreed to in order to keep the retirement health benefit);
13) the city on occasion used the retirement health benefit as part of a carrot to encourage employees to enter early retirement; and
14) the health insurance benefit was a significant factor in their personal decisions to retire when they did (City of Omaha, 2010c).

On May 18, 2010 the Omaha City Council unanimously voted (with Council President Garry Gernandt a retired Omaha police officer abstaining from participation and voting) to pass the proposed ordinance, with the mayor's second premium proposal, into law. The ordinance required retirees to pay a portion of the premium and provided that the city council may, at any time, pass an ordinance changing the premium paid by retirees. The ordinance also changed the insurance benefits requiring retirees pay higher co-pays and receive reduced service coverage as compared to the coverage in effect at the time of retirement.

Within hours of the council vote, a lawsuit was filed in the United States District Court of Nebraska seeking preliminary and permanent injunctions against the enforcement of the ordinance (O'Brien, 2010f). The class action lawsuit was filed by the police, fire, and civilian unions and the council that represents management personnel in collective bargaining with the city. The lawsuit also names four individuals who are retirees, one under each collective bargaining group (*Professional Firefighters Association of Omaha, Local 385 v. City of Omaha*, 2010). By September 1, 2010, the union and city were close to settling the lawsuit. The terms of the potential settlement were not made immediately public, but the trial of the case was postponed because of the tentative settlement (O'Brien, 2010g).

Is requiring retirees to pay a portion of the health insurance premiums and reducing coverage benefits as simple as announcing to retirees that their portion of the insurance premium will increase and have city council pass an ordinance? The city maintains that it is that simple. The unions involved and the affected retirees disagree.

Does a governmental entity unilaterally changing the provisions of a labor contract simply by passing a law (statute/ordinance) violate the Impairment of Contract Clause of the U.S. Constitution (Contract Clause), the Nebraska state constitution or the Omaha City Charter? The answer may differ depending on an individual's status, 1) currently retired, 2) eligible to retire but still employed or 3) employed but not eligible to retire. Whether or not such action violates the obligation of contract are similar regardless of the group impacted, i.e. sworn police, sworn fire or civilian retirees. The immediate impact of the legislative action will be on current retirees. Therefore, for the sake of brevity, this paper will primarily examine the issue as it pertains to current sworn police officer retirees.

ADDITIONAL FACTUAL BACKGROUND

Beginning in 1969, under the provisions of the Industrial Relations Act, public employees in Nebraska have had the right to organize and bargain collectively with political subdivisions. In 1972 Omaha police officers formed the Omaha Police Union, Local No. 101, associated with the International Union of Police Associations, which is part of the AFL-CIO (Omaha Police Union Local 101, n.d.).

Since at least 1979 the contract between the Omaha Police Union and the city has had a provision concerning the city paying health insurance benefits for retirees. In 1979 the city agreed to pay the health insurance premium for retirees and their families for normal service retirees between ages 55-65. The contractual provision required the same coverage be provided as was currently provided to active employees under the contract ("Agreement", 1978-1980).

For years subsequent CBAs saw mostly only tweaking of this provision. In the 1982 union contract the cap on premiums was eliminated. Disability retirees with 25 years or more of service were added to the free health insurance premium provision ("Agreement", 1982). There were no changes in the provision in the 1983 contract ("Agreement", 1983). The union contract in place from December 30, 1984 to December 29, 1986, provided the same coverage as the prior contract with some minor change in how the benefit was worded ("Agreement", 1984-1985). There was no change in the health insurance provisions for retirees in the union contract in place from December 28, 1986 until December 24, 1988 ("Agreement", 1986-1988). In the union contract effective December 25, 1988, the only change was to provide free health insurance to all service-related disability retirees, regardless of length of employment ("Agreement", 1989-1990). A minor change to the provision was made for the 1991-1993 union contract; the ending date of the health insurance premium was changed to the 1st day of the month in which the retiree turned 65 years of age ("Agreement", 1991-1993).

The health insurance benefit for retirees provision was the essentially the same in the contract that covered 1993 through 1997. However, a major change in the actual benefit for retirees was contained in another provision of that contract. In the Insurance clause for current employees, employees were required to pay a portion of their health insurance premium. Retirees who retired after the effective date of the contract were required to pay the same percentage of the insurance premium ("Agreement", 1993-1997). There were no changes in the applicable provision in the contract that expired on December 23, 2000 ("Agreement", 1998-2000).

Two major changes were made to the retiree health care provision in the contract that became effective on December 24, 2000. Effective May 31, 2001, current employees would no longer have to pay a portion of their health insurance premium. Therefore, those who retired after that date would not have to pay a portion of their health insurance premium. Also a bridge/gap insurance option was added for employees who retired before reaching age 50 but who had 20+ years of service. The employees who selected this option would qualify for the full premium benefit upon reaching their 50th birthday ("Agreement", 2001-2003).

In the 2004-2007 union contract, the last to be negotiated, the health care provision for retirees was modified extensively. It still provided for the city to pay the entire health insurance premium for retirees, except those who retired between June 1, 1993 and May 31, 2001. The changes dealt with under which circumstances employees who retired with a normal service retirement with less than 25 years of service or under age 55 would qualify for the no-cost health insurance premium benefit ("Agreement", 2004-2007).

Understanding the history of city-union negotiations that resulted in the 2003-2004 contracts is important. In 2003 the city of Omaha was facing a $10 million shortfall (Morton, 2003b). Then Mayor Mike Fahey had negotiated a contract extension with the fire union in

September 2003 that would have frozen wages for a year and ended a $450 per year per person uniform allowance in exchange for bigger raises in the future, additional leave time, and increased pension benefits. As one local Economics professor observed, the deal probably assured the firefighters long term benefits in exchange for short term savings to the city (Morton, 2003a). The city council originally rejected the firefighter contract extension (Morton, 2003b). A scaled back version of the proposed firefighter contract, containing a wage freeze and surrender of some holiday pay in exchange for future compensation and benefits, was approved by the city council and firefighters in December 2003. The opponents to the pact argued that the deal overall was too generous. The opponents feared that the contract extension simply delayed and eventually would compound the budget woes of the city (Morton, 2003c).

In 2003 then city council member Dan Welch wrote an editorial in the *Omaha World Herald* criticizing the proposed firefighters contract as being too expensive for the city. One of his criticisms was that the city would have to pay the health insurance premiums for 90% of firefighter retirees until they reached their 65th birthday (Welch, 2003).

By April 2004 the city had negotiated the new police contract. The contract deferred about $3 million worth of pay raises and other compensation in exchange for a one-year pay freeze by the police officers (Morton, 2004a). The city council approved the police contract on May 11, 2004, despite worries that the city would have to increase taxes in the future to pay for the contract (Morton, 2004b).

The police contract would be in effect through December 2007. The contract provided that police officers who met the requirements for retirement would be provided health insurance at no charge until their 65th birthday. The coverage was to be substantially the same as the employee health insurance coverage in place at the time of retirement ("Agreement", 2004-2007). The contract specifically defined this as "an obligation of the CITY." ("Agreement", 2004-2007).

The city of Omaha indicated in 2006 that health care costs had risen 134% from 1997 to 2005 ($13.4 million to $31.4 million) (Ruggles, 2006).

In a June 17, 2007, article the *Omaha World Herald* reported that approximately 115 active duty police officers and firefighters were considered ready to retire. There was a potential for a large proportion of these people retiring before the end of 2007 when the contract expired. The newspaper reported there were two primary reasons for an expected surge in police and fire retirements, the pension benefits reached an all-time highest rate and there was talk that the city wanted to negotiate a lower maximum payout in the next contract. The second reason was that the city, in the new contract, wanted to have the retirees and officers pay a portion of the health insurance premium (Sloan, 2007a).

Toward the end of 2007, the retirement picture exploded. Almost 9% (75 out of 805) of the Omaha Police Department sworn officers were projected to retire by the end of 2007. By mid-November 147 police officers and firefighters had either retired or provided notice of intent to retire by the end of 2007. Most of the year's retirements occurred after July 1st when the pension benefits reached the maximum. The rate of retirement was approximately triple the normal rate. Union officials indicated that higher retirement rate was fueled by the fear that benefits, such as fully paid health insurance premiums, would be reduced in the next contract (Sloan, 2007b).

As 2007 came to an end the number of police officers retiring reached 102. Of those retirees, approximately 65% retired early (less than 25 years on the job). Forty-two police officers retired in the month of December. The retirements were motivated by the expiring contract and fear that pension and retirement benefits would be reduced under the new contract, when negotiated (Stafranek & Sloan, 2008).

Police officers who retired in 2008, after the expiration of the contract received the same retirement benefits as provided under the contract. Tom Marfisi, the then Human Resources Director, stated that the retirement benefits could be recalculated if the Nebraska Commission of Industrial Relations (CIR), (i.e., the Nebraska agency charged with by statute to decide on labor disputes involving a government entity, including contractual impasse), in its order makes the provisions retroactive back to January 1, 2008. Otherwise, the terms of the expired contract will apply. Union lawyers said that the CIR cannot change the way pension payments are structured. The city through the Human Resources Department sent a letter in late 2007 to retirement-eligible police officers and firefighters warning them that to ensure they get the pension and retirement insurance benefits of the current contracts, they needed to retire before the end of 2007 (Sloan, 2008a).

In the negotiations for the new contract, a key issue was health insurance premiums for both current employees and retirees. At the time then mayor, Mike Fahey, said that the city could not afford to provide free health care. The city had wanted current police officers to pay 5% of the premium and also wanted to change to less comprehensive health insurance provisions. The other issue of contention was determining officer pensions. In April 2008 talks between the city and police union came to impasse (Sloan & Kotok, 2008).

The city and police union basically have been negotiating a new contract for almost three years. Health insurance and pensions appeared to be the sticking points between the police union and the city (Sloan, 2008b). City health care costs were estimated to jump 17%. That would be the largest jump since 2004 when the costs rose 19% (Sloan, 2008c).

Between 2002 and 2009 the city of Omaha's property tax rate remained constant at 43.387 cents per $100 valuation. The 2010 property tax rate increased to 47.587 cents per $100 value. Historically the 2010 rate is the third lowest rate in the past 50 years. The highest Omaha property tax rates over the past 50 years occurred in the late-1970s at 9.5 cents per $100 valuation (City of Omaha, 2010d).

APPLICABLE LAW AND LEGAL PRECEDENTS

The first paragraph of Article 1, Section 10 of the United States Constitution provides in relevant part, "No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . ." (U. S. Const.). The Nebraska Constitution provides, "No . . . law impairing the obligation of contracts . . . shall be passed" (Neb. Const.). The Omaha City Charter Section 6.09 provides in part that "The legal right to a pension or benefit for the members and beneficiaries entitled thereto shall become effective when such pensions or benefits become payable, and the same shall not be impaired, abrogated, or diminished thereafter" (Omaha, Neb., City Charter).

UNITED STATES SUPREME COURT CASES

Over the past century federal and state courts have struggled with the interpretation of the Contract clause. As with other constitutional provision, the rights provided by the Contract Clause are not absolute. More recent United States Supreme Court rulings have expanded the ability of states and local governments to impair contractual rights. However, strong dissenting opinions have frequently accompanied the court's expansion of the ability to impair.

In 1902 the United States Supreme Court decided *City of Detroit v. Detroit Citizens' Street Railway Company* involving a city granting a franchise to street car companies to lay track and operate a street car system inside the city of Detroit. The contract provided for a maximum fare that the street car company would be allowed to charge passengers. Several years later, the city unilaterally passed an ordinance that reduced the maximum allowable fare. The street car company sued to prohibit enforcement of the ordinance. The United States Supreme Court affirmed the lower court decision that found the ordinance violated the constitutional prohibition against states passing laws that impair the obligation of contract (*City of Detroit v. Detroit Citizens' Street Railway Company*, 1902).

In 1928 the United States Supreme Court decided *State of Mississippi, for the use of Robertson v. Miller*. Justice Pierce Butler delivered the opinion for a unanimous court. Robertson had been a state revenue agent in Mississippi. During his term in office Robertson instituted tax collection litigation that was still pending when his term expired. At the time Robertson left office, state law provided that the outgoing revenue agent was liable for the expenses and entitled to the commissions associated with any litigation started by the outgoing revenue agent. However, about five years after Robertson left office the state changed the law so that the successor was entitled to half of any commission for litigation that started before his/her term. After the change in law, some of the taxes for which Robertson had instituted legal action were paid. Miller, Robertson's successor, refused to give Robertson the entire commissions based on the new law. The state courts upheld Miller's position and Robertson appealed to the

United States Supreme Court arguing the law violated the Contract Clause (*State of Mississippi, for the use of Robertson v. Miller*, 1928, pp.175-177).

Justice Butler, writing for the unanimous court, acknowledged that the Contract Clause does not limit a state's right during the term of its officers to pass laws that change future duties and compensation paid. However, the court held that after services had been performed by a public officer under a law that specifies compensation for that action, the Contract Clause protects the compensation from being changed retroactively (*State of Mississippi, for the use of Robertson v. Miller*, 1928, pp. 178-179).

The Great Depression provided one of the more modern United States Supreme Court Contract Clause cases. *Home Building & Loan Association v. Blaisdell* (1934) arose when the state of Minnesota passed a temporary law delaying home foreclosure sales and extending redemption periods. As stated in the law, it was an emergency response to the economic conditions and its provision would last no longer than two years. In a 5-4 decision, the United States Supreme Court upheld the law as constitutional. Justice Charles Evans Hughes, writing the majority opinion, stated "While emergency does not create power, emergency may furnish the occasion for the exercise of power" (*Home Building & Loan Association v. Blaisdell,* 1934, p. 426). Justice Hughes continued, "But, where constitutional grants and limitations of power are set forth in general clauses, which afford a broad outline, the process of construction is essential to fill in the details. That is true of the Contract Clause" (*Home Building & Loan Association v. Blaisdell,* 1934).

The court's majority in *Blaisdell* found that the statute did not violate the constitutional prohibition against impairing the obligation of contract based on the criteria established by the court:

1) a state of emergency existed,
2) the legislation was designed to address that emergency and protect the interests of society as a whole,
3) the legislation was appropriate and reasonable for the emergency,
4) the nature of the legislation did not alter the basic terms of the mortgages in question, and
5) the legislation was temporary.

The law also provided that defaulting mortgagees who remained in the property under the provisions of the legislation were required to pay reasonable rent as determined by the appropriate court. The change in the law simply delayed enforcement of the contractual terms; the law did not extinguish the contractual remedies (*Home Building & Loan Association v. Blaisdell,* 1934, pp. 445-447).

In the dissenting opinion, Justice George Sutherland set forth the history of the Contract Clause, both its creation and judicial interpretation. Justice Sutherland stated that the meaning of constitutional provisions does not change over time. He continued that “Constitutional grants of power and restrictions upon the exercise of power are not flexible as the doctrines of the common law are flexible” (*Home Building & Loan Association v. Blaisdell,* 1934, pp. 451-452). According to the dissent, based on the history of the Contract Clause, “the contract impairment clause denies to the several states the power to mitigate hard consequences resulting to debtors from financial or economic exigencies by an impairment of the obligation of contracts of indebtedness” (*Home Building & Loan Association v. Blaisdell,* 1934, p. 453). Justice Sutherland in referring to the Contract Clause stated “the clause of the Constitution now under consideration was meant to foreclose state action impairing the obligation of contracts primarily and especially in respect of such action aimed at giving relief to debtors in time of emergency” (*Home Building & Loan Association v. Blaisdell,* 1934, p. 465). The dissenting judges argued that the Minnesota law was unconstitutional because its provisions impaired the substantive right of the creditor to enjoy ownership and control of the property in default for an extended period of time. Further no emergency circumstances justified ignoring the constitutional prohibition against state’s impairing the obligations of contract (*Home Building & Loan Association v. Blaisdell,* 1934).

It was thirty years before the United States Supreme Court again meaningfully visited the Contract Clause by deciding *City of El Paso v. Simmons* (1965). The case involved a 1910 transaction in which the state of Texas sold certain public land pursuant to the statutes at the time. Those statutes allowed a defaulting purchaser to reinstate the purchase contract at anytime by paying the past due amount, provided the reinstatement would not adversely affect the rights of a third-party purchaser. In 1941 the Texas legislature changed the law to allow a window of five years for reinstatement. A successor party to the 1910 contract, Simmons, sued when he attempted to reinstate the defaulted contract more than five years after the default. At that point in time, the land was still owned by the state. Subsequently, the state sold the land to the city of El Paso. Simmons sued claiming that the 1941 law impaired the obligation of the original contract. The court’s majority agreed that the 1941 law impaired the obligation of contract but stated that not every impairment of contractual obligation violates the constitutional provision (*City of El Paso v. Simmons*, 1965, pp. 506-507). Justice Byron White, writing for the majority, quoted from the *Blaisdell* decision in setting forth a balancing test:

> Of course, the power of a State to modify or affect the obligation of contract is not without limit. ‘(W)hatever is reserved of state power must be consistent with the fair intent of the constitutional limitation of that power. The reserved power cannot be construed so as to destroy the limitation, nor is the limitation to be construed to destroy the reserved power in its essential aspects. They must be construed in harmony with each other. This principle precludes a construction which would permit the state to adopt as its policy the repudiation of debts or the

> destruction of contracts or the denial of means to enforce them' (*City of El Paso v. Simmons*, 1965, p. 509).

Justice Hugo Black was the lone dissenting justice in the *Simmons* case. After noting the reason that Texas changed the statute was to make the transactions more profitable for the state, Justice Black wrote:

> If the hope and realization of profit to a contract breaker are hereafter to be given either partial or sufficient weight to cancel out the unequivocal constitutional command against impairing the obligations of contracts, that command will be nullified by what is the most common cause for breaking contracts. I cannot subscribe to such a devitalizing constitutional doctrine (*City of El Paso v. Simmons*, 1965, p. 520).

In 1976 the United States Supreme Court heard arguments involving the Contract Clause in *United States Trust Company of New York v. State of New Jersey* (1977). The appellant was the trustee and holder of bonds issued by the Port Authority of New York and New Jersey to subsidize operations. In 1962 New York and New Jersey passed a statutory covenant that limited the Port Authority's ability to subsidize rail passenger operations from its revenues and reserves. The covenant had pledged those funds as security for bonds issued by the Port Authority. In 1974 both states passed laws retroactively repealing the 1962 statutory covenant so the Port Authority could subsidize passenger rail operations between the two states (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 3).

The action was originally brought in the New Jersey state court system. The Superior Court found the legislation to be a legitimate exercise of the state's police powers and dismissed the lawsuit filed by the appellant. The New Jersey Supreme Court, in a per curiam opinion, affirmed the Superior Court's ruling. The United States Supreme Court accepted the appeal (*United States Trust Company of New York v. State of New Jersey*, 1977, pp. 3-4).

In a 4-3 decision, the United States Supreme Court reversed the lower courts' rulings. In the court's decision Justice Harry Blackmun wrote that for the first century of our country's history the Contract Clause was one of the few express limitations on a state's powers. The importance of this clause was shown by the numerous decisions that have been based on the Contract Clause. However, according to Blackmun, over the past century, the 14th Amendment has taken a more prominent role in limitations of state powers. Justice Blackmun referred to the *Blaisdell* and *Simmons* decisions. He noted that both decisions chose not to use a rigid interpretation of the Contract Clause. At the same time neither case indicated that the Contract Clause was meaningless in modern society (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 16).

Justice Blackmun explained that finding a technical impairment occurred is the first step in the analysis. The Contract Clause, according to the decision, limits the legitimate exercise of state powers. An important public interest is not always sufficient to overcome the Contract Clause. Further the scope of the state's power is dependent on the nature of the contractual relationship involved (*United States Trust Company of New York v. State of New Jersey*, 1977, pp. 21-22).

When the contract involved, is that of the governmental entity, a different analysis is necessary. According to the court, "the Contract Clause does not require a State to adhere to a contract that surrenders an essential attribute of its sovereignty" (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 23). Historically the court has held that police powers and eminent domain could not be contracted away; however, taxing and spending powers could be bound by contract. As indicated in the decision "the Court has regularly held that the States are bound by their debt contracts" (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 24). However, according to the majority opinion, the state still may have the authority to subsequently modify its own financial obligation if the modification is reasonable and necessary to serve an important public interest. In making this analysis when an entity is modifying its own financial obligation, the courts should not give deference to the entity's assessment of necessity and reasonableness (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 25). Justice Blackmun wrote:

> A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 26).

Justice Blackmun wrote that an impairment can only be upheld if the impairment is both reasonable and necessary to achieve the important public purpose declared by the state. In *United States Trust Company* the court's majority ruled that the impairment could not be upheld because it was not necessary to achieve the stated purpose or reasonable based on the involved circumstances (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 29).

In determining necessity, two levels are to be examined. First will a more modest modification accomplished the desired end. The other test involves the existence of another alternative to achieve the desired goal without impairing the contract in any nature (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 29-30). The court held that the impairment was not reasonable because the circumstances were neither new nor unforeseen (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 31).

The dissenting opinion, authored by Justice William Brennan, basically held that the Contract Clause has little role in today's society. The minority believe that the state should be free to repudiate its obligations when it feels that such action is appropriate. Justice Brennan wrote that governments, to save integrity, will not use the power inappropriately too often (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 33-62).

The United States Supreme Court again considered the Contract Clause in 1978 when it decided *Allied Structural Steel Company v. Spannaus* (1978). Justice Potter Stewart wrote the majority opinion in this 5-3 decision, with Justice Harry Blackmum not participating in this decision. Minnesota enacted the Minnesota Private Pension Benefits Protection Act in 1974. The law required private employers with at least 100 employees, one or more of whom were residents of Minnesota, provided a qualified pension plan to pay a pension funding charge if the employer closed a facility in Minnesota or ended the plan. The fee was based on the funding level of the plan regarding employees who had worked at least 10 full years. The fee only applied to plant closing and pension plan terminations that occurred after the act's passage (*Allied Structural Steel Company v. Spannaus*, 1978, pp. 238-239).

Allied Structural Steel, a company with more than 100 employees, had a facility in Minnesota with 30 employees. It offered a qualified pension plan since 1963. After passage of the act, Allied decided to close its Minnesota facility. The state, under the provisions of the act, assessed the fee. Allied took the matter to court arguing that the Contract Clause prohibited the state of Minnesota from enforcing the law because it impaired the contractual rights between the employer and employees (*Allied Structural Steel Company v. Spannaus*, 1978, pp. 236-237).

The majority opinion explained the 5-factor test from *Blaisdell* that was to be used to determine if a legislative act of a state illegally impairs the obligation of contract. The factors were (1) an emergency existed, (2) law intended to protect a basic societal interest, not a favored group; (3) relief was appropriately tailored to the emergency conditions it was meant to address, (4) the conditions were reasonable and (5) legislation limited to the duration of the emergency (*Allied Structural Steel Company v. Spannaus*, 1978, pp. 242). The majority then held that an emergency was not necessary and that the action does not have to be temporary. The test should be, according to the court, (1) did the legislation create a substantial impairment on the contractual relationship, (2) was the legislation in furtherance of a broad, generalized societal issue (economic or social) and (3) was the legislation reasonable to achieve its goal (*Allied Structural Steel Company v. Spannaus*, 1978, pp. 244-251).

Justice Potter Stewart wrote, "The severity of the impairment measures the height of the hurdle the state legislation must clear. Minimal alteration of contractual obligations may end the inquiry at its first stage. Severe impairment, on the other hand, will push the inquiry to a careful examination of the nature and purpose of the state legislation" (*Allied Structural Steel Company v. Spannaus*, 1978, pp. 245, internal citations omitted).

