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LETTER FROM THE EDITORS

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

Readers should note that our mission goes beyond studies involving business law or the effect of legislation on businesses and organizations. We are also interested in articles involving ethics. In addition, we invite articles exploring the regulatory environment in which we all exist. These include manuscripts exploring accounting regulations, governmental regulations, international trade regulations, etc., and their effect on businesses and organizations. Of course, we continue to be interested in articles exploring issues in business law.

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MANUSCRIPTS FOR
VOLUME 8, NUMBER 1

COMPUTER FORENSICS: ADMISSIBILITY OF EVIDENCE IN CRIMINAL CASES

Jerry Wegman, University of Idaho

ABSTRACT

Computers and the Internet have become a pervasive element in modern life. This technology is also used by those who engage in crime and other misconduct. Effective investigation of these offenses requires evidence derived from computers, telecommunications and the Internet. The need for digital evidence has led to a new area of criminal investigation: Computer Forensics. Forensic investigators identify, extract, preserve and document computer and other digital evidence. This new field is less than fifteen years old, and is rapidly evolving. Education in this field has focused largely on its technical aspects. However, there are significant legal issues and ethical problems that investigators must deal with. Failure to follow proper legal procedure will result in evidence being ruled inadmissible in court. As a result, a guilty criminal might go free. Failure to behave in an ethical manner will erode public confidence in law enforcement, making its job more difficult and less effective.

This paper will provide an introduction to the most significant legal issue in computer forensics: admissibility of evidence in criminal cases. The law of search and seizure, as it relates to digital equipment, will be reviewed. Interception of electronic communications and accessing stored digital information will be examined. Public policy in the form of federal legislation will be discussed. Finally, ethical concerns will be considered.

INTRODUCTION

On December 17, 2003 CSO (Chief Security Officer) Magazine predicted that "cybercrime will only get worse" (CSO 2003). On January 22, 2004 the Federal Trade Commission reported that in 2003 complaints of identity theft alone exceeded half a million (FTC 2004), up 40% from 2002. The Computer Security Institute's 2003 CSI/FBI Computer Crime & Security Survey reported that losses continued to climb and that "90% of respondents (primarily large corporations and government agencies) detected computer security breaches within the last 12 months" (CSI/FBI 2003).

The antidote to this problem is effective investigation and prosecution. Critical evidence needed to convict cyber-criminals is located on computers, networks and the Internet. However, this evidence is often difficult to obtain. It may have been deleted, overwritten, encrypted or hidden in a vast database (Schultz 2001). Nevertheless, cyber-detectives have developed techniques to salvage such information. A new investigative specialty has thus emerged: “Computer Forensics”. This term, first used in 1991, refers to the identification, extraction, preservation and documentation of computer based evidence (Armstrong 2000).

An important legal challenge faces cyber- investigators: not only must they discover incriminating evidence they must also do it in a lawful manner. Otherwise, the evidence will not be admissible in court. As Marcella and Greenfield point out, an investigator “should always conduct the investigation as if you are going to trial, just in case you have to” (Marcella and Greenfield 2002).

Investigators must have a working knowledge of legal issues involved in computer forensics. They must know what constitutes a legal search of a stand-alone computer as opposed to a network; what laws govern obtaining evidence and securing it so that the chain of evidence is not compromised; what telecommunications may lawfully be intercepted or examined after they have been received; what legally protected privacy rights employees and other individuals possess. This paper will address all these concerns.

Because computer forensics is such a new field, investigative and legal norms are just now emerging. Little has been written about the legal requirements for admissibility of computer forensic evidence, or about the ethical and regulatory issues related to this new field. First we will examine the admissibility of evidence in a criminal prosecution, both with and without a search warrant. Next, public policy in the form of federal legislation will be discussed. Finally, ethical implications will be considered.

SEARCHING WITH A WARRANT

The balance between the individual's right of privacy and the government’s right to violate that privacy by searching and seizing property is defined by the Fourth Amendment to the U.S. Constitution. This amendment, part of the Bill of Rights, was adopted in 1791 in response to British soldiers breaking into colonists’ homes in search of pamphlets or other evidence supporting independence before the Revolutionary War (Del Bianco 2002). It is in frequent use in law enforcement today, as police searches and seizures must comply with its requirements. The Amendment reads:

> The right of the people to be secure in their persons, houses, papers and effects against unreasonable searches and seizures shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched and the persons or things to be seized.

The Amendment interposes a magistrate as an impartial arbiter between the defendant and the police. The magistrate may issue a search warrant if he/she is convinced that probable cause exists to support a belief that evidence of a crime is located at a premises. The officer must prepare an affidavit that describes the basis for probable cause, and the affidavit must limit the area to be searched and evidence searched for. The warrant thus gives the police only a limited right to violate a citizen's privacy. If the police exceed that limited right, or if a warrant is required but the police have not first obtained one, then any evidence seized must be suppressed (U.S. Department of Justice 2002).

Suppressed evidence may not be used in court. In many cases the criminal charges will be dismissed, even though the guilt of the defendant is clear. However, if other, untainted evidence exists supporting conviction, the defendant may be convicted on the strength of that evidence (Dershowitz 2002). Criminal trials are often preceded by a suppression hearing, at which the admissibility or suppression of evidence is determined. Often a guilty plea is obtained following the suppression hearing. Thus the issue of suppression, driven by a determination of whether the Fourth Amendment has been correctly followed by the police, is often the determining factor in criminal cases.

In a traditional, "old fashioned" case, a detective would receive information from a reliable informant that contraband, for example drugs, was located at a premises. The detective would prepare a statement describing the informant's reliability and that the informant had recently observed drugs at the premises. The detective would take the affidavit to a judge, who would determine whether probable cause existed. If that determination was positive, the judge would sign the search warrant authorizing the detective to search for and seize a specific type and quantity of drugs at that premises. The detective would then go to the location and execute the warrant (Skibell 2003).

However, in a computer forensics case there is added complexity. The contraband might consist of child pornography or records of drug sales. This information might be located on a laptop computer, but it might also be located on a network server in another state or in a foreign country. The information might be located on a hard drive, a diskette or a CD. The contraband information might be very difficult to recognize: it could be encrypted, misleadingly titled, or buried among a large number of innocent files (Villano 2001). It could take considerable time to identify the contraband.

As noted above, a search warrant gives only limited authority to the police to search. The search should be no more extensive than necessary, as justified by probable cause. Thus, if the probable cause indicates that the contraband is located in a file on a CD, this would not justify seizing every computer and server on the premises (Brenner 2001/2002). The extent of the search is tailored to the extent of the probable cause. If the police wish to seize a computer and analyze it at a later time, the probable cause statement should demonstrate the impracticality or danger of examining the computer on the premises hence the need to confiscate it and analyze it off-site.

A new question facing law enforcement since passage of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act) in 2001 is when to notify the target of a search. Normally the target is notified at the time a physical search is made. However the USA PATRIOT Act amended Title 18, Sec. 3103a of the United States Code to permit delayed notification. This has been described as a "sneak and peek" provision by critics of the Act (Shulman 2003). Law enforcement may now delay notification of the target for up to 90 days, with another delay possible upon a showing of good cause. In order to obtain authority for delayed notification, an investigator must show a need for the delay, such as danger to the life or safety of an individual, risk of flight from prosecution, witness or evidence tampering, or that immediate notice would "seriously jeopardize" an investigation.

Another legal issue in computer forensic cases is how much time the police may have to analyze a computer after seizing it. Federal Rule of Criminal Procedure 41(c)(1) gives the police 10 days after issuance of the warrant to serve it. But there is nothing in the Rule about how long the police may keep and analyze the computer. Nevertheless, some magistrates issuing warrants for computers have demanded such time limits, and some prosecutors have complied. In the case of *United State v. Brunette*, 76 F. Supp. 2d 30 (1999), a magistrate issued a warrant on condition that the police complete their examination of the computer within 30 days. When the police took two days longer than the allowed time, the court suppressed child pornography evidence obtained after the deadline. As a practical matter, the search of a computer in police custody should be done as quickly as possible (Brenner 2002). This is especially important if the computer is needed for the operation of a business.

SEARCHING WITHOUT A WARRANT

In the Unites State Supreme Court case of *Illinois v. Andreas*, 463 U.S. 765 (1983), the Court held that a search warrant is not needed if the target does not have a "reasonable expectation of privacy" in the area searched. In *U.S. v. Barth*, 26 F. Supp. 2d 929 (1998) a U.S. District Court held that the owner of a computer has a reasonable expectation of privacy in the information stored on that computer. However, if the computer owner transfers possession of the computer to a third party, for example for repair, that expectation of privacy may be lost, because numerous repair personnel would then have access to the computer and its stored contents.

Earlier non-computer cases suggest that when information is divulged to third parties the expectation of privacy may be lost. In *U.S. v. Miller*, 425 U.S. 435 (1976) the Supreme Court held that the expectation of privacy is lost when bank account information is divulged to the bank. In *Couch v. U.S.*, 409 U.S. 322 (1973) the Supreme Court held that a client had no reasonable expectation of privacy in information divulged to his accountant. Cyber examples would include posting a message on an Internet bulletin board or sending an email to a chat room.

The loss of a reasonable expectation of privacy, and therefore the loss of Fourth Amendment protection is extremely important because much information is transmitted to networks and to the Internet. If circumstances suggest the sender had no reasonable expectation of privacy, then no warrant is required by the police in order to obtain that information (Nimsger 2003).

In the case of *U.S. v. Simons*, 206 F.3d 392 (2000) a government employee working for the Central Intelligence Agency was suspected of using his office computer to download pornography. The CIA, acting without a warrant, remotely accessed the computer, and discovered photos of child pornography. In the criminal case that resulted, Simmons tried to suppress those photos, claiming a violation of the Fourth Amendment. However, the CIA had an Internet use policy that allowed it to "periodically audit, inspect, and/or monitor … users' Internet access". The Court determined that in light of this formal policy, the employee had no reasonable expectation of privacy hence no warrant was required for the government search.

No warrant is needed when the target consents to a search of his/her computer. No warrant is needed where a third party, such as a spouse, parent, employer or co-worker consents to the search, so long as the third party has equal control over the computer.

No warrant is required when probable cause exists but there is an "emergency", leaving no time or opportunity to obtain a warrant. An example is *U.S. v. David*, 756 F. Supp. 1385 (1991), where agents observing the target deleting files immediately seized the computer.

In some cases the Electronic Communications Privacy Act (ECPA), 18 U.S.C. Sec. 2701-2712 (1986) is the controlling legal authority, rather than the Fourth Amendment. Typically this occurs when information is transmitted to a network and is then stored under the control of a network administrator. This will be discussed below in the section on public policy.

WORKPLACE SEARCHES

The widespread use of computers and Internet access in the workplace has tempted many to use these facilities for crime. The seminal case involving the admissibility of evidence derived from a workplace search is *O'Connor v. Ortega*, 480 U.S. 709 (1987). This case makes an important distinction between workplaces that are in the private sector as opposed to those in the public sector. As noted above, an employer may be able to give effective consent to the police to search an employee's computer. However, if the employer is the government, the government would be giving itself consent. The *O'Connor* decision held such consent to be invalid. Let us therefore first consider the situation relating to private sector employment.

As noted earlier, a fellow employee who has equal control over a computer can consent to its search. If that search reveals evidence incriminating to another employee, the warrantless search does not violate the Fourth Amendment and the evidence is admissible. Employers and supervisors who have authority over an employee's computer can also consent to its search. It is helpful if the employer has a formal employment policy stating that the employer retains authority over its computers and network, as in the *Simons* case, noted above.

The foregoing discussion deals with a situation in which the police seek and obtain consent from an employer to conduct a search of an employee's computer. A different situation exists where a private employer conducts the search on his/her own initiative, without police involvement. For example, the employer may have reason to suspect that the employee is spending considerable time buying and selling on eBay using the office computer. Upon searching the computer, the employer discovers evidence of embezzlement and contacts the police. Such a search does not violate the Fourth Amendment, because the Amendment only limits government searches, not searches by private persons. Evidence thus obtained is therefore admissible in the criminal trial against that employee. Such private searches rarely violate the Fourth Amendment (U.S. Department of Justice 2002).

The situation is quite different if the employer is the government. As noted above, the *O'Connor* case holds that the government can not give itself effective consent to search an employee's computer. In such a case the government will have to seek other authority for a search, such as a search warrant.

PUBLIC POLICY CONSIDERATIONS

Congress has responded to the changing technological landscape. The most important federal statutes affecting computer forensics are the Electronic Communications Privacy Act (ECPA), the Wiretap Statute, the Pen/Trap Statute and the USA PATRIOT Act.

The Electronic Communications Privacy Act (ECPA) 1986

As noted above in the section on warrantless searches, ECPA often is the controlling legal authority with regard to *stored* computer files that have been transmitted to a network administrator. It is important to note that this discussion involves stored computer information, as opposed to the real-time *interception* of communications. Interception falls under the Wiretap statute, discussed below. Stored information includes all Internet communications, such as email stored on an Internet Service Provider's (ISP) servers.

ECPA is a highly nuanced example of public policy. Congress felt that information stored on a network deserved varying levels of privacy protection, depending on how important or sensitive the information was. Accordingly, in Title 18, Section 2703 of the U.S. Code ECPA created five categories of sensitivity. The more sensitive the category, the greater the justification the government must show in order to obtain the information from a third party (usually the system administrator). The most sensitive information consists of the content of un-retrieved communications such as email that has resided in electronic storage for 180 days or less. After 180 days the information is considered "stale" and not deserving of the top category of protection, so does not require a full search warrant for access. The least sensitive category includes only basic information such as the name of the subscriber and how bills are paid. To obtain that information, the government needs only an administrative subpoena. An administrative subpoena can be issued by a government agency on its own, without prior approval by a court. For example, the FBI could issue an administrative subpoena for good cause. That subpoena could latter be challenged, and if a court later decided that good cause did not exist then information obtained under that subpoena would be suppressed.

The Wiretap Statute (Title III), amended 1986

While ECPA regulates government access to *stored* computer information in the hands of third parties, the Wiretap statute deals with direct surveillance or real-time interception of electronic communications by government agents. The Wiretap statute is commonly known as Title III, because it was first passed as Title III of the Omnibus Crime Control and Safe Streets Act of 1968, 18 United States Code Sec. 2510-2522, amended in 1986. A government investigator who was accessing a target computer as messages were being sent would be subject to the Wiretap statute (Strang 2001). Wiretaps most commonly affect telephone conversations.

Before the government may wiretap, a court order must be obtained. Court orders vary widely in the amount of justification that must be demonstrated for their issuance. Section 2518 of the Wiretap statute requires a substantial amount of justification. This includes a demonstration of probable cause to believe that the interception will produce evidence relating to a felony; that normal investigative procedures have either failed, are unlikely to succeed, or are too dangerous; that the computer or other electronic device is being used in the commission of a crime; and finally, that the surveillance will be conducted in a manner that will minimize the interception of innocent communications. If a judge is satisfied that all these requirements have been met he or she will sign the court order. The target will be notified only after the wiretap order has expired. In comparison, a court order for a pen/trap device requires only a statement by the investigator that it is his/her belief that the information likely to be obtained is "relevant" to a criminal investigation.

The Pen/Trap Statute, amended 2001

The Pen/Trap statute, 18 United States Code Sec. 3121-3127, provides for a less intrusive form of government surveillance than the Wiretap statute. This statute authorizes the installation of pen registers and trap-and-trace devices. A pen register records only dialing, routing and addressing information regarding *outgoing* electronic communications. Electronic communications include telephone, computer, telegraph and telex communications. A trap-and-trace device records the same information regarding *incoming* electronic communications. The significant fact regarding both is that the *content* of communications is not recorded. Only information such as telephone numbers of incoming and outgoing calls is recorded. Because these devices record less sensitive private information, the legal burden upon the government is significantly less than with a wiretap. A court order for a pen/trap device requires only a statement by the investigator that it is his/her belief that the information likely to be obtained is "relevant" to a criminal investigation. A recitation of probable cause is not necessary, nor is it necessary to attest to the many other requirements necessary to obtain a wiretap order or a search warrant.

The USA PATRIOT Act 2001

On October 26, 2001 President Bush signed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act). This Act was overwhelmingly passed by Congress shortly after the events of September 11, 2001. It expands the government's investigative power. This Act has become very controversial, drawing criticism from both Conservatives and Liberals who question whether the Act goes too far.