The court majority found that retroactively modifying the compensation the company had agreed to pay was a substantial impairment of the contract between the employer and employee. The court then indicated there was nothing in the record to indicate that the act was passed to meet an important societal goal. Further the court found that no emergency situation existed.

Finally, the act was not a temporary alteration of contractual obligation but a severe, permanent change that irrevocably and retroactively changed the employer-employee contractual relationship. Therefore the court ruled that the act was unconstitutional as a violation of the Contract Clause (*Allied Structural Steel Company v. Spannaus*, 1978, pp. 245-252).

The dissenting opinion, written by Justice William Brennan, concluded that the majority opinion expanded the historic reach of the Contract Clause. The court's minority believed that the act was a valid exercise of state police powers in order to protect its citizens regarding pensions. The dissenting opinion argued that the act did not impair the contractual relationship but simply added a known, legal duty to certain employers. Because the act only applied to closings and plan terminations that occurred after its passage, the employers could incorporate the law's impact into the decision-making process. Justice Brennen believed that majority decision distorted the meaning of the Contract Clause (*Allied Structural Steel Company v. Spannaus*, 1978, pp. 254-261).

A Kansas law regulating the intrastate price of natural gas was the subject of a Contract Clause challenge in *Energy Reserve Group, Inc. v. Kansas Power and Light Company* (1983). In 1975 the parties, or their predecessors in interest, entered into a long-term contract. The contract had price adjustment clauses. In 1978 the federal government passed the Natural Gas Policy Act of 1978. The law gave states certain regulatory authority over the intrastate pricing of natural gas. In 1979 the state of Kansas exercised that authority in passing the Kansas Natural Gas Price Protection Act (Kan. Stat. Ann., 1981). Energy Reserves Group brought suit for declaratory judgment finding the Kansas statute invalid as impairing the obligation of contract. The Supreme Court upheld the statute (*Energy Reserve Group, Inc. v. Kansas Power and Light Company,* 1983).

Justice Harry Blackmun, writing the decision of the court, acknowledged that the language of the Contract Clause is not absolute. The clause does not prevent the state from acting in regard to a inherent police power to protect the vital interests of the state's residents (*Energy Reserve Group, Inc. v. Kansas Power and Light Company,* 1983, p. 410). Justice Blackmun then explained the analysis to be undertaken as to a law's constitutionality. The first step in the process is to determine if the legislation impairs a contractual obligation. If so, then is it a substantial impairment. One factor to be considered is the historic nature of governmental regulation of the activities associated with the contractual obligation. If the court finds that a substantial impairment has occurred, the legislation must have a legitimate, significant public purpose; although the public purpose does not have to be either an emergency or a temporary situation. If a legitimate public purpose is involved, then the analysis considers the reasonableness and appropriateness of the legislation (*Energy Reserve Group, Inc. v. Kansas Power and Light Company,* 1983, pp. 411-412).

The Pennsylvania Subsidence Act (Bituminous Mine Subsidence and Land Conservation Act, 1986) prohibited removing more than 50% of coal beneath certain structures to provide surface support. The coal miners association challenged the law as an unlawful taking of their property and a violation of the Contract Clause in *Keystone Bituminous Coal Association v. DeBenedictis* (1987). In prefacing the Contract Clause analysis Justice John Stevens, who wrote the majority opinion, provided a historical perspective of the Contract Clause, "The context in which the Contracts Clause is found, the historical setting in which it was adopted, and our cases construing the Clause, indicate that its primary focus was upon legislation that was designed to repudiate or adjust pre-existing debtor-creditor relationships that obligors were unable to satisfy" (*Keystone Bituminous Coal Association v. DeBenedictis,* 1987, pp.502-503, citations omitted)

The majority found that the act created a significant impairment of the obligation of contract, the first step in the analysis. Regarding a finding of significant and legitimate public purpose, Justice Stevens wrote:

> Of course, the finding of a significant and legitimate public purpose is not, by itself, enough to justify the impairment of contractual obligations. A court must also satisfy itself that the legislature's "adjustment of 'the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption.' (citations omitted) But, we have repeatedly held that unless the State is itself a contracting party, courts should "'properly defer to legislative judgment as to the necessity and reasonableness of a particular measure.' " (*Keystone Bituminous Coal Association v. DeBenedictis,* 1987, p. 505, citations omitted).

The majority then found that the legislation in question was reasonable and appropriate. The court upheld the legislation as not contrary to the Contract Clause. The dissent in the case was based on the unlawful taking claim and did not discuss the Contract Clause analysis (*Keystone Bituminous Coal Association v. DeBenedictis,* 1987).

In 1992 the United States Supreme Court in *General Motors Corporation v. Romein* further clarified the components used to determine if a contract imposed an impairment of obligation of contract. Those three components are (1) a contractual relationship, (2) the legislation impairs that contractual relationship and (3) the impairment is substantial (*General Motors Corporation v. Romein*, 1992).

OTHER FEDERAL COURT DECISIONS

The Court of Appeals for the First Circuit in 1997 addressed the issue of a legislative change to public employee pension funds in deciding *Parker v. Wakelin* (1997). Maine state statutes created the Maine State Retirement System as a public trust. Membership in the pension trust was mandatory for all Maine state employees and public school teachers. The pension plan was a defined benefit plan to which the employee contributes. To be eligible to receive pension benefits employees had to meet certain age and employment longevity measures. Eligible retirees received two percent of his/her average final compensation multiplied by the number of years of countable service (25 years maximum). The plan was a legislative enactment not the result of collective bargaining. The statute provided no vesting provision before retirement. In 1993 the Maine legislature passed an amendment to the law that changed the method of computing average final compensation in a manner that reduced expected pension benefits for many of the members. The motivation for the change was to save the state money during a budget crisis (*Parker v. Wakelin*, 1997, pp. 2-3).

The 1993 amendment had three changes that impacted current employees who had not met retirement requirements and three changes that impacted all current employees. The amendment did not impact current retirees in any manner (*Parker v. Wakelin*, 1997, p. 3). According to the decision, "It is not disputed that the 1993 Amendments operate to the disadvantage of MSRS members without providing substantive offsetting benefits" (*Parker v. Wakelin*, 1997). The Circuit Court found that the law did not violate the Contract Clause because the MSRS was a legislative enactment that did not create contractual obligations until a member retired. The court intentionally chose not to decide if the pension was a gratuity or not. Since the 1993 amendments did not impact retirees, there was no contractual relationship involved in the claim (*Parker v. Wakelin*, 1997, p. 9).

Larsen v. Pennsylvania (1998) involved Rolf Larsen, a former justice on the Pennsylvania Supreme Court. Larsen had been on the court for about 12 years when, in 1989, the court adopted a benefit plan that would provide retired justices with ten years or more service on the Supreme Court with lifetime health insurance. Approximately two years later Larsen was investigated for judicial misconduct and was reprimanded. As a result of a grand jury investigation the following year, criminal charges were brought against Larsen. A week later Larsen was suspended. A year later, Larsen's impeachment was final. Larsen was convicted of two felony counts and the trial judge pursuant to state law also removed Larsen from office. Larsen sued to get his retirement benefits, including the health insurance (*Larsen v. Pennsylvania*, 1998, pp. 85-86).

In 1992 the Pennsylvania Supreme Court had ruled that the state constitutional prohibition from paying compensation to suspended or removed judges did not include retirement benefits; therefore, a judge removed for misconduct was still entitled to receive appropriate retirement benefits. The following year the applicable constitutional provision was amended to explicitly include a prohibition regarding retirement benefits. Larsen sued for his retirement benefits arguing, among other theories, violation of the Contract Clause. The defendants moved for dismissal because of failure to state a claim and qualified immunity. The district court denied the motion and the defendants appealed (*Larsen v. Pennsylvania*, 1998, p. 86).

In citing a 1983 Pennsylvania Supreme Court decision involving a state retirement board, the Third Circuit ruled that Larsen had stated a claim in alleging that the state unilaterally and retroactively denied him vested retirement benefits. The Pennsylvania Supreme Court had written "to emphasize that no law, regardless of how noble it purposes may retroactively affect existing contract obligations. (citation omitted) Once a contractual obligation vests . . . the same cannot be altered, amended or changed by unilateral action" (*Larsen v. Pennsylvania*, 1998, p. 89 quoting *Commonwealth ex rel. Zimmerman v. Officers & Employees Retirement Board*, 1983). The court further cited four additional Pennsylvania cases from 1958 – 1984 which held that legislation could not adversely affect vested rights in retirement pay and benefits. Pennsylvania considered retirement provisions as deferred compensation for services actually rendered in the past (*Larsen v. Pennsylvania*, 1998).

The defendants argued that the holding in *United States Trust Company* held that the state could make the changes due to a significant public interest. The Third Circuit wrote, "'Any argument predicated upon a compelling state interest must necessarily fail when applied to this attempted retroactive forfeiture' of previously vested retirement benefits" (*Larsen v. Pennsylvania*, 1998, p. 91 quoting *Commonwealth ex rel. Zimmerman v. Officers & Employees Retirement Board*, 1983). The Third Circuit ruled in favor of Larsen on the Contract Clause cause of action.

When the state of Hawaii legislatively changed the state pay system from a predictive system to an after-the-fact system, the union representing the professors at the state university filed suit. After the District Court entered a preliminary injunction to prohibit the state from making the change during the pendency of the lawsuit, the state appealed to the Ninth Circuit Court of Appeals in *University of Hawaii Professional Assembly v. Cayetano* (1999). One element the court must analyze is the likelihood of success on the merits. The state had used the predictive pay model for more than 25 years. Knowing that the state was thinking about changing the payroll method, the union attempted to negotiate the point during regular contract negotiations. The state refused to bargain on the issue. A contract was entered into without a specific provision as to the method of payment. The state then unilaterally changed the payment system which would have resulted in delay of six pay periods. The state claimed that it would save $51 million by rolling over some salary payments to the following fiscal year and in less overpayment of salaries. The measure was being taken during difficult economic times in Hawaii (*University of Hawaii Professional Assembly v. Cayetano*, 1999).

The union claimed that the legislation impaired the obligation of contract as prohibited by the United States Constitution. The Ninth Circuit applied the three step analysis to determine the likelihood of success. First the Ninth Circuit cited the United States Supreme Court in holding that employers may not unilaterally implement changes on bargaining topics (*University of Hawaii Professional Assembly v. Cayetano*, 1999, p. 1102, citing *NLRB v. Katz*, 1962).

The Ninth Circuit referenced several court opinions that held a governmental entity cannot balance its budget by unilaterally changing its obligations to its employees. The court citing the Second Circuit Court of Appeals in a case involving the unilateral implication of a pay lag system, "'the menu of alternatives' open to the State for revenue-raising or revenue savings. 'does not include impairing contract rights to obtain forced loans to the State from its employees'" (*University of Hawaii Professional Assembly v. Cayetano*, 1999, pp. 1105-1106 quoting from *Association of Surrogates & Supreme Court Reporters v. New York*, 1991).

The Ninth Circuit also quoted from the New Hampshire Supreme Court in a case involving a unilateral forced furlough requirement to address budget concerns. The Ninth Circuit wrote "The legislature had many alternatives available to it, including reducing non-contractual state services and raising taxes and fees. Although neither of these choices may be as politically feasible as the furlough program, the State cannot resort to contract violations to solve its financial problems" (*University of Hawaii Professional Assembly v. Cayetano*, 1999, p. 1106 quoting *Opinion of the Justices (Furlough)*, 1992).

In *Cayetano* the Ninth Circuit observed being faced with more politically difficult alternatives does not justify the state to impose the brunt of the budgetary problems onto its employees. It also held that an impairment is unreasonable if a problem existed at the time the contractual obligation was incurred (*University of Hawaii Professional Assembly v. Cayetano*, 1999, p. 1107).

In 2007 the Court of Appeals for the Eighth Circuit considered the unilateral modification of retiree benefits in *Crown Cork & Seal Company, Inc. v. International Association of Machinists and Aerospace Workers* (2007). Crown Cork & Seal, plaintiff, appealed from a District Court decision dismissing its declaratory judgment case on summary judgment. In 1990 plaintiff had acquired Continental Can Company. Continental had negotiated labor contracts that provided health insurance benefits for its retirees. After the acquisition Crown continued to negotiate with the union and the health insurance benefits for retirees remained in the contracts. In 2003 Crown announced its unilateral decision to modify the health insurance benefits for retirees who were under prior contracts. The changes brought premium sharing, increased deductibles and out-of-pocket maximums, decreased coverage, elimination of some dependent coverage and increases to lifetime benefits. Crown then sought declaratory judgment that it acted legally in making these unilateral modifications. The union filed a grievance under the contract and sought arbitration. Crown refused (*Crown Cork & Seal Company, Inc. v. International Association of Machinists and Aerospace Workers*, 2007, pp. 913-914).

In analyzing the fact situation the Eighth Circuit reversed the lower court decision and found in favor of Crown. In doing so the appellate court noted that the retiree health benefit never vested based on the terms of the labor contract. Further, there was a specific provision in the retiree health plan adopted into the agreement that Crown reserved the right to modify or terminate the retiree health plan at any time (*Crown Cork & Seal Company, Inc. v. International Association of Machinists and Aerospace Workers*, 2007, p. 918).

Another Eighth Circuit decision may be more relevant to the situation in Omaha. *American Federation of State, County and Municipal Employees v. City of Benton* (2008) involved the city's unilateral decision to reduce and then end paying health insurance premiums for retirees. Beginning in 1979 the union had bargained for the non-uniformed employees of the city. In 2002 the union and city entered a collective bargaining agreement effective through

2004 that provide, in part, retirees would receive health insurance to be fully paid by the city. The city had paid the entire health insurance premium for employees for more than ten years. On October 13, 2003, upon recommendation of the personnel committee, the city council passed a resolution unilaterally changing the retiree health insurance benefit. Employees with 28 or more years of service still had 100% of their premium paid by the city. If a retired employee did not have at least 10 years of service, then the city would not pay anything toward the premium. For all other retirees, the city's contribution toward the insurance premium would be 3% per year of service. Five months later the city council voted to end all city contribution toward insurance premiums for retired employees. This second amendment was purportedly based on the belief that state law required the retirees to pay 100% of the premium (*American Federation of State, County and Municipal Employees v. City of Benton*, 2008, p. 877).

In deciding the case, the Eighth Circuit used a three-part test to determine if the city's actions violated the Contract Clause. The first step was to determine if the state action created a substantial impairment of a contractual relationship. To determine legality the court must determine if (1) a contractual relationship existed; (2) a change in law impaired that contractual relationship and (3) the impairment was substantial. If the court found that there was a substantial impairment, then the second step was to determine if there is a significant and legitimate public purpose behind the legislation. If the court found that the second step exists, the final step in the analysis is whether or not the impairment of the contractual rights and responsibilities were reasonable and appropriate to the public purpose (*American Federation of State, County and Municipal Employees v. City of Benton*, 2008, p. 879).

The city argued that there was no contractual obligation for it to pay the insurance premiums because (1) the language of the collective bargaining agreement was ambiguous; (2) it was illegal for the city to pay the retirees' health insurance premium under Arkansas law; (3) the city did not have authority to enter into a multi-year contract and (4) the payment of the retiree premiums is a matter of city policy that cannot be negotiated away.

The alleged ambiguous language that the city would pay *100% of retirement coverage* should be interpreted using past practices, usage and custom according to the court. Similar language had been in the contract for more than five years, and the city interpreted it to mean that the city paid all of the retirees' health insurance premiums. Therefore, the contractual wording is interpreted to mean that the city would pay the health insurance premiums.

As to the statutory interpretation, the court found that the statutory language was intended to protect minimum benefits for retirees and not limiting a more generous benefit from the city. Regarding the argument that the city could not enter into a multi-year contract, the court found that the Arkansas Supreme Court previously ruled that a governmental unit could not hide behind such a claim when it had already benefited from the contract. In response to the public policy argument, the court again looked at state precedent in which the state courts had ruled that the city could not enter into a contract with an unreasonably long period of time. A collective bargaining agreement for two years was not unreasonable (*American Federation of State, County* *and Municipal Employees v. City of Benton*, 2008, p. 881). Having addressed each of the defendant's arguments, the court found that, "Upon the expiration of the agreement, the City was free to renegotiate terms with the Union based on its fiscal restraints. In attempting to alter the CBA's terms unilaterally, however, the city impaired its agreement with plaintiffs" (*American Federation of State, County and Municipal Employees v. City of Benton*, 2008).

The court then moved on to the second step of the analysis, significant and legitimate public purpose. The court stated that economic concerns may give the city the legitimate ability to use police powers, but that those concerns must be unprecedented emergencies and that any such law must address a broad, generalized economic or social problem. Though the testimony suggested that the 2003 resolution was to address economic necessity, there was no evidence that the economic conditions were unprecedented. Further, at the time of passing the 2003 resolution there was no discussion of budgetary concerns. Therefore, the city did not have a legitimate public purpose. Because the city failed to meet the second prong of the test, the court did not discuss the final prong (*American Federation of State, County and Municipal Employees v. City of Benton*, 2008, p. 882).

In April 2010 the United States District Court for the District of Rhode Island decided *Rhode Island Council 94 A.F.S.C.M.E. v. Rhode Island* (2010). Because of the current financial crisis the state of Rhode Island unilaterally enacted legislation reducing retiree health benefits. The union and state negotiated a collective bargaining agreement that was in effect from July 1, 2004 through June 30, 2008. In May 2008 the state passed the legislation that unilaterally changed the retirement health benefits. Then on June 16, 2008, the state notified the union that the collective bargaining agreement was being terminated and not renewed. The unilateral legislative changes decreased the state's contributions toward the retiree's health insurance premium for most retirees (*Rhode Island Council 94 A.F.S.C.M.E. v. Rhode Island*, 2010).

The Rhode Island District Court used a four prong test to determine if the legislative act violated the contract clause. The prongs were: (1) did a contract exist; (2) did the law impair that contract; (3) was the impairment substantial; and (4) was the impairment reasonable and necessary to achieve an important public purpose. Although the collective bargaining agreement was negotiated between the state and union, the state argued it had terminated the contract prior to the effective date of the law. The court found in favor of the state on this point and said that the state might have a statutory obligation to continue the terms of the terminated contract until a new contract was formed, but there was no contractual obligation (*Rhode Island Council 94 A.F.S.C.M.E. v. Rhode Island*, 2010).

The union also argued that the retirement health benefit provisions of the collective bargaining agreement were meant to survive the termination of the agreement. The court, examining the wording of the contract tying the health insurance benefit to state law, ruled that the provision was not clearly intended to survive the termination of the agreement. Therefore, the court found not impairment of contract because there was no contractual obligation (*Rhode Island Council 94 A.F.S.C.M.E. v. Rhode Island*, 2010).

NEBRASKA COURT DECISIONS

The Nebraska Supreme Court in 1929 decided *Travelers' Insurance Company v. Ohler* (1929). The case involved a change in state law that impacted the standard of appeal from the findings of the trial court in a workers' compensation case. The Nebraska Supreme Court stated that a legislative act cannot act retrospectively if it will invalidate or impair the obligation of contract or interfere with a vested right. The court, quoting an 1876 Nebraska case:

> In the interpretation of statutes, it is a familiar doctrine that they can have no retrospective operation beyond the time of their commencement, unless so declared by express words or positive enactment, and in such case they will be considered as inoperative and void, if they affect or change vested rights (*Travelers' Insurance Company v. Ohler*, 1929, p. 450 quoting Wilcox v. Sauners, 1876).

The Nebraska Supreme Court summed up the law by holding that:

> It may be conceded that, ordinarily, the rules of court procedure alone may at any time be changed by legislative enactment, but if a legislative enactment does, in fact, impair or affect a vested right it is unenforceable or inapplicable as against the enforcement of rights so impaired. What belongs merely to the remedy may be altered, provided that the alteration does not impair the obligation of the contract or interfere with the vested right. If it does the latter, then it is invalid and contrary to the Fourteenth Amendment to the Federal Constitution (*Travelers' Insurance Company v. Ohler*, 1929).

In the 1940 case *Ritter v. Drainage District No. 1 of Otoe and Johnson Counties* (1940), the Nebraska Supreme Court reiterated the legal point that a legislative act cannot retrospectively invalidate or impair a vested right. The court further stated that contractual and vested rights created by statute cannot be destroyed by a subsequent legislative act (*Ritter v. Drainage District No. 1 of Otoe and Johnson Counties*, 1940, p. 721).

Halpin v. Nebraska State Patrolmen's Retirement System (1982) involved the unilateral decision to change the method of calculating the pension benefit. Halpin retired from the Nebraska State Patrol in December 1979 with 32 years of service. The action was brought to require the Retirement System to include lump sum payments for unused vacation and sick leave in the calculation of the pension benefit. From 1969 until January 4, 1979, the pension benefit calculation included such lump sum payments. In 1972 the Retirement Board officially approved the inclusion. However, a 1978 audit and attorney general's opinion questioned the practice. These 1978 documents motivated the Retirement Board to change the method of computation. The inclusion of the lump sum payments ended on January 4, 1979. The retirees presented evidence that they had been advised prior to the change by representatives of the state that those lump sum payments would be included in the calculations. The legal question for the court was whether or not the change in method of calculation constituted an impairment of contractual obligation (*Halpin v. Nebraska State Patrolmen's Retirement System*, 1982, p. 913).

The court noted that in Nebraska pension benefits have been considered deferred compensation since at least 1911. Since these benefits are deferred compensation earned in exchange for services rendered, employees have a reasonable expectation that the benefits will be afforded legal protection under the laws of contracts (*Halpin v. Nebraska State Patrolmen's Retirement System*, 1982, p. 914).

The Nebraska Supreme Court acknowledged that not every modification of a contract is a violation of the state or federal Contract Clauses. In analyzing the situation before it, the court ruled that, absent a specific provision to the contrary, the pension benefits vested at the time of employment. Therefore, the retirees in the case had an expectation and contractual right to have the lump sum payments included in the pension determination. Therefore, the change was an impairment of the contractual right (*Halpin v. Nebraska State Patrolmen's Retirement System*, 1982, p. 915).

However, the court observed that not all impairments violate the constitutional prohibitions. The court must determine if the state action was reasonable and necessary to accomplish an important public purpose. The level of scrutiny should be greater in a case that the state is attempting to abrogate its own financial obligations. In quoting a Massachusetts case the Nebraska court stated "That the maintenance of a retirement plan is heavily burdening a governmental unit has not itself been permitted to serve as justification for a scaling down of benefits figuring in the 'contract'" (*Halpin v. Nebraska State Patrolmen's Retirement System*, 1982, quoting *Opinion of Justices*, 1973).

The court held that the change in method of calculation was unconstitutional as there was no evidence that the choice for the state was change the method of calculation or insolvency and because the impairment was without comparable new advantage to the retirees (*Halpin v. Nebraska State Patrolmen's Retirement System*, 1982, p. 916).

In *Caruso v. City of Omaha* (1986) city employees challenged the provisions of Omaha municipal code that required them to continue to pay into the retirement system without additional retirement compensation because they had reached the maximum percentage of pension. The prior law in Omaha provided a flat pension of $150 per month without vesting until retirement. Contributions were forfeited if the employee left city employment prior to retirement. The new pension provision provided a percentage of average monthly compensation as determined by a formula. The employee was entitled to return of his/her contributions should the employee leave before retirement. At retirement the maximum pension payment would be 40% or 50% of average monthly compensation based on age and length of service. The court stated that the plain meaning of impairment, make worse, should be used in making a Contract Clause analysis. The court continued:

> Obviously, then, not every change constitutes an impairment under the federal Constitution. The change must *take something away* and not work to the parties' benefit. Therefore, in order for appellants to succeed under their contention that the ordinances of the City of Omaha "impair" the obligation of a contract, appellants have the burden of showing how the situation which now exists has been made worse than that which existed when their rights were created. Absent such a showing, there is no proof of any "impairment" (*Caruso v. City of Omaha*, 1986, p. 44).

The court noted that *Halpin* stood for the proposition that pension benefits are a matter of contract not gratuities. The law does not guarantee a public employee the best pension that that employee may desire (*Caruso v. City of Omaha*, 1986).

In 1990 the Nebraska Supreme Court again reiterated that retiree health insurance benefits are deferred compensation and are matters of contractual obligation in *Omer v. Tagg* (1990). A retired highway patrolman sued for health insurance benefits that were promised him when he was hired. A change in law prior to his retirement made him ineligible for health insurance benefits. The court ruled that the patrolman was entitled to be part of the health insurance program based on the contractual obligation to pay him the earned deferred compensation (*Omer v. Tagg*, 1990).

Calabro v. City of Omaha (1995) involved a class action lawsuit brought by current and retired Omaha firefighters seeking to require the city to reinstate the supplemental pension benefits started in 1973 that the city unilaterally ceased in 1989. The ordinance would eliminate the benefit as to those employees who became eligible for pension payments after the effective date. The court held that the supplemental benefits were part of the pension program. The pension plan was deferred compensation. The court rejected the city's argument that the supplemental benefits were a gift that could be taken away at any time. In rejecting the city's argument the court noted that the ordinance did not reserve the right to end at anytime. Employees may have relied on the supplemental benefits in making employment and retirement decisions. The city also argued that the supplemental benefits did not fit the pension requirements contained in the city charter. The court stated that the contractual nature of the supplemental basis was not defined by the city charter but by the nature of the benefits and the reasonable expectation of employees (*Calabro v. City of Omaha*, 1995, pp. 549-550).

The Nebraska Supreme Court, regarding the Contract Clause, used the three step analysis approach of (1) impairment of contract, (2) substantial impairment and (3) legitimate exercise of sovereign powers. The court found that the first two steps were met, so it analyzed the legitimacy of the action. To be a legitimate exercise of sovereign powers requires that the act must be reasonable and necessary to meet an important public purpose. Because the city is attempting to relieve its own financial obligation the level of judicial scrutiny must be greater than a private contract. To meet the standard the city must show its actions bear on the successful operation of the pension system and that the employees were accorded a comparable new advantage (*Calabro v. City of Omaha*, 1995, pp. 551-552).

The city argued that it faced potential bankruptcy if the supplemental plan remained in place. The city provided a fiscal report from a third-party consultant to support its position. The court stated that the report recommended exploring funding options not elimination of supplemental benefits. Further the court held that the necessity element should be examined on two levels, if the modification is sufficient to accomplish the city's purpose and does the city have other alternative methods for achieving the purpose. The court also acknowledged that a city may make reasonable changes or modifications in pension plans, even as to people with vested interest therein, provided the disadvantages are offset by counterbalancing advantages (*Calabro v. City of Omaha*, 1995, p. 552).

In *Livengood v. Nebraska State Patrol Retirement System* (2007) the Nebraska Supreme Court ruled that the reduction of allowable sick leave accumulation was not an unlawful impairment of contract because the action was the result of the collective bargaining process and not a unilateral move by the state. The court stated that an employee has a protectable expectation when he/she relies on the state's offer of deferred compensation in exchange for loyal and valuable services performed. However changes to that expectation based on a collective bargaining agreement do not constitute an unconstitutional impairment of contract (*Livengood v. Nebraska State Patrol Retirement System*, 2007).

ANALYSIS OF CONTRACT CLAUSE CLAIM REGARDING OMAHA ACTION

The question to be addressed is whether or not the actions of the city of Omaha in unilaterally changing the police retirees' retirement health insurance benefit constituted an unconstitutional impairment of contractual obligation. Because the federal and state constitutional provisions are essentially the same, the analysis is similar.

The city of Omaha has a significant burden to overcome to be able to justify its unilateral action. In its 1928 *Robertson* decision the United States Supreme Court ruled that the Contract Clause protected compensation from being changed retroactively. Although several Contract Clause cases have reached the U.S. Supreme Court since *Robertson*, none has directly reversed or overruled the *Robertson* holding. Certainly it can be argued the *Blaisdell* analysis would put the *Robertson* holding in question, but it did not overrule the prior case.

The substantial hurdle faced by the city of Omaha is bolstered by the Third Circuit's *Larsen* decision in which the court held that a compelling state interest must fail regarding a state's retroactive attempt to forfeit previously vested retirement benefits. The multiple holdings by the Nebraska Supreme Court that negative legislative changes that retroactively affect or change vested rights are void also creates a barrier for the city to overcome. The *Cayetano* holding that a governmental entity cannot correct budget problems by unilaterally changing terms of employment adds to the burden the city of Omaha will have to meet.

Finally, both the United States Supreme Court and the Nebraska Supreme Court have held that the analysis of necessity and reasonableness when a governmental entity impairs its own contract must not simply accept that entity's reasons. The entity must show a greater need in cases it is impairing its own obligations than when the impaired contract is between private parties.

The lawsuit challenging the action has been filed in Nebraska federal district court. Since Nebraska is part of the Eighth Circuit, the analysis scheme used in *Benton* should be utilized in the Omaha case. The Eighth Circuit adopted the following three-step analysis:

1) Has the legislation operated as a substantial impairment?
    a. Is there a contractual relationship?
    b. Does the law impair the contractual relationship?
    c. Is the impairment substantial?
2) Does the city have significant and legitimate public purpose?
3) Is the impairment reasonable and appropriate to justify the legislation?

It could be argued that as to the Nebraska Contract Clause, the Nebraska Supreme Court's analysis scheme should be utilized. In Nebraska the court in *Calabro* adopted the three step approach of (1) impairment of contract, (2) substantial impairment and (3) legitimate exercise of sovereign power. Arguably, the Nebraska and Eighth Circuit approaches should result in the same findings. Therefore, the Eighth Circuit approach will be used.

The first step in the analysis is to determine if there is a contract and is that contract substantially impaired. This analysis, as discussed below, should result in a finding that there is a substantial impairment of a contractual relationship. It may be difficult for the city of Omaha to argue that this element has not been met. In the *Benton* decision the Eighth Circuit ruled that a unilateral alteration of a collective bargaining agreement is a contractual impairment.

It may be argued that there is no contractual relationship. The city and police union had entered into a collective bargaining agreement in 2004 that expired at the end of 2007. In 2008 the city and the union went to the Nebraska Commission on Industrial Relations (CIR) to resolve an impasse. In late 2008 the CIR provided its ruling which left some related items unresolved. The CIR order applied to calendar year 2008. The parties were not able to resolve the remaining issues in 2008 or enter into a new collective bargaining agreement for 2009. The city and union operated under the order of the CIR as the parties tried to negotiate a new agreement. In 2010, at approximately the same time as the city passed the ordinance in question, the parties were talking about taking their contract impasse back to the CIR. It certainly could be argued, as the court ruled in *Rhode Island Council 94*, that a statutory obligation to follow the terms of a terminated contract does not create contractual obligations.

Another argument against a contract existing is that rights under the contract are not vested. If the rights are not vested, the city would be able to change the health care benefits at any time. Omaha City Charter Section 6.09 provides that:

> The benefit schedule for the system may include benefits for service retirement . . . Provisions for vesting may be included. The legal right to a pension or benefit for the members and beneficiaries entitled thereto shall become effective when such pensions or benefits become payable, and the same shall not be impaired, abrogated, or diminished thereafter. The benefit schedule may provide for automatic recalculation and adjustment of pensions and benefits whenever salaries being paid to specific classes of active employees are revised (Omaha, Neb., City Charter).

Arguably from the city's perspective, this provision would indicate that the rights did not vest unless such a clause was included in the collective bargaining agreement. Further, this provision of the city charter reserves the right of the city to automatically recalculate and adjust retirement benefits whenever salaries are revised.

On the contrary it could be argued that the city charter provision clearly indicates that the city cannot negatively change the retirement benefits for the current retires. Further, because there is no specific vesting clause in the collective bargaining, Nebraska common law would prevail. The charter provision does not indicate that vesting does not occur unless there is a specific provision. As to the recalculation argument, the charter provision does not give the city the unilateral right to recalculate retirement benefits. The charter provision provides that the parties can include such a provision in the agreed upon benefit schedule. For example, when the union and city agreed to retirees in 1993 paying a percentage of the insurance premium, that could be automatically recalculated in future contracts when the base insurance premium amount was agreed upon.

The Nebraska Supreme Court interpreted Section 6.09 of the Omaha City Charter regarding retirement benefits in the *Calabro* case. The city argued that the city charter section 6.09 provided that the legal right to retirement benefits occurred at retirement. The Nebraska Supreme Court rejected that argument and held that "a public employee's constitutionally protected rights in his or her pension vests upon acceptance and commencement of employment, subject to reasonable or equitable unilateral changes by the Legislature" (*Calabro v. City of Omaha*, 1995, p. 551). Therefore, all current employees and retirees have a protected contractual interest in the retirement benefit.

A party could argue that the 2004 contract provided that it would continue each successive calendar year unless certain steps are taken. Further, based on the *Halpin* decision in Nebraska, retirement benefits are deferred compensation and a statutory provision for such compensation creates a contractual obligation. Finally, as to most of the retirees, the argument could be made that the contract in place at the time of the retiree's retirement is controlling.

The charter provides that the city is without authority to impair, abrogate or diminish benefits once they become payable. Clearly retirement benefits as to current retirees have become payable. It also could be argued that once a police officer reaches the appropriate age and years in service, the benefits become payable, even if the employee continues working. This is the logic of the *Larsen* decision.

Since there is no specific vesting clause in the contract, the contractual rights vest as provided by Nebraska case law. The Nebraska Supreme Court has consistently held that retirement benefits, as deferred compensation and incentive for loyal employees, vest at the time of employment. Based on Nebraska law and the city charter, there is a contractual obligation in regard to the former employees who have already retired and collecting their retirement benefits, as well as, current employees.

Based on the facts and case law, a court should find that a contractual relationship exists. The next issue is whether or not there is an impairment. Under Nebraska law, as set forth in *Caruso*, an impairment simply means to make worse or take something away. It would be difficult for the city to argue that the change does not make the contractual relationship worse for or takes nothing away from the retirees when requiring retirees to pay a portion of the premium when they currently pay nothing (or increasing their premium payment) and reducing insurance policy benefits.

The Court of Appeals for the Eighth Circuit in *Benton* found that changing retiree's insurance benefits constituted a substantial impairment. The Nebraska Supreme Court, as discussed above, has also consistently held that changing retirement benefits once there is a contractual obligation is a substantial impairment. It certainly can be argued that the changes in the health care benefit may result in some retirees not being able to afford needed health care. To deny people health care is a substantial impairment.

Therefore, as to current police employees and retirees, the first prong of the impairment test confirms that the ordinance changing the retirees' insurance benefits constitutes a substantial impairment of contract. The second step now is to determine if there is a legitimate and significant public purpose for the change.

The City has stated that it is in a financial crisis and cannot afford to continue paying the current health insurance benefits. It also has indicated that having 34 different health plans is costly to administer. According to the statements made to the public, the city is looking at a $12 million budget shortfall.

First, the city could reduce the number of health plans and reap the financial benefits to such an action. However, in doing so, the benefits received by the retiree cannot be reduced. If the benefits received by the retiree remained the same or were improved, then an impairment of contract would not occur. The city by having fewer plans could still save in the areas outlined at the public hearing, such as: reduced claims processing, standardized benefits, fewer errors in transactions, better customer service and automated claims processing.

In *Benton* the Eighth Circuit Court indicated that economic conditions could give rise to legitimate use of police power that may substantially impair a contractual obligation. The court indicated that economic condition must be unprecedented and concern a broad, generalized economic problem.

As stated above, the Nebraska Supreme Court did not recognize the city of Omaha's possible bankruptcy if the supplemental benefit continued as a legitimate use of police powers to impair the obligation of contract in *Caruso*. Further, the Nebraska Supreme Court in *Caruso* stated that changes in retirement plans made after vesting must be accompanied by offsetting advantages to those with vested rights.

The Nebraska Supreme Court in *Halpin* noted that retirement plans create a heavy financial burden on governmental employers. However that burden alone is not sufficient reason to scale down the benefits to save money.

Many jurisdictions, as set forth above, have held that a governmental agency cannot unilaterally change its contractual obligations to employees in order to resolve budgetary shortfalls. The logic behind not placing this type of burden on the back of employees, certainly would also apply to the retirees.

As to current retirees, it can be argued that the city of Omaha does not have the power or authority to change the provisions. The court interpretations that have held that the Contract Clause is not an absolute bar to state action impairing contractual rights is based on the general nature of the provision. (see *Blaisdell*) The Omaha city charter provision is not a general prohibition against impairing contractual rights. Rather it is a specific limitation regarding the impairment, diminishing or abrogation of pension or retirement benefits once they are payable. As this is a specific limitation of power in the city's charter, the city is powerless and without authority to pass such an ordinance as it applies to people who have already retired.

Arguably, the city has not shown a legitimate use of police powers. In regard to unprecedented economic circumstances, in 2004 when the city negotiated the last contract with the police union, the city was facing a $10 million budget shortfall. In the city council's consideration of the 2004 contract, the issues of the future costs and future financial woes were discussed and the city council still approved the contract. The city was aware of the increasing health care costs. The year 2004 saw the highest single year increase in the city's health care cost in recent times. Health insurance premiums nationwide had been increasing significantly for years. In all cases examined, no court, in jurisdictions that retirement benefits are deemed deferred compensation, has yet to allow, as a legitimate use of police power, a governmental unit to unilaterally and retroactively change retirement benefits once those benefits have been vested without offsetting benefits. Clearly, the city has offered no new advantage to the retirees. However as discussed above, many courts have ruled that a governmental entity cannot unilaterally change an employment contract in order to resolve a financial crisis.

However, a court may deem the current financial condition of the city to be a sufficient legitimate legislative purpose. Thus the third prong of the test is the impairment reasonable and necessary should be examined.

It can be argued that the city is facing a $12.3 million shortfall and that the change will save the city approximately $4.1 million. This one action will erase approximately one-third of the city's projected shortfall. The city must close its budget shortfall and therefore its actions are necessary.

The argument could further include that the current retirement insurance benefits are significantly better than those offered by many comparable cities and in the private sector. In many of those cases, retirees must pay the entire insurance premium, if they are even eligible for a retirement insurance benefit. Thus the city's move is reasonable to unilaterally modify the benefit, as the retirees still have a better health care package than most other retirees.

But are the city's actions necessary and reasonable?

The city publically has taken the position that the ordinance is necessary to reduce the budget deficit. As to any current employee, the change in retirement benefits has no impact in addressing the budget shortfall. The current employees are already paying a portion of their insurance premium. Therefore, as to all current employees the ordinance is not necessary to achieve the stated purpose of reducing the budget deficit.

As to current retirees, the ordinance will result in savings to the city. Simply because the city realizes the savings does not mean that the action is either reasonable or necessary.

As Justice Blackmun wrote in *United States Trust Company*, "A governmental entity can always find a use for extra money, especially when taxes do not have to be raised" (*United States Trust Company of New York v. State of New Jersey*, 1977, p. 26). The Ninth Circuit in *Cayetano* ruled that the impairment of contractual obligation regarding a collective bargaining agreement in order to address budget shortfalls is not reasonable. The Second Circuit ruled in *Surrogates I* that it was not reasonable to impair the contractual obligations with employees in order to avoid alternatives that are politically more difficult. In *Katz*, the United States Supreme Court ruled that employers cannot unilaterally change terms in collective bargaining agreements.

The current property tax rate, 47.587 cents per $100 value, is at the third lowest level in 50 years. The lowest (42.523¢/$100 value) and second lowest (43.387¢/$100 value) level were from 2001-2009. The city of Omaha projects that it will collect $127,534,266 in property taxes in 2010 (City of Omaha, 2010d). If the city raised the property tax by 10%, 4.758 cents per $100 value, the city would clear the entire $12.3 million shortfall. The median home value in Omaha is $135,700. The additional property tax on the median home would be approximately $62.00 per year. Even if the city were to increase the 2010 property tax rate by 10%, raising the rate to 52.346¢/$100 value, the rate would be significantly lower than the 2008 national average property tax rate of 96¢/$100 value (The Tax Foundation, 2009). However, instead of spreading the deficit burden across the taxpayers of Omaha, the city is looking to have the retirees pay one-third of the deficit. With 1100 retirees saving the city \$4.1 million, the burden, on average, is just over \$3700 per retiree.

The city has provided no indication as to why cutting the retiree's health insurance benefit is the only action it can take to remedy the budget deficit. Without showing that there are no other means to accomplish the stated public purpose, it has not met the necessity requirement. The Nebraska Supreme Court stated in *Calabro*, "the city has not convinced us that terminating the supplemental benefit was the only viable alternative for correcting its alleged fiscal woes" (*Calabro v. City of Omaha*, 1995, p. 553).

In Nebraska public employee retirement benefits are a form of deferred compensation. It can be argued to allow the city to unilaterally change those benefits is against public policy. The public policy of the state, as demonstrated by its laws, is that public employees have the right to bargain collectively (Neb. Rev. Stat. §48-837). For a period of time, 1993-2001, the police union contract provided that employees and retirees, who retired under those contracts, would pay a portion of their insurance premium. The union was able to negotiate an end to the employees' (and retirees') contribution toward the insurance premium. The city has been trying, for at least six years, to change the retirements in the collective bargaining agreements with the police union, without success, to have employees and retirees contribute to health insurance premiums. To allow the city to unilaterally accomplish what it could not accomplish through collective bargaining eliminates the public employee's right to collectively bargain. The importance of wages under Nebraska law is also demonstrated by the provision that an employer who does not timely pay compensation to an employee is subject to enhanced damages and an award of attorneys' fees (Neb. Rev. Stat. §§48-1230 to 48-1232). Nebraska civil law has few provisions for enhanced damages.

The city's actions were neither necessary nor reasonable to allow it to impair the obligation of contract. Therefore, based on current law and precedents, the city's act violates the federal and state constitutions' prohibition of impairment of contractual obligations.

CONCLUSION

Their exists contractual obligations for the city of Omaha to provide retirees health insurance benefits substantially the same as at the time of their retirement. The contractual obligation includes either no shared premium or a specific percentage premium. The unilateral effort to increase the premium payment for all retirees and to lessen the benefits is an impairment of that obligation. The change may result in some retirees not being able to afford health care, so the impairment is substantial. The city does not have a legitimate public purpose to support its action. Further the changes in health care benefits are not reasonable or necessary. Based on current law and precedent, the city of Omaha cannot unilaterally change the retirement health benefits for current retirees. Such an action violates the Contract Clause of the United States Constitution and the state of Nebraska Constitution.

However, there is a question if the ruling would stand on appeal to the United States Supreme Court. The current court has a record of supporting government and corporations in matters involving individuals. The court has been willing to overrule precedent. The Supreme Court could take the approach that the Contract Clause has no relevance in today's society, as the dissenting justices argued in *United Trust*. The court could also find that financial need is always an appropriate reason for a state or city to unilaterally modify their own contracts.

It is always difficult to predict how the U.S. Supreme Court will rule on a case. However, lower courts are bound by precedent and *stare decisis*. The lower courts should find for the retirees and against the city of Omaha.

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RISING RISKS AND UNCERTAINTIES FOR U.S. FIRMS' GIFTS, TRAVEL AND ENTERTAINMENT EXPENSES FOR MARKETING IN FOREIGN COUNTRIES: THE IMPLICATIONS OF INCREASED FOREIGN CORRUPT PRACTICES ACT ENFORCEMENT

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ABSTRACT

Significant increases in Foreign Corrupt Practices Act enforcement activities have heightened the legal risks associated with giving gifts or paying travel and entertainment expenses for U.S. firms when promoting their goods or services in foreign markets. This change in the external environment necessitates appropriate strategic adjustments and managerial actions. The lack of specific standards of conduct under the FCPA's general prohibitions requires that U.S. firms closely monitor the increasing number of investigations and legal actions initiated by the U.S. Securities Exchange Commission and the U.S. Department of Justice.

INTRODUCTION

As U.S. firms expand their presence in foreign markets, they need to account for the risks of inadvertently incurring legal liability under the Foreign Corrupt Practices Act ["FCPA" or the "Act"] that results from the use of gifts, travel and entertainment as part of their promotional efforts. What would otherwise be routine marketing and promotion activities aimed at wooing private sector domestic customers present a legal minefield for American businesses attempting to obtain business from foreign companies that have an element of government ownership or control, whether outright or because a manager also has a position in the host country government or political party.

This article provides a brief overview of the FCPA along with a more detailed explanation of the key provisions that heighten risks associated with the use of gifts, travel and entertainment to win contracts with foreign companies. It also describes the recent increase in FCPA enforcement actions by the United States Securities and Exchange Commission ["SEC"] and the Department of Justice ["DOJ"], along with the resulting fines and prison sentences. The paper then lays out the steps that U.S. firms seeking business abroad should take in order to minimize this legal exposure.

THE FOREIGN CORRUPT PRACTICES ACT

Originally passed in 1977, the FCPA arose out of an SEC investigation launched in the wake of the Watergate hearings. Publicly traded American corporations had concealed a variety of illicit payments in deliberately mislabeled accounts, from illegal domestic political campaign contributions to bribes paid to foreign government officials (Sporkin, 1998). Congress responded to these revelations with passage of the FCPA, a statute mandating that publicly traded corporations keep accurate books and records, with the SEC given exclusive right to bring either civil or criminal proceedings to enforce the statute. Congress also included a requirement that corporations maintain an effective system of internal controls to insure accuracy in its books and records, along with a specific anti-bribery prohibition (Foreign Corrupt Practices Act, 1977).

In 1988, Congressional amendments legalized "facilitating payments," also referred to as "grease payments," to hasten the performance of ministerial functions, *i.e.*, administrative actions, such as an expedited issuance of permits or similar, non-magisterial actions to which the corporation was entitled under host country law (Foreign Corrupt Practices Act, 1988). Worried that American firms would suffer a competitive disadvantage relative to those in other industrialized countries that did not adhere to the FCPA bribery standards, the United States sought an agreement from those nations to pass similar legislation. This led to the Organization for Economic Cooperation and Development ["OECD"] Convention on Combating Bribery of Foreign Government Officials in 1997, in which 33 other economically advanced countries agreed to do so (OECD Convention, 1997). Congress last amended the FCPA in 1998, primarily to meet United States' obligations as a party to the original 1997 treaty (Foreign Corrupt Practices Act, 1998). As of March 2009, 38 countries had ratified that treaty (OECD Anti-Bribery Convention, 2010).

KEY FCPA MANDATES

Any U.S. firm that uses gifts, travel and entertainment to promote its goods or services to prospective customers outside the country must understand both the accounting and anti-bribery prongs of the act. Key aspects of the latter prohibit payments to foreign officials for the purpose of obtaining or retaining business. More specifically, the FCPA renders illegal use of the mail or any … instrumentality of interstate commerce "corruptly'" to offer, pay, promise to pay or authorize any money or gift to any foreign official, *i.e.*, in an effort to gain improper advantage in order to obtain or retain business. The same prohibitions apply with respect any foreign political party or party official or any candidate for foreign political office. (Foreign Corrupt Practices Act, 1998). As noted above, an exception exists for a "facilitating or expediting payment" (sometimes unofficially referred to as "grease payments") to expedite or secure the performance of a routine ministerial governmental action (*id*).