Perhaps the most controversial provision of the Patriot Act is the so-called "sneak and peek" authority conveyed in Section 213 of the Act (Shulman 2003). This Section provides delayed notification to the targets of searches. The Act modifies the U.S. Criminal Code, Title 18, Sections 3103a and 2705. These modifications allow the government to delay notification of physical searches for up to 90 days. Extensions may be given for good cause. However, the delayed notification provision is restricted to cases where the government demonstrates an urgent need for delay, including situations where the life or physical safety of an individual is in jeopardy, or to avoid the destruction of evidence. Excerpts of Section 2705 are reproduced in Appendix A.

Delayed notification is not an entirely new element in federal criminal law. It is the norm in wiretap cases, as noted above, and was used and upheld in the seminal U.S. Supreme Court case of *Dalia v. U.S.* in 1979. In that case federal investigators entered a home, searched and implanted a hidden microphone pursuant to a search warrant. Notice was delayed until the surveillance ended. What is new about the Patriot Act is that it provides for delayed notification in ordinary physical searches. In the past delayed notification has been used only in connection with electronic surveillance (Carter and Spafford 2003).

The Act also makes it easier for law enforcement to install an electronic surveillance device. Formerly, a wiretap order or pen register order had to be obtained in the jurisdiction in which the device was to be installed. Internet communications typically involve Internet service providers located in many jurisdictions. Sections 216 and 220 allow devices to be installed anywhere in the U.S.A.

Section 225 of the Act is of particular importance to computer forensic investigators and providers of information to the government. It gives immunity from civil lawsuits to any person who provides technical or other assistance in obtaining electronic information pursuant to a court order or valid request for emergency assistance.

The Act contains numerous other provisions expanding the scope of forensic investigations. However, it also contains a "sunset" provision. Under this provision the Act will terminate on December 31, 2005 unless Congress votes to extend it. The sunset provision does not apply to the entire Act, however. Significant sections, including those authorizing delayed notification and national wiretap and pen register orders will not sunset automatically.

Computer forensics is specifically supported by the Patriot Act. Section 816 authorizes the expenditure of $50 million for the creation and support of regional computer forensic laboratories. These laboratories will conduct investigations and also train investigators.

ETHICAL CONCERNS

Ethical concerns relating to the use of computer forensics include proper use of prosecutorial and police discretion. Prosecutors and police officers are invested with considerable discretion in exercising their authority (Healy and Manak 1971). For example, if a motorist is driving 5 miles over the posted speed limit, an officer stopping that motorist could issue a ticket or merely give a warning. An officer who, for example, tickets Blacks going 5 miles over the speed limit while giving warnings to Whites is abusing his/her discretion. On the other hand an officer who gives warnings to all motorists traveling 5 miles over the speed limit if they have clean driving records is not abusing discretion.

Effective exercise of discretion requires a proper balance of law enforcement zeal and respect for individual liberties (Goldberg 2002). For example when an agent applies for a search warrant, the agent must decide whether to apply for a conventional warrant, which requires prompt notice to the target or whether to apply for a "sneak and peek" warrant with it's delayed notice feature. Effective investigation will likely be promoted if the target is unaware of the search. But the intrusion upon privacy and the "big brother" impact will be greater (Brenner 2002). Is the greater damage to privacy justified?

A similar issue faces an agent applying for a pen/trap order. All that is needed to obtain the order is for the agent to certify his/her belief that the information to be gained is "relevant" to an ongoing investigation. How relevant must it be? There could be temptation to exaggerate the relevance in order to obtain the order.

An ethical dilemma also faces the custodian of electronic records such as a network administrator or Internet service provider (Holtzman 2002). As noted above in the section dealing with the USA PATRIOT Act, Section 225 of that Act gives immunity to one who complies with a court order or valid request for emergency assistance. If the government has a court order there is no problem. Without a court order however, immunity is not automatic, because a court might later determine that the "emergency" was not valid.

Imagine for example that you are a network administrator. A federal officer comes to your office and says that he believes that a terror attack is planned in an hour. He needs confidential customer information in your custody. He does not have a court order, warrant or any other formal authority. If you turn over the information you may save lives, but you are also exposing yourself and your firm to potential civil liability if a court later determines that no valid emergency existed. What should you do? How much evidence should you demand before you turn over the information?

A partial answer to these dilemmas lies in educating investigators regarding their lawful obligations under the Constitution and federal statutes. This educational process should include emphasizing the importance of maintaining public support for law enforcement. This support can be eroded by heavy-handed use of techniques like "sneak and peek" searches. Role-playing, for example, can help sensitize investigators to ethical dilemmas such as those described above. This would allow investigators to consider ethical dilemmas before they occur, and to resolve them in an unstressed classroom environment with the help of an instructor. Hopefully this will help lead to more responsible exercise of discretion by those entrusted with our security.

CONCLUSION

Computer crime threatens our commercial and personal safety. Computer forensics has developed as an indispensable tool for law enforcement. But in the digital world, as in the physical world, the goals of law enforcement are balanced with the goals of maintaining personal liberty and privacy. Computer forensic investigators must be aware of the legal environment in which they work, or they risk having the evidence they obtain being ruled inadmissible.

Forensic investigators should understand that before they seize a computer or other electronic hardware they must consider whether the Fourth Amendment requires a search warrant. They should be aware that if they wish to access stored electronic communications, they will need to comply with the Electronic Communication Privacy Act. If they wish to conduct real-time electronic surveillance, they will need to obtain a wiretap order from a judge.

Computer forensic investigators face ethical dilemmas. They must exercise their discretion wisely, balancing their prosecutorial zeal with respect for citizens' individual liberties. Criminal investigators in America have grappled with these same issues for over two hundred years. Digital technology is not the first "new era" to challenge law enforcement. The railroad, telephone and automobile posed similar challenges. By following Constitutional principles and encouraging ethical behavior we will achieve the right balance between liberty and security in the digital age.

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APPENDIX A
Delayed Notification of Searches

TITLE 18 - CRIMES AND CRIMINAL PROCEDURE

Sec. 2705. Delayed notice.

(a) Delay of Notification.

(1) A governmental entity acting under section 2703(b) of this title may -

(A) where a court order is sought, include in the application a request, which the court shall grant, for an order delaying the notification required under section 2703(b) of this title for a period not to exceed ninety days, if the court determines that there is reason to believe that notification of the existence of the court order may have an adverse result described in paragraph (2) of this subsection …

***

(2) An adverse result for the purposes of paragraph (1) of this subsection is -

(A) endangering the life or physical safety of an individual;

(B) flight from prosecution;

(C) destruction of or tampering with evidence;

(D) intimidation of potential witnesses; or

(E) otherwise seriously jeopardizing an investigation or unduly delaying a trial.

(3) The governmental entity shall maintain a true copy of certification under paragraph (1)(B).

(4) Extensions of the delay of notification provided in section 2703 of up to ninety days each may be granted by the court upon application, or by certification by a governmental entity, but only in accordance with subsection (b) of this section.

CONTINUING ETHICS EDUCATION IS CRITICAL TO IMPROVING PROFESSIONAL CONDUCT OF AUDITORS

D'Arcy Becker, University of Wisconsin – Eau Claire
Susan Haugen, University of Wisconsin – Eau Claire
Lucretia Mattson, University of Wisconsin – Eau Claire

ABSTRACT

Audit opinions provide assurance that financial statements used for equity investment, loan and other decisions are fairly stated. The opinions are based on professional judgment and technical competence, and ethical behavior by auditors is critical to their quality. Substandard audit work by auditors has placed the profession under siege. Auditors at all of the large firms have allegedly broken the Code of Professional Conduct, and we provide a summary of 10 major current cases.

Action by regulatory agencies is needed to improve auditor ethics. Perhaps the most progress can be made at the state level, which sets licensing requirements for CPAs. We reviewed the continuing professional education (CPE) requirements of all 50 states and found that 48 of 50 states have CPE requirements. We analyzed the amount of required CPE as well as the type of CPE for which credit is given. We also analyzed CPE requirements regarding ethics training. We found 32 states have no requirement that CPE include ethics training. For states requiring ethics, the annual requirements amount to less than one required hour of ethics CPE per year. Action by the accounting profession as well as at the state level is needed to improve auditor ethics.

INTRODUCTION

The auditing profession is under siege for its lack of ethical conduct in the past decade. Auditors have allegedly helped clients hide unfavorable financial information, ignored evidence of fraudulent financial reporting, and broken their own Code of Professional Conduct, among other transgressions. A study done by Vanderbilt University found that auditing firms may lie to keep a profitable audit client if the expected benefits of keeping the client happy outweigh the expected costs of an audit failure if the firm gets caught (Jensen, 2004). It appears that profits have become more important than good auditing practices at some firms.

Substandard audit work and unethical decisions by auditors have resulted in the loss of billions of dollars by investors and retirees, and the loss of thousands of jobs. Perhaps the most important loss for auditors has been their esteemed place in the financial world. No longer are auditors assumed to be keepers of the public trust.

In this paper we discuss the role ethics plays in audits, and analyze how auditor ethics can be improved through efforts at the national, state, audit firm and individual auditor levels. Current requirements for ethics study as a part of auditors' continuing professional education are also analyzed.

THE NATURE OF THE AUDIT

Certified Public Accountants (CPAs) perform a variety of essential financial functions for business. In addition to maintaining financial and other important information representing the day-to-day business activities, accountants provide tax advice, design internal control systems, and perform many other analytical tasks that are indispensable to effective company management.

No role filled by CPAs is more important than the role of external auditor. Auditing is the process of attesting to the fairness of financial statements. External auditors collect evidence about the transactions underlying the client's financial statements. They also collect evidence about the design and operation of internal controls, the systems of checks and balances that ensure reliable financial reporting and deter fraud. This evidence is analyzed in light of the auditor's experience and expertise. It is the job of external auditors to verify that clients have accounted for their transactions fairly according to Generally Accepted Accounting Principles, including applying assumptions and estimates in a reasonable manner.

The importance of an audit by a licensed professional accountant was eloquently stated in a 1984 Supreme Court decision opinion written by Justice Warren Burger:

> "By certifying the public reports that collectively depict a corporation's financial statements, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands... complete fidelity to the public trust." (U.S. v. Arthur Young, 1984).

THE IMPORTANCE OF AUDITOR ETHICS

Audit opinions provide assurance that financial statements used for equity investment, loan and other decisions are fairly stated. Audit opinions are based on professional judgment, and technical competence and ethical behavior by auditors are critical to their quality. (Libby and Thorne, 2003). The ethics of those providing opinions have been an issue since the Securities Act of 1934 (the Act) required publicly held companies to have external audits(see *Security Lawyers'*

Deskbook for a complete copy of The Act). The Act presumed that the opinions of auditors were not beyond the reach of ethical challenges, and was especially concerned about auditor independence.

The Act prohibited auditors from sitting on the boards of directors for audit clients as well as auditor investment in audit clients in an effort to ensure audit opinions' independence (Norris, 2000). Over the years since The Act, the AICPA Code of Professional Conduct has extended the list of independence regulations along with other ethics requirements designed to improve the quality of auditors' opinions. For example, auditors are now barred from performing many types of consulting work for their audit clients, are not allowed to have financial interests of any kind in their clients, and must rotate audit partners every five years.

KEEPING THE PUBLIC TRUST

A distinguishing mark of the auditing profession has always been acceptance of its responsibility to the public (AICPA, 2004). When speaking upon his appointment as Chairperson of the new Public Company Accounting Oversight Board (PCAOB), William McDonough stated "Confidence in the accuracy of accounting statements is the bedrock of investors being willing to invest, lenders being willing to lend, and employees knowing that their firm's obligations to them can be trusted." (KPMG Audit Committee Quarterly, 2003). The opinion of a CPA regarding a company's financial reporting has been so important to the financial markets that auditing has grown into a $6 billion a year industry. The opinions of auditors have taken center stage in regulation of the financial markets.

Recently, the role of the CPA in providing reliable assurance information has come into question. In his keynote speech to the 2003 annual meeting of the American Accounting Association, former chairperson of the Securities and Exchange Commission Art Wyatt stated that managing partners (of major accounting firms) have too often been cheerleaders promoting revenue growth, and individuals with more administrative expertise then auditing expertise (Wyatt, 2003). A bad audit may have resulted from a lack of auditor knowledge and expertise, but as long as profits were good, the auditing firm was satisfied.

This lack of knowledge and expertise may be one contributing factor in all the lawsuits against accounting firms. All of the large accounting firms have been charged with having done substandard work and having made unethical decisions in recent years. Andersen failed to require Enron to consolidate losses and debt into its financial statements, permitting these undesirable elements to be kept off the books (Ohly, 2002). Andersen was forced out of business as a result of its audit of Enron.

Andersen has gained the most publicity for its unethical conduct, but it is not the only firm that has been accused of acting unethically. Ernst & Young (E&Y) consultants marketed PeopleSoft products in the same periods E&Y audited PeopleSoft (Bryan-Low, 2003). KPMG permitted Xerox to book revenue from long term contracts long before the revenue was earned (Neumeister, 2003).

PWC failed to force the proper accounting of improper loans by Tyco (Hill, 2002). Deloitte, Touche Tomatsu permitted Adelphia to improperly account for loans to officers and directors, keeping material debt off the balance sheet (Newswire, 2002).

The list of suits alleging failures of audit firms to uphold the public trust is very long (see Table 1 for a sample of the suits).

Table 1: Recent Scandals at the Largest Audit Firms

Company Name	Audit Firm	Alleged Auditor Impropriety
Enron	Andersen	Auditors allowed client to hide losses and debt in SPEs that should have been consolidated.
WorldCom	Andersen	Auditors failed to detect client capitalization of material operating expenses to inflate revenues
PeopleSoft	Ernst & Young	Auditors marketed PeopleSoft software in consulting engagements while auditing PeopleSoft.
HealthSouth	Ernst & Young	Auditors allowed client to overstate revenues
Lucent	PWC	Auditors failed to detect material understatement of bad debt expense
Tyco	PWC	Auditors permitted the client to book personal loans to officers as company expenses.
Xerox	KPMG	Auditors permitted the client to book revenue from long term contracts in the period the contract was signed
Parmalat	KPMG	Auditors approved accounting treatment of interest on Citigroup loans to Parmalat as a return paid to an investor, disguising Parmalat's real cost of borrowings.
Adelphia	Deloitte Touche Tomatsu	Auditors allowed the company to keep substantial debt off the balance sheet.
Reliable Insurance	Deloitte Touche Tomatsu	Auditors failed to report the client's insufficient cash reserves.

These improper acts by auditors have been cast into the national consciousness, and public disclosure and criticism of these acts continues to erode public trust in the accounting profession. The Edelman Trust Barometer for 2004 survey asked college-educated people in households with incomes over $75,000 what they thought had led to the greatest reduction in trust of corporations and institutions. The winning answer: unethical business practices by accounting firms, getting 66% of respondents' votes. Unethical practices of accounting firms was a more popular choice than excessive compensation for executives, misleading communications from companies themselves, and misappropriation of pension and 401(k) funds (Edelman, 2004).

To add insult to injury, USA Today published these survey results on the front of its Business Section on February 10, 2004 (Haralson and Laird, 2004). Investors need not read the financial press to find out about problems in the auditing profession; the popular press is only too happy to spread the news. The Edelman survey also found that only 30% of respondents find communications issued by companies (presumably including audit opinions and audited financial statements) to be credible sources of information about those companies. This is somewhat good news considering the response to this question in January 2003 was only 19% (Edelman, 2004).

Due to the Enron/Andersen scandal and others, the Sarbanes-Oxley Act of 2002 (SOX) was passed. The Act was designed to help renew public faith in corporate reporting. SOX requires audit firms to register with the PCAOB, prohibits auditors from performing several categories of non-audit services for audit clients, and requires that audit committees pre-approve any consulting to be performed by auditors. While SOX will help improve auditor independence, it is up to the profession itself to take the initiative in ensuring that faith in CPAs and the auditing profession is renewed.

The auditing profession has every reason to expect improvement in its ethics performance. Indeed, the actions of regulators such as the SEC indicate that improvement is assumed. SOX provisions require new accounting standards be developed using a 'principles based approach', and it is presumed that auditors can and will adhere to those principles. In requiring audit opinions on financial outcomes under such standards, auditors will be held more accountable for ensuring that the financial reporting complies with these principles (KPMG, 2003).

So what can be done to improve auditor ethics? There are some options, but it is a task that will require effort at every level of the profession.

NATIONAL EFFORTS AT IMPROVING AUDITOR ETHICS

At the national level, the AICPA Professional Ethics Executive Committee helps the AICPA carry out key aspects of its overall mission related to auditor ethics. Among other goals, the Committee establishes and enforces professional ethics standards for the profession, it assists members in continually improving their professional conduct and performance, and it monitors such performance by enforcing current standards (AICPA, 2003a). The Committee is also helping revise and modernize the Code of Professional Conduct, and is responsible for the Joint Ethics Enforcement Program.