The FCPA includes two affirmative defenses that provide exceptions to the above-described prohibitions. (An affirmative defense is "[a] defendant's assertion raising new facts and arguments that, if true, will defeat the plaintiff's or prosecution's claim, even if all allegations in the complaint are true." (Black's Law Dictionary, 1999, p. 430)). The first is when the defendant can show that the payment or promise was legal in the host country. The second applies where the defendant can prove that the payment, gift, offer, or promise was: 1) a reasonable and *bona fide* expenditure (such as travel and lodging expenses) for the foreign official directly related to either the promotion, demonstration, or explanation of products or services or, 2) the performance of a contract with a foreign government or agency thereof (*id*).

FCPA violations may lead to civil and criminal penalties, including substantial fines and prison terms (*id*). Indictment alone may cause the individual or firm to be barred from doing business with the federal government. An FCPA conviction may lead to denial of export licenses, a ban from the securities business and debarment from participation in the Overseas Private Investment Program (U.S. Department of Justice, Foreign Corrupt Practices Act, Anti-Bribery Provisions, 2010).

The United States Department of Justice [“DOJ”] carries out all criminal enforcement under the FCPA. Both the SEC and the DOJ can bring civil enforcement actions, depending upon the defendant and the particular charge. No private party may bring a direct action for damages under the act (Lamb v. Phillip Morris, 1990), but a government conviction can give rise to a civil suit under either federal or state Racketeering Influenced or Corrupt Organizations [“RICO”] statutes (Racketeering Act, 2010) brought by a competitor who suffers economic harm from a violator’s illegal action. A successful recovery under such a statute includes three times the actual loss (treble damages) plus attorneys’ fees (Environmental Techtonics vs. Kirkpatrick, 1987).

THE DOJ OPINION RELEASE PROCEDURE

The FCPA mandates that the U.S. Attorney General, or a representative of that office, provide guidance to any firm that requests an opinion about its enforcement intentions concerning specified prospective conduct (Foreign Corrupt Practices Act, 1998; Code of Federal Regulations, 2010). This DOJ Opinion Release Procedure offers a means for a company subject to FCPA jurisdiction to reduce its risk of prosecution before undertaking a transaction that might or might not constitution a violation. The DOJ makes these Opinion Releases publicly available on its website (see www.usdoj.gov,) although a requesting firm [the “Requestor”] may ask not to have its name or proprietary information disclosed. The Attorney General must respond within 30 days of receiving such a request. The DOJ creates a rebuttable presumption of legality when it issues an opinion that the proposed action conforms to current enforcement policy. A review of these Opinion Releases offers further information about the standards and interpretations of the statutory language.

RECENT INCREASES IN FCPA ENFORCEMENT ACTIVITY

Both the SEC and DOJ have significantly increased FCPA enforcement over the past six years (Searcy, 2009, May 26). In 2007, the DOJ brought 16 enforcement actions in 2007, up from four in 2002 (U.S.DOJ Press Release, 2008, March 27). It launched 55 investigations during 2007 – 2008 (Wrage, 2008); by 2009 it had 120 companies under investigation. (Searcy, 2009, May 26).

This emphasis upon pursuing FCPA violators reflects agency decisions regarding internal resource allocations. Within the DOJ, the Federal Bureau of Investigation [“FBI”] created a team of special agents in 2007 to work on FCPA cases (Wrage, 2008). In 2009, the SEC likewise established a special unit, one of only five within the agency, to focus on FCPA violations (Khuzami, 2009).

These federal efforts have led to substantial settlements by organizations that chose to avoid the additional time and expenses of ongoing investigations, in addition to the risks of trial. In 2010, Daimler AG agreed to plead guilty to two FCPA violations and pay $93.6 million in criminal fines. The company also had to disgorge $91.4 million in profits to resolve a related civil action, also brought by the SEC, for a total cost of $185 million (U.S. DOJ Press Release, 2010). The U.S. jurisdiction over these actions by a German corporation arose from a “nexus” to the U.S. that included actions by American firms’ foreign subsidiaries and the movement of funds used in corrupt payments through U.S. banks; moreover, FDCPA jurisdiction extends to foreign companies whose securities trade on American exchanges (Foreign Corrupt Practices Act, 1998).

In 2007, Baker Hughes entered into the then-largest settlement of FCPA violations by agreeing to pay a total of $44 million in the form of an $11 million criminal fine to the DOJ, $10 million in civil penalties to the SEC and disgorgement of $24 million in profits, also to the SEC. The Baker Hughes penalties arose out of their improper payments in Kazakhstan to obtain contracts to provide various oil services to a state-owned venture (U.S. DOJ Press Release, 2007, April 26).

In December 2008, Siemens AG, another German firm with a nexus to the U.S., settled an SEC complaint that alleged multiple FCPA violations between 2001 and 2007. Siemens agreed to disgorge $350 million in profits to the SEC and paid a $450 criminal fine to the DOJ in a related action. A German investigation led to additional penalties for these violations. Total payments to U.S. and German authorities combined exceeded $1.6 billion SEC (U.S. SEC, 2008).

In addition to taking legal action against firms that violate the FCPA, federal agencies have also made a point of prosecuting individual managers. The SEC filed actions against the former Chairman and CEO of Schnitzler Steel Industries for its activities in China, and another against the CEO and Chairman of Syncor International for alleged bribes of doctors who worked for public hospitals in Taiwan (Thomsen, 2008). Mark Mendelsohn, former deputy chief of the DOJ fraud section of the criminal division, observed, "To really achieve the kind of deterrent effect we're shooting for, you have to prosecute individuals ... If the only sanctions out there are monetary, penalties against companies could be interpreted as the cost of doing business," Mr. Mendelsohn says. "But when people's liberty is at stake, it resonates in new ways" (Searcy, 2009, October 8).

Thus, "Albert" Jack Stanley, a former executive of Halliburton Company, received a seven year jail sentence pursuant to a guilty plea in response to charges of FCPA violations, along with mail and wire fraud, in efforts to secure natural gas contracts in Nigeria. He further agreed to cooperate in continuing investigations of related transactions, as well as $10.8 million in restitution payments (U.S. DOJ Press Release, 2008, September 3).

RISKS AND UNCERTAINTIES REGARDING GIFTS, TRAVEL AND ENTERTAINMENT

The increase in attention and resources devoted to FCPA enforcement significantly increases the risks to U.S. firms doing business internationally with respect to a number of practices, not the least of which involve gifts, travel and entertainment aimed at promoting their products and services to foreign customers. While the FCPA includes several sections that directly affect such promotional activities, considerable uncertainty exists as to their interpretation and application; therefore, firms must pay close attention to such provisions and proceed with due caution. In particular, businesses should take care to ascertain whether an employee of a foreign company falls within the statutory definition of a "foreign official," and whether travel and entertainment expenses are "reasonable and *bona fide*."

In the United States, the distinction between a government agency and a privately owned or operated business non-profit organization is clear and unambiguous; therefore, a marketing manager has no problems distinguishing private sector employees from government officials or public sector employees. Such distinctions can be murkier in other parts of the world. A U.S. firm that does not take care to ascertain whether a customer fits the FCPA definition of a "foreign official" can violate the statute because they have improperly directed promotional efforts to such a person. The act itself defines "foreign official" as:

> … any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization (Foreign Corrupt Practices Act, 1998).

Both the SEC and the DOJ have taken the position that this provision encompasses employees of state-owned or state-controlled entities because such operations amount to "instrumentalities" of foreign governments (U.S. SEC, 2005; U.S. DOJ Press Release, 2006). Thus, physicians and other laboratory workers in government run Peoples' Republic of China hospitals were regarded as "foreign officials" under the FCPA when Diagnostic Products Corporation (Tianjin), the Chinese subsidiary of the U.S. firm Diagnostic Products Corporation, was charged with paying nearly $1.6 million in illegal "commissions" in order to obtain the hospital's business. DPC (Tianjin) settled the resulting criminal charges with the DOJ for $2 million. Its U.S. parent company (DPC) agreed to disgorge approximately $2.8 million in profits, an amount equal to its net gains in the PRC during the time of the violations, in order to resolve SEC charges that arose out of the same payments (U.S. DOJ Press Release, 2005).

The public-or-private-entity question becomes even more complex as governments in parts of the world where state ownership of the means of production begin a process of "privatization," such as Russia, Eastern Europe and China. This transfer of ownership from public to private hands may involve less than a 100 percent of interest in an enterprise. Even if the government in question retains only a small stake in the new firm, the officers and employees may still fit into the "foreign official" category. And, government control may continue after complete privatization of ownership, rendering company personnel "instrumentalities of a foreign government." (Pederson, 2008; Cohen, Holland and Wolf, 2008).

Nonetheless, the FCPA does not outlaw gifts, travel or entertainment for foreign officials altogether. The legislative history of the Act strongly indicates that Congress meant to permit some such activities as part of legitimate marketing and promotional expenditures. As noted in a frequently quoted passage from the legislative hearings about the affirmative defenses in the statute:

"This exemption ... is meant to sanction legitimate informational and promotional expenditures. Examples are paying travel and lodging expenses of a foreign official required for his attendance at a seminar concerning a domestic concern's goods or services; or transporting a foreign official to the site of a manufacturing plant for an inspection tour as part of an effort to persuade the official to contract for the building of a similar plant in his country. While such activities are instrumental to obtaining business, in that they may persuade the official of the quality of a business' products or services, it is not expected that the official will give business to the concern in return for the incidental value of the travel and lodging provided. Given the absence of a *quid pro quo* understanding, these activities are not in violation of the current law (Hearings on H.R. 2157, 1983).

GIFTS

The FCPA prohibits gifts to foreign officials when given with "corrupt intent," *i.e.*, to obtain or retain business or to influence any act or decision of a foreign official in his official capacity (Foreign Corrupt Practices Act, 1998). While this unequivocally applies to a *quid pro quo* transaction where the gift amounts to a bribe, it does not forbid all gifts. The statute specifically allows gifts to foreign officials, provided they are "*bona fide,*" lawful in the host country, reasonable in amount and directly related to promotion of the donor's business or in connection with the execution of a contract (*id*). In the absence of further statutory clarification, the DOJ has adopted a "facts and circumstances" approach to enforcement, as reflected in its advisory opinions. Thus, in determining whether a particular gift violates the statue, the DOJ has considered whether:

- the gift violates host country law
- the ceremonial value of the item exceeds its intrinsic value
- the cost of the gift does not exceed $500 per person (in 1981)
- the expense is commensurate with the legitimate and generally accepted local custom for such gifts by private business persons in the country (U.S. DOJ Opinion Release No. 81-01, 1981)

The DOJ has specifically approved modest gifts of product samples from a U.S. firm to prospective foreign customers (U.S. DOJ Opinion Release No. 82-01, 1982).
Black and Witten (2010) maintain that the DOJ probably cannot show that corrupt intent motivated a gift where the gift is:

- nominal in value
- not in the form of money
- permitted under the laws of the host country
- customary, in type and value, in the host country.
- made at an appropriate time and in appropriate circumstances
- made as a courtesy or token of regard or esteem, or in return for hospitality
- given openly, rather than secretly
- accurately reflected on the FCPA-covered entity's books and records. [I1 Complying with the Foreign Corrupt Practices Act Division I TEXT Chapter 4 Recurring Issues under the Anti-bribery Provisions I1-4 Business Law Monographs § 4.03 Copyright 2009, Matthew Bender & Company, Inc.]

Travel and Entertainment

The same FCPA standards regarding gifts apply to travel and entertainment expenses; hence, the same kinds of uncertainties resulting from lack of statutory guidance as to what is permissible (Foreign Corrupt Practices Act, 1998). As with gifts, the FCPA specifically allows payment of "reasonable and *bona fide*" travel and entertainment expenses to foreign government officials as an affirmative defense. Thus, if a U.S. firm can show that such expenditures were "directly related to" either the promotion, demonstration, or explanation of products or services, or the execution or performance of a contract with a foreign government or agency, it does not violate the act (*id*).

In the absence of more explicit guidelines regarding the payment of travel and entertainment expenses for foreign officials with whom a U.S. organization seeks to do business, one must make inferences from SEC and DOJ litigation settlements, as well as the latter's Opinion Releases in response to inquiries from those uncertain about whether a proposed action would trigger prosecution.

In a leading case, United States v. Metcalf & Eddy (1999), the DOJ achieved a settlement for alleged travel and entertainment violations that resulted in a $400,000 civil fine plus $50,000 for litigation expenses levied against the defendant, an environmental engineering firm that sought contracts in Egypt through the United States Agency for International Development. The DOJ Complaint (U.S. v. Metcalf & Eddy, 1991) cited excessive *per diem* payments to an Egyptian government official who had yet to recommend awarding a contract to the U.S. firm. The DOJ charged additional violations because the defendants had paid travel and entertainment expenses for the official's wife and children, including first class airfare on their international flights. The defendant firm subsequently received both the official's recommendation and the contract. In addition to claiming that payment of these expenses violated the anti-bribery provisions of the FCPA, the Complaint charged that defendant had failed to maintain adequate books and records that properly recorded those payments (Black and Witten, 2008; Black and Witten, 2009).

In 2006, the SEC filed suit against Tyco International for FCPA violations that included improper travel and entertainment expenses paid by its South Korean subsidiary to South Korean officials. The Commission specifically faulted Tyco for "… failure to implement procedures sufficient to prevent and detect FCPA misconduct, despite knowledge and awareness within the company that corruption and illicit payments were common practices in the foreign country where the unlawful payments were made." (U.S. SEC v. Tyco International, 2006). The company's use of false invoices to conceal illegal payments violated both the record-keeping and anti-bribery provisions of the Act. Tyco paid a $50 million civil penalty to settle this and related matters (U.S. SEC, 2006).

The DOJ has also prosecuted individual managers for FCPA violations, as in the case of David Pillor, Senior Vice President for Sales and Marketing at InVision, a company that manufactured explosive detection systems used by airports. Regional Sales Managers in China, the Philippines and Thailand advised him that local distributors were using Invision payments for gifts, improper travel expenses and other payments to government officials in order to obtain business. Pillor did not acknowledge or respond to any of their messages about these payoffs, which led to the SEC charges for failure to maintain an adequate system of internal controls and indirectly causing the falsification of a book, record or account. As part of a settlement agreement, he personally paid a $65,000 civil penalty (U.S. Securities and Exchange Commission v. Pillor, 2006; U.S. SEC, 2006).

Dow Chemical Company settled a 2007 SEC action for illegal payments by a subsidiary to government officials in India that included improper gift, travel and entertainment expenses. Over a six year period, these payments totaled approximately $200,000. Dow paid a $325,000 civil penalty and agreed to a cease and desist order against further violations of the books, records and internal controls requirements under the Act (U.S. SEC, 2007, February 13).

Both the SEC and the DOJ instituted legal actions against Lucent Technologies for numerous travel and entertainment violations in connection with telecommunication contracts in China with state-owned and state-controlled enterprises. Between 2000 and 2003, both before and after obtaining these contracts, Lucent paid for approximately 315 Chinese government officials trips to the U.S. and other countries, 65 of which came before the sales were closed. Lucent recorded the expenses in its "Factory Training Account," even when the Chinese officials did not visit any factories. Instead, they spent time in Hawaii Las Vegas, the Grand Canyon, Niagara Falls, Disney World, Universal Studios and New York City. Post-sale, Lucent paid for Chinese employees of these state enterprises (which makes them "foreign officials" under the Act) to visit the United States for factory inspections and training. Lucent, having outsourced all its manufacturing by 2001, no longer had any U.S. factories to tour. Instead, the trips consisted of sightseeing in the same places as the pre-sale travel. Lucent paid $1 million criminal fine to resolve the resulting DOJ action and a $1.5 million civil penalty to settle with the SEC (U.S. DOJ Press Release, 2007, December 21; U.S. SEC, 2007, December 21).

In a similar 2009 case, the DOJ and SEC brought actions against UTStarcom, Inc. (UTSI), a U.S. telecommunications company that markets network equipment and handsets. UTSI's China subsidiary, UTStarcom China Company, Ltd. (UTS-China) paid for the state-owned Chinese telecommunications firms' employees' trips to UTSI factories in Hawaii, Las Vegas and New York City for training, even though UTSI had no factories in those places and conducted no training. The SEC contended that defendant also provided lavish gifts and all-expenses-paid executive training programs for current and prospective customers in China and Thailand. To settle this matter, UTSI agreed to pay a $1.5 million penalty settlement of the DOJ case and another $1.5 million to the SEC (U.S. DOJ, 2009; U.S. SEC, 20009; U.S. Securities and Exchange Commission v. UTStarcom, 2009).

Indications of travel and entertainment expenses for foreign government officials that the DOJ will not challenge appear in its Opinion Procedure Releases. For example, a U.S. insurance firm (the "Requestor") advised the DOJ that it intended to pay travel expenses for five foreign officials to visit the Requestor's offices, meet with insurance regulators, other industry groups and other insurance companies in order to gain a "practical understanding" of how mutual insurance companies work in the U.S. The Requestor had no immediate plans to enter the foreign country's market, but anticipated that sponsoring this "Study Tour" would fulfill a requirement under that country's law for obtaining a business license there at some future date. The Requestor stated that it would spend an estimated $16,875 for economy airfare, lodging, transportation, a $35/day *per diem* and occasional tourist activities. The Requestor specified that it would not select the foreign officials for the tour and would not provide any gifts or tokens to them (U.S. DOJ Opinion No. 04-04, 2004).

The DOJ approved a similar request by an unnamed U.S. firm that sought to invite six foreign officials for a promotional and educational tour of its domestic sites. Over four days, the Requestor intended to pay domestic economy airfare (the delegates would pay their own international transportation costs,) plus domestic lodging, local transport and meals. It further noted that it would not select the foreign official delegates, not pay any expenses for spouses, families or other guests, and that any souvenirs would be of nominal value and have the Requestor's name or logo. (U.S. DOJ Opinion No. 07-01, 2007).

A medical device manufacturer gained DOJ approval for providing 100 units of its equipment, valued at $1.9 million, to a foreign government official in charge of a testing program that the foreign country required before it could grant approval for sale of the devices through its government. This process required that any prospective vendor of medical devices had to provide enough products for a clinical test in ten local health centers. If its products passed the tests, the Requestor could then bid against other approved providers for contracts with a government agency that would resell the devices to patients at a subsidized rate. The DOJ specified that "The foreign government and Requestor jointly determined that the optimal sample size for such a study was 100 units … based on the size of the overall potential patient population in the country and the government's experience with other similar medical devices." Moreover, the "evaluation of the donated medical devices will be based on objective criteria that are standard for this type of medical device and that have been provided to the Department." (U.S. DOJ Opinion No. 09-01, 2009).

In light of the above, U.S. firms seeking or doing business with organizations owned, run or influenced by foreign governments should not:

- Offer any gifts other than token items, preferably with the U.S. firm's name and logo
- Pay any travel or entertainment expenses for spouses, other family members or guests of the foreign official
- Pay for international travel from the foreign official's home country to the U.S.
- Pay for first class travel or luxury hotel/resort accommodations
- Provide excessive *per deim* allowances
- Select the foreign officials for whom the U.S. firm will pay travel and entertainment expenses for inspection or training visits to U.S. sites
- Include elaborate sightseeing ventures, especially if they involve travel to places other than where the U.S firm has facilities
- Do anything that looks like an outright scheme in support of a *quid pro quo* understanding

On the other hand, U.S. firms that want to promote their goods and services to entities controlled or strongly influenced by foreign governments should:

- Periodically assess the risks of doing business with foreign entities that may have an element of government ownership or influence
- Devise specific policies for avoiding FCPA liability when conducting business with foreign customers
- Take care to determine whether a prospective customer fits the FCPA definition of a "foreign official," including whether that customer works for an entity that could be construed as "an instrumentality of a foreign government"
- Maintain careful records of travel and entertainment expenses with adequate bookkeeping and internal controls
- Audit all travel and entertainment reimbursements to assure that they are appropriate, accurate and properly recorded
- Provide FCPA training for marketing and accounting personnel
- Carefully justify in advance the legitimacy of providing product samples to a prospective foreign official customer in light of FCPA standards
- Take advantage of the DOJ Opinion procedure if at all concerned about the legality of providing a gift or travel and entertainment to a prospective customer who might have foreign official status under the FCPA.

CONCLUSION

Both the SEC and DOJ have significantly increased their FCPA enforcement activities over the past several years. As a result, U.S. firms operating in the global economy must be careful to ascertain whether they are dealing with an organization that has either a government ownership interest or sufficient government control to make it an instrumentality of a foreign government, thereby making that organization's employees foreign officials under the FCPA. The use of gifts or payment of travel and entertainment expenses to promote products and services to such foreign officials are permissible as long as they are "reasonable and *bona fide*." The absence of specific statutory guidance as to what fits this category makes what might be regarded as legitimate marketing and promotion activities within the United States legally problematic when dealing with a foreign customer that has some degree of government interest or control in its home country. Thus, U.S. firms cannot blithely assume that the same legal standards governing gift, travel and entertainment expenditures domestically also apply to their promotion and marketing strategies in foreign markets. The FCPA can be a minefield of legal liability for the uninformed or reckless.

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ACTIVE VERSUS PASSIVE ACADEMIC DISHONESTY: COMPARATIVE PERCEPTIONS OF ACCOUNTING VERSUS NON-ACCOUNTING MAJORS

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ABSTRACT

Accountants must track investments, complete taxes, and protect the investor financially. Although rarely criticized for lacking technical competence, professional accountants are often criticized for unethical behavior. The accounting profession requires more than applying rules and regulations. Professional judgment is often required when no technical solution exists. Therefore, accountants need both technical and moral expertise. However, some businesses ignore codes of conduct, leading to a professional "credibility crisis." The literature reveals a positive correlation between academic dishonesty in college and unethical behavior in work environments. Therefore, understanding college students' perceptions of academic dishonesty is important. This paper compares those perceptions of accounting and non-accounting majors in a business college at a major Southeastern state university. Structural equation modeling has been used to test the hypotheses. Similarities and differences in the conceptual model regarding active and passive academic dishonesty are discussed. The results show major differences between accounting and non-accounting majors.

INTRODUCTION

In the last several decades, investor confidence has been eroded by mushrooming scandals based on the accounting practices of such companies as Enron, Qwest and WorldCom Amazingly, executives participating in these frauds were trained in prestigious schools (Burke, Polimeni and Slavin, 2007). Although Congress passed the Sarbanes-Oxley Act in an effort to restore investor confidence in 2002, we are potentially facing another wave of scandals with the current economic crises.

According to researchers' investigations, academic dishonesty has been a growing problem (Evans and Craig, 1990; Davis, et. al, 1992, 1995; Whitley and Kost, 1999; McCabe 1999; 2005; Whitley, 1998; and Davis and Lidvigson, 1995). Furthermore, a culture of cheating in our colleges (McCabe D.L. and Trevino, L.K, 1997; McCabe, 2005) will likely lead to future unethical behavior in work environments (Brown and Choong 2005; Jennings 2004, Nonis and

Swift 2001; Hilbert 1985; Sierles, Hendrick, and Circle 1980; Sims 1993). For a more ethical business environment, universities aim to "educate principled leaders" with "the highest standards of integrity, sound judgment, and a strong moral compass" as noted by Kim B. Clark, Dean of Harvard Business School (Gloeckler and Merritt 2005). However, Moffatt (1990, p. 2) notes, "The university … sounds like a place where cheating comes almost as naturally as breathing" as cited in (Whitley 1998).

Discussed developments have increased interest in teaching and research in business ethics in general and accounting programs in particular. Accounting has been described as an ethical rather than a technical discipline (Waddel 2005). Accounting majors are held to higher standards by their profession and clients than non-accounting majors (Smith, K.J., et al, 2002). Accountants are expected to track investments, complete taxes, and generally protect the investor financially. These expectations are supported by the professional codes of ethics and the litigation not present in other areas of business. However, some businesses ignore codes of conduct (Cowton, 2000), leading toward a "credibility crisis" in the profession (Earley and Kelley 2004). Acceptance of a profession such as accounting is critical to its acceptance in society (Mintz, 1995). Although professional accountants are rarely criticized for lack of technical competence, they are often criticized for their lack of ethical behavior and standards. The accounting profession requires more than applying rules and regulations. Professional judgment often must be provided when no technical solution is available (Gaa, 1994). Therefore, accountants need both technical and moral expertise (Mintz 1995).

ETHICS EDUCATION AND ACCOUNTING

During the 1960s and early 1970s, covering the AICPA Code of Ethics was considered adequate for accountants' ethics education (Madison and Schmidt, 2006). In 1970, the AACSB included ethics in the common body of knowledge (Madison and Schmidt 2006) and encouraged integrating ethics into courses but did not include a separate course. The scandals of the early 1970's and the Savings and Loans crises in the late 1980's resulted in more attention to ethics. Despite an increase in ethics research in scholarly journals, there was little evidence that ethics coverage was widespread in the curriculum. Ethics in accounting was typically covered only in auditing courses (Van Wyhe, 2007).

The AACSB in the 1980's and the AICPA in the 1990's suggested integrating ethics into the accounting curriculum. In 1987, the National Commission on Fraudulent Financial Reporting (Treadway Commission) endorsed a fifth year of accounting education and called for integrating ethics into courses as well as requiring three courses in ethics.

The American Accounting Association Committee on the Future, Content, and Scope of Accounting Education (Bedford Committee) also emphasized ethics' importance in the curriculum. Ironically at this time, Arthur Anderson & Co. (1988) issued "Perspectives on Education: Capabilities for Success in the Accounting Profession" to identify the types of skills needed for success in the accounting program and developed a multimillion-dollar program to "... expose students to true life situations." The Accounting Education Change Commission (AECC) was established in 1989 to respond to these reports by providing recommendations to improve accountants' education and their chance for success. Both reports called for increased emphasis on ethics, including the central ideas of virtue, civility, reason, and accountability. However, little was said about how this "ethical attitude" was to be accomplished. The grants provided by the AECC "… do not appear to adequately address the matter of just how students will become skilled in making value-based judgments (Mintz 1993, p. 98). At this time, it was contended that "…many academicians believed ethics should be taught by philosophers, while others believed ethics could not be taught" (Van Wyhe, 2007, p. 489).

In 1988, The AICPA Code of Professional Conduct was revised, resulting in a conservative code-based model relying on principles and rules with increased emphasis on education in developing ethical behavior (Lampe, et.al. 1992). Other accounting professional organizations have provided their own codes. Armstrong (1993) reported that "Accounting ethics are not covered in a significant way in most U.S. institutes of higher education" (p.78). This lack of coverage was despite the fact that ethical behavior was considered the most significant factor to employers in public accounting (Ahadiat and Mackie, 1993). The general attitude at that time was that increasing profits was the social responsibility of business (Friedman 1970).

Loeb (1988) stated, "…unless practitioners of a profession both understand and can apply their profession's ethical standards in actual practice, public policy makers may take away any existing authority a profession has to regulate itself" (p. 317). This prediction became reality with the passage of Sarbanes-Oxley (SOX), whereby the government took responsibility for writing accounting standards for publicly traded companies.

Price Waterhouse Cooper's 2003 survey, pinpointing that ethics was not properly integrated into accounting education, encouraged academicians to increase classroom coverage of ethics and ethical issues (PWC 2003). The National Association of State Boards of Accountancy (NASBA) defines education in ethical and professional responsibilities as "a program of learning that provides potential professional accountants with a framework of professional values, ethics, and attributes for exercising professional judgment and for acting in an ethical manner that is in the best interest of the public and the profession" (2005). NASBA also recommends a process for ethics education including discussion of broad philosophical ethical concepts as a starting point, followed by application of these concepts to accounting and business environments. Such an educational program should include two courses (each for three semester-hours credit): (1) ethical and professional responsibilities of CPAs and (2) ethical foundations and applications in business. Additionally, NASBA suggests that these courses' content requirements should be separate from the legal environment of business course.

American Accounting Association is also an advocate for accounting ethics education. Toward that end, instructors should develop course materials and increase their skills and knowledge in ethics (Gaa and Thorne 2004). Contending that the focus has been on smoothing earnings to maximize shareholders' wealth, Jennings (2004) suggests that "… very little in textbooks and mandates from the AACSB focuses on 'moral absolutes or 'bright lights' virtue ethics such as honesty, fairness, or even false impressions in financial disclosures" (pp.13-14). In the post-Enron era, however, numerous support materials for teaching ethics and corporate governance are available. Such resources include books, articles, web sources and videos that can be used in a stand-alone course on accounting ethics and corporate governance. Those resources can also be integrated as modules into accounting courses (Thomas 2004).

ETHICAL MODELS

Along with covering codes and current issues, any successful course must also have a theoretical base in philosophy, sociology, and moral development (Armstrong 1993). Several theoretical approaches have also been suggested. McDonald and Donleavy (1985) contend that "If business ethics and business ethics research is to warrant a place in the field of business administration and to receive academic recognition, then it must utilize its theoretical foundation, ensure the integration of research into the theoretical foundation, encourage the development of new theories for further examination, present testable models for investigation, and ensure the transference of these concepts to the students of ethics and into the business community" (p. 843). Jennings (2004) identifies three currently used models in business schools: Social Responsibility, Professional Code, and Stakeholder /Normative Models. Lampe and Finn (1992) identify several alternative models that describe the ethical decision process: Agency, and Cognitive Ethics Models. Minz (1995) proposes a value theory model.

The Social Responsibility Model focuses on topics such as environmentalism, including going green, no nuclear power, product liability, and environmentally safe products. This model also includes diversity by hiring women, minorities, economically disadvantaged contractors and suppliers, and the disabled. Human rights, no revenue from weapons production, and philanthropy are other topics included in the Social Responsibility model.

Historically, the Professional Code Model has been the dominate approach in professional organizations. The 1988 revision of the AICPA Code of Ethics resulted in a conservative code-based model relying on principles and rules (Lampe et.al. 1992). This approach was supported by other professional accounting organizations that also have provided their own codes. Green and Weber (1997) found that emphasizing the AICPA Code in class "…not only increased their level of moral maturity, but subsequently enabled more students to select the ethical course of action based upon their higher level of moral reasoning" (p.786). The current AICPA Code (2003) is criticized as "nebulous," offering little in "clarity of definition or guidelines for conduct" (Jennings 2004, p.15).

The Stakeholder/Normative Model focuses on stakeholders. The business is accountable to any group affected by its conclusions, including utilitarianism and deontology (McDonald and Donleavy 1985). This model emphasizes duties, justice, equity, truth, and rights.

The Agency Model (Zimmerman 1988, Noreen 1988) applies to ethics where ownership is separated from delegated authority. Auditors as agents require monitoring costs to be borne by the principal. Other research has examined the researchers' own content-specific instrument.

In terms of Cognitive-Based Ethical Models, much of the research in ethics is based on Kohlberg's model of three stages of moral development and six stages of moral reasoning as well as Rest's Defining Issues Test (DIT) (Bean and Bernardi 2007). Rest provides a measure of moral development in his Defining Issues Test (1986). This model is based on the "recognition of a decision maker's stage of cognitive moral development" as defined by Kohlberg has provided the basis for many business ethics research projects. Recognizing actors' interactions, several researchers have modified the Kohlberg model. Trevino (1986) provided a decision-based model on "the interaction of individual and situational moderators following recognition of the dilemma." Recognizing that characteristics of the "model issue" affect the decision, Jones (1991) provided a contingent model. Thorne (2000) designed the Accounting Ethical Dilemma Instrument "…developing measures to assess accountants' moral reasoning as applied to accounting specific dilemmas, and to compare the level of moral reasoning applied by accountants to their cognitive moral capacity as measured by the Defining Issues Test (DIT)" (p.139). Moral reasoning is divided into two measures: prescriptive reasoning, involving ideal professional judgment, and deliberate reasoning, involving intention to exercise professional judgment. Langenderfer and Rockness (1989) provided a decision model that can be applied to ethical development, while Lampe and Finn (1992) proposed the five-component auditors' model.

Minz (1995) provided a "virtue theory model," which includes five virtues considered to be "dispositional properties" allowing accountants to "meet their ethical obligations." Therefore, the focus is on the person's character and morality.

The AACSB suggested "multiple frameworks "with a focus on considering "…multiple stakeholders and to assess and evaluate using different lenses and enlarged perspectives" (2004, p.24). The AACSB's Ethics Education Task Force also suggested consequentalist, deontology, and virtue ethics approaches. Their approach generally follows the Stockholder/Normative Model with a focus on "…harms and benefits to stakeholders … and the greatest good for the greatest number."

ETHICS COURSES IN ACCOUNTING

The ultimate question is whether or not ethics should be taught. Studies are typically based on Kohlberg's level of ethical reasoning and Rest's Defining Issues Test (DIT) (Bean and Bernardi 2007). Kohlburg (1979) provided a six-level progressive model of moral development. Rest provides a measure of moral development in the Rest Defining Issues Test (1986). This model has provided the basis for many business-ethics research projects. Based on a review of previous educational studies, Rest (1987) concluded that ethics can be taught. Armstrong (1993) also found that ethics courses raised the students' level of moral development. Likewise, Glenn (1992) found that courses can have a positive effect on ethical judgment. Furthermore, Jeffrey (1993) found seniors have a higher moral development than freshman. Several studies conclude that an undergraduate ethics course does increase moral development (Hitlebeitel & Jones 1991, Green and Weber, 1997). Therefore, a significant body of research supports the belief that education can have a significant positive effect on ethical development.

On the other hand, several researchers, including St. Pierre et al. (1990), did not find that ethics courses improved students' moral development. Pappas and Diskin (2001) found no significant difference between those having an ethics class and those that did not. Several studies have concluded that graduate ethics courses did not increase students' moral reasoning (Poneman 1993, Walton et al, 1994, LaGrone, 1996). Although ethics courses were included in the business curriculum, researchers argued that one course in one semester was not enough to produce a lasting effect on a student's personal approach to academic dishonesty (Sims 1993). In contrast, using Thorne's AEDI content-specific instrument, Early and Kelly (2004) concluded that "… educational interventions regarding ethical issues can be effective in improving students content-specific moral reasoning from the beginning to the end of the semester" (p.68). The corresponding DIT exam, however, showed no improvement in moral reasoning, and Poneman (1993) had similar results.

Historically, most objections to the teaching of ethics have been theoretical. Business ethics is considered "… unscientific, and non-empirical" with "… an inherent element of subjectivity, or 'softness' … to lack an analytical foundation of its own" (McDonald et al 1995, p. 943). Generally, the objection to covering ethics fits into the following arguments: First, ethical standards are set before students enter college. Secondly, ethical dilemmas can only be handled on the job (Early & Kelly, 2004). Hosmer (1985) argues that what should be taught is not moral standards of behavior, but "… a method of moral reasoning through complex issues so that the students can apply the moral standards they have" (19). Thus, Hosmer advocates teaching ethical analysis systems. Other researchers have attempted to justify ethics classes from a theoretical standpoint (McDonald and Donleavy, 1995), suggesting that effectiveness depends on how the course is taught. Although the studies' results are sometimes mixed, support seems to exist for an accounting ethics course.

ACCOUNTING VERSUS NON-ACCOUNTING STUDENTS

The first studies comparing accounting students to other students used Rest's Defining Issues Test (Ponemon, 1993). Generally, "… accounting majors' scores on Rest's measures are consistently below that of the general population throughout and after college" (Bean & Bernardi 2007, p. 65). Both Armstrong (1987) and St. Pierre, Nelson, and Gabin (1990) found lower DIT scores for accounting majors compared to other business majors. Armstrong (1987) also found college students had higher ethical standards than CPA's and accountants. Accounting students were closer to the general population than similar occupational groups in DIT scores. Lampe and Finn (1992) found that practicing accountants and accounting students performed lower on Rest's DIT tests than university graduates and other professional groups. Accounting students and practitioners had lower DIT scores and higher stage 4 measures. Based on Kohlberg's levels, these outcomes reflect a "follow the rules" mentality. Gaa (1994) concluded that academic dishonesty is more widespread in the more rigorous majors including accounting. Accountants must make decisions regarding ethical dilemmas in which no single ethically correct answer exists (Gaa, 1994). Thorne (2000, 2004) found that accountants have higher prescriptive reasoning scores than deliberative reasoning scores, suggesting a rule-oriented profession with little concern for ethical dilemmas. They concluded that auditors lagged behind other professions, college graduates, and other students in moral development.

Jeffrey (1993), however, found that accounting majors' ethical level was higher than peer groups'. Ethical levels were higher for accounting majors entering college and for accounting seniors. All the college students developed ethically during college with accounting students being at the highest level. Jeffrey (1993) suggested that the university's moral environment might have an effect. According to the results of a survey conducted among management majors in an AACSB accredited state university and a private Catholic university (Brown and Choong 2005), students were found to be very similar in terms of their "extent of participation in 16 dishonest academic practices" despite the fact that "more emphasis was placed on ethics and values at the Catholic university." Iver and Eastman found that non-business students were more likely to cheat than business students (2006).

Studies comparing accounting majors with non-accounting majors have found that accounting students tend to resemble the general population in ethics more than comparable educational and occupational groups (Gaa, 1995; Shaub, 1994). Researchers speculate that business professors are more aware and vigilant because of AACSB and the media. According to Waddock (2005), "Courses on ethics, corporate responsibility, business/public policy, stakeholder relationships, and other 'soft' subjects are typically given short shrift in favor of applied analytical tools and techniques, conceptual models and measures of profitability, which are all rooted in the mythology of positive economic science" (p.150).

Anitsal, Anitsal and Elmore (2009) found two modes of academic dishonesty among business students: active and passive. As Early & Kelly (2004) mentioned, students come to college with preset academic-honesty standards. Students easily identify turning in a paper written by someone else as an academically dishonest behavior. Similarly, using cell phones to transfer questions and answers and looking at another student's exams were identified as active cheating behaviors. Academic honesty standards learned during their college education clearly identified active dishonest behaviors. These standards are similar to rules of conduct or accounting codes.

Research indicated that students had more difficulty in correctly identifying situations involving passive academic dishonesty. Students failed to report someone they noticed cheating.

Similarly, they did not consider giving information about an exam's content to someone who has not taken it yet as cheating. These are gray areas because instructors did not include such situations in their instructions. These activities also resemble complex business situations in which codes of conduct had not yet been covered.

Anitsal, Anitsal and Elmore (2009) tested active and passive academic dishonesty constructs among male and female students. Validity and reliability of constructs and items were established in that research. The researchers found that female students failed to recognize passive academic dishonesty situations and engaged in passive cheating more than male students, who have more propensities to actively cheat. These researchers' model can also be used to compare accounting and non-accounting students.

This paper compares the perceptions of accounting majors and non-accounting majors in a college of business at a major state university in the Southeast. Specifically, a conceptual model of academic dishonesty is developed, and the structural equation model is tested to see if accounting majors and non-accounting majors perceive "active academic dishonesty" and "passive academic dishonesty" in the same way. Therefore, the hypotheses are as follows:

H1: There is a significant negative relationship between the ability to perceive active academic dishonest situations as cheating and intention to cheat for both accounting and non-accounting majors.

H2: There is a significant negative relationship between the ability to perceive passive academic dishonest situations as cheating and intention to cheat for both accounting and non-accounting majors.

METHOD

Data were collected from business majors at a state university in the Southeast through an online survey. Students were offered extra credit if they completed this voluntary survey. Responses were kept completely anonymous. In the data preparation stage, anomalies, patterns and possible data-entry errors were checked. Missingness was not an issue in data, and multivariate outliers did not exist in the data. The usable sample size was 249.

The sample had a relatively balanced distribution in terms of respondents' gender; males and females had a share of 54 percent and 46 percent, respectively. Two-thirds of the respondents were younger than 23 and had a GPA lower than 3.25. Approximately four-fifths of the respondents had on-campus work experience. Accounting majors represented 25 percent share of the total sample.

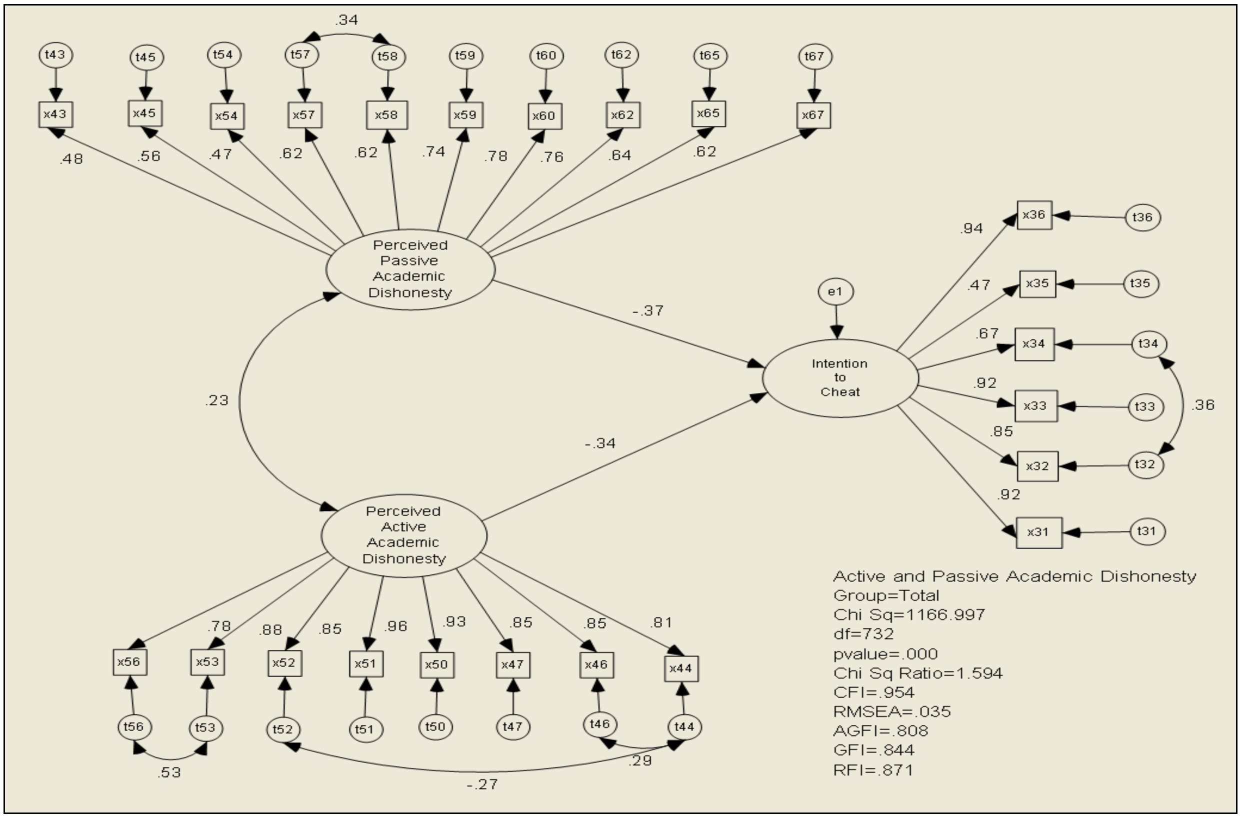
The perceived active academic dishonesty construct has 6 items (Anitsal, Anitsal, and Elmore 2009) (Table 1). The perceived passive academic dishonesty construct has 10 items, 5 of which 5 were generated by Anitsal, Anitsal and Elmore 2009; the remaining items were taken from Brown and Choong (2005), Turrens (2004), Crawford and Juday (1999), Spangenberg and

Obermiller (1996), and Sims (1993). Students were given situations and asked whether or not each described was cheating. A 7-point Likert scale from strongly disagree (1) to strongly agree (7) was used. The theoretical model is in Figure 1. Intention to cheat items were taken from Bruner, James and Hensel (2001). Reliability items and validity of constructs were checked and found satisfactory; however, discussions about details of checks have been excluded here due to page limits.

Table 1
VARIABLE DESCRIPTIONS

Perceived Passive Academic Dishonesty
x43: Searching the Internet to find an applicable test-bank for the course. x45: Noticing someone else cheating and not reporting it (not "whistle-blowing"). x54: Writing notes on the test when it is first handed out. x57: Visiting a professor to influence grade. x58: Using a false excuse to delay an exam. x59: Having someone check over a take-home test before turning it in. x60: Giving information about the content of an exam to someone who has not yet taken it. x62: Exceeding the specified time limit on a take-home exam. x65: Using sorority/ fraternity test files. x67: Preparing cheating notes to take to class without using them.
Perceived Active Academic Dishonesty
x44: Having another person take the test for you. x46: Turning in a paper written 100% by someone else. x47: Copying answers from someone else's exam. x50: Using a cell phone to transmit answers to another student. x51: Using a calculator to give another student a test answer. x52: Taking pictures of the exam with a digital camera. x53: Writing notes on your body parts. x56: Placing notes in other accessible places.
Intention to Cheat
x31: Unlikely - Likely x32: Nonexistent - Existent x33: Improbable - Probable x34: Impossible - Possible x35: Uncertain - Certain x36: Definitely would not cheat - Definitely would cheat

Figure 1
MODEL ON ACTIVE VERSUS PASSIVE ACADEMIC DISHONESTY: TOTAL SAMPLE OUTCOMES



RESULTS AND DISCUSSION

The model was run for total sample, accounting student sample, and non-accounting student sample using the AMOS 7.0 structural equation modeling software. The results are summarized in Table 2. The model fit is good as indicated by RMSEA= 0.035 and CFI=0.954 indices. The total sample model showed that perceptions of active and passive academic dishonesty are equally important on intentions to cheat. Similar results were found for non-accounting students. Hypotheses 1 and 2 were supported for non-accounting students. Results indicated that non-accounting students successfully recognized both active and passive dishonesty situations and avoided activities considered as cheating.

Surprisingly, the path connecting intentions to cheat to passive academic dishonesty situations was insignificant. This result means that accounting students recognized only active dishonesty situations as cheating and avoided them. Situations such as using sorority/fraternity test files, preparing cheat notes, or not whistle-blowing when noticing someone else cheating were not considered academic dishonesty and had no impact on the intentions to cheat construct.

Table 2
MODEL FIT AND TESTS OF PROPOSED RELATIONSHIPS IN THE MODEL

Model Fit Statistics:

Chi-Sq	df	p	Chi-Sq Ratio	CFI	RMSEA	AGFI	GFI	RFI
1166.997	732	0.000	1.594	0.954	0.035	0.808	0.844	0.871

Structural Relationships: Hypothesized Paths	Sample	Proposed Relationship	Standardized Coefficients	Critical Ratio	Significance at p = 0.0000
H_1: Perceived Passive Academic Dishonesty Intention to Cheat	Total (n=249)	Negative	-.370	-4.859	Supported
	Acc (n=63)		-.132	-0.984	Not Supported
	Non-Acc(n=186)		-.423	-4711	Supported
H_2: Perceived Active Academic Dishonesty Intention to Cheat	Total (n=249)	Negative	-.338	-5.563	Supported
	Acc (n=63)		-.315	-2.463	Supported
	Non-Acc(n=186)		-.368	-5.355	Supported

These results have important effects on the elaborate discussion of how an accounting faculty can produce ethically aware accountants and business people. This research indicated once more that accounting students are likely to follow rules. If a new situation that may have ethical consequences is not included in the rules, they simply ignore it. Such attitudes make them ethically vulnerable to complex business situations that may arise later in their practices.