It is not clear how such efforts translate into improved ethical decision making by auditors. Expansion of the Code of Conduct runs the risk of resulting in a "cook book" approach to satisfying the Code. If auditors continue to meet the letter of the Code but not its intent, no progress can be made. Firm-wide training in the ethics area needs to emphasize the underlying concepts, overall philosophy, and expectations rather than on the "thou shalt nots" that are commonly emphasized ...The Code must become a personal mind-set rather than a list of rules" (Wyatt, 2003).

The AICPA is also making efforts to improve ethics enforcement. In October 2003, the AICPA announced that its membership had voted (in a 7:1 ratio) to increase the transparency and timeliness of the AICPA ethics enforcement process (AICPA, 2003b). The purposes are to give the AICPA more flexibility to act in the public interest when the Code is violated, and to help members see how the enforcement process works. This may have a deterrent effect on ethics violations.

In addition, some provisions of SOX may help improve auditor ethics indirectly. For example, audit committees of publicly held companies are increasingly undergoing continuing education in an effort to better understand and fulfill their responsibilities to shareholders and investors (KPMG, 2003). In the past, audit committees frequently had very little understanding of accounting and auditing. The SOX requirement that audit committees include a financial expert may mean the committees are better able to detect unethical actions of their external auditors than they have been.

STATE EFFORTS AT IMPROVING AUDITOR ETHICS

CPAs are licensed by states, so states may have the best opportunity to directly impact auditor ethics. All states require ethics testing in the initial licensure of CPAs. Newly licensed CPAs prove they have read and understand the Code of Professional Conduct for their state by passing an ethics exam. The question is how to ensure these ethical standards are followed.

One of the main lessons from research on business ethics is that regular, overall refresher courses on ethical decision making and the company's Code of Ethics will help all employees keep their perspectives on ethics. Even the most careful managers can become focused on the day-to-day "trees" or details of their jobs and lose sight of the larger forest. Well designed refresher courses can help managers and employees stretch their imaginations and make more informed moral assessments (Mead, 2002).

Because professional associations have a key standards enforcement role in improving auditor ethics, many state boards of accountancy have debated the content of their CPE requirements in recent years. For example, New York is debating whether to require an ethics component in CPE or leave ethics optional (as is now the case) (Grumet, 2002). We reviewed the web sites for all 50 states, and found CPE requirements as shown in Table 2.

Nearly all states (48 of 50) require CPAs to participate in formal CPE on a continuing basis; 2 states have no formal CPE requirement. The requirement in most states results in CPAs completing an average of 40 hours of education per year. This amount is likely exceeded by many CPAs, and seems adequate as a minimum requirement for formal CPE.

Most states specify the types of training which are allowable for meeting the CPE requirement (see Table 3). Forty of 48 states with CPE requirements hold seminars which result in CPE credit, and 40 states give credit for college and university courses completed. A variety of other

CPE methods are allowed, including serving as a journal reviewer (7 states), attending continuing legal education (6 states), and serving on state CPA society committees (11 states).

Table 2: Overall CPE Hour Requirements for CPAs

CPE Requirement	Number of States
None	2
20 hrs/ 2 yrs	1
40 hrs/ year	10
80 hrs/ 2 yrs	15
120 hrs/ 3 yrs	22

Table 3: Methods of Completing CPE Requirements for Maintaining the CPA License to Practice

Method of CPE Allowed	Number of States
Professional development seminars sponsored by the state CPA society	40
College and university Courses	40
Individual self study	39
Discussion or leader of CPE meetings	36
Technical session updates	34
Accounting firm education programs	31
Publication of articles and books	29
Programs from other sponsors	27
Formal correspondence classes	22
Group programs	16
Independent study	12
Committee meetings for state CPA society	11
Successful completion of other exams (e.g. CMA or CFP)	8
Journal or article reviewer	7
Continuing legal education	6

While many states (17 of 48) require some accounting and auditing update hours, most (31 of 48) fail to specify any precise content for CPE. Most states permit tax, practice management, technology updates, marketing and management training (among others) to be included in CPE.

These are all valuable topics for CPAs to learn about on a continuing basis. What is missing from the CPE requirements of most states is mandatory ethics training.

The longer someone is out of college, the less likely that ethics training learned in college will influence the auditor's decisions. The policies of the firm, auditing experience with clients, and the business world in general reinforce the need to be realistic rather than idealistic. Wyatt's (2003) call for ethics training that renews and reinforces an overall ethical decision making philosophy can help offset this decline in ethics.

We reviewed the required ethics training component of CPE for all 50 states according to the states' CPA Society web sites, and the results are shown in Table 4. Only 18 of 48 states with a CPE requirement specifically require ethics training as a required component of CPE; 32 states fail to require any ethics training as part of CPE.

Table 4: Ethics Training Included inCPE Requirements for CPAs

Ethics CPE Requirement	Number of States
None	32
2 hrs/yr	3
2 hrs/2 yrs	2
2 hrs/ 3 yrs	5
3 hrs/3 yrs	2
4 hrs/ yr	2
4 hrs/2 yrs	1
4 hrs/3 yrs	1
8 hrs/6 yrs	1
8 hrs/ 3 yrs	1

As Table 4 shows, the amount of required ethics training as part of CPE is consistently low. Many states with an ethics requirement specifically mention the Code of Professional Conduct as part of the expected ethics update. Two to 4 hours of ethics training is enough to provide an overview of a state's Code of Professional Conduct changes, but is not enough time for discussion of implementation of those changes in audit situations.

Overall, one brief seminar about ethics every 2 or 3 years seems to provide window dressing CPAs can use when giving lip service to improving ethics, but it is no real opportunity for ethics training. To enable auditors to internalize proper ethical practices, cases and readings containing complex ethical issues should be presented and discussed. CPE seminars with substantial ethics content are an ideal setting for refreshing auditors' ethical outlook. Of the one week (on average) auditors devote to CPE each year, certainly some hours should be devoted to ethics training. Frequent ethics training can help stop the free fall of audit problems and renew the public trust by allowing for the kind of thoughtful consideration of ethical challenges that is necessary to help CPAs make ethical decisions.

CORPORATE EFFORTS AT IMPROVING AUDITOR ETHICS

While CPA firms hold some meetings regarding ethics policies, there is no guarantee of the quality, quantity or content of such meetings. Further, as Andersen showed, meetings on ethics may focus on implementing firm policies rather than on improving the quality of ethics being employed across the firm (e.g., Schroeder, 2002). One should recall Andersen audit partner David Duncan's assertion that he destroyed important audit documents at the request of Andersen attorneys wishing to enforce firm document retention policies (Schroeder, 2002). At the time he took these actions, Duncan put his interest in following firm rules (and the interests of Andersen) above the interests of shareholders, retirees and employees.

Now that Andersen no longer exists, and the remaining firms have seen how important ethics are to their continued existence, it may be tempting to think unethical accounting firm policies have been rooted out. There is evidence to the contrary. In 2004, PWC admitted to receiving substantial discounts from airlines while billing clients as though no discounts were received – and pocketing the difference (Weil, 2004). The billing was done according to firm policy. E&Y and KPMG continue to provide advice on tax shelters that are alleged to be improper. Unfortunately, all too often regulators make the rules, accountants promise to obey the rules, but nobody checks to ensure this is what is happening. Self interest has replaced much of the profession's fidelity to the public trust (Norris, 2000).

It is likely that the culture and prevailing values of accounting firms will continue to have significant influence on auditors' ethical behavior (Clikeman, 2003). Auditors must conform to expectations of their firms to be successful in obtaining promotions and raises; an understanding of a firm's ethics policies, and implementation of those policies, is central to this conformity. Andersen, even more than the other firms, became known for having a very well defined culture: dynamic, aggressive, client focused but also conformist, precisely because of the demands for conformity inherent in "strong" cultures (Grey, 2003). While a strong sense of ethics may have gone along with this culture for most of the firm's auditors, that sense of ethics was not pervasive.

Ethics improvement may arise from changes in the firms themselves. One suggestion comes from Art Wyatt, former Chairperson of the Securities and Exchange Commission: "The firms need to evaluate the cost to their culture of injecting into it individuals who have no understanding of the significance of accounting professionalism and the importance of ethical behavior…" resulting from hiring nonaccounting majors who have not been trained in ethics in college. (Wyatt, 2003). It is quite possible that, by building a strong ethical corporate culture, fraud can be minimized (Singleton, King, Messina and Turpen, 2003).

INDIVIDUAL EFFORTS AT IMPROVING AUDITOR ETHICS

Ultimately, improving auditor ethics is up to each individual auditor. Auditors entering the profession out of college have relatively high standards for ethical conduct (Clikeman and Henning, 2000). To ensure the efforts of higher education continue to be successful in educating about ethics, many colleges and universities have initiated changes to their curricula. For example, Massachusetts Institute of Technology (MIT) faculty constantly seek alternatives to giving students tools they can use to get ahead by acting unethically, hoping to inspire students to become true professionals, with aspirations that go well beyond greed (Schmalensee, 2003).

The Treadway Commission called for ethics training to be integrated throughout the accounting curriculum for maximum benefit, saying "The business and accounting curricula should emphasize ethical values by integrating their development with the acquisition of knowledge and skills to help prevent, detect, and deter fraudulent financial reporting. (COSO, 2004).

The burden of maintaining high ethics must be born by each individual if the ethics of the profession as a whole are to improve. In some instances, students graduate, get a job with an accounting firm, and almost immediately come under pressure to compromise basic principles they were taught in school (Hall, 2003). Ethics can improve only if individuals stand up to these pressures.

CONCLUSIONS

The audit profession is experiencing turbulent times. Most current lawsuits against auditing firms allege unethical behavior on the part of auditors, and public trust in the auditing profession is in decline. However, the need for assurance provided by auditing firms has not declined. Audit opinions that result from ethical judgment and technical expertise still provide valuable information regarding a company's financial statements. The profession needs to take action to ensure the public that future audit opinions are the result of the highest ethical decision making possible.

No matter what an auditor learns about ethics in college, accounting firms put ethics in their own context and convey their ethics through auditor training. This appears to have the capacity to diminish rather than heighten ethical conduct. The disappointing performance of accounting firms in recent years indicates it is time for accountants to examine the priorities, reward systems and cultures of their own firms (Clikeman, 2003). It is also time for the profession to step up requirements for ethics training throughout auditors' careers.

Actions at the national, state, firm and individual level will all contribute to an improvement in auditor ethics. Efforts at the state level may yield the most improvement in ethics because states have the power to require ethics training through CPE requirements. Our analysis of the CPE requirements for CPAs reveals very little requirement of ethics training by state CPA societies at the present time. Auditors must realize that the public no longer believes that unethical actions by auditors are isolated incidents. Too much money has been lost, and too many jobs have been lost, for all of the current scandals to be considered ‘isolated incidents’. Ethics training can improve auditor ethics, helping to reduce the likelihood of future audit failures and increase public trust in audit opinions.

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COPYRIGHT ISSUES AND THE WEB

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ABSTRACT

The extensive use of the Internet for small business web sites has focused increased attention on issues relating to copyright law. "Copyright is the right to exclude, not to publish" (Field, 2002). United States copyright law envelops all forms of expression as long as the form is permanent (i.e. scribed on paper, recorded on tape, painted on canvas, or coded into a computer). International copyright law does not exist, but resides within each country. Survey results indicated that only 56.5 percent of respondents knew that cutting and pasting the source code of a setup from a web page is a copyright infringement. When asked if copying a page that does not have a copyright notice on it is a copyright infringement only 53.8 percent responded with the correct answers. Likewise, only 51.4 percent of respondents answered correctly when asked if sharing an image or background with friends violates copyright guidelines. Representatives from the construction industry scored significantly lower than did survey participants from other types of businesses. Small business owners should become more knowledgeable about copyright issues for web pages. If the business is cited for copyright violations, the owner will ultimately be held responsible.

INTRODUCTION

The advent of the Internet makes it imperative for all businesses, individuals, and institutions with web sites to develop an understanding of copyright laws. New works are created and shared widely on the Internet, which raise concerns about protecting owner rights. Additionally, using works created by others on the Internet further clouds the complex issue of Fair Use. With the passing of the Digital Millennium Copyright Act and other new statutes, the application of Fair Use has become a complicated struggle.

One of the most popular segments of the Internet is the World Wide Web (Web for short), which contains millions of web pages. These web pages represent the creative work of Generation X and the palette and canvas for future generations. The virtually unlimited access to web pages generates several complex issues/questions pertaining to copyright and the Web. For example:

Can you scan a photo or graphic and duplicate it on your web page if someone else created it?
Is it legal to include sound clips from your favorite song or musical score on your web page?

An image or background catches your attention while viewing another web page; can you download, save, and use it on your web page?

Are you permitted to cut and paste the source code of a web page not created by you? Determining whether you have violated copyright law rests on the answers to these questions. Often we infringe upon someone else's rights, when we do not think that we have.

COPYRIGHT BASICS

"Copyright is the right to exclude, not to publish" (Field, 2002). United States copyright law envelops all forms of expression as long as the form is permanent (i.e. scribed on paper, recorded on tape, painted on canvas, or coded into a computer). An idea in one's head is not protected by copyright law, but if it is written down, recorded, or put in some durable format, the idea is protected (Simpson, 2001). The copyright notice or symbol does not have to be present for the item to be protected by law. The cardinal rule in regard to copyright is that the owner reserves any right not expressly granted on or in the work (Gatlin-Watts, et. al. 1997).

Any work not protected by copyright is considered public domain. Public domain refers to materials for which copyright has been abandoned or expired (O'Mahoney, 2002). Copyright law does not protect materials created by the federal government. Items created by the Federal Government are considered to be public domain. Anyone may use materials classified as public domain. If desired, the author of a work can register it with the Copyright Office of the Library of Congress.

What are the rights of the copyright holder? Six basic rights are set forth in United States copyright law – the right: 1) to reproduce, 2) of adaptation or creation of derivative works, 3) to distribute copies by selling, giving, renting, leasing, or lending, 4) of public performance, 5) of public display, and 6) of digital audio transmission (Diotalevi, 2000).

International copyright law does not exist, but resides within each country. The World Intellectual Property Organization is a special agency that helps to enforce copyright internationally (What is WIPO, 2002). Additionally, the Berne Convention helped to fortify international issues by establishing a worldwide treaty in which nations agreed to abide by each others copyright laws. The user simply abides by the laws of only one country—their own (International Protection of Copyright, 2002).

Copyright ownership begins upon creation. Depending upon the country, copyright ownership ends 50 to 70 years after the author's death (WIPO Intellectual Property Handbook, 2002). Specifically in the United States, works are protected for the life of the author plus 70 years. If the work has two or more authors, then it is protected through the life of the longest surviving author plus 70 years. Corporate works are protected for 95 years from the date work is published, or 120 years from the date it was created, which ever is the shortest time span (Crews, 2000).

The law does outline acceptable avenues for using copyright materials without copyright holder permission. These avenues are covered in the "Fair Use" provisions. Embedded within the copyright law, the Fair Use provisions grant certain users conditional rights to use or reproduce specific copyrighted materials. The reproduction or use of those materials must meet the defined guidelines established in the Fair Use provisions (Crews, 2000). When considering a copyright violation claim, courts generally weigh the rights of the user and the rights of the author; however the burden of proof (Fair Use) falls squarely on the shoulders of the user.

The Fair Use provisions outline six acceptable ways to use copyright items: criticism, comment, news reporting, teaching, scholarship, and research. When determining whether the use falls under the Fair Use provisions courts use four tests to gauge the use of the copyrighted material: the character of the use – profit or non-profit, the nature and scope of the copyrighted work, the amount or portion used in relation to the whole, the potential market effect (Hartnich, 2000).

WEB PAGE COPYRIGHT ISSUES

The Web generates a new medium for displaying our creative abilities. Virtually everyone has a web page on the Internet. Most individuals understand that copyright exists in regard to books, magazine articles, sound recordings, video, and software, but typically do not transfer that understanding to web pages. This laissez-faire attitude concerning the Web developed from the myth that everything on the Web is public domain. In fact, the vast majority of items on the Web are protected by copyright law (Diotalevi, 2000). The author of the web page owns the copyright of his/her work. When addressing the copyright issue in relation to web pages, one needs to consider the various components that might comprise a web page – text, images/graphics, sound clips, HTML source code, and links.

The same rules that apply to text in other formats apply to text that is on a web page. Copying text word for word is plagiarism; although using segments or excerpts from someone else's web page would be covered by Fair Use (O'Mahoney, 2000).

The temptation to borrow images, pictures, or graphics from a web page is hard to resist. The works may be original, which are covered under copyright law. The owner of the page determines the terms and conditions of the use (Crews, 2000). Usually the owner's terms and conditions are spelled out on the web page and must be followed in order to avoid violating the rights of the owner. When in doubt, obtaining express written permission is the best bet.