Extant literature suggests that teaching ethics in one course is not enough, especially if that course is taught at the philosophical level. AACSB suggests using multiple frameworks that consider multiple stakeholders and perspectives. This approach may be a good start in teaching students moral reasoning through complex accounting issues. Whether specific courses designed for that purpose or regular accounting courses with embedded ethics-related situations are preferred is the teaching institution's decision. However, this research clearly indicates the need to teach accounting students what to do in complex situations laden with ethical consequences.

CONCLUSION

In the current economic crisis, we are faced with another wave of scandals. The scandals of the "…1970's, 1980's 1990's and 2000's have spotlighted a deepening crisis of ethics—a crises that neither the profession nor accounting education appear to be compelled to address" (Van Wyeth 2007, p.494.) Abuses have resulted from CPAs' reacting to Wall Street by maximizing shareholder value and ignoring other stakeholders. Accounting is an "ethical rather than technical discourse"; therefore, "ethics, accuracy, and transparency are integral to accounting" (Waddock 2005, p.150). However, accounting students and practitioners typically perform lower than the general population on the Rust test (Bean and Bernardi, 2007) and at Kohlberg's stage four, which is a "following the rules" mentality.

Although findings are sometimes mixed, they seem to support that an accounting ethics course is needed. Moreover, insufficient knowledge is available about how student group norms form and change on what is acceptable and unacceptable in academic environments. Therefore, future research is needed in this area. Research finds a strong relationship between the ethical decision process of accountants and their professional judgment (Jennings, 2004; Nonis and Swift, 2002). Cheating is a conscious decision in which the benefits outweigh the risks (Williams and Hosek, 2003). Furthermore, these findings have been supported by auditors (Waddock 2005; Berensen, 2003). As noted by Pullen (2000),"Cheating is the bane of higher education and strikes at the heart of established values in American Culture" (p. 616).

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SHE'S NOT HEAVY, SHE'S MY SISTER: DOES ANYONE REALLY GIVE A HOOT ABOUT OBESITY AND WEIGHT DISCRIMINATION? THE CASE OF THE "HEAVY" HOOTERS GIRLS

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ABSTRACT

Hooters – along with their overtly conspicuous waitresses – opened their first restaurant in Florida in 1983. (About Hooters, 2008). Controversy would soon follow in the form of lawsuits for sexual harassment, men suing to become "Hooters Girls," and allegations of one-sided arbitration agreements that purportedly disadvantaged employees. Most recently, however, Hooters was sued by two former waitresses who claim they were illegally fired because they were deemed to be overweight. (Roth, 2010). All of this comes at a time when the overall fitness of Americans has been called into question, as evidenced by the Centers for Disease Control and Prevention asserting that there has been a dramatic increase in obesity in the last twenty years. (Centers for Disease Control and Prevention, 2010). Given the reported expanding waistlines of Americans, should weight be a protected class covered by civil rights legislation? Or is this just a case of political correctness gone mad?

INTRODUCTION

The lead plaintiff in the Hooters weight bias case is Cassandra Smith, who interestingly measures out at 5'8" tall and 132.5 pounds. (Roth, 2010). One popular measure of fitness that has gained currency in recent years is the so-called Body Mass Index (BMI). According to the BMI, which is determined by a combination of height and weight, Smith has a BMI between 18.5 and 24.9, which is considered to be in the normal range. How normal? Well, that range is characterized as follows: "People whose BMI is within 18.5 to 24.9 possess the ideal amount of body weight, associated with living longest, the lowest incidence of serious illness, as well as being perceived as more physically attractive than people with BMI in higher or lower ranges." (BMI Calculator, 2010). As a caveat, however, since Body Fat Percentage calculations use total body weight and not estimates of lean muscle mass and fat, BMI cannot determine between the overweight and the more muscular (in other words, you could be incredibly fit and muscular and your BMI would indicate you are overweight).

Hooters has never made a secret of the fact that they hire attractive women as waitresses in their chain. In fact, the Hooters Restaurant Mission Statement explicitly establishes that such woman are a part of their identity:

We are committed to providing an environment of employee growth and development so that we can provide every guest a unique, entertaining dining experience in a fun and casual atmosphere delivered by ***attractive, vivacious Hooters Girls*** while making positive contributions to the communities in which we live [emphasis added]. (Hooters Restaurant Mission Statement, 2008).

According to the Hooters website, "[T]he element of female sex appeal is prevalent in the restaurants, and the company believes the Hooters Girl is as socially acceptable as a Dallas Cowboy cheerleader, a Sports Illustrated swimsuit model, or a Radio City Rockette." (About Hooters, 2010).

NO MALES NEED APPLY

The Cassandra Smith case is not the first time Hooters has faced a legal issue involving their practice of featuring only attractive females as servers in their restaurants. In 1991, the Equal Employment Opportunity Commission (EEOC) began an investigation of Hooters for discriminatory hiring practices against men. Title VII of the Civil Rights Act (CRA) of 1964 prohibits discrimination in employment based on gender. The EEOC's investigation into this issue lasted for several years. In 1995, Hooters of America struck back:

. . . probably the greatest marketing coup came in 1995 when Hooters of America hired a hairy male actor and dressed him in a Hooters waitress outfit to poke fun at allegations that Hooters restaurants discriminated against men. Hooters of America ran full-page advertisements showing "Vince" in *USA Today* and the *Washington Post.* But more importantly, according to then vice-president of marketing Michael McNeil, television camera crews showed up at every Hooters restaurant in the United States the same day to do local stories. (See Appendix A, Vince Gigliotti, the Hooters Guy).

Moreover, on November 15, 1995, the chain took the EEOC's charge public with a 100 Hooters Girl march on Washington D.C. Hooters received support from the nation's media, calling the charge "another example of ridiculous government waste," and some 500,000 Hooters customers supported the chain by sending postcards to Congress. (About Hooters, 2010).

Nevertheless, in 1996, three male plaintiffs launched a lawsuit as representatives of a class action against Hooters "because of defendant's refusal to hire men to work the 'front of house' positions of wait staff, bartender or host." (*Latuga v. Hooters*). In 1997 the case resulted in a settlement that required no change in policy, acknowledging that "being female is reasonably necessary" to the performance of the Hooters Girl's job duties.

The most recent challenge to Hooters gender-specific hiring policies came in 2009 when a Texas man brought a class action lawsuit for Hooters' refusal to hire males as waiters. (Heller, 2010). Hooters argued that the 1997 settlement in the *Latuga v. Hooters* case served as a to bar the claims in the 2009 Texas case in light of how the 1997 settlement specifically acknowledged the propriety of Hooters' hiring policy, i.e., that "being female is reasonably necessary" to the performance of the Hooters Girl's job duties. (Heller, 2010). The Texas case settled in April of 2010, with Hooters paying the plaintiff $1,000 plus his attorney fees. Had the case not settled, it seems Hooters may have had a strong defense by asserting the so-called "bona-fide occupational qualification" (BFOQ) exception, which applies when the "essence of the business operation would be undermined if the business eliminated its discriminatory policy." (Heller, 2010).

WHAT ABOUT A BONAFIDE OCCUPATIONAL QUALIFICATION?

Gender as BFOQ

An exception (or defense) to discrimination under Title VII of the CRA is a bona-fide occupational qualification (BFOQ). For example, the BFOQ exception permits employers to make hiring decisions based on otherwise prohibited reasons, such as sex, if such decisions are necessary to the "essence of the business." (Cantor, 1999). When it comes to gender, however, there is a presumption in the law against permitting BFOQ defenses based on customer preference. The EEOC, in fact, claims as a matter of policy that consumer preferences cannot justify employment decisions. (29 CFR § 1604.2(a)(1)(iii)). The rationale for the EEOC's position becomes clear if one can imagine the preposterousness of customers of a generic restaurant insisting that they refused to be served by waiters of a certain race or religion. Conversely, however, the courts have held that in certain limited circumstances consumer preferences may justify BFOQ defenses. (Wilson v. Southwest Airlines Co.) For example, if a Hollywood producer is producing a film and needs a female for a role, then it is perfectly legal to require that the person playing the role be a female. Similarly, through its settlements with males who allege gender discrimination, Hooters has de facto prevailed by arguing successfully that being female is a BFOQ for a position as a server at any Hooter's restaurant.

Weight as BFOQ

What about weight as a BFOQ? There are legitimate and well-recognized standards related to weight for certain types of jobs. For example, in the interest of public safety, police and fire personnel have general weight requirements in most cities. (*Hegwer v. Bd. of Civ. Serv. Commissioners*). Moreover, there is no requirement that a clothing designer hire a model who is larger than a traditional runway model or who will not fit the designer samples. Moreover, there is no federal legislation labeling "weight" as a protected class.

Nevertheless, there have been a number of cases in which employees have sued their employers alleging that their weight constitutes a disability that deserves protection under state and federal statutes such as the Americans with Disabilities Act (ADA) and the Rehabilitation Act. It turns out that weight as a disability "may" be a protected class in some instances. In 1993, the First Circuit Court of Appeals considered a case of obesity discrimination and determined that the plaintiff (Cook) had a valid disability claim. This case was the first time a plaintiff had been successful in claiming that morbid obesity qualified as a protected disability under federal law. (*Id*.) The facts of the case were as follows:

Cook had twice been employed by the Rhode Island Department of Mental Health, Retardation and Hospitals (MHRH), but then was refused reemployment, despite having a satisfactory work record, a fact which MHRH did not dispute. MHRH admitted its reason for not rehiring Cook was because she was morbidly obese. Given those facts, the district court held that, under certain conditions, the provisions of the Rehabilitation Act prohibited discrimination due to obesity, such as here, where the employer perceived obesity as a disability. (Id., citing *Cook v. R.I.)*

In *Cook,* the plaintiff prevailed on her claim because the jury believed she was discriminated against because she was "perceived as" disabled. (*Id*.) The court of appeals held that a reasonable jury could also have concluded that her weight was an actual impairment. (*Id.*) *Cook*, however, appears to be the exception to the rule. Many employers have successfully fended off attempted weight discrimination cases by arguing that for a given type of employment weight is in fact a BFOQ. In other words, in a situation in which a person who is either overweight or underweight for a particular job arguably cannot successfully carry out the responsibilities of the job, the employer has a defense to a charge of weight discrimination.

A classic example of weight as a BFOQ is the case of *Tudyman v. United Airlines.* In that case, a bodybuilder was denied a position as a flight attendant because his weight exceeded the maximum weight permitted for the job. The court held that Tudyman's weight was voluntary and self-inflicted, therefore it did not constitute a disability. (Browne, Morrison, Keeley, & Gromko, 2010). In yet another case, Middleton v. CSX Transp., Inc., the plaintiff claimed he could not pass a strength test because of his obesity. Plaintiff's theory was that this was illegal as disability discrimination under the ADA. The court disagreed, holding that passing a strength test was a BFOQ, in that a certain amount of strength was required for an employee to successfully carry out the responsibilities of the job, and by failing the strength test the plaintiff demonstrated he was not qualified for the position. (*Middleton v. CSX Transp., Inc.*)

WEIGHT – A PROTECTED CLASS OUTSIDE OF OBESITY?

Title VII of the 1964 Civil Rights Act recognizes only five specific protected classes – race, color, national original, religion, or gender – and, as such, weight is not a specifically protected classification under the federal law. (Title VII of CRA of 1964). Even under the Americans with Disabilities Act (ADA), the EEOC has recognized that being overweight, in and of itself, generally is not a recognized impairment under the ADA definition of disability.

(Mook, 2008). Given the lack of specific protection under federal law for weight discrimination, then under what authority was Hooters sued for weight bias?

It turns out that the Cassandra Smith lawsuit against Hooters was brought in Michigan, under a Michigan state law that specifically prohibits discriminatory practices based on, among other things, "weight." (Elliott-Larsen Civil Rights Act). Michigan is the only state in the U.S. with such a law (though the District of Columbia does have a statute that protects against "personal appearance" discrimination – the *D.C. Human Rights Act*). According to the Michigan Elliott-Larson Civil Rights Act, it is:

> AN ACT to define civil rights**; to prohibit discriminatory practices, policies, and customs in the exercise of those rights based upon** religion, race, color, national origin, age, sex, height, **weight**, familial status, or marital status . . ; to prescribe the powers and duties of the civil rights commission and the department of civil rights; to provide remedies and penalties; to provide for fees; and to repeal certain acts and parts of acts. (*Id.*, emphasis added).

Cassandra Smith, one of the two former "Hooters girls" suing Hooters of Roseville (Michigan), alleges that she received good reviews and a promotion to shift leader before being placed on "weight probation" and being told to join a gym. (Roth, 2010). Hooters filed a motion to have the case dismissed and sent to arbitration given that both plaintiffs had signed employment contracts containing binding arbitration clauses. (Roth, 2010). On August 25, 2010, a Michigan judge announced that the case may continue in court because the two plaintiffs "may not have knowingly waived their right to litigate their claims in court should their claim be proven that they were never afforded the opportunity to take the agreement with them to consult with counsel." (Roth, 2010).

It is expected that Hooters will file an appeal regarding Judge Maceroni's ruling that voided the arbitration clause. If Hooters prevails on appeal, the case will proceed to binding arbitration where there will be no public hearing and no appeal – in essence, a private dispute resolution procedure. If the arbitration clause issue is resolved in favor of the plaintiffs, however, the case will continue through a jury trial and possible future appeals. The question then becomes who should prevail in this case. Would a jury concede that Hooters should have the authority to establish and enforce weight requirements, or would a jury be sympathetic to Ms. Smith, who is 5'8" tall and weighs 132.5 pounds? And were Ms. Smith and her co-plaintiff to prevail, what are the remedies afforded under Michigan law?

PLAINTIFFS' BURDEN UNDER MICHIGAN LAW

In the area of employment law, if an employee believes he or she has been intentionally discriminated against that employee may pursue what is referred to as a "disparate treatment" case, i.e., disparate treatment means intentional discrimination. A plaintiff may seek to prove disparate treatment discrimination based on 1) direct evidence or 2) the *McDonnell Douglas* burden-shifting approach. ("Elliott-Larsen Civil Rights," 2009). Under the direct evidence approach, weight-based discrimination may not be based simply on rumors or subjective beliefs, nor vague, ambiguous, or isolated remarks. (*Hein v. All Am. Plywood Co.*) Moreover, plaintiffs seeking to prove their case through direct evidence must show that the defendant had a predisposition to act in a discriminatory manner and that the defendant's "alleged prejudice against heavier individuals" was connected with the decision that caused the adverse employment against taken against plaintiffs. (*Id.*)

WHAT WOULD THE PLAINTIFFS CITE AS DIRECT EVIDENCE?

Plaintiff Cassandra Smith began working at Hooters of Roseville (Michigan) in 2008 after being recruited while dining at Hooters. At the time, Smith weighed 145 pounds – quite interestingly, this is significantly more than she weighed at the time her employment was terminated. During her two year tenure at Hooters, Smith claims she received good reviews and a promotion to shift leader. (Stempel, 2010). On May 14, 2010, Smith alleges she was "admonished, disciplined and counseled" by two Roseville Hooters supervisors and two representatives from Hooters' corporate office. (Complaint). Smith was counseled about the fit of her uniform and advised to join a gym in order to lose weight and improve her looks so she would fit better into the extra-small size uniform she was required to wear. (Complaint). Smith was then required to sign an agreement putting her on 30-day "weight probation" as a condition of retaining her employment. (Complaint). Smith further alleges that Hooter girl uniforms only come in three sizes: extra-extra small; extra-small; and small. At the end of Smith's "counseling" session, the two corporate Hooters employees told Smith that they would understand if she felt she could not succeed and wanted to quit her job. Smith was specifically not told what an acceptable weight would be. Smith later discovered that the Hooters officials who counseled her disclosed to others – including Smith's co-employees – that she was on "weight-probation."

Assuming Smith's allegations are true, including that the remarks about her weight came from four Hooters high-ranking officials (two supervisors at the Roseville restaurant and two corporate employees), it is arguable that the comments are not vague or ambiguous. Moreover, the fact that she was specifically put on "weight probation" and that the "largest" size of Hooters uniform is a "small," a compelling case is presented that Hooters has a predisposition to act in a discriminatory manner with regard to weight. It also seems plausible that Hooters' prejudice against heavier individuals led to her constructive discharge (this occurs when an employee feels they are forced to leave their employment against their will).

ANALYSIS UNDER THE BURDEN-SHIFTING APPROACH

As stated above, plaintiffs may also seek to prove disparate treatment discrimination by using the *McDonnell Douglas* burden-shifting approach. This approach allows a plaintiff to prove his or her or case without so-called direct evidence. The law allows for this because, although discrimination in the workplace certainly has not been eradicated, those who discriminate are often subtle about it and are careful to avoid saying or doing anything that can be used as direct evidence. Accordingly, under the *McDonnell Douglas* burden-shifting framework, a plaintiff must show that he or she was:

- a member of a protected class,
- subject to an adverse employment action,
- qualified for the position from which she was rejected or terminated, and
- either replaced by a person from outside the protected class, or treated differently than a similarly situated employee from outside the protected class. (*Hein v. All Am. Plywood Co.)*

In the burden-shifting approach to proving discrimination, Smith would first demonstrate that she is a member of a protected class. This could prove difficult. Under the Elliott-Larsen Civil Rights Act, "weight" is a protected class. But what does that mean? In another case alleging weight discrimination, the Sixth Circuit Court of Appeals held that a Michigan man failed to even state a prima facie case of disparate treatment because no evidence in the record showed that his replacement weighed less than him or that he was treated differently than similarly-situated employees from outside the protected class. (*Hein v. All Am. Plywood Co*.) In the Hooters case, it is not clear that Smith is a member of a protected class. The complaint does not indicate whether Smith's replacement weighed less than her. Nor do we know whether Smith was treated differently from others "similarly-situated."

By analogy, consider an age discrimination case, which under federal law is specifically designed to afford protection for individuals in the workplace age forty or older. In other words, is there wiggle room for Hooter's to make the claim that Cassandra Smith, whose BMI is in the normal range, is even in the class of people the statute was designed to protect? For example, an employer can tell a 39 year-old he or she is "too old" for a particular job, and that you want to replace him or her with a younger person. And while such a 39 year-old is in a colloquial sense being discriminated against based on age, the 39 year-old is NOT in class of people the Age Discrimination is designed to protect, i.e., people over the age of 40. Accordingly, is Michigan's weight discrimination statute really designed to protect people who have a BMI in the normal range? Or is the law designed to protect obese people, or at least people whose BMI is outside the normal range?

Assuming, however, that Smith can meet the burden of presenting a prima facie case of weight discrimination, the burden then shifts to Hooters to prove that there was a "legitimate, non-discriminatory reason" for the employment decision (i.e., the decision to "counsel" Smith and put her on "weight probation"). (Elliott-Larsen Civil Rights, 2009). If Hooters is able to articulate a legitimate, business reason for their decision, then the burden shifts one last time back to Smith, who must demonstrate that Hooters' given reason is a mere pretext. In other words, despite Hooters' protests, a jury must believe that Hooters' actions toward Smith were because of her weight.

REMEDIES UNDER MICHIGAN LAW

Under the Michigan Elliott-Larsen Civil Rights Act, the court may grant both equitable and monetary relief. Examples of equitable relief could include reinstating the plaintiff to her job, expungement of negative comments from personnel records, and even an injunction prohibiting the company from giving potential future employers a bad recommendation of the employee (*Ross v. Beaumont Hosp*.)

Monetary relief may be afforded in a number of ways, including:

- Reimbursement to a prevailing plaintiff for the costs and attorney fees associated with bringing the lawsuit (*Eide v. Kelsey-Hayes Co*.);
- Reimbursement for lost wages; and
- Emotional distress damages (*Dep't of Civil Rights ex rel. Johnson v. Silver Dollar Café*).
- Exemplary (i.e., punitive) damages may not be awarded. (Elliott-Larsen Civil Rights, 2009).

CONCLUSION

Amid frequent news reports that Americans are increasing in size, a somewhat schizophrenic response to weight gain has emerged. On the one hand, numerous health risks associated with excess weight are bandied about, fast food restaurants are vilified for their high caloric menus, and people are endlessly encouraged to diet and lose weight, while on the other hand much sentiment exists to accept people as they are, to tell people to be comfortable in their own bodies, and to treat heftier family, friends, and neighbors without disapproval, prejudice, and discrimination. On the political correctness front, what is one to make of the Hooters girls? Are they essentially food servers for whom weight should not be an issue? And even if Hooters officials insist they want attractive female waitresses, full-figured women certainly have their share of admirers. Conversely, should Hooters be able to assert a BFOQ defense and make the case that their waitresses are as much entertainment as they are food servers and that they and they alone should be able to decide who they want to put in their show to attract customers?

And how far might Hooters go to make their point? Although it was seemingly quite effective to use the hairy male "Vince" in their prior gender discrimination lawsuit, one cannot imagine that Hooters would use an analogous "hairy male" strategy to combat a lawsuit alleging discrimination based on weight. Imagine the outrage if Hooters bought full page newspaper ads featuring obese Hooters girls!

On a larger societal level, how far should our laws go to prohibit various forms of discrimination? Few argue with the original protected classes set forth in Title VII of the 1964 Civil Rights (race, color, national origin, religion, and sex), or the federal Age and Disability anti-discrimination laws that followed. But should obesity be a recognized disability under the American with Disabilities Act, or should weight discrimination become its own protected classification as the state of Michigan has decided to do? What about the previously mentioned District of Columbia statute that protects against "personal appearance" discrimination? Should such a law be adopted throughout the country?

Discrimination in the workplace on attributes on unrelated to job performance is undeniably an insidious evil. Even so, questions of 1) what is related to job performance, e.g., a BFOQ, and 2) how far should the law go to combat discrimination are still very contentious and very much unresolved. The Hooters case in Michigan is the latest example of this tension, and it demonstrates that when it comes to weight discrimination plenty of people do indeed give a hoot!

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APPENDIX A

Vince Gigliotti – the Hooters guy. Vince appeared in the Washington Post, Wall Street Journal, Fortune Magazine, and hundreds of newspapers and magazines. (USA Today, Day in Sports Photo Gallery, http://www.usatoday.com/travel/gallery/hooters/contenttemplate4.htm).

WHEN A LIE IS THE TRUTH: PANDERING CHILD PORNOGRPAHY

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ABSTRACT

In 2003 Congress enacted the Prosecutorial Remedies and Other Tools against the Exploitation of Children Today Act to discourage trafficking in child pornography. The Act contained, among other provisions, a pandering provision that prohibited offers to provide, or requests to obtain, child pornography. Against a challenge of overbreadth and vagueness, the Supreme Court in United States v. Williams held that the pandering provision did not prohibit a substantial amount of protected speech, and that the language of the statute, along with its intent requirement, created a sufficiently clear fact-based scheme. In reaching its decision, the Court focused on the illegality of the materials described in the pandering provision as justifying the limitations on speech. This article argues that rather than focus on the nature of the materials underlying a proposed transaction, the Court could have rendered a more persuasive decision had it instead focused on the nature of the speech itself.