Music CDs and other sound recordings are generally copyrighted. Therefore, using such music on your web page without permission is a violation of copyright. Downloading, saving, and using sound clips from another web page is also in violation of copyright. Remember what applies to audio in other formats also applies to the Web medium (Simpson, 2001).

HTML stands for hypertext markup language. It is a series of codes that signal a Web browser to display certain formatting and layout effects. Infringement of copyright occurs when source code is copied and pasted to another web page regardless of the modification of the code. The context in which the code is used does not supercede copyright, because the HTML code remains the same (Web Law, 1999).

A hyperlink's specific web address is noted by its Uniform Resource Locator (URL). A URL is similar in nature to a telephone number or a mailing address; thus the link itself is not copyrightable. There is a difference between an IMG (Image) link and a HPER (Hypertext) link. An IMG link pulls only the image from the page, which is a violation of copyright unless the owner grants permission. A HPER link is a reference to another web page. It is a link from one website to another. Because of the nature of a HPER link, no violation occurs (O'Mahoney, 2000). Cross-linking of information is the fundamental structure of the Web.

Web-based works are copyrighted and should be treated in the same manner as other mediums. Copyright notification is not necessary; therefore, one should assume that every component of the web page is protected. The Fair Use provisions can be utilized in relation to the Web. As with other formats, the four tests of Fair Use should be kept in mind. Finally, when designing a web page, one needs to be concerned about using copyrighted materials to build the page.

METHODOLOGY

A survey was developed to assess understanding of copyright issues relating to the development of web pages. The survey was sent to a list serve of small businesses that was made available by the Small Business National Advancement Center at the University of Central Arkansas. Within 3 days, 151 responses were received. Data was analyzed using T-tests, F-tests, and Scheffe's procedure to determine significant sub-groups.

FINDINGS

Table 1 lists the eight copyright-related questions, the correct response, and the mean score of participants. The mean score of all the respondents was 68.9 percent with a standard error of 21.3 percent. Questions receiving the lowest number of correct responses were numbers 2, 3, 5, and 6. Only 63.7 percent of respondents knew that using an image or background from someone else's web page represented a copyright infringement.

Data were collected on nine demographic characteristics of the respondents. These characteristics are listed in Table 2. The respondents were predominantly male, 63.4 percent male versus 36.6 percent female. The most common age of respondents was 45 to 54 years of age (39.0 percent). Incomes of the small business respondents were generally high with 42.7 percent earning more than $60,000 per year. An unusually large percentage (60.9 percent) were education-related businesses. Given the previous result, it was not surprising to find that 72.4 percent had completed graduate or professional degrees. Four of the nine demographic characteristics were related to the creation or use of web pages. The majority of respondents had a personal or business web page (54.5 percent). While few of the small business owners had taken courses specifically related to web page design (20.4 percent), a surprising number had personally designed a web page (38.2%). A very small percentage of respondents were employed as web page designers (3.5 percent).

Table 1: Test Questions and Frequencies of Correct Responses

	Test Questions	Correct Response	Frequency
1.	It is considered copyright infringement to scan a picture taken by a professional photographer and use it on your personal web page.	Yes	86.8%
2.	Using an image or background from someone else's web page is copyright infringement.	Yes	63.7%
3.	To cut and paste the source code of a setup from a web page for your own web page is copyright infringement.	Yes	56.5%
4.	To use a popular song or a sound clip on your own web page that you found on someone else's web page is copyright infringement.	Yes	77.4%
5.	To copy a page that does not have a copyright notice is copyright infringement.	Yes	53.8%
6.	Sharing with friends an image or background that you have permission to use is copyright infringement.	Yes	51.4%
7.	Everything on the Internet is public domain.	No	84.2%
8.	To link to any other web pages on the Internet from your web page is copyright infringement.	No	91.9%

Table 2: C Characteristics of Respondents	
Characteristic	
What is your gender?	Do you currently have a personal or business web page?
What is your age?	Have you ever taken a course in web page design?
What is your estimated gross annual income?	Have you personally designed a web page?
Please indicate the type of company in which you work.	Are you personally employed as a web page designer?
What is the highest level of education you have completed?	

T-tests and F-tests were done to determine if the scores on the test were dependent upon these characteristics. The results of the t-tests are shown in Table 3. As indicated in Table 3, the mean score on the test of understanding of copyright laws is significantly higher for those who have a personal or business web page. The mean score of those with a personal or business web page is 72.627, or 6.149 points higher than those who do not. The mean score is also higher for those who have designed a web page. The mean score for this group is 75.9009, or 9.898 points higher than those who have not designed a web page. Gender, web page courses, and professional employment as a web page designer seem to have no effect on test scores.

Table 3: T-tests of Significant Differences in Scores

Characteristic	t	d.f.	Sign.	Mean Diff.
1. Gender	0.257	143	.798	.905
2. Web Page Course	0.884	140	.378	3.696
3. Personal or Business Web Page	1.833	143	.069	6.149
4. Designed a Web Page	3.130	138.142*	.002	9.898
5. Web Page Designer	-1.072	5.170*	.331	-5.347

* degrees of freedom are for an unequal variance t-test.

F-tests were conducted to determine if there were significant differences in scores based upon age, gross annual income, level of education or industry. There were no significant differences in mean scores based upon age, gross annual income or level of education. However, there were significant differences based upon the industry in which the respondent was employed. The results of this F-test are reported in Table 4. Respondents in the construction industry scored significantly lower than respondents in any other industry.

Table 4: F-tests of Significant Differences in Scores Based upon Industry					
	Sum of Squares	d.f.	Mean Square	F	Sign.
Between Groups	8004.912	4	2001.228	4.863	.001
Within Groups	60078.698	146	411.498		
Total	68083.609	150			

The results of Scheffe's procedure to determine significant subgroups are reported in Table 5. The mean score of respondents employed in the construction industry was significantly lower than the mean scores of respondents in any other industry. Further tests indicated there were no differences between the mean scores of any of the other industry groups at the five percent level.

Table 5: Results of Scheffe's Test for Significant Subgroups				
(I) Industry	(J) Industry	Mean Difference (I-J)	Std. Error	Sign.
Construction	Education	-43.478	10.3069	.002
	Government	-35.938	11.3399	.040
	Service Sector	-44.196	11.5007	.007
	Other	-38.375	10.9240	.018

CONCLUSIONS AND RECOMMENDATIONS

Survey results indicated that only 56.5 percent of respondents knew that cutting and pasting the source code of a setup from a web page is a copyright infringement. When asked if copying a page that does not have a copyright notice is a copyright infringement only 53.8 percent responded with the correct answers. Likewise, only 51.4 percent of respondents answered correctly when asked if sharing an image or background with friends violates copyright guidelines. Representatives from the construction industry scored significantly lower than did survey participants from other types of businesses.

When designing a web page, do not use copyrighted material unless permission has been granted. If using an image, background, or graphic from another web page, ask permission first and follow the terms expressed in their usage agreement. Always write HTML code rather than copying it from another site. An entire web page should never be copied and pasted from another site. Before linking to other web sites, be certain that the content of your page would not be offensive to them or their constituents. Do not link directly to another web page to bring its graphics or pictures into your web page.

The small business representatives responding to our survey need to know that copyright guidelines are violated when:

An image or background from someone else's web page is used.

A source code of a setup from a web page is cut and pasted.

A page that does not contain a copyright notice is copied.

An image or background is shared with friends.

Small business owners need to become more knowledgeable about copyright issues for web pages. If a business is cited for copyright violations, the owner will ultimately be held responsible. Reputable web site designers with knowledge of copyright guidelines for web design should be hired. Workshops on copyright for web pages should be held by the Small Business Administration for businesses nation-wide.

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CEOs 1, SOX 0: THE CASE AGAINST RICHARD SCRUSHY AND HEALTHSOUTH

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ABSTRACT

The first major court test of the Sarbanes-Oxley (SOX) Act of 2002 is in trial in Birmingham, Alabama. The defendant in the case is Healthsouth Corporation's founder and chairman, Richard Scrushy, who has pleaded innocent to all charges. We obtained the Complaint from the SEC website and searched Lexis-Nexis database for articles relating to the case. Motions filed by the defense were obtained from the defendant's website. The focus of our analysis is on SOX Section 906 relating to the certification of financial statements by the CEO and CFO and the criminal penalties for certifying false financials. We discuss the SEC's 58 count complaint, (reduced from 85 counts on defense motion), the defense challenge under the "void-for-vagueness doctrine,"(won by the prosecution) and the legal arguments/strategies. We also discuss the implications of the case to the accounting and legal professions. An abiding question in this case is whether the entrepreneurial, risk taking skills necessary to found a company are the same skill set needed to successfully lead the company through public offering and beyond.

INTRODUCTION

The purpose of this paper is to illuminate the accounting, legal and corporate governance issues associated with the first major court test of the Sarbanes-Oxley (SOX) Act of 2002. This is a progress report since the case is in trial at this writing and expected to continue for several months. The defendant in the case is the company's founder and chairman, Richard Scrushy. The company is Healthsouth Corporation. Scrushy has pleaded innocent to all charges. Eighteen Healthsouth executives have been charged in the case; fifteen have pleaded guilty. An abiding question in this case is whether the entrepreneurial, risk taking skills necessary to found a company are the same skill set needed to successfully lead the company through public offering and beyond.

We obtained the Complaint from the SEC website and searched Lexis-Nexis database for articles relating to the case. Motions filed by the defense were obtained from the defendant's website. We discuss the SEC complaint, the defense challenge under the "void-for-vagueness doctrine," and the legal arguments/strategies. We also discuss the implications of the case to the accounting and legal professions.

THE CASE, THE PLAYERS, THE ARGUMENTS

Healthsouth Corporation (HRC) was incorporated in Delaware in 1984 and is headquartered in Birmingham, Alabama. HRC is the nation's largest provider of outpatient surgery, diagnostic and rehabilitative healthcare services. HRC's securities are registered with the SEC pursuant to Section 12 (b) of the Exchange Act. In its highlight year, 2001, HRC reported total revenues of $4 billion and net income of $76 million. HRC's stock is listed on the New York Stock Exchange and is actively traded under the symbol HRC. Richard M. Scrushy, age 52, founded HRC and served as its Chairman of the Board from 1994 to 2002; he continues as a board member to the present. He served as CEO from 1994 until August 27, 2002. On January 6, 2003 he reassumed the position of CEO (Complaint, 2004).

The 58-count criminal indictment contained in Civil Action No. CV-03-J-0615-S - SEC v. Healthsouth Corporation and Richard M. Scrushy covers a wide range of issues, including the charge that Scrushy oversaw a fraud in his "willful" certification of the company's false financial statements. SOX Section 906 (a) and (b) provide that company officers (CEO) and (CFO) certify that financial statements filed with the SEC fully comply with requirements of the Exchange Act of 1934. Further, Section 906 (c) (1) provides a criminal penalty of $1,000,000 and 10 years imprisonment for knowingly submitting a certification that does not meet *all requirements* of the 1934 act. The penalty is increased to a fine of $5,000,000 and a prison term of 20 years when the officer "willfully certifies" financial statements which misrepresent the financial condition of the company (Complaint, 2004). Most of Scrushy's alleged misconduct occurred prior to SOX and consequently all but three of the charges against him relate to other criminal statutes. The SOX violations are contained in Counts 48, 49, and 50. Count 48 charges that Scrushy "willfully certified" HRC's false Form 10-Q for the second quarter of 2002; Count 49 charges that Scrushy "caused" HRC's CFO and CEO to "willfully" certify Form 10-Q for the third quarter of 2002; and Count 50 charges that in March 2003 Scrushy "attempted to cause" the CFO to "willfully certify" an amended false 10-Q for the third quarter 2002. The term "willfully," when used in 906 (c) leaves open the possibilities associated with the "Void-for-Vagueness Doctrine." This doctrine is invoked by defendants when the statute under which charges are brought is so vague and unclear to render a defense to the charges impossible. Specifically, a criminal prosecution would be rendered invalid when the defense can show that the statute: 1. fails to give fair notice of what conduct is forbidden; and 2. encourages arbitrary and discriminatory enforcement (Kolender v. Lawson, 461 U.S. 352, 357 (1983)). Further clarification of this two-part test is found in Village of Hoffman Estates v. Flipside, 455 U.S. 489, 499 (1982). The court declares, “The most important factor affecting the clarity that the Constitution demands of a law is whether it threatens to inhibit the exercise of constitutionally protected rights.” Therefore, in the case of SOX 906, a plaintiff must demonstrate that the law is so lacking in clarity that their constitutional rights are infringed upon. The words and phrases in 906 that are subject to interpretation are “willfully certify” and “fairly presents in all material respects.” According to the (Salky and Rosman, 2004) Section 906 meets the standards for clarity. The Foundation presents arguments supporting that, “The proscribed conduct (certifying false financial statements) is neither constitutionally protected nor potentially innocent” and “The statute gives fair warning of the forbidden conduct” and “The statute does not invite arbitrary and discriminatory enforcement.” Notwithstanding the legal arguments against a void-for-vagueness motion to dismiss, Scrushy challenged SOX 906 (c) asserting the void-for-vagueness doctrine. His arguments are contained in “Defendant Scrushy’s Motion to Dismiss Counts 48-50 of the Indictment,” filed with the Court on April 5, 2004. Subsequently, the challenge of the wording in SOX Section 906 under the void-for-vagueness doctrine was denied by the District Court. It should be noted that federal prosecutors have already applied SOX successfully in the HRC case, but the much touted penalty sections of the law have not had teeth to this point. Of the fifteen plea agreements, including all five of the former CFOs, only one person has received actual prison time – five months, although not all defendants have been sentenced (Bond, 2005).

Other Lawsuits filed by Scrushy include: “Defendant Scrushy’s Motion to Dismiss or Consolidate Counts of the Indictment as Multiplicitous, “Opening Brief of Appellant Richard M. Scrushy” (Scrushy’s appeal to the Supreme Court of the State of Delaware in regards to HRC shareholder litigation), and a suit against the Birmingham News filed in December 2004 claiming a series of libelous articles against Mr. Scrushy (Scrushy, 2005).

According to the Complaint, on August 14, 2002, Scrushy knowingly or was reckless in not knowing that he was certifying false financial statements for 2001 in the company’s filing of SEC Form 10-K. In truth, the financial statements filed with this report overstated HRC’s earnings, identified on HRC’s income statement as Income Before Taxes and Minority Interests, by at least 4,700% (SEC Complaint, para. 2). SEC Commission Order No. 4-460 requires sworn certification of company financial statements pursuant to Exchange Act of 1934 Section 21 (a) (1) as amended by SOX, 2002 (Complaint, 2004). In summary, prosecutors claim that Scrushy orchestrated a six-year, $2.64 billion accounting scheme which included conspiracy, money laundering, obstruction of justice, and perjury, in addition to the violation of SOX Section 906 (Complaint, 2004). Perhaps borrowing from the so-called “dummy” defense asserted successfully by CEO Walter Forbes in the Cendant Corporation case and by Bernard Ebbers in his $11 billion WorldCom trial, Scrushy’s defense attorney claims “The former respiratory therapist with no accounting background simply got duped” by a conspiracy among his five CFOs (Bond, 2005). Not in dispute in the case is whether a fraud occurred. A Price WaterhouseCoopers forensic accounting team investigated HRC’s accounting and reporting practices from 1996-2002 and determined that earnings were overstated during that period by $2.7 billion (Farrell, 2005). The only issue to be decided is whether Scrushy orchestrated the fraud or was mislead by his financial team. The fraud was perpetrated by making false entries in the accounting system. Accountants primarily used an estimated contra revenue account, referred to as the "Contractual Adjustment" account and/or a reduction of recorded expenses to increase profits. Correspondingly, false entries were made in the balance sheet accounts. A fictituous fixed asset was set up at each HRC facility. This account was titled "AP Summary." To cover the fraud, false documents were created.

The case is being tried in District Court with the Honorable Karen Bowdre presiding. The prosecution team is led by Alice H. Martin, U. S. Attorney for the Northern District of Alabama. Scrushy's constant influence and overseer in developing the defense strategy is Mr. Donald Watkins, a Birmingham attorney, banker and entrepreneur. Currently, the lead attorney at trial is Jim Parkman. Parkman is assisted primarily by Mr. Art Leach, a former U. S. Attorney and others, including Scrushy's son-in-law, Martin Adams (Mollenkamp, 2005).