INTRODUCTION

Child pornography is a significant social problem, which the Internet exacerbated. Hundreds of thousand of images of child pornography are routinely seized by police, and increasingly the images are of small children not teens, often provided by international pedophile rings that require members to contribute thousands of images in order to join (Sieg, 2005). A fairly new development concerns the use of *avatars*, three-dimensional likenesses employed by computer users for gaming and other activities on the Internet. Participants in websites, such as Second Life, can make their avatars look like anything, including children engaging in child-like activities, such as playing on playgrounds; unfortunately, such avatars also may be engaging in simulated child molestation (Wagner, 2007; Meek-Prieto, 2008).

Online child pornography also represents a multi-million dollar business with thousands of images being posted weekly, and thousands of people being arrested annually for trafficking in such images (Fairchild, 2007). A Senate report speculated that pornography, including child pornography, generates an estimated eight to ten billion per year and is the third largest of organized crime's revenue builders (Bergelt, 2003). The commercial exploitation of the demand for child pornography arguably is increasing, as evidenced by *Landslide*, a child pornography access provider which generated as much as $1.5 million a month (Sanford, 2002).

Evidence suggests that there is a strong correlation between the consumption of child pornography and pedophilic behavior (Burgess, 1974; Quinsey & LaLumiere, 1996). Scientific data currently supports a correlation between the use of child pornography and the likelihood of the user sexually exploiting children (Dallas, 2007). Newspaper reports abound concerning the arrests of pedophiles, who have committed horrific sexual crimes against children, and who also had child pornography in their possession (Neighbor Convicted, 2002). The numbers of children trafficked globally for purposes of sexual exploitation in a global sex industry are astonishingly large and intimately linked to the seemingly insatiable demand for child pornography, as well (Dillon, 2008).

The Committee on the Rights of Children of the United Nations' High Commission on Human Rights recognizes the substantial threat that child pornography in all its forms poses to children worldwide. Its Optional Protocol to the Convention on the Rights of the Child concerning the sale of children, child prostitution and child pornography defines child pornography as "any representation, by whatever means, of a child engaged in real or simulated explicit sexual activities or any representation of the sexual parts of a child for primarily sexual purposes" (Article 2, Optional Protocol, 2002).

Such a sweeping definition of child pornography would prove problematic under the criminal justice system in the United States, however. Much pornographic material is protected under the First Amendment's Freedom of Speech Clause. While free speech is valued highly in our constitutional jurisprudence, it is not the only interest valued in our legal system. The protection of children is a recognized compelling state interest in constitutional law, as well (Federal Communications Commission v. Pacifica Foundation, 1978; Ginsberg v. New York, 1968; Prince v. Massachusetts, 1944). Thus, legislative bodies at the state and federal level have seen fit to suppress child pornography to the limits permissible under the Constitution in an effort to protect children from the predatory activities of pedophiles, which are believed to be inextricably linked to child pornography. What are those constitutional limits imposed by the First Amendment?

UNPROTECTED SPEECH UNDER THE FIRST AMENDMENT

The First Amendment provides that "Congress shall make no law…abridging the freedom of speech..." Nevertheless, that declaration is not an absolute. It is widely accepted, for example, that falsely shouting "fire" in a crowded theater is not an utterance deserving of constitutional protection (Schenck v. United States, 1919). Several categories of speech, judicially defined, have emerged that do not enjoy constitutional protection. "There are certain well-defined and narrowly limited classes of speech, the prevention of which have never been thought to raise any constitutional problem. These included the lewd and obscene, the profane, the libelous, and the insulting or 'fighting' words—those which by their very utterance inflict injury or tend to incite an immediate breach of the peace. It has been well observed that such utterances are no essential part of any exposition of ideas, and are of such slight social value as a step to truth that any benefit that may be derived from them is clearly outweighed by the social interest in order and morality”(Chaplinsky v. New Hampshire, 572, 1942).

In addition to the exclusion of fighting words from constitutional protection, the Supreme Court in *Brandenburg v. Ohio* (1969) held that speech which incites illegal conduct is not protected, defining such speech as "advocacy . . . directed to incite or produce such action," and not the mere advocacy or encouragement of illegal activity (Brandenburg v. Ohio, 446, 1969). For such speech to fall outside the protection of the First Amendment, the unprotected conduct incited by the speech must be immediately produced (Adler, 2001). Advocacy of illegal action at some indefinite future time is protected speech and cannot be punished (Hess v. Indiana, 1973). Moreover, *true threats*, objectively viewed in their total context, can be forbidden by statute, as such threats usually are linked to criminal conduct (Watts v. United States, 1969).

Defamatory speech, which by definition consists of untruthful allegations, enjoys no constitutional protection because false speech contributes nothing to valued public discourse. Although falsity is the key to its unprotected status, public officials and public persons must establish malice, defined as a reckless disregard for the truth or falsity of the statements asserted, before such speech may be punished in civil courts through an award of damages (New York Times v. Sullivan, 1964). The malice requirement, as well as the requirement that public persons prove falsity with respect to speech of public concern (Philadelphia Newspapers, Inc. v. Hepps, 1986), is designed to preserve the open debate of both public issues and the characteristics of those persons involved in their resolution (Curtis Publishing Company v. Butts, 1967). A negligence standard is permitted for private person plaintiffs (Gertz v. Robert Welch, Inc., 1974).

Finally, some sexually explicit speech falls outside the parameters of constitutional protection. In *Roth v. United States* (1957) the Supreme Court held that "obscenity is not within the area of constitutionally protected speech or press" (Roth v. United States, 485, 1957). Subsequently, the Court defined that class of unprotected speech in *Miller v. California* (1973) as that which, taken as a whole, appeals to the prurient interest of the average person applying contemporary community standards, depicts or describes, in a patently offensive way, sexual conduct, and as a whole, lacks serious literary, artistic, political, or scientific value, such as “[P]atently offensive representations or descriptions of ultimate sexual acts, normal or perverted, actual or simulated...” and “[P]atently offensive representations or descriptions of masturbation, excretory functions, and lewd exhibition of the genitals” (Miller v. California, 24-25, 1973). Federal statutes that criminalize the transportation and distribution of such materials are limited to the Court’s definition announced in *Miller* (18 USC §§1461-1465); thus, non-obscene, pornographic materials enjoy constitutional protection.

While some child pornography would be considered obscene under *Miller*, the Supreme Court permitted a separate category of *non-obscene* pornographic material to be suppressed if the content involved images of actual children. At issue in *New York v. Ferber* (1982) was the constitutionality of a New York criminal statute prohibiting persons from knowingly promoting sexual performances by minors by distributing materials that depict such performances, even if the materials were not legally obscene. Concluding that states were entitled to greater leeway in the regulation of pornographic depictions of children, the Court upheld the statute. The Court reasoned that a state legitimately could determine that sexual abuse is linked to the distribution of child pornography, and that the advertising and selling of child pornography plays a role in the production of such materials, "an activity [that is] illegal throughout the Nation" (New York v. Ferber, 761, 1982). The Court also recognized that "[t]he value of permitting live performances and photographic reproductions of children engaged in lewd sexual conduct is exceedingly modest, if not de minimis" (New York v. Ferber, 762, 1982).

COMMERCIAL SPEECH AND THE FIRST AMENDMENT

Until fairly recently, commercial speech, defined as that which is designed to propose a commercial transaction (Board. of Trustees of the State University of N.Y. v. Fox, 1989; Posadas de Puerto Rico Assoc. v. Tourism Co. of Puerto Rico, 1986), also would have fallen into the "unprotected" categories of speech under constitutional law. Early Supreme Court cases involving First Amendment challenges to restrictions on commercial speech were widely interpreted as establishing that commercial speech was not protected by the First Amendment. In a very brief decision rendered in 1942, the Court observed that "the Constitution imposes no restraint on government [restrictions] as respects purely commercial advertising (Valentine v. Chrestensen, 1942). Later cases refined this concept to deny constitutional protection of speech that does "no more than propose a commercial transaction" (Pittsburgh Press Company v. Pittsburgh Commission on Human Relations, 385, 1973). The Court in *Pittsburgh Press* also noted that where the commercial transaction proposed is itself illegal, there can be no First Amendment protection for the speech that proposes that transaction.

However, beginning with a series of decisions in the mid-1970s, and continuing through the end of the twentieth century, the Supreme Court became increasingly protective of commercial speech. One of the first decisions to signal this shift towards protecting commercial speech occurred only two years after the Court's decision in *Pittsburgh Press*. In *Bigelow v. Virginia* (1975), the Court began distancing itself from what it declared was a mistaken interpretation of the decision in *Chrestensen.* According to the *Bigelow* Court, the government restriction in *Chrestensen* involved the manner in which the commercial speech was being disseminated, not the speech itself. The *Bigelow* Court recognized that commercial speech is entitled to some degree of First Amendment protection, but did not attempt to define the extent of that protection. The Court did, however, note that commercial speech was subject to reasonable governmental regulations designed to serve legitimate governmental interests.

The Court continued to recognize the value of commercial speech in the seminal case, *Virginia Board of Pharmacy v. Virginia Consumers Council* (1976), involving a challenge to a state law forbidding pharmacists from publishing or otherwise advertising prices for prescription medications. In addition to reaffirming that commercial speech enjoys First Amendment protection, the Court also noted that the intended recipients of that speech have an undeniable interest in receiving information that may be useful in consumer decision-making. By unequivocally recognizing society's "strong interest in the free flow of commercial information" (Virginia Board of Pharmacy v. Virginia Consumers Council, 764, 1976), the Court made it clear that commercial speech does in fact enjoy First Amendment protection. As in *Bigelow,* the Court acknowledged that some regulation of commercial speech would be permissible but did not attempt to establish comprehensive boundaries for such regulation. Rather, the Court offered several examples of reasonable regulations: content-neutral time, place, and manner restrictions, bans on false or misleading advertising, and bans on advertising for illegal transactions.

Subsequently, the Court articulated a four-part analysis to be applied when government regulation of commercial speech was being challenged. In *Central Hudson Gas & Electric v. Public Service Commission* (1980), an electric utility company challenged a New York state law banning advertisements that might encourage power consumption. The prohibition was initially motivated by a nationwide energy crisis in the early 1970s and by concerns that energy resources might not be sufficient to meet consumer demand, but remained intact even after the energy crisis had abated. Upon review, the United States Supreme Court repeated the now familiar mantra that truthful commercial speech does enjoy First Amendment protection, albeit to a lesser extent than other forms of protected speech since it can be regulated by the government (Ohralik v. Ohio State Bar Association, 1978; Cincinnati v. Discovery Network, Inc., 1993).

The first step of the *Central Hudson* analysis in examining the constitutionality of either government suppression or permissible regulation is to determine if the commercial speech is misleading or is directed toward an illegal activity. If so, it is not protected; if not, it is protected, but may still be subject to regulation. Therefore, the second step requires the government to articulate a substantial interest to be served by any restriction it seeks to impose on commercial speech. Third, the restriction must directly serve that interest and, finally, it must be the least restrictive alternative by which the interest may be served. The fourth factor in Central Hudson's analysis subsequently was modified to require only a *reasonable fit* between the governmental restriction and the substantial interest it seeks to serve (Board of Trustees of the State University of N.Y. v. Fox, 1989).

THE REGULATION OF CHILD PORNOGRAPHY AND PANDERNG

While truthful commercial speech enjoys a degree of constitutional protection, obscenity is not speech protected by the constitution. Therefore, both state and federal statutes may prohibit its distribution. As previously noted, such legislation is permissible providing that the definition of this class of speech is in accordance with the Supreme Court's definition in *Miller v. California*: "The basic guidelines for the trier of fact must be: (a) whether 'the average person, applying contemporary community standards' would find that the work, taken as a whole, appeals to the prurient interest; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value” (Miller v. California, 24, 1973). Previously, in *Ginzburg v. United States* (1966), the Supreme Court had held that in close cases the manner of promotion or dissemination could be considered in determining whether or not the material in question was legally obscene, and that evidence of pandering could support a finding of obscenity, even though the material otherwise would not be considered obscene. “We perceive no threat to First Amendment guarantees in thus holding that in close cases evidence of pandering may be probative with respect to the nature of the material in question and thus satisfy the *Roth* test" (Ginzburg v. United States 474, 1966).

However, *Ginzburg* was decided before commercial speech was recognized as having constitutional protection. Therefore, its viability as a precedent for pandering is questionable (United States v. Williams, 2006). If *Ginzburg* has no precedential value after truthful advertising gained constitutional protection, it is likely because it allowed the defendant’s characterization of the material to be considered in classifying the material as being obscene. The problem with that approach is two-fold: it permits the defendant rather than the *Miller* standard to determine the classification of the material, and also, in a convoluted way, then punishes truthful speech, which may not be permissible after *Virginia Board of Pharmacy*. As Justice Stevens observed in his dissent in an obscenity case involving pandering, "I would not send Mr. Splawn to jail for telling the truth about his shabby business" (Splawn v. California, 604, 1977), whereas presumably Mr. Splawn could go to jail for conducting his shabby business, if it involved obscenity as defined by *Miller*.

Again, while no doubt some sexually explicit materials depicting children would be considered obscene under *Miller’s* definition of obscenity, legislatures are permitted to regulate non-obscene pornography involving children as well (Cohen, 2002). In *New York v. Ferber* (1982) the Supreme Court approved such a restriction on speech, citing the government’s compelling interest in protecting children from the physical abuse that occurs during the production of child pornography, as well as the subsequent psychological harms caused by the existence of a permanent record of the illegal acts. The *Ferber* Court, however, adjusted the *Miller* formulation by stipulating that the trier of fact (1) did not need to find that the material appeals to the prurient interest of the average person, (2) is not required to find that the sexual conduct portrayed be done in a patently offensive manner, and (3) need not consider the material as a whole.

That the Court realized the intrinsic harm imposed upon children by the creation and distribution of actual child pornography as a record of illegal abuse is evidenced in the contrasting results of two cases concerning the illegal *possession* of sexually explicit materials. In *Stanley v. Georgia* (1969), a case that involved the possession of obscene materials with no intent to exhibit, sell, or display them, the Supreme Court held that it was unconstitutional for the government to criminalize mere private possession of obscene materials. The Court stressed the privacy interests of Stanley, and his right "to satisfy his intellectual and emotional needs in the privacy of his own home" (Stanley v. Georgia, 565, 1969), although the Court refused to extend this protection to embrace the right to transport obscene materials into one's home (United States v. Reidel, 1971; United States v. Orito, 1973).

Subsequently, in *Osborne v. Ohio* (1990) the Court addressed the constitutionality of a statute, which criminalized the possession and viewing of non-obscene child pornography, and concluded that the state's interest in criminalizing possession outweighed any privacy interest associated with the possession of child pornography. The Court cited three state interests in support of the Ohio statute that criminalized the possession of child pornography: 1) the materials produced by child pornographers permanently recorded the victims' abuse, which would result in continuing harm to the child victims by haunting them for years to come; 2) the state legitimately could encourage the destruction of child pornography by banning its possession because evidence suggested that pedophiles use child pornography to seduce children; and 3) the state reasonably could conclude that production would decrease if demand decreased as a result of penalizing possession. In other words, the government's overriding interest in protecting the physical and psychological health of minors is absent with respect to adult obscenity, which necessarily distinguishes the result in *Stanley*.

Notice, however, that both *Ferber* and *Osborne* presumed the use of actual minors in the creation of child pornography. Subsequently, computer-imaging technology developed such that children were no longer necessary to produce child pornography, since innocent pictures of children could be morphed into sexually explicit ones and sexually explicit pictures of adults could be morphed to depict children instead (Burke, 1997). In other words, actual children were not needed to create *virtual*, or computer-generated, child pornography; therefore, criminal laws which focused on the use of children in the production of child did not necessarily contemplate penalties for the possession or distribution of such virtual images. In response, Congress passed the *Child Pornography Prevention Act of 1996*, supplementing federal law to include computer-generated child pornography within the definition of child pornography if: (a) its production involved the use of a minor engaging in sexually explicit conduct; (b) it depicts, or appears to depict, a minor engaging in sexually explicit conduct; (c) it has been created, adapted or modified to appear that an identifiable minor is engaging in sexually explicit conduct; or (d) it is promoted or advertised as depicting a minor engaging in sexually explicit conduct (Tridgell, 2000).

Shortly thereafter defendants began challenging its constitutionality, and the federal circuit courts of appeals split on the issue, with only the Ninth Circuit concluding that the statute unconstitutionally suppressed protected speech (Free Speech Coalition v. Reno, 1999). Ultimately, the Supreme Court in *Ashcroft v. Free Speech Coalition* held that the provisions of the Child Pornography Prevention Act, which regulated non-obscene, virtual child pornography created without real or identifiable minors, was unconstitutionally overbroad. The majority emphasized that the CPPA pulled into its reach more than what could be banned under current obscenity law because depictions of older adolescents do not necessarily contravene community standards under *Miller*, and also concluded that the CPPA exceeded *Ferber*'s reach as well, since the legislation prohibited speech that "records no crime and creates no victims by its production" (Ashcroft v. Free Speech Coalition, 250, 2002).

Further, the Court concluded that the pandering provision of the Act, which banned depictions of sexually explicit conduct that were advertised, promoted, presented, described, or distributed in such a manner that *conveyed the impression* that the material depicted a minor engaging in sexually explicit conduct (whether or not the image was virtual or real) was unconstitutional. The Court observed that the government was silent on the evils of pandering images as child pornography when the images were not as described, and determined that the provision was constitutionally overbroad in that it proscribed materials that were actually protected speech, thus permitting possessors to be punished even though they may not know that the materials were mislabeled (Ashcroft v. Free Speech Coalition, 2002). In response, Congress passed the *Prosecutorial Remedies and Tools Against the Exploitation of Children Today Act* ("PROTECT") to address the constitutional infirmities of its previous effort (P.L. 108-21 Title V, 117 Stat. 681).

That Act narrowed the definition of child pornography, tightened the affirmative defense available, and amended federal obscenity law to address visual depictions of young children. Specifically, PROTECT prohibits visual depictions that are digital images, computer images or computer generated images that are indistinguishable from that of a minor engaging in sexually explicit conduct, defined for virtual child pornography as "graphic sexual intercourse, including genital-genital, oral genital, anal-genital, or oral-anal, whether between persons of the same or opposite sex, or lascivious simulated sexual intercourse where the genitals, breast, or pubic area of any person is exhibited; graphic or lascivious simulated bestiality, masturbation; or sadistic or masochistic abuse; or graphic or simulated lascivious exhibition of the genitals or pubic area of any person" (18 U.S.C. § 2256). "Indistinguishable" is defined as meaning *virtually indistinguishable*, "such that an ordinary person viewing the depiction would conclude that the depiction is of an actual minor engaged in sexually explicit conduct," and expressly exempts "drawings, cartoons, sculptures, or paintings" (18 U.S.C. § 2256(11)). The legislation also amended obscenity statutes to prohibit the production, distribution, receipt, or possession of "a visual depiction of any kind including a drawing, cartoon, sculpture or painting that depicts a minor engaging in sexually explicit conduct and is obscene" (18 U.S.C. § 1466A). The statute permits two affirmative defenses: 1) that the production of the alleged child pornography did not involve the use of a minor, and 2) that the accused only possessed less than three depictions of obscene visual representations of the sexual abuse of children, and either destroyed them or reported them immediately to the appropriate authorities (18 U.S.C. §§ 1466A(e) & 2252A).

With respect to pandering and solicitation, the Act provides criminal penalties for anyone who knowingly "advertises, promotes, presents, distributes, or solicits through the mails, or in interstate or foreign commerce by any means, including by computer, any material or *purported* material in a manner that reflects the belief, or that is intended to cause another to believe, that the material or *purported* material is, or contains - -(i) an obscene visual depiction of a minor engaging in sexually explicit conduct; or (ii) a visual depiction of an actual minor engaging in sexually explicit conduct" (18 U.S.C. § 2252A (a)(3)(B)). As such, the legislation seemingly criminalizes the distribution of speech which might otherwise be protected by the First Amendment except for the fact that it was flaunted as being illegal. Further, such speech is made illegal by the Act whether or not it proposes a commercial transaction, and thus is less deserving of protection under the commercial speech jurisprudence, or presumably fully protected by the First Amendment as noncommercial speech. The provision seemingly even goes beyond the conclusion in *Ginzburg*, since the manner of promotion or dissemination is not merely a factor to consider in determining whether or not the material in question is illegal, it defines the underlying speech. Is this provision, then, constitutional?

THE PANDERING PROVISION CHALLENGED: U.S. V. WILLIAMS

Mr. Williams signed onto a public chat room and discussed swapping pictures of his daughter with an undercover agent. He invited the agent to access his photo album online, where the agent viewed five pictures of a one to two year-old child in various poses. Williams then claimed that he had nude, "hard core" photographs of his four-year-old daughter, and asked for additional pictures of the agent's daughter. When the agent failed to produce such pictures, Williams accused him of being a police officer. Williams then posted a message to the chat room which stated "HERE ROOM: I CAN PUT UP LINK CUZ IM FOR REAL -- SHE CAN'T" followed by a hyperlink to child pornography (United States v. Williams, 2, 2004). He entered into a plea agreement for the child pornography charges related to the posted link and materials subsequently seized pursuant to a search of his home, but reserved the right to challenge the pandering charge on constitutional grounds.

Williams contended that the pandering provision of PROTECT was facially overbroad in its inclusion of speech that is otherwise protected, as well as being unconstitutionally vague. Because one could be punished for marketing material that either did not exist or that did not constitute illegal obscenity or actual child pornography and thus was protected expression, the defendant asserted that the provision was overbroad. A statute may be invalidated on overbreadth grounds only if it prohibits a substantial amount of protected free speech as judged in relation to its plainly legitimate sweep (Virginia v. Hicks, 2003). Nevertheless, a statute's overbreadth "must not only be real, but substantial as well, judged in relation to the statute's plainly legitimate sweep" (Broadrick v. Oklahoma, 615, 1973).

Furthermore, the pandering provision makes reference to *purported* material and bases criminal liability upon a defendant's intent and subjective belief, or intent to cause another to believe, language which the defendant argued rendered the provision too vague for the average person to know what conduct is forbidden. The void for vagueness doctrine in constitutional law provides that a statute will be held unconstitutional if it fails to “define the criminal offense with sufficient definiteness that ordinary people can understand what conduct is prohibited and in a manner that does not encourage arbitrary or discriminate enforcement” (Kolendar v. Lawson, 357, 1983). The failure to provide adequate notice and the encouragement of arbitrary or discriminatory enforcement constitute *independent* grounds for invalidating a criminal statute under this doctrine (Morales v. City of Chicago, 1999).

The district court noted that the pandering provision was “intended to be a strong tool for prosecutors to allow them ‘to punish true child pornographers who for some technical reason are beyond the reach of the normal child porn distribution or production statutes’" (United States v. Williams, 21, 2004). Relying also on *Ginzburg v. United States* (1966), which permitted the consideration of the manner of promotion or dissemination in determining the obscenity classification of speech, the district court upheld the statute and the defendant’s pandering conviction.

On appeal, the Eleventh Circuit reversed the district court in part (Gaxiola-Viss, 2008). The appeals court split its analysis of the constitutionality of the statute between the commercial and noncommercial aspects of the speech. It observed that “[T]he government may prohibit completely the advertisement or solicitation of an illegal product or activity as well as false or misleading advertisement because neither is protected speech. If a person possessing or seeking either obscene synthetic child pornography or ‘real’ child pornography offers to sell or buy it, this is unlawful commercial activity that the government may constitutionally proscribe. If a person does not have obscene or ‘real’ child pornography but offers such things for sale, then the offeror is engaged in false or misleading advertising, which the government may likewise punish” (United States v. Williams,1297, 2006).