Scrushy was subpoenaed in February 2003 to appear before the SEC. He testified with aid of counsel, Bill Clark, a Birmingham criminal attorney. When other HRC executives were questioned they implicated Scrushy as the leader of the fraud. In March, the court moved to freeze Scrushy's assets, estimated to be $250 million (Mollenkamp, 2005). Upon appeal and further testimony, the freeze was lifted by Judge Inge Johnson in May 2003. Scrushy was removed as board chairman following the government's suit against him in March 2003; he remains on the board. It is estimated that by the end of 2004, Scrushy had spent over $20 million on his defense (Woolner, 2005).

In late January 2004, eighteen jurors were selected; eleven are African American; ten are male (Walton and Tomberlin, 2005). According to some court watchers the race issue may be more powerful than the evidence. Scrushy has courted African American religious figures, but did not have any African Americans on his executive team at HRC. Nonetheless, in one news report, a black law student from Birmingham is quoted as saying that "blacks are less likely to own stock and tend to be "more forgiving" of those accused of fraud," implying that Scrushy may be motivated to have as many African American jurors as possible decide his fate.

STRATEGY OR HAPPENSTANCE: RELIGION AND RACE

According to a Bloomberg News reporter, "The pews behind Scrushy some days resemble an 'amen corner.'" The reporter notes that "Scrushy family members sit with pastors and congregants from nondenominational, African-American churches, who bring Bibles and prayers……" to the courtroom. According to news reports, Scrushy and his wife Leslie joined a predominately African American church, Guiding Light, in early 2003 (Woolner, 2005).

When the federal probe began, Scrushy turned to Richard Arrington, Birmingham's first black mayor for advice. While mayor, Arrington had been investigated for corruption but never charged. Many in the community believed then and continue to believe that Arrington was targeted because of his race. The mayor recommended his attorney in that case, Donald Watkins, who is also African American, to Scrushy (Mollenkamp, 2005).

Scrushy's personal website states, "Born in 1952 in Selma, Alabama – a town known as the birthplace of the civil-rights movement – Richard Scrushy is now fighting for his own rights and freedoms in the face of false allegations." His website may be an attempt to compare his plight – unfair and unjust persecution and prosecution - to the freedom fighters of that era. To buttress his argument that he is innocent of all charges and perhaps to influence the jury pool, Scrushy and his wife, Leslie, began a television ministry in early 2003. In the daily 30 minute TV show offered by Guiding Light Ministries, a predominately African American church in Birmingham, the two "discuss current events and God with guests from local ministries." Moreover, Scrushy's foundation has given millions to black causes, religious groups, colleges, and individuals. An African American admirer is quoted as saying, "In the community (assumed to be the African American community), he (Scrushy) is known as a help to people in need of assistance." According to one of Scrushy's principal accusers, former CFO William Owens, when addressing Scrushy's religious practices, he is quoted as saying, "Richard Scrushy may be the best salesman I ever met" (Reeves, 2005).

If convicted on all counts, Scrushy faces fines of $30 million, forfeiture of his assets assumed to be around $250 million, and a prison term of 450 years.

IMPLICATIONS OF THIS CASE FOR THE ACCOUNTING AND LEGAL PROFESSIONS

The accounting and legal professions were at the center of the Enron accounting scandal and many of the others in recent years. As principal advisors to company CEOs, lawyers and accountants must make difficult and often quick decisions concerning complex issues on behalf of the company. In other situations, the accountants and attorneys may be involved in the fraud as willing participants. The Scrushy case is a test of the SOX penalty requirements. To this point, executives have escaped the long jail terms. Policing and convicting white collar criminals has been difficult over time. Few executives have actually had to serve long sentences (Coffee, 2004).

The public is watching to see if the remediation measures taken in SOX to deter corporate crime are implement able in our judiciary. Moreover, are accountants too crafty, the accounting rules too vague and/or too complex, and the reporting process too unmonitored to allow convictions and punishments under SOX? Are corporate attorneys too skillful in covering their tracks, too artful in explaining the choices to the CEOs, and too insulated with legal protections to be convicted and punished under SOX? And, is the judicial process too cumbersome, the prosecution and defense attorneys too skillful in using the law to advantage, and the laws (SOX and other statutes) under which the complaints are filed too complex for justice to be served? The evidence so far suggests that the legal hurdles of SOX Section 906 may be too high. In the Cendant case, the "dummy" defense worked with the jury even though the wording in SOX would suggest a "dummy" defense to be a mute argument. Can it work again?

In the final analysis, it may be the accounting and legal professions that are really on trial in this case.

CONCLUSION

In companies where the founder continues as CEO the looming question is always whether the skills and risk perceptions needed to be a successful entrepreneur are the same ones needed to oversee a company as it grows, develops alliances, and assumes responsibility for a large network of shareholders, bondholders, and bankers. A principal characteristic of an entrepreneur is the willingness to take risks – and often huge risks. Whereas, operating a company requires significant risk averseness. Whether Scrushy was victimized by his own ego to control events by taking risks with the company's financial reports will be decided by the Birmingham jury of 12 currently hearing the prosecution and defense vastly different versions of the facts.

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END OF VOLUME 8, NUMBER 1

BEGINNING OF VOLUME 8, NUMBER 2

VOLUME 8, NUMBER 2

HOW OUR FIDUCIARY INSTITUTIONS HAVE BETRAYED OUR TRUST

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INTRODUCTION

The new millennium wasn't a year old when the foundations of the business world shook. Beginning with the Enron-Arthur Andersen scandal in October, 2001, ongoing revelations of fraud, sharp practices and misgovernance in corporate financial reporting, securities trading and CEO compensation have profoundly shaken the confidence of investors. Yet the loss of public trust was not solely attributable to the greed and ethical deficiencies of the perpetrators. Those failings, however regrettable, are expectable. Perhaps even more affecting to investors was the growing realization that their faith in the legal and regulatory oversight mechanisms that were established to monitor and prevent the kinds of misdeeds that occurred had been grossly misplaced.

Some of our most venerable fiduciary institutions have been culpable. The boards of large publicly-held corporations, public auditors (CPAs), brokerage houses, mutual funds, the New York Stock Exchange and the federal government have all contributed to investor insecurity. Shareholders from individuals to the giant pension funds no longer know whom, if anyone, they can trust.

Collectively, the breaches of trust by some of the major institutions undergirding the legal environment of business may have far-reaching and long-lasting consequences, the parameters of which remain to be seen as the scandals—and the responses to them—continue to unfold. This article identifies and discusses inherent conflicts of interest as a contributing factor to the scandals within each institution. Part I assesses the loss of trust among investors and the general public in these financial institutions, as measured by various surveys. Part II reviews the specific transgressions of trust that have aroused the investing public's sense of betrayal by the trusted institutions. Part III then discusses some of the major legal reforms, public and private, that have been implemented or proposed to prevent a recurrence and restore investor confidence.

MISPLACED TRUST

Evidence of eroding investor confidence among the 50 million Americans who own stock is unmistakable.[1] A recent Gallup survey said that 26% of U.S. investors are "less likely" to invest in mutual funds following disclosures of widespread improper trading at money-management companies.[2] The poll also said that 70% of investors "would consider" moving their investments out of funds named in the investigation; 20% said they would "definitely" move their money out of such funds.[3] In another poll, 43% of investors said dishonesty was the biggest issue facing the securities industry—up from 8% in 2001.[4]

A correlate recent survey found that 74% of the general public respondents indicated that their perceptions of a company's ethical behavior directly influenced their decision to invest in the company's stock.[5] Alarmingly, the study showed a yawning gap when comparing public perceptions with those of top executives from the nation's largest corporations. For example, 71% of the general public respondents said that, at best, "only some" of the top 1000 corporations in America operate in a fair and honest manner, 32% said "very few," and 6% said "none" operate ethically.[6] In contrast, 79% of executives surveyed believed that "most" or "almost all" of the top 1000 corporations in America are operating in a fair and honest manner.[7] According to the survey's author:

> *This survey only reiterates the immense impact of trust on our corporate economy. Companies simply cannot underestimate the destructive effects of ethical missteps on their short-term profits and long-term reputations. The findings of this study reveal that, despite the advent of regulatory measures and the compliance of a well-informed few, most organizations are just not doing enough to change long-standing and bitter perceptions among the lay public.*[8]

In Gallup's annual national poll of professions most admired for the honesty and ethics of their practitioners, only 18% of those surveyed indicated "Business executives," which was even better than "Stockbrokers" (15%).[9] Other polls reflect this distrust. Beginning in 2002, the Conference Board reported findings on public perceptions of the corporate scandals. Of the surveys addressing the prevalence of corporate wrongdoing, one survey found that 46% of the public believes: "Every company does this kind of thing, but only a few more will get caught."[10] In another survey, 79% felt that the practice of corporate executives taking improper actions to enrich themselves at the expense of their corporation was widespread.[11] When asked in the same poll who can be trusted, only 23% said "CEOs of large corporations," whereas 75% trusted "People who run small businesses."[12] And in a survey of employees, 37% said that in the previous year alone they had observed misconduct that they believed could result in a significant loss of public trust if it became known.[13]

Public consciousness of crises tends to congeal around particular symbolic events. When recalling the deeds that eventuated in former President Nixon's 1974 resignation, for example, most people would probable reference one botched break-in in the Watergate Hotel. Perhaps the events that most symbolize the nadir of the current wave of corporate scandals were the ousters of Harvey Pitt and Richard Grasso. Both were individuals in who were reposed large measures of public trust by virtue of their positions.

Harvey Pitt was chair of the Securities and Exchange Commission (SEC). The SEC is the primary federal government watchdog of corporate financial practices. But in November, 2002, Pitt was forced to resign because he had not revealed that his appointee to the Public Company Accounting Oversight Board (hereafter the PCAOB), the new regulatory body established by the Sarbanes-Oxley Act [14] to regulate public audits and financial reporting, had problems of his own in this area.[15]

Richard Grasso was chair of the NYSE. Amidst a continuing wave of scandalous reports of excessive CEO compensation—sometimes at failing companies—was revealed Grasso's outrageous $188 million compensation package. Grasso resigned under pressure in September, 2003.

THE TRUSTEES

The Public Accounting Profession

Although Arthur Andersen & Co. received the most notoriety, the entire public accounting profession was stigmatized by the corporate scandals. Enron, WorldCom and other corporate collapses were widely seen as a failure of the profession which is perceived as Public Watchdogs certifying the honesty and accuracy of corporate financial reporting.[16] The CPA firms whose incompetence failed to detect corporate reporting fraud were now rubber-stamps; the firms complicit in the fraud were foxes guarding the henhouse.

Critics maintained that the expansion of CPA firms into myriad new and highly lucrative non-auditing services (e.g., management and financial consulting) had compromised their objectivity. Simply put, a conflict of interests obtained. Some CPA firms succumbed to the conflict. In so doing, they breached their responsibility to those in the public arena who rely upon CPA certification of financial statements—existing and potential investors, lenders and the government—in favor of private gain.

Arthur Levitt, a former SEC chair, had railed for years against this inherent conflict of interest. But he needed (and sought) Congressional support to fix it. Formidable forces opposed him. The public accounting profession, especially the global accounting firms—whether it was the Big 8, Big 6 or Big 5—coveted its self-regulatory prerogatives in general and the substantial consulting revenues in particular.

In his book, *How the Accounting Profession Forfeited a Public Trust*,[17] Mike Brewster details how the profession's trade association, the American Institute of Certified Public Accountants (hereafter the AICPA), fought Levitt's proposal—even after enactment of the landmark Sarbanes-Oxley Act, the reform legislation passed in 2002 in reaction to the scandals. Sarbanes-

Oxley threatened the public auditing industry in two major respects. First, it threatened the industry's autonomy. Second, it specifically endorsed the Levitt proposal by outlawing public auditors from performing a wide variety of non-auditing consulting services to their auditing clients.[18] The AICPA hired lobbyists to recruit Congressional legislators sympathetic to the profession, including Representative Michael Oxley (R-Ohio). Writes Brewster: "There may be no greater irony in the wars of accounting reform than Oxley's name being attached to the legislation, as it endorses essentially what Arthur Levitt wanted in 2000, which is just about everything Oxley had fought against on this issue."[19]

After WorldCom announced in June, 2002, that it had overstated earnings by $3.6 billion, any major resistance to the reform withered.[20] So the AICPA and its allies tactics and fought a rearguard action to weaken the implementation and enforcement of the law. To do this, it was critical they get the right person to head the PCAOB. The original choice was John Biggs, the retiring head of TIAA-CREF. Biggs was a staunch advocate of accounting reforms, including banning firms from selling non-auditing services to their audit clients. When word got out that Biggs might actually want the PCAOB to ignore AICPA recommendations and write its own rules, most importantly the ban on consulting services for audit clients, the AICPA lobby and its friends in Congress and the White House pressured Pitt to rescind the offer.[21]

An undercurrent of the resistance to Biggs was the fear that he would reintroduce the search for fraud as a primary duty of auditors. The industry's aversion to this was probably impelled by concern over jeopardizing the new, lucrative consulting service. If public auditors were more diligent in the search for client fraud, that would create a more adversarial relationship between auditors and management—not exactly conducive to chummy consulting contracts with the same firm. Nevertheless, the public trust in CPA certifications of corporate financial statements supports the need for auditors to look beyond mere compliance with Generally Accepted Accounting Principles and actively search for client fraud.

Corporate Boards

Enron, WorldCom, Tyco, Qwest, Adelphia: What these and other members of the corporate scandal Hall of Infamy shared were top managements whose corruption resulted in monumental losses to shareholders and employees. Their sins range from overstating corporate net income to looting their corporations' assets. In each case, the structural problem was the failure of the institutional oversight mechanism to detect and rectify the wrongdoing. That mechanism is the corporate board of directors, whose primary role, at least in theory, is to monitor top management so as to ensure that the law is followed and the corporation is run for the benefit of the shareholders and other stakeholders. In short, the board of directors is responsible for corporate governance. The resounding failure of numerous boards to meet that responsibility has created a corporate governance crisis in the United States.

In a perverse corruption of intention, many boards of directors are de facto selected by the top management they presumably monitor. A board hand-picked by, and often including members of, top management is unlikely to perform its oversight function with independence and dispassion. Indeed, CEOs of top corporations often are also the chairs of their boards of directors. All of this is effectuated by top management's control of the proxy process. In board of director elections, those shareholders voting by proxy are usually given no alternative to the slate of candidates proposed by management.[22] The allegiance by directors to their management sponsors creates a conflict of interest that is at the nub of the current crisis, and that is the impetus for reform.

Even those directors who were truly independent often lacked the financial sophistication or the support staff to detect the reporting abuses by top management. Some of the abuses were tactics that a first year accounting student would easily discern, such as capitalizing expenditures that should have been expensed.[23] Other devices—such as Enron's off-balance sheet special purpose entities—were so abstruse that CPAs would have difficulty descrying them. Boards and their audit committees have the responsibility of appointing and overseeing the corporation's external auditors. The significance of this function cannot be overstated, for if potential investors cannot rely upon the accuracy of the corporation's financial statements, they invest at their peril.

In many instances, the reason for the breakdown in corporate governance was obvious. Many directors simply did not put in the time and effort to do their jobs. There was little pressure to do so during the market boom of the 90s. But when the boom turned to bust, investors sought companies with competent boards of directors. The growing list of companies engulfed in scandal fueled a corporate governance revolution.[24]

Probably no other manifestation of the failure of corporate governance has caught the public eye—and its ire—more than the soaring levels of executive compensation. *Business Week* called astronomical executive pay "the most egregious governance failure of the 20th century."[25] The most controversial executive compensation packages contain more than huge salaries. Options to purchase company stock at well below market value, a variety of low-interest or no-interest loans, huge signing bonuses and enormous severance packages were commonly implicated. Stock options were the most consequential. During the go-go 90s, companies lured top executive talent by offering large quantities of low-priced options. That, in turn, incentivized the executives to manipulate corporate earnings, because higher earnings were reflected in the company's stock market value.[26]

Most galling to shareholders and laid-off employees were the big compensation packages awarded by corporate boards to executives whose corporations were foundering. Shareholders and employees questioned what it is for which these executives were being rewarded. A recent study found that the CEOs of companies that had the largest layoffs, the most underfunded pensions and that had moved their operations offshore to avoid U.S. taxes were rewarded with the largest pay hikes in 2002.[27] The same study noted a growing trend of another troubling practice: corporations are sheltering their executive retirement plans with special trusts that are not subject to the same risks as are the pension plans of rank and file workers. In essence, these are guaranteed golden retirement packages. Corporate boards secured the executive retirement even as the retirement funds for other workers were sinking.[28]

A salient indicator of excessive CEO compensation is the ratio of mean CEO compensation to mean employee compensation. In 1982, the ratio was 42:1.[29] By 2000, the ratio was 531:1.[30] Because there is no correlation between the growth of CEO compensation and other relevant markers such as increase in worker pay, the performance of the S & P 500 or the rise in corporate profits,[31] much of the public is understandably alienated. A Harris poll taken in October, 2002, found that "87% of all adults believe that most top company managers are paid more than they deserve, and that they become rich at the expense of ordinary workers."[32]

Corporate America's reputation remains tarnished. A recent public opinion survey by Harris Interactive and the Reputation Institute, a respected New York-based research group, found the standing of public companies precariously low. Three-quarters of the respondents graded the image of big corporations as "terrible" or "not good."[33]

Yet public anger over bloated executive compensation packages, stoked by the loss of approximately $7 trillion in stock market value since the 2000 peak,[34] seemed not to have had much impact on corporate boards. Until recently. The revelation of Richard Grasso's pay package at the NYSE bids fair to epitomize the insensitivity of corporate boards.