However, because the Act also covered non-commercial promotion and solicitation, the appeals court subjected the pandering provision to a strict scrutiny analysis in order to determine whether or not it impermissibly included a substantial amount of protected speech. Under this standard, the court found the language of the provision problematic for three reasons: 1) pandered child pornography need only be "purported" to fall under the statutory prohibition, resulting in speech being criminalized even when the touted materials are clean or non-existent; 2) the commercial speech doctrine does not apply to non-commercial speech in situations involving the non-inciteful promotion of illegal child pornography; and 3) liability could be established based purely on promotional speech reflecting the deluded belief that real children are depicted, simply because the speech "reflects the belief" that materials constitute obscene synthetic or actual child pornography.

The Eleventh Circuit also disagreed with the lower court that *Ginzburg* supported pandering as an independent offense for several reasons. First, the pandering prohibition did not require that the context be part of an effort at commercial exploitation. Second, the appeals court questioned the continued vitality of *Ginzburg* after the recognition of a degree of constitutional protection for commercial speech. Third, the Act did not merely allow the form of solicitation to be a factor to consider as evidence of the crime, but classified pandering as an independent count.

The court of appeals also concluded that the pandering provision could not be saved in the noncommercial speech context by legislative findings concerning the need to protect children. It surmised that Congress failed to explain why the mere pandering of otherwise legal material should be prohibited in the pursuit of this interest, failed to articulate how pandering fuels the market for illegal images of real children and, in essence, disregarded the principle that the ends do not justify the means, particularly with respect to First Amendment concerns, concluding that "[T]he Government must do its job to determine whether illegal material is behind the pander" (United States v. Williams, 1304, 2006).

The district court did not address the defendant's vagueness challenge because it did not consider it to be adequately presented. However, the Eleventh Circuit considered this challenge and found the pandering provision impermissibly vague. "The statute is unnecessarily muddled by the nebulous 'purported material' and 'reflects the belief, or is intended to cause another to believe' language. Because of this language, the pandering provision fails to convey the contours of its restriction with sufficient clarity to permit law-abiding persons to conform to its requirements…(and) is insusceptible of uniform interpretation and application by those charged with the responsibility of enforcing it" (United States v. Williams, 1307, 2006).

The Supreme Court granted certiorari to resolve the narrow question of whether or not the pandering provision of PROTECT was overly broad and impermissibly vague, and thus facially unconstitutional. The Court upheld the statute against those challenges (United States v. Williams, 2008). First, the Court discussed five features of the statute it deemed to be significant to its analysis: 1) the statute's inclusion of a scienter requirement as evidenced by the use of the term *knowingly*; 2) its string of operative verbs which evidenced the penalization of speech which accompanies or seeks to induce a transfer of child pornography; 3) language suggesting that the defendant must actually have held the subjective belief that the material or purported material was child pornography, 4) a requisite intent for the listener to believe the material is child pornography, which inspires the corresponding selection of a distribution method to foster that belief, and 5) a definition of *sexually explicit conduct* that connotes an actual depiction of the sex act rather than merely the suggestion that it is occurring, coupled with a definition of *simulated* sexual intercourse that requires an explicit portrayal, whether or not it actually occurred.

The Court then examined if the statute, as construed, criminalized a substantial amount of protected expressive activity. It first considered the demarcation drawn by the Eleventh Circuit between commercial and non-commercial speech. The Court observed that the distinction "mistakes the rationale for the categorical exclusion. It is based not on the less privileged First Amendment status of commercial speech, but on the principle that offers to give or receive what it is unlawful to possess have no social value and thus, like obscenity enjoy no First Amendment protection" (United States v. Williams, 1841, 2008). In other words, "noncommercial proposals to engage in illegal activity have no greater protection than commercial proposals to do so" (United States v. Williams, 1841, 2008). In concluding that the pandering prohibition fell within constitutional bounds, it distinguished the defect with the previous attempt by Congress to make the pandering of child pornography illegal, noting that it had gone beyond pandering to prohibit the possession of material that could not otherwise be proscribed. As the court interpreted this statute, that is, as only criminalizing transactions in which both parties knowingly intend to transfer child pornography, as more narrowly defined by the statute, it survived a facial challenge on overbreadth grounds.

With respect to the defendant's vagueness challenge, the majority observed that "[W]hat renders a statute vague is not the possibility that it will sometimes be difficult to determine whether the incriminating fact it establishes has been proved; but rather the indeterminacy of precisely what that fact is…There is no such indeterminacy here" (United States v. Williams, 1846, 2008). The Court reached that conclusion because the statute requires the defendant to hold, and to make a statement that reflects, the belief that the material is child pornography, or to communicate in a manner intended to cause others to so believe, all of which conditions are "clear questions of fact" (United States v. Williams, 1846, 2008). In rejecting defendant's vagueness argument, the Court asserted that the intent element of the pandering provisions is a determination that judges and juries routinely make; thus, the statute was not impermissibly vague on its face.

Justices Stevens and Breyer concurred, emphasizing the general proposition that, whenever possible, statutes are to be construed in support of their constitutionality. In focusing on Congressional intent in examining the feasibility of the statute's constitutionality, the concurring justices concluded that the statute in this context was firm constitutionally, particularly in light of its heightened scienter requirement and the limiting construction the Court ascribed to its operative provisions, which did not impose criminal liability unless the defendant actually believed, or intended to induce another to believe, that the material in question depicted real children.

Justices Souter and Ginsburg dissented. While the dissenting justices agreed that Congress could criminalize proposals unrelated to any existing image, they disagreed with the majority's conclusions with respect to proposals made concerning specific representations. They admonished that the elements of the pandering offense were the same, whether or not the images were of real children, and rationalized that a transaction in material, which did not show real children, could not be prosecuted consistently with the First Amendment. "In failing to confront the tension between ostensibly protecting the material pandered while approving prosecution of the pandering of that same material, and in allowing the new pandering prohibition to suppress otherwise protected speech, the Court undermines Ferber and Free Speech Coalition in both reasoning and result" (United States v. Williams, 1849, 2008). In other words, the dissent objected to criminalizing the pandering of protected material (non-obscene depictions of children or virtual child pornography) simply because the persons who transferred the materials intended to portray them as unprotected speech, or believed they were unprotected. While upholding the conviction of a man who tried to pander pornographic photos of his daughter is easy to applaud, and while saving a statute earnestly intended by Congress to protect children from the myriad of evils associated with child pornography from a facial challenge of overbreadth and vagueness is commendable, the justifications offered by the majority, as well as the sincere concerns noted by the dissent, are worthy of further examination.

POLICY IMPLICATIONS AND ANALYSIS

The pandering provision as passed by Congress targeted panderers and solicitors who either believed, or caused others to believe, that they were transferring either child pornography depicting actual children or obscene child pornography, or who were actually dealing in illegal materials. Unfortunately, even though the question was not squarely before the court, the two justices who concurred, as well as the two dissenting justices, reiterated that non-obscene pornography, which did not depict actual minors engaging in sexually explicit conduct, was constitutionally protected. The concurring opinion stated: "It is true that proof that a pornographic but not obscene representation did not depict real children would place that representation on the protected side of the line" (United States v. Williams, 1848, 2008). The dissent clearly agreed that "only pornographic photographs of actual children may be prohibited" (United States v. Williams, 1848, 2008). The majority opinion noted in passing that Congress, in its findings, feared that limiting the child-pornography prohibition only to material that could be proved to feature actual children, would allow child pornographers to evade conviction since "technology and the repeated retransmission of picture files over the Internet could make it nearly impossible to prove that a particular image was produced using real children;" however, it also reiterated the conclusion in *Ashcroft v. Free Speech Coalition*, that "the child-protection rationale for speech restriction does not apply to materials produced without children" (United States v. Williams, 1835-37, 2008).

This recurring theme of the opinion tends to suggest that the latest attempt by Congress to criminalize the possession and distribution of child pornography statutorily defined as artificial, yet "virtually indistinguishable" from actual child pornography will not pass constitutional muster. The dissenters addressed the need to define child pornography more liberally in light of technological capabilities, and concluded that the statistics on prosecutions did not suggest a crisis in the ability to prosecute. They noted that there was no reference that could be made to any case in which a defendant's acquittal was "reasonably attributable to that defense…Without some demonstration that juries have been rendering exploitation of children unpunishable, there is no excuse for cutting back on the First Amendment and no alternative to finding overbreadth in this Act" (United States v. Williams, 1857-58, 2008). The question of whether or not is it constitutionally permissible for Congress, in light of technological advances, to adopt a definition of child pornography which does not embrace the depiction of real children, and which is not obscene, is a complex one (Burke, 2003). As such, these hints in the opinion are unfortunate, as they come without a fully developed appellate record as to the prosecutorial hardships faced in proving that pornographic materials depicting children are in fact "real," and without any briefing on the issues concerning the more carefully crafted provisions of PROTECT, including its affirmative defense, in contrast to the statute at issue in *Ashcroft*.

While such verbiage may give defense attorneys a heads-up on how to refute prosecutions in the lower courts, the decision itself counsels the savvy prosecutor to ensure a supplemental conviction in each case on pandering. Moreover, *Williams* dealt with a facial challenge to the statute. Subsequent prosecutions will need to establish the scienter requirement under the pandering provision, as well as to convince fact-finders beyond a reasonable doubt that under the specific circumstances defendants either believed, or intended others to believe, that the purported material was either obscene or real child pornography.

The issue of the constitutionality of virtual child pornography was raised in part because the Court characterized the issue as centering on the constitutionality of the material being touted, rather than on the constitutionality of the panderer's speech. As such, the concern raised by the dissenters is less easily dismissed. As Justice Souter stated in dissent, "[I]f the Act can effectively eliminate the real-child requirement when a proposal relates to extant material, a class of protected speech will disappear. True, what will be lost is short on merit, but intrinsic value is not the reason for protecting unpopular expression" (United States v. Williams, 1854, 2008). Indeed, the entire justification for protecting virtual child pornography is that it is merely a pernicious idea, which is not properly classified as being obscene, and for which children have not been harmed on its production. Yet while there may be no such thing as a false idea (Gertz v. Robert Welch, Inc., 1974), there is such a thing as a false statement of fact or a statement recklessly made without consideration of its truth or falsity. As such, the Court should have instead focused on the proper suppression and penalization of the speech of the panderer or solicitor, and not the constitutional status of the material to be exchanged, in cases in which the material is merely "purported" to be child pornography.

PROTECT does not permit the method of distribution to be a factor affecting the constitutional status of the material pandered. Rather, the gap filled by PROTECT's pandering provision in "purported" cases is aimed specifically at the exploitation, or marketing, of materials (that may not be capable of being proscribed constitutionally), which nevertheless are advertised or solicited as being so proscribed. The *Williams* Court admitted that the prohibition banned the "collateral speech that introduces such material into the child-pornography distribution network" rather than the underlying material (United States v. Williams, 1838-39, 2008). The legislative provision "prohibits offers to provide and requests to obtain child pornography…[and] does not require the actual existence of child pornography" (United States v. Williams, 1838, 2008). The Eleventh Circuit also recognized that "[B]y moving the pandering provision from the definitions section to a stand-alone status, and using language that targets only the act of pandering, the new provision has shifted from regulation of the underlying material to regulation of the speech related to the material" (United States v. Williams, 1295, 2006). Thus, the constitutionality of prosecuting such collateral speech should be what is evaluated.

In this context, the Eleventh Circuit's analysis of the commercial speech doctrine is instructive. The Circuit Court of Appeals concluded that the government may prohibit completely the advertisement or solicitation of an illegal product or activity as well as false or misleading advertisement because neither is protected speech. A straightforward application of the first *Central Hudson* factor, whether the speech is directed towards an illegal activity, appears to be sufficient to conclude that the Act is a constitutional restriction on commercial speech. Although most false advertising statutes are designed to protect innocent consumers, and a solicitor of child pornography is not easily identified as falling within that traditional characterization, nevertheless, the speech is still a lie and lies may be punished. Lies are not a form of speech entitled to protection and are not immune from prosecution. The appeals court, however, took issue with fact that the pandering provision was not limited to commercial exploitation and embraced non-commercial speech as well.

Much of child pornography is exchanged in non-commercial transactions. Yet, why should that matter? There are several arguments in support of the lack of relevancy of this distinction. First, it is the market in which child pornography is exchanged that Congress seeks to regulate, and the fact that the market prospers without the exchange of monetary currency should be of no import. Bartering, as a means of transacting business, certainly is the predecessor to using money as a medium of exchange. Amici briefs before the Court in *Williams* properly argued that the government's traditional interests in regulating commercial speech apply whether or not a proposed transaction for goods or services is supported by consideration or a contractual obligation. In other words, that the market for child pornography is non-pecuniary should not affect the outcome.

Second, the Supreme Court chided the Eleventh Circuit's analysis in which the anti-pandering provision's application to non-commercial offers to provide or receive child pornography was subjected to strict scrutiny. Regardless of whether there is a profit motive behind the speech, the Court asserted that "[o]ffers to engage in illegal transactions are categorically excluded from First Amendment protection" (United States v. Williams, 1841, 2008). The Court illustrated its reasoning with an analogy: assuming that the government may ban the possession of certain drugs, it makes no sense to punish advertisements offering to sell the drugs while permitting advertisements offering to give the drugs away for free. Consistently, many state deceptive trade practices acts, as well as the Federal Trade Commission, regulate promotional "giveaways" for their truthfulness.

Finally, the definition of what is a commercial transaction or commercial speech is not necessarily limited to traditional advertisements promoting wares. For example, the California Supreme Court, in applying its deceptive trade practices legislation to letters and press releases written by Nike, Inc. to rebut allegations that it was mistreating and underpaying workers at foreign facilities, concluded that "[b]ecause the messages in question were directed by a commercial speaker to a commercial audience, and because they made representations of fact about the speaker's own business operations for the purpose of promoting sales of its products, . . . [the] messages are commercial speech" (Kasky v. Nike, Inc., 247, 2003). The Supreme Court has acknowledged that the distinction between commercial and noncommercial speech is anything but a litmus test (Edenfield v. Fane, 1993; Bolger v. Youngs Drug Products Corporation, 1983). Justice Stevens describes the critical factor in what he characterizes as *transaction-driven* speech: “As a matter of common sense, any description of commercial speech that is intended to identify the category of speech…should relate to the reasons for permitting broader regulation: namely, commercial speech's potential to mislead” (Rubin v. Coors Brewing Company, 494, 1995). Such potential invites regulation whether or not the transaction is economically based.

Using this approach then, which focuses on the falsity of the speech, is there any problem with the fact that the penalties for such false advertising equate to those of actual child pornographers, or is such a penalty too Draconian? The dissent in *Williams* in a footnote dismissed such a fraud analysis for purported materials, noting that the Court in other contexts placed limits on the policing of fraud when it cuts too far into other protected speech. The dissenting justices further maintained that the Act is “hardly a consumer-protection statute,” and observed that the penalties for violating the Act “are quite onerous compared with other consumer-protection laws,” permitting a court legitimately to question “whether the unprotected status of fraud enables the Government to punish the transfer of otherwise protected speech with penalties so apparently disproportionate to the harm that fraud is understood to cause” (United States v. Williams, 1851, 2008).

Yet there is a recognized legitimate government interest in stemming the commercial exploitation of sexually explicit materials (Paris Adult Theatre I v. Slaton, 1972; Young v. American Mini Theatres, Inc., 1976). While it may not be wise to include evidence of the exploitation as part of the definition of a category of unprotected speech, there is no reason why pandering could not be regulated independently to advance a significant governmental interest (Burke, 1995). It also would seem that the government has an overriding substantial interest in stemming both the commercial and noncommercial exploitation of children through the prolific attempts to disseminate child pornography, however characterized. The analysis of harm should include not only the harm caused to the transferee, but also the harm caused to children and society as a whole (United States v. Toler, 1990). Fairchild (2007) argues that the PROTECT Act represents a good-faith effort to curb the pandering of child pornography, which otherwise furthers the market for illegal pornographic material, and that the potential, significant harm to children which will result, if such trafficking is unabated, justifies the substantial penalties. Furthermore, under the pandering provision, if a person touts his or her material as being child pornography, and it *is* child pornography, then any subsequent punishment should be solely for the possession and distribution of properly proscribed material. Why then would Congress choose also to punish the defendant for telling the truth, other than to solidify the government's interest in stemming the flow of such illicit materials?

In sum, the case could have been resolved by focusing on the First Amendment protection afforded the speech which pandered the materials, rather than the constitutionality of the materials pandered. If the materials pandered were neither obscene nor depictions of real children, then the falsity of the speech justifies its suppression. Whether or not consideration is exchanged should not be a pivotal factor, as the speech is still a lie, and lies subvert the justification for the protection of speech, as exemplified by the law of defamation. If the materials in fact were as pandered, then the overriding governmental interest in stemming the tide of illicit materials justifies criminalizing its advertisement, in addition to its possession and distribution, and that same interest justifies the penalties levied by Congress. If those penalties are unconstitutionally harsh, that determination poses an Eighth, not a First, Amendment issue.

There can be no doubt that obscene images of children and actual child pornography threaten extraordinary harm to the children who are sexually exploited and also to society as a whole. That government can and should protect children from such exploitation is also an accepted proposition. To this end, the government has a compelling interest in protecting innocent members of society from the horrendous effects of virtual child pornography and its market (Ladle, 2004; Liu, 2007).

Similarly, the importance of the First Amendment's guarantee of freedom of speech is a cherished constitutional protection, and any interference with freedom of speech should be justified by governmental interests of the highest order. Where an entire class of speech is prohibited, such as the pandering provision of the PROTECT Act seeks to do, the prohibition must be carefully drawn so as to accomplish the government's interest while not encompassing speech that is protected.

In *Williams*, the Court determined that the pandering provision, as construed, successfully achieved that delicate balance. In reaching its conclusion, however, the Court's focus on the constitutionality of the materials being pandered could have been better directed on the First Amendment value of the speech itself. The Court, the concurring justices, and the dissenters all appear to agree that speech seeking to incite immediate unlawful activity may be properly forbidden, regardless of whether the speech is commercial or non-commercial. The justices also all seem to agree that false or fraudulent speech is not protected by the First Amendment. Where the dissenters part company with the other justices is whether or not speech that on its face proposes an unlawful transaction may be punished if the actual underlying transaction turns out to be lawful. This focus on the underlying transaction is a distraction from what could have been a more straightforward analysis of the justification of the government's attempt to address the harms threatened by the pandering speech itself, that is, that pandering threatens to foster the continued market for child pornography and its attendant evils. Such a focus would have alleviated the need to discuss the underlying materials and the resultant questioning of the validity of its suppression, an issue which was not squarely before the Court.

CONCLUSION

Of all the constitutional protections available to the American people, perhaps none is as familiar as the First Amendment's guarantee of freedom of speech. In spite of the relative simplicity and seemingly absolute terms in which this protection is couched, the United States Supreme Court has spent much of the last century attempting to define the scope of this First Amendment right. Uncertainty over the proper boundaries of freedom of speech shows no sign of abating, as the Court continues to address new permutations of the conflict between free speech and a number of significant and even compelling governmental interests. The recent decision by the Court in *United States v. Williams* (2008) involved an attempt by Congress to eradicate child pornography by, among other things, criminalizing offers to provide or solicitations seeking to obtain unprotected forms of child pornography.

It is well-established that the First Amendment does not protect obscene material, regardless of whether the material portrays adults or minors. It is also well-established that the First Amendment does not protect child pornography depicting images of actual children. The rationale for excluding obscenity from First Amendment protection is that certain sexually explicit material lacking serious literary, artistic, political, or scientific value contributes little or nothing to the marketplace of ideas that the First Amendment was presumably designed to protect. The rationale for excluding from First Amendment protection child pornography using actual children is that the government's compelling interest in protecting the physical, mental, and psychological well-being of children clearly outweighs any expressive value that might be found in such material.

Congress, however, concerned that technological advances in computer imaging will make it difficult, if not impossible, to distinguish between virtual child pornography and pornography using actual children, attempted for a second time to discourage trafficking in both with the 2003 passage of PROTECT. The provision that was before the Court in *Williams*, prohibited intentional offers to provide or requests to acquire obscene or actual child pornography. The Court upheld the constitutionality of the pandering provision, reasoning that because Congress could prohibit obscenity or actual child pornography, offers to provide or solicitations to acquire such material could be proscribed.

In so holding, the majority repeatedly stressed that speech seeking to instigate criminal activity may be forbidden regardless of whether or not actual criminal activity occurs. It does not matter that the actual material to be transferred might actually be protected virtual child pornography, or that the material does not even exist. It also does not matter that a speaker is mistaken about the nature of the material he is offering or seeking. What is relevant under the Act as construed by the Court is the speaker's intent to engage in immediate unlawful activity. In essence, then, the Court unnecessarily created a new inchoate crime, the crime of pandering. A speaker who, by his speech, seeks to initiate criminal activity but is mistaken about his ability to carry out his offer may be punished, depending on the circumstances, for incomplete, or inchoate, crimes such as conspiracy, solicitation, attempt, and now pandering, all of which recognize that the actual commission of a crime is not necessary to impose criminal responsibility.

The creation of this seemingly new inchoate crime is arguably an unnecessary encroachment on the First Amendment's protection of non-obscene child pornography that does not depict actual children. The dissenters found it anomalous that an individual could not be prosecuted for distributing or receiving what it refers to as "fake" child pornography, yet could be prosecuted for proposing such transactions in terms that imply that the material is "true" child pornography. The dissent also was concerned that the government need not prove that the underlying materials that were the subject of a proposed transaction are actually obscene or "true" child pornography. Relieving the government of this burden of proof will encourage prosecutions for pandering when prosecutions for actual production, possession, or distribution would be unsuccessful. The end result will be that, through the Act, Congress will succeed in suppressing speech that enjoys First Amendment protection.

Such concerns could have been avoided if the Court instead had justified the pandering provision based upon the fact that the speech is not protected by the First Amendment because it is either false or misleading, or alternatively, a truthful attempt to commit a crime. By focusing on the underlying speech the Court permits defendants by their lies to classify speech, rather than the Constitution. It was thought that this result, permitted by *Ginzburg* with respect to obscenity, was no longer the law, but *Williams* may have breathed new life into *Ginzburg*. Justice Scalia, who wrote the majority opinion in *Williams*, previously indicated in a dissenting opinion concerning obscenity that he would *not* restrict the application of the pandering doctrine, whereby the manner by which the material is advertised may be considered in determining whether or not it is protected, to commercial speech, as long as the material is in fact patently offensive (United States v. Playboy Entm't Group, Inc., 2000). His assertion rings true now for child pornography to an even greater degree.

From both a legal and an ethical perspective, it seems more logical to punish lies, than to justify an encroachment on potentially protected speech, unnecessarily. It is unfortunate that the Court took the approach it did, rather than one which could have clarified further the definition of that class of "commercial" speech, which may be regulated according to *Central Hudson.* In response to the Eleventh Circuit's faulty delineation that focused on pecuniary exchanges, the Court could have enunciated more clearly what a *commercial transaction* is that prompts the classification, potentially allowing the government more regulatory oversight of false representations which are not grounded in a monetary exchange of value. It also could have more fully examined the harm to children and society posed by pandering, and justified its suppression on those grounds. Instead, it made a lie the truth.

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