The New York Stock Exchange

One would have thought that as the principle regulator of the nation's biggest companies the NYSE would want to lead by example on matters of corporate governance. Amidst all the furor over excessive executive compensation, news of Mr. Grasso's pay package shocked the business community. Grasso was not just another CEO. He was the chair of the organization that symbolized American capitalism. His ouster did not mollify critics who, with increasing numbers and intensity, called for a reexamination of the governance structure of the NYSE.

The NYSE says it is "the most active self-regulator in the securities industry."[35] As a national securities exchange, it is "affected with a public interest" under the Securities Exchange Act of 1934, which requires the SEC to oversee it "to insure the maintenance of fair and honest markets."[36] The NYSE has two principal functions: as a marketplace for securities transactions, and as a regulator. It is a self regulatory organization (SRO) in four areas: governance and disclosure of listed companies; surveillance and discipline of its own markets, specialists and floor brokers; financial and operational compliance of member firms; and fair and equitable treatment of customers.

Critics have suggested that the NYSE's main competitor, the National Association of Securities Dealers, Inc. (NASD), has a structural governance model that the NYSE would do well to emulate. NASD bifurcates the two stock exchange functions: NASD's marketplace is the all-electronic Nasdaq stock market; its regulatory arm is NASD Regulation (NASDR).[37] In contrast, the combined NYSE functions of marketplace and regulator created a conflict of interest in governance.[38] That's because the NYSE board of directors was dominated by securities industry members and executives from listed companies—the same 1366 seat-holder members that control and own it. This lack of independence was cited as the *sine qua non* for Grasso's pay package. Further, abandoning the trading floor for a Nasdaq model would address complaints that the floor specialists on the NYSE have engaged in insider trading. In December, 2003, the California Public Employees Retirement System (CalPERS) filed a civil suit against the NYSE and its seven specialist firms alleging self-trading practices that have cost U.S. investors $150 million over the last three years.[39] The suit also alleges that the abuses were abetted by a lack of NYSE oversight. Here too, the conflict of interests are rife because specialists help run the NYSE, which is charged with regulating the specialists.[40]

Brokerage Firms

In April, 2003, ten of the country's biggest brokerage firms entered into a $1.4 billion settlement agreement with federal and state regulators. The abuse that led to the settlement was the touting by brokerage firm analysts of the stocks of companies with which the brokerage firms did highly profitable investment banking business. Even the stocks of companies not highly regarded by the brokerage firm would get a "Buy" recommendation if they employed the firm to do their investment banking. Of course, many of the firm's regular customers relied on these bogus recommendations to their severe detriment. In addition, the firms would reserve hot IPO shares and issue bogus research for the executives of companies that provided investment banking business.[41]

Although the settlement fund provided some restitution, many of the brokerage firm customers were badly burned. As with most breaches of financial trust, the motivation lay in a conflict of interest. However hefty, the settlement did nothing to address the source of the problem. "It will be very difficult to get rid of the inherent conflict as long as the investment banking and research functions happen under the same roof," said Andy Ratkai, president of the Praxis Advisory Group. "I don't think it will fundamentally change the way business is done on Wall Street."[42]

Ratkai's prediction rang true. Seven months later, another wave of scandals racked brokerage firms. Again the key issue was abuse of individual investors' trust in Wall Street. The charges were familiar. In November, 2003, brokerage giant Morgan Stanley agreed to pay $50 million to settle SEC charges that it had received secret payments from mutual funds in return for promoting their funds to investors over those offered by competitors.[43] Morgan Stanley wasn't alone. In January, 2004, the SEC said it found that 13 of 15 major brokerages it examined appeared to emphasize sales of funds that made special payments to the firms.[44] The practice is known in the industry as "pay to play" or paying for "shelf space"—a reference to the financial inducements given by consumer products companies to supermarkets for high-profile placement of products on supermarket shelves. In December, 2003, the NASD fined several brokerages for issuing bogus stock research that misled investors. Some of the brokerage analysts touted stocks that they privately predicted would fail.[45] Both the NASD and the SEC are pursuing a dozen investigations into brokerage firms charged with participation in these fund-touting arrangements.[46]

An annual survey by the Securities Industry Association shows that clients of brokers are increasingly concerned that their brokers are succumbing to the conflict of interest created by the receipt of special payments they receive from funds. The percentage of investors feeling this way has climbed from the high 30s in 1999 to 61% in 2003.[47] A principal at Morningstar fund research characterizes these "revenue sharing" arrangements as either bribes by mutual fund companies to spur sales or blackmail by the brokerages.[48] Although much of the pressure to disclose these arrangements has been placed on the mutual fund firms, some industry analysts feel this allocation of responsibility is misplaced. The onus, they say, should be on the brokerages to tell their customers everything affecting their recommendations, especially revenue sharing payments received from mutual funds whose portfolios are being recommended.[49]

Mutual Funds

A good deal of the recent negative press—and the related loss of investor faith—relates to deals that brokerages struck with members of another traditional institution of investor trust—mutual funds. The NASD gave the contested deals a new term: "directed brokerage." Yet the new term was simply attached to an old practice with a new partner. Directed brokerage refers to the following quid pro quo: a mutual fund sends ("directs") trading business to a brokerage firm in exchange for the firm aggressively marketing the funds, e.g., putting it on a preferred list, to brokerage clients. The NASD and SEC ban undisclosed directed brokerage, a practice that may also violate securities law.

Brokerage firms were also major facilitators of another mutual fund scandal, this one involving massive-scale trading abuses. Mutual funds hold $7 trillion dollars of investment money from 95 million Americans.[50] In September, 2003, much of the presumed safety of that investment from trading abuses by fund managers and brokers was revealed to be little more than a chimera. Federal and state regulators charged several funds with improper trading practices that favored fund managers, brokers and favored clients (such as hedge funds) at the expense of the mass of regular fund investors.

One of the practices, late trading, is clearly illegal. Late trading occurs when a fund permits trades after the official 4 PM (EST) closing time. The obvious advantage is that information arising after the closing time that affects the price of the fund allows the late trader to make sure-fire gains on purchases or sales.[51] Other fund investors are hurt because the fund is in essence selling to the late traders at an unfairly low price or buying at an unfairly high price, thereby taking profits from the long-term investors.

The other trading abuse is market timing. The usual form this practice takes is when the market timer buys international funds whose price is determined by foreign stocks whose markets close 12 or more hours earlier than the 4 PM U.S. closing time. Thus the US closing price does not reflect changes that occur after the close of the foreign market. When information arising during that time gap creates a high probability that the fund price will go up the next day, the market timer buys before the closing time, when the price of market funds are set, and sells the next day. This quick, in-and-out trading is called arbitrage.

The legality of market timing is unclear. Although not illegal *per se*, it is widely considered unethical.[52] That is why almost all funds claim to have policies prohibiting it. But their actions belie their words. The SEC recently said that about half of mutual fund companies (and 30% of broker-dealers) engage in market timing. Other estimates are higher. Eric Zitzewitz, an assistant professor at Stanford who has studied mutual funds, said 90 percent of the mutual funds in his sample engaged in market timing.[53]

Each trading abuse not only skims profit from the fund, it also causes the fund to incur higher transaction costs. Professor Zitzewitz estimates that the two scams cost the funds about $5.4 billion yearly, most of it attributable to market timing, which is far more prevalent.[54] The beneficiaries are the preferred customers, e.g., hedge funds, whom the fund allows to late trade or market time, or brokers or fund managers or fund executives who trade for their personal accounts. In so doing, the responsible fund managers or executives violate the trust placed in them as stewards of those investments. “We’ve turned an industry of stewardship into an industry of salesmanship,” said John Bogle, founder of the Vanguard family of mutual funds.[55]

Revelations of mutual fund trading abuses have spurred litigation. Just after NY Attorney General Eliot Spitzer announced his settlement with Canary Capital, one of the major hedge funds involved in trading abuses, the mutual funds involved with Canary—Bank of America and Janus Capital Group—announced that investors would be make whole if losses were confirmed.[56] Rather than placate the investors, this announcement spawned a series of federal and state class action lawsuits by fund investors whose funds permitted late trading and market timing.[57]

Just as the investing public was digesting—no doubt with a large measure of dyspepsia—the news of these trading abuses, another scandal hit the industry. Beginning in September, 2003, revelations poured forth that mutual funds had been overcharging their investors, probably in amounts that dwarf the expenses associated with trading abuses. The overcharging was undisclosed and effectuated in several ways. Purchasers of large blocks of shares who were entitled to "break point" discounts were often not advised of the discounts, nor credited with them. Another large but undisclosed credit is that received from brokers in the form of "soft dollars"—credits that are spent on various services, e.g., research, computer support, office rent.[58] The credits are typically given to a fund in exchange for the extra trading fees it gave to brokers for directed brokerage. These extra fees are estimated to be in the billions of dollars.[59] Fund companies are willing to pay them because they don't have to be explicitly reported to investors.[60] Thus mutual funds were the frequent collaborators in the scheme that caused many investors to buy funds on the advice of their brokers—advice often given not because of the quality of the funds, but because of kickbacks.[61]

Because extra trading costs are passed on to the consumer without their knowledge, mutual fund managers that engage in directed brokerage have little incentive to hold down the related costs. Yet such costs could easily be lowered. Electronic trading, for example, could halve commissions paid on directed brokerage, per a 2003 poll of 34 mutual fund companies.[62]

The driving force behind exposing the substantial hidden costs to mutual fund investors has been Eliot Spitzer. He has given a public tutorial on the underlying conflict of interest that has impelled the mutual fund scandal. "In most if not all cases," Spitzer says, "the chairman of the fund's board of directors is affiliated with the management company. And even the fund's so-called independent directors are often people who have joined the board after retiring from a job at the management company."[63] Mutual fund directors hire outside managers. The management firm is paid a percentage of the funds under management. If the amounts invested in the fund rises, so does the manager's compensation. That, in turn, led to managers' insistence that traders engaged in late trading or market timing had to increase the amount of money invested in the fund—so-called "sticky assets." This was profitable for the managers, but bad for the investors, who lost money as a result of these activities.[64]

But the greatest loss to the investors comes from advisory and management fees charged by the fund managers. According to Section 36(b) of the Investment Company Act of 1940, "the investment advisor of a registered investment company shall be deemed to have a *fiduciary duty* with respect to the receipt of compensation for services."[65] Simply put, that means that fund directors are legally obliged to ensure that fees are reasonable and not excessive.

Spitzer notes that in 2002, investors paid over $50 billion in advisory fees and almost $20 billion in other management fees.[66] Yet mutual funds pay about a quarter of a percent more than pension funds for the same advice. That is substantial; it means double what pension funds pay. The factual source of Spitzer's charge comes from a published study that cites as the underlying cause of the disparity the conflict of interest in the typical mutual fund board of directors.[67] They are supposed to act in the interest of fund investors but are often financially tied to the managers who get the advisory fees. According to Bogle, "[T]his data can only be explained by the fact that mutual-fund boards do not engage in arms-length negotiations [over fees] with the investment advisers."[68] Writes Spitzer:

The reason mutual fund investors pay a higher rate is simple: their directors don't put the contract out for bid. Instead, the contract is invariably given to the management company that the fund directors are affiliated with.[69]

Another way of looking at the conflict of interest is by juxtaposing the interests of the investors of a mutual fund with the interests of the directors and managers. The investors own the money in the fund but not the fund itself. They make money when the stocks that comprise the fund holdings go up. In contrast, the real owners of a fund are the shareholders in the fund company. They make money by fees paid to the fund and the fund managers by investors.[70] These potentially conflicting interests and the undisclosed status of the fees lead, perhaps inevitably, to the directed brokerage epidemic. Now SEC regulators are claiming that the perpetrators violated SEC disclosure requirements.

The impact of the mutual fund scandal on investor confidence remains to be seen. Government hearings will shine a light on the abusive practices, but will that alienate more potential investors or assure them that the practices will be curbed? Key to the answer is whether and to what extent the underlying conflict is mitigated. U.S. Senator Peter Fitzgerald (R-Ill.), chair of the Governmental Affairs subcommittee on Financial Management, the Budget and International Security that held hearings on the scandal, calls the mutual fund industry the world's largest skimming operation. "The governance structure of a typical mutual fund is a study in institutionalized conflict of interest," he believes. "Until we eliminate the conflicts, lots of mutual funds will continue to engage in behavior that benefits fund managers at the expense of fund shareholders."[71]

In the meantime, employees and the sponsors of employee retirement programs who invest most of the funds will reevaluate whether to continue mutual funds as their primary investment vehicle. One important factor in that decision will be investor confidence. David Wray, president of the Profit Sharing/401(k) Council of America, says the malfeasance by mutual fund companies, "threatens to erode the trust tens of millions of American workers have in their profit sharing, 401(k), and other employer retirement programs."[72]

The SEC

As the ultimate regulatory overseer of the financial markets, the SEC shoulders the greatest fiduciary responsibility to the public. Yet recent events suggest to many that the trust reposed in the agency has been distinctly undeserved. Prominent among these events was the mini-scandal that led to the ouster of former Chair Harvey Pitt.

Prior to his appointment to the SEC, Harvey Pitt had close ties to the accounting industry. As a partner in a law firm, he had represented the AICPA and each of the Big Five. Consequently, his objectivity and intentions with regard to policing the public accounting profession was suspect. This impression was reinforced when he rescinded the PCAOB head job offer to accounting reformer John Biggs, and instead offered it to William Webster.[73]

Webster was popularly known as the former head of both the CIA and the FBI. But far less known was that only two years before his appointment to head the PCAOB he had been the chair of the audit committee of U.S. Technologies. As part of his compensation package, Webster was given 650,000 options to purchase shares of U.S. Technologies at significantly below the market price.[74] At the time, U.S. Technologies was in trouble with its public auditor, which was about to issue a "going-concern" qualified opinion that would have been devastating for the company. In response, the U.S. Technologies audit committee, headed by Webster, fired the auditor and went auditor-shopping.[75] Pitt had not apprised the other commissioners on the SEC of Webster's firing of U.S. Technologies' auditor. When Webster's involvement with U.S. Technologies became a front-page scandal, both Pitt and Webster were forced to resign their respective positions, and the SEC was left with a monumental black eye.

Often, criticism of the SEC is for not doing the right thing, or enough of the right thing, rather than for taking wrongful action, as in the Pitt-Webster-PCAOB affair. Simply put, the claimed failings of the agency are usually omissions, not commissions. Take, for example, the prevalent lack of independent corporate directors that many believe enabled the scandals. The only practical way to elect independent directors is to allow non-management shareholders to nominate director candidates whose names will appear in the annual corporate proxy statement ballots sent to shareholders. Yet for more than six decades the SEC has declined to pass rules enabling that much-needed proxy reform.[76] Without access to proxies, dissident candidates have virtually no chance of success.

After the corporate governance scandals, the SEC finally came forward with a proxy access proposal. But to the pension funds of California, New York and several other states, the proposal was anemic. The main concern was the "trigger" conditions that had to be met under the proposal before shareholders could obtain the right to place their own board nominees on the corporate proxy ballot. One such trigger was the requirement that the nominating shareholder have owned at least 5% of the company's stock for at least the two previous years. That's a huge threshold, especially at large, S&P 500 companies, one that even institutional investors may not meet.[77]

Another assessment of "too little, too late" was with respect to SEC action on the mutual fund scandals. For instance, when the SEC finally proposed regulations in December, 2003, to prevent late trading and market timing, critics charged that the proposals had been urged on the SEC by consumer advocates for years.[78] Over that time the SEC did nothing, though repeatedly warned that the trading abuses skimmed profits from mutual funds.[79] According to an SEC spokesman, the agency staff could not recall a single late trading enforcement action.[80] Further, lawmakers have asked why state regulators, e.g., Elliot Spitzer, and not the SEC, first uncovered evidence of the trading abuses in the mutual fund industry.[81]

The SEC has been especially criticized regarding its failure to address the excessive advisory fees charged by mutual fund managers, particularly those collected during the time they were permitting improper trading. In November, 2002, the SEC settled charges against the giant mutual fund, Putnam Investments. The company had been accused of defrauding investors by allowing its own managers to engage in abusive trading. William Galvin, Massachusetts's chief securities regulator, and Elliot Spitzer both trashed the Putnam settlement, calling it premature and meek.[82] Galvin said the settlement "shows the SEC is more interested in papering over wrongdoing than uncovering it."[83] Spitzer censured the SEC for not demanding a return of the advisory fees taken by Putnam during the time that the company was permitting improper trading, and for failing to take action to ensure the fairness of future fees.[84]

More than just criticizing, Spitzer was conspicuously able to walk the walk where the SEC didn't. The following month (December, 2003), Alliance Capital Management settled a trading abuse probe by Spitzer and the SEC by agreeing to cut their fees by $350 million and paying $250 million in fines and retribution. In addition, Alliance agreed to cut fees on all its funds by 20% for the next five years. Spitzer had insisted on the fee reductions as a condition of settlement. In stark contrast, the SEC did not ask for fee reductions. Its position has been that requiring fee reduction would be tantamount to setting fund fees, which it feels would be improper for a government agency.[85] Thereafter, other fund firms agreed with Spitzer to settle trading probes by lowering their fees. The Alliance settlement specifically required the company to hire a fee overseer to ensure the company sought competitive bids on fund management fees if the fee overseer deemed the fund's management company to be charging fees that were unfair to the shareholders.[86] This pattern repeated in March, 2004, when Bank of America and Fleet Boston (a bank that B of A is buying) agreed to a record $675 million settlement with the SEC and Spitzer. The agreement resolved charges that the banks' mutual funds had allowed Canary Capital and other favored clients to engage in billions of dollars of trading abuses to the detriment of less wealthy clients. Of that settlement amount, $160 million was a separate accord with Spitzer only to reduce fund fees over five years.[87]

Other criticisms further evidence the reluctance of the SEC to take needed remedial measures. For example, in the summer of 2003, the SEC opposed the idea of requiring board chairmen of mutual fund companies to be independent from the companies managing the funds.[88] Yet this relationship is at the core of the conflict of interest plaguing the mutual fund industry.

Another pertinent criticism of the SEC has been its inaction on the proposal to expense stock options. As noted above, the stock option compensation of top executives is widely perceived as tempting those executives to pump up stock prices by escalating corporate earnings. When stock option compensation is expensed on the corporate income statement, however, the temptation to offer it is all but vitiated because of the negative impact on corporate net income. In 1994, the accounting profession's standard-setter, the Financial Accounting Standards Board (FASB), proposed that stock options be expensed. But the SEC rejected the proposal.[89] In the wake of the corporate scandals, the expensing of stock options proposal has arisen again in 2004. To date, the only SEC Commissioner voicing an opinion on it has opposed the idea.[90]

REFORMS

Public Accounting Firms

The primary reform vehicle of public accounting, of course, has been the Sarbanes-Oxley Act. Included in it are major restrictions on public auditors, who now must register with the PCAOB. The most significant of these restrictions seek to reestablish the independence of the auditors from their audit clientele by establishing conflict of interest rules. To that end, auditors are prohibited from offering eight specific types of consulting or other non-audit services to their audit clients.[91] Also, the lead audit partner must rotate off an audit every five years.[92]

Both of these measures, however, fall short of more drastic but undoubtedly more effective measures. For instance, auditors can still provide tax and other non-prohibited services to their audit clients if the audit committee of the client approves.[93] Yet it betrays great naiveté to believe that providing tax return and tax advisory services for a client does not foster a conflict of interest if you audit the same client. The SEC had proposed adding tax advisory services to the list of prohibited services, but backed off after harsh attacks from accounting firms.[94] And one has to wonder why the law allows the PCAOB to grant specific exemptions from the eight prohibited non-audit services.[95]

With respect to rotating the lead auditors, the objective was to prevent sweetheart relations between auditors and the audited. Then why bar just the lead auditor and not the entire audit company itself? As a middle ground, the SEC had originally proposed requiring all partners on the audit team, not just the lead auditor, to rotate every five years. But again the SEC bowed to complaints from accounting firms that the original proposal was too burdensome.[96]

Corporate Boards

The relationship between top management and the board of directors has been the most commonly cited reason for the failure of corporate governance. Simply put, corporate boards are too often in the thrall of their corporations' CEOs. Boards are often weak, inattentive, inept at understanding complex financial matters and too likely to rubber-stamp the position of top management. Most importantly, they are frequently beholden to the same management that they are supposed to be monitoring. Reform proposals, therefore, tend to focus on constraining the power of the CEO, and increasing the independence of directors, while fortifying board oversight wherewithal and responsibilities.

Most of the corporate governance reform measures relate to one of three categories: CEO accountability, board of director independence or executive compensation. In the first category, CEOs unchecked by their boards have run amok, overstating net income and rewarding themselves with huge compensation packages. Thus the Sarbanes-Oxley Act requires CEOs first, to certify the accuracy of the corporation's financial statements,[97] and second, to disgorge any bonuses or profits on sale of the company stock in the year after issuing financial statements that must be restated due to material noncompliance.[98]

The CEO certification and penalty provisions are really just stopgaps measures to staunch further corporate fraud until more structural reform is effected where most needed—in the corporate boardroom. Specifically, boards must become more independent of CEO influence in order to realistically exercise effective monitoring of management, and thereby regain public and investor confidence—hence the second category. To this end, Sarbanes-Oxley requires that public companies have Audit Committees comprised entirely of directors who are independent of the company, and who shall be directly responsible for the appointment, compensation and oversight of the public auditor.[99]

Other than on audit committees, Sarbanes-Oxley does not mandate any change in the percentage of independent directors on public company boards. Nevertheless there has been a perceptible—if peace meal—movement in corporate America to more independent directors in the wake of the financial scandals.[100] Yet the response has not been enough to impress the SRO exchanges, whose reputations have already been tarnished. New corporate governance rules proposed by the NYSE and Nasdaq have been approved by the SEC. Under the new rules, the boards of listed companies must have a majority of independent directors. Further, independent directors would be given exclusive decision-making authority not only over audit committee matters (as required under Sarbanes-Oxley), but also over executive compensation and nominating/corporate governance committees.[101]

Mandating independent directors is one thing; providing them is another. A major initiative to realize this desideratum has been proxy reform. As mentioned above, the SEC has finally endorsed a proxy reform proposal. Critics of the proposal, especially institutional investors, claim the proposal falls short. The key issue is the threshold minimum 5% ownership requirement. At the least, the proposal legally prescribes a procedural mechanism by which some shareholders can require that their candidates for directorships be placed on the proxy ballot. Yet to be determined is whether any corporations will, in the name of corporate governance, voluntarily lower the standards.

A final category of corporate governance reform measures addresses executive compensation. Sarbanes-Oxley addresses one area of abuse by barring loans to directors and officers.[102] The central issue, however, is whether stock options will—willy-nilly—be expensed. For the granting corporation, options are the ideal executive compensation: they are deductible for tax purposes, yet they are the only substantial form of compensation that does not have to be expensed on the corporate income statement. They've enabled corporations to make their top executives—who are the primary beneficiaries—instant millionaires without any corresponding expense reportable on the corporations' income statements. Just like magic.

Inasmuch as corporations do not write checks when granting options, they argue that there is no cost and thus nothing to expense. (In fact, they have a cost to other shareholders because once exercised, they dilute the value of existing shares.) Writing in Fortune magazine, Justin Fox has termed this, "the mother of all accounting abuses."[103] "Because options are 'free,'" Fox continued, "they came to constitute the bulk of CEO pay in the 1990s, which in turn helped spur the over-the-top greed and sick obsession with stock prices that afflicted far too many top executives."[104]

By not expensing options, the market and shareholders are being kept in the dark as to real corporate net income. For example, in 2001, expensing would have reduced the earnings of the S & P 500 by 21%.[105] In the same year, had options been expensed, Dell's earnings would have been reduced 59%; Intel's 79%; Cisco's 171%.[106] Because of this considerable downward impact on net income, stock options would clearly be far less prevalent if they were expensed.

In 1994, FASB considered the non-expensing of options to be deceptive accounting, and was prepared to put out a rule that would require that companies expense options at their fair market value. But strong lobbying by the business community—particularly Silicon Valley—and by the accounting profession defeated the proposal.[107] Instead, they were relegated to a mere requirement of mention in the financial statement footnotes. "What it came down to," observes Fox, "was that the powers that be in American economic life decided that dishonesty in the service of prosperity was no vice."[108]

Notwithstanding the political victory over the proposed expensing rule, a growing number of corporations are voluntarily expensing options.[109] And Microsoft may have set a trend by discontinuing options in favor of restricted stock grants tied to performance targets, not stock prices.[110] The restricted stock grants are to be expensed.

Now, ten years after the original setback, FASB is again proposing a rule mandating the expensing of stock options.[111] And the opposing forces are again mounting their counter-attack. The battle promises to be instructive as to the robustness of the reform movement.

The new and proposed regulations notwithstanding, there is an ineluctable limit to the efficacy of legislating honesty and ethicality. Some corporate governance experts fear that corporations are simply going through the motions of compliance without appreciating the moral imperative behind the changes.[112] Litigation may be the remaining—and perhaps most affecting—impetus for reform. Already there has been an increase in lawsuits naming directors and officers as defendants. Directors and officers insurers have responded by tightening terms, seeking to rescind policies, reducing coverage amounts and significantly increasing rates.[113]

The New York Stock Exchange

In September, 2003, John Reed succeeded Richard Grasso as chair of the NYSE. (Reed has been deemed an interim chief.) Shortly thereafter he proposed to the SEC a governance reform plan for the Exchange, which was approved by the SEC in December.[114] Its major features are:

> *Separation of the jobs of chair and CEO*. This was to reduce the concentration of power in one person, a direct response to the Grasso scandal.
>
> *A new, independent board of directors*. Members are to be free of ties to the exchange's management, members or listed companies.
>
> *A new advisory board*. The panel comprised of the chair and representatives from Wall Street firms and NYSE-listed companies will advise the board of directors.
>
> *A new autonomous regulatory office*. The office would assume regulatory duties and report to a committee of the independent board.

The plan was immediately assailed by the large public employee 401(k) investors, such as CAL Pers, CAL STRS and the mutual fund industry. The most prominent criticism was of the lack of public institutional investors on the reconstructed board.[115] Another criticism was the continued absence of an outside regulatory body; i.e., no separation of the Exchange's regulatory function from its business functions.[116] Other than this potential structural flaw, any evaluation of the adequacy of the proposed reform must await the performances of Reed's successor and the new board.

There have been some promising developments. In February, 2004, an S.E.C. investigation showed that some trades by the Big Board's specialist firms were done at their customers' expense, resulting in a $240 million settlement by the firms and calling their role into question.[117] And in response to the Big Board's promise to allow investors to nominate directors as part of the broader effort to reform its governance practices, it accepted CalPERS' nomination of the reform-minded Arthur Levitt to its new governing board.[118]

Brokerage Firms

If there is reform in the brokerage industry, it will be exogenous. In January, 2003, the SEC proposed rules that would require broker-dealers to provide customers with information about costs and conflicts of interest both at the point of sale and in transaction confirmations. The costs include front-end and deferred sales fees, as well as other costs that would directly impact the returns earned by investors.[119] The conflict of interest information would include broker compensation for selling the securities, including any revenue-sharing arrangements with the funds whose securities are being sold. Any extra compensation received for selling particular fund shares would also have to be disclosed.[120]

Mutual Funds and the SEC

Most of the current reform proposals before the SEC relate to the mutual fund scandals. A passel of mutual fund reform measures are before the SEC. Simultaneously, there are several bills before Congress addressing mutual fund abuses. One is hard put to see any coordination between the two bodies.

Not surprisingly, the mutual fund industry's main trade group, The Investment Company Institute (ICI), has been cool to most of the proposals. But in at least one instance it has urged the SEC to impose reforms. In December, 2003, the ICI called on the SEC to restrict soft-dollar kickback deals between mutual funds and brokerages. The excessive commissions involved in these arrangements are ultimately charged to fund investors, in large part because trading fees do not have to be explicitly reported to investors.[121] And the ICI recommended an outright ban of directed brokerage. The ICI's proposals received a cynical response from some industry experts who believed the ICI was motivated by a fear that the SEC would impose even greater restrictions, such as a complete ban on soft-dollar arrangements.

Although the SEC did not propose a ban on soft-dollar deals, it did propose a rule requiring disclosure of the details of such deals. Disclosure rather than bans, fee-setting and other forms of substantive intervention has apparently been the polestar of the SEC regulatory response to the mutual fund/brokerage abuses. For example, another disclosure proposed by the SEC in December, 2003, is of the break point discount an investor earns when buying large a large block of shares.[122]

Some other noteworthy proposals the SEC has proposed for public comment or is planning to consider in early 2004 address mutual fund trading abuses. The rule relating to late trading requires that buy and sell orders from mutual fund investors be delivered to the fund or be well on their way by the 4 PM closing time. Market timing is addressed by proposals of a mandatory fee on short-term trading and disclosure of policies on market timing (proposed by the ICI). Personal trading by fund managers and other insiders is addressed by a rule requiring disclosure of such transactions.[123]

A separate set of proposals respond to the widespread conflict of interest within mutual fund companies.[124] One would mandate independent chairs for fund boards of directors. Another would raise the required share of independent directors from a majority to three-fourths, with independent directors hiring their own staffs. Finally, the board must hire a compliance officer reporting directly to the board, circumventing potentially corrupt fund managers.[125]

The agenda set by the SEC clearly evinces a willingness to tackle the problems in the mutual fund industry. But some question whether the measures proposed are adequate. Spitzer, for example, has said that the most serious problem is excessive advisory fees. To this end, he has called on mutual fund boards to earn back investor trust by negotiating lower management and advisory fees. They can do this, he claims, by obtaining multiple bids, and by insisting in their contracts that the fund is getting the lowest fee charged, known as a “most-favored nations” clause.[126]

Spitzer charged the mutual fund industry with resisting reform, and insisted that legislation was necessary to curb its abuses. His clear implication is that the SEC was not doing enough. The SEC rules were also scored by the General Accounting Office, which reported to Congress that more extensive rules were necessary to increase the transparency and disclosure of fees.[127]

Even critics of the SEC cannot gainsay that the agency is getting tougher on mutual fund and brokerage abuses. In February, 2004, for example, the agency proposed a ban on directed brokerage payments to brokers. Previously they had merely recommended disclosure of such arrangements.[128] In the same month, they approved a new requirement that funds enhance their disclosure of the fees they charge investors.[129] And in April, 2004, they passed a rule requiring fund company disclosure of risks that shareholders might face from market-timing. Further, the companies will have to explain in their prospectuses whether a fund board has policies governing market-timing trades, and if not, why not.[130]

But is tougher tough enough? Not to Senator Fitzgerald and other proponents of greater regulation of advisory fees. Consider: The SEC’s proposal is to require that mutual funds tell shareholders twice a year about the typical costs associated with a $1000 investment. In contrast, proposed legislation by Fitzgerald would require funds to inform investors about the *actual* advisory costs they paid, not a hypothetical amount.[131] Consider further the relative positions on the controversial SEC rule 12b-1, which allows funds to pass on marketing costs to shareholders: the SEC has agreed to study the rule; the Fitzgerald bill would kill it.[132]

Only time will tell what magnitude of reform in all of these wayward institutions will woo back investor trust. What is certain is that the faith and goodwill with which many regarded our major financial fiduciary institutions is now an artifact of an innocent past.

ENDNOTES

1 Joe Lauria, “America No Longer Flinches at Sight of Wall Street in Handcuffs,” *Sunday Business* (London), 11/30/03. http://0-web.lexis-nexis.com.

2 “Polls: Scandal Eroding Investor Confidence,” *Los Angeles Times*, 11/7/03, C4.

3 Id.

[4] Id.

[5] "Attitude Toward Ethical Behavior In Corporate America Still Suffers From A Gaping Divide Among Executives And Rank-And-File Employees; Survey Shows Executives Feel Businesses Operate Ethically; Employees/Customers Admit To Mistrust," *PR Newswire*, 11/18/03. http://0-web.lexis-nexis.com.

[6] Id.

[7] Id.

[8] Id.

[9] Nurses scored the highest with 83%. Only HMO managers and salespersons scored lower than both executives and stockbrokers. "Those Angels in White," *Los Angeles Times*, 12/23/03, B12.

[10] *The Conference Board Commission on Public Trust and PrivateEnterprise: Executive Summary*, 1/03, p. 3.

[11] Id

[12] Id.

[13] Id at pp 4-5

[14] Sarbanes-Oxley Act of 2002, P.L. No. 107-204, 116 Stat. 745.

[15] Michael Forman, "Consortia, Initiatives Go Down The Drain In 2002," *Security Industry News*, 1/6/03, 15(1), p. 17.

[16] Tom Petruno & Thomas Mulligan, "Corporate Reform's Baby Steps," *Los Angeles Times*, 7/23/03, A1. More precisely, CPA firms only opine that the audited company has employed generally accepted accounting principles according to generally accepted auditing standards. But that more narrow responsibility is not the general perception. And in this case, perception was more important than reality.

[17] New York: John Wiley & Sons, 2003.

[18] Sarbanes-Oxley Act, *supra* note 14, at §201(a).

[19] Mike Brewster, *op. cit.*, p. 263.

[20] *Id.*, p. 261.

[21] *Id.*, pp. 268-69; see also Robert Kuttner, "So Much For Cracking Down on the Accountants," *Business Week*, 11/18/02, p. 24.

[22] For a still-unsurpassed discussion of the separation of corporate ownership from control, see Adolf Berle and Gardiner Means, *Modern Corporation and Private Property*, 1932.

[23] Typical is the "capacity swap" scam used by Global Crossing Ltd., the fiber optic network firm that fell into bankruptcy, but not before primary owner Gary Winnick pocketed $575 million selling his shares during the network's heyday. Investors and employees lost billions and sued Global Crossing for securities fraud by using improper accounting to inflfate company revenue. Global Crossing would lease capacity space on its network to a competitor; at the same time Global Crossing would rent capacity from the same rival. The lease income was booked as current revenue, while the rental expense was capitalized as a prepaid asset, and expensed over the life of the contract. Alex Pham and David Colker, "Global Crossing Ex-Execs to Pay $324 Million," *Los Angeles Times*, 3/20/04, C1. Yet to be established is whether anything was actually exchanged.

[24] "The Best and Worst Boards: How the corporate scandals are sparking a revolution in corporate governance," *Business Week*, 10/7/02. http://www.businessweek.com/magazine/content

[25] Id

[26] From the company's standpoint, options were preferable to salary for several reasons. First, options were deductible for tax purposes but, unlike salary, were not expensed on the income statement. Secondly, there was

no limit on the deductibility of stock options, unlike salary. Third, granting stock options seemed like a no-cost form of compensation: there was no apparent diminution of corporate assets; and no immediate dilution of the value of existing stock.

27 Kathy Kristoff, "Study Ties Biggest CEO Raises to Largest Layoffs," *Los Angeles Times*, 8/26/03, C1.

28 Id

29 Institute for Policy Studies, *Executive Excess 2003*, p. 21.

30 *Id.*, p. 20. A more recent datum indicates the ratio has dropped to 282:1. "CEOs Pay Boosted by 53% Rise in Options," *Los Angeles Times*, 3/9/04, C3.

31 Id.

32 Harris Interactive press release, 10/18/02.

33 "Corporate Scandals Hit Home," *Wall Street Journal*, 2/19/04, B1. One of the main reasons was that alleged corporate criminals had not been brought to account.

34 Alvo Svaldi, "Wall Street's $1 Billion Settlement Too Little, Too Late for Small Investors," *Denver Post*, 4/30/03. http://0-web.lexis-nexis.com.torofind.csudh.edu/universe/document?_m=e859ab658fded015519856f34a135be8&_docnum=2&wchp=dGLbVzz-zSkVA&_md5=0aead3d7229db498418312a12a405528

35 www.nyse.com/regulation/regulatin.html.

36 Exchange Act, 15 *USC* §78b [2003].

37 This bifurcation itself was ordered by the SEC as the result of a scandal. In 1998, the NASD was censured by the SEC for the price-fixing and other rule violations by its market-makers (traders). (Unlike the NYSE, the NASD is a profit-making organization.) The NASD knew of the violations but turned a blind eye because Nasdaq market-makers had undue influence over the NASD's oversight and disciplinary committees. Arthur Levitt, *Take On the Street*, NY: Pantheon, 2002, pp. 181-88. See also Tracy Stoneman and Douglas Schulz, *Brokerage Fraud*, Chicago: Dearborn Trade Publishing, 2002. "As a self-regulatory organization, the NASD does not appear to be willing to slap the hands that feed it to any serious extent. We have long believed that the sanctions and penalties imposed by the NASD when it finds wrongdoing typically pale in comparison to the act itself or the harm inflicted." P. 133.

38 Roberta Karmel, "Should The New York Stock Exchange Be Reorganized?" *New York Law* Journal, 10/16/03. http://0-web.lexis-nexis.com.torofind.csudh.edu/universe/document?_m=0b68a914f21e2d5a27bf9bd18aa27bb6&_docnum=6&wchp=dGLbVlz-zSkVA&_md5=8166ee7f99b850a607168b0276580eb3

39 Ari Weinberg, "CalPERS Takes On Wall Street," *Forbes*, 12/16/03. http://www.forbes.com/2003/12/16/cx_aw_1216calpers_print.html

40 Kathy Kristof, "CalPERS Sues NYSE, Specialist Firms," *Los Angeles Times,* 12/17/03, C1.

41 Alvo Svaldi, *op. cit.*

42 Id.

43 Walter Hamilton, "Fund Scandal Spreads to Sales," *Los Angeles Times*, 11/18/03, C1.

44 Tom Petruno, "Funds Have Company in Scandal Blame Game," *Los Angeles Times*, 1/18/04, C1.

45 See, e.g., Walter Hamilton, "NASD Fines 3 Brokerages Over Stock Research," *Los Angeles Times*, 12/10/03, C4.

46 "NASD Probes Touting of Funds," *Los Angeles Times*, 12/7/03, C4.

47 Petruno, "Funds Have Company…" *op cit.*

[48] Id.

[49] Id.

[50] Alwyn Scott, "What Investors Should Know about Mutual Funds in Wake of Scandal," *Seattle Times,* 11/23/03. http://0-web.lexis-nexis.com.torofind.csudh.edu/universe/document?_m=3eac51e277da9c5.

[51] One means of accomplishing this is by the late trader submitting "buy" and "sell" orders for the same number of mutual fund shares before the market closes, then canceling one of the orders after hours based on late-arriving news. *Id*.

[52] There may be civil liability for mutual funds and their managers who permit market timing. In November, 2003, the SEC and New York Attorney General filed civil actions against a mutual fund management company for permitting a hedge fund to engage in market timing trades of the growth fund that the defendant managed. The complaint charges the company with fraud and breach of fiduciary duty. "SEC Charges Pilgrim Baxter With Fraudulent Market Timing of Trades," *Securities Litigation & Regulation Reporter*, 12/3/03, vol. 9(14), p. 10.

[53] Id.

[54] Id.

[55] Id.

[56] Patty Roer and Joellen Valentine, "The Hedge Fund Probes," Startup *& Emerging Company Strategist. 11/21/03. http://web.lexis-nexis.com/universe/document?_m=c322d134cabdda3b483b309eeaaaf80e.*

[57] Id.

[58] See, e.g., "SEC Seeks to Better Show Costs of Funds," *Los Angeles Times*, 12/18/03, C4; and Walter Hamilton and Kathy Kristof, "Fund Industry Urges Reforms," *Los Angeles Times*, 12/10/03, C1.

[59] Id.

[60] Id.

[61] The *form* of this revenue-sharing is consequential. If the payments to brokers are in the form of *commissions* to the brokerage, these are paid out of portfolio assets and are thus direct expenses to fund investors. On the other hand, if it is deemed a "support payment" from the mutual fund to get its portfolio noticed by the broker, then this is charged to the fund's management company. But there is no assurance that this cost is not passed on to fund investors through higher management fees.

[62] Walter Hamilton and Josh Friedman, "Fund Probe Focusing on Big-Money Practice," *Los Angeles Times*, 12/5/03, C1. The poll was conducted by Greenwhich Associates. It found that the average commission on directed brokerage payments was 4.2 cents, double the amount for electronic trades.

[63] Walter Hamilton and Josh Friedman, "Fund Probe Focusing on Big-Money Practice," *Los Angeles Times*, 12/5/03, C1. The poll was conducted by Greenwhich Associates. It found that the average commission on directed brokerage payments was 4.2 cents, double the amount for electronic trades.

[64] Id.

[65] 15 *USCS* § 80-35(b). Emphasis supplied.

[66] Spitzer, *op. cit.*

[67] John Freeman & Stuart Brown, "Mutual Fund Advisory Fees: The Costs of Conflicts of Interest," 26 *Iowa J. of Corporate Law* 609 (2001). The study blames lax SEC oversight.

[68] Quoted in Tom Lauricella, "This Is News? Fund Fees Are Too High, Study Says," *The Wall Street Journal*, 8/27/01, C1.

[69] Spitzer, *op. cit.*

[70] Alwyn Scott, *op. cit.*

[71] "DC Plan News," *D.C. Plan Investing*, 11/11/03, p. 9.

[72] "Recordkeepers & Sponsors Tackle Mutual Fund Scandal to Protect 401(K) Participants," *DC Plan Investing*, 11/25/03, p. 1.

[73] See Brewster, *op. cit,.* p. 269.

[74] *Id*., p. 270.

[75] Id.

[76] "People On The Move," *Palm Beach Daily Business Review*, 3(12-26), 12/26/03, p. 3.

[77] See Gregory Crawford, "Tougher Rules: institutional investors say SEC proxy process proposals fall short," *Pensions & Investments*, 12/8/03, p. 27.

[78] Jonathan Peterson, "SEC Attacks Fund Abuses," *Los Angeles Times,* 12/4/03, p. A1.

[79] Craig Rose, "Tricks of the Trade," *The San Diego Union Tribune*, 12/7/03, p. H-1.

[80] Id.

[81] "Cut Proposed for SEC Budget," *Los Angeles Times,* 12/2/03, p. C4.

[82] Tom Petruno, "What Penalties Befit Fund Trading Scandal?" *Los Angeles Times*, 11/16/03, C1.

[83] Id.

[84] Spitzer, *op. cit.*

[85] Walter Hamilton & Josh Friedman, "Index Funds Drawing Scrutiny of Regulators," *Los Angeles Times*, 1/29/04, C1, C4.

[86] Walter Hamilton & Josh Friedman, "Index Funds Drawing Scrutiny of Regulators," *Los Angeles Times*, 1/29/04, C1, C4.

[87] http://0-web.lexis-nexis.com.torofind.csudh.edu/universe/document?_m=133a56e1c49b98e0a8be8ad3b0fbe6ca&_docnum=2&wchp=dGLbVzz-zSkVA&_md5=765dc88ab6c5ca3e3ca8814d7bc9b239

[88] Mary Gordon, "Momentum builds for action on mutual funds, but how forceful will it be?" http://0-web.lexis-nexis.com.torofind.csudh.edu/universe/document?_m=3eac51e277da9c5.

[89] See Arthur Levitt, *op. cit.,* pp. 108-111 for a discussion of the political pressure that was brought to bear on the SEC's decision.

[90] "SEC Commissioner Questions Options Rule," Los *Angeles Times*, 1/9/04, C4.

[91] Sarbanes-Oxley, *supra* note 14, §201(a).

[92] *Id.*, §203.

[93] *Id.*, §20(b)

[94] Jonathan Glater, "SEC Backs Rules for Auditors, Revised from Original Plan," *NY Times*, 1/23/03, C7

[95] Id.

[96] Id.

[97] Sarbanes-Oxley, *supra* note 14, §302.

[98] *Id.* §305.

[99] *Id.* §301.

[100] See, e.g., The Best and Worst Corporate Boards Named in BusinessWeek's Fourth Rating," http://web.lexis-nexis.com/universe.

[101] Luci Stallerman, Andrew Beck & Daniel Miller, "NYSE Corporate Governance Requirements Finalized," *The Metropolitan Corporate Counsel*, 1/04, p. 17.

[102] Sarbanes-Oxley, *supra* note 14, §402(a).

[103] Justin Fox, "The Only Option (For Stock Options, That Is)," *Fortune*, 8/12/02. http://www.fortune.com/index.jhtml.

[104] Id.

[105] Id.

[106] Id.

[107] *Id.* See also, Levitt*, op. cit*., pp. 105-111.

[108] Fox, *op. cit.*

[109] *Id*. See also Elizabeth McDonald, "An Option That Does Nothing," *Fortune*, 11/12/02. http://www.forbes.com/2002/11/12.

[110] Kathy Kristof, "Microsoft Switch Stirs Up Debate," *Los Angeles Times*, 7/14/03, C1.

[111] "Taxpayer Watchdog Assails Mandatory Stock Option Expensing as an Unneeded Regulation," *PR Newswire*, 1/23/04. http://www.lexis-nexis.com.torofind.csudh.edu/universe/document?_m=daef4e8fc2774335.

[112] E.g., Charles Elson, the director of the University of Delaware's Corporate Governance Center, says, "I worry that there's more form than substance here. It's not the recitation, but the spirit behind the recitation that matters." Quoted in Tom Petruno and Thomas Mulligan, "Corporate Reforms Baby Steps, *op. cit.* See also Marianne Jennings, "A Primer on Enron: Lessons From a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures,": "[T]he remainder of the repairs for the crisis in confidence comes from an unequivocal return to honesty … Regulation, additional disclosure, and more widespread disclosures have not solved the problem, nor will the new legislation and SEC mandates prove to be solutions. Honesty cannot be legislated and the return of honesty is no small task because the dishonesty is so pervasive." In 39 *Cal Western Law Review* 163 at 265.

[113] Robert Bostrom, "Corporate governance: developments and best practices one year after Sarbanes-Oxley," *International Financial Law Review* 22(10) 189-204, October 2003. http://0-vnweb.hwwilsonweb.com.torofind.csudh.edu/ hww/results/results_single.jthml?n.

[114] Jonathan Peterson, "Overhaul of NYSE Approved," *Los Angeles Times*, 12/18/03, C1.

[115] "CalSTRS Urges SEC to Intervene in NYSE Reform Proposal," *Business Wire*, 11/20/03. http://0-web.lexis-nexis.com.torofind.csudh.edu/universe/document?_m=3eac51e277da9c5.

[116] Id.

[117] Landon Thomas, Jr., "A Big Board Specialist Firm With a Burden of Debt," *New York Times*, 3/17/04, C4.

[118] "Levitt is an NYSE Director Nominee," *Los Angeles Time,* 3/26/04, C4.

[119] Lynn Hume, "SEC Proposes 2 New Mutual Fund Rules," *The Bond Buyer*, 2/2/04, p. 35.

[120] Id.

[121] Walter Hamilton & Kathy Kristof, "Fund Industry Urges Reforms," *op. cit.*

[122] Id.

[123] Jonathan Peterson, "SEC Attacks Fund Abuses," *op. cit.* Disclosure of personal trading by fund managers has also been the subject of bills before the House and Senate. See Tom Petruno, "Congress Takes Aim at Manager Disclosure," *Los Angeles Times*, 11/18/03, C1.

[124] See the discussion accompanying notes 65-69, *supra*.

[125] Jonathan Peterson, "Directors to Get New Rules From the SEC," *Los Angeles Times,* 1/12/04, C1. The majority rule was applicable to all companies listed on the NYSE or Nasdaq per SEC final rule as of November, 2003.

[126] Eliot Spitzer, *op. cit.*

[127] Debra Brewster and Demetri Sevastopulo, "Spitzer says funds are opposing reform regulation," *The Financial Times*, 1/28/04, p. 20.

[128] Jonathan Peterson, "SEC Issues Rules on Fund Fee Disclosure," *Los Angeles Times*, 2/12/04, C1.

[129] Jonathan Peterson, "Mutual Funds Face New SEC Rule," *Los Angeles Times*, 4/14/04, C

[130] Id. The disclosure rules take effect in December, 2004.

[131] Jonathan Peterson, "SEC Issues Rules on Fund Fee Disclosure," *op. cit.*

[132] Id.

RESPONDING TO ALLEGATIONS OF 3RD PARTY SEXUAL HARASSMENT: THE CUSTOMER IS NOT ALWAYS RIGHT

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ABSTRACT

Employee allegations of sexual harassment by supervisors and co-workers continue to be a complex human resource management problem for employers. While recent Supreme Court decisions in Burlington Industries, Inc. v. Ellerth and Faragher v. City of Boca Raton provided employers with guidance in dealing with harassment in the workplace, allegations of harassment involving customers, clients, vendors, and suppliers is emerging as an area of liability that many employers may have overlooked and continue to struggle with. Equal Employment Opportunity Commission regulations have long held that employers may also be responsible for the acts of non-employees with respect to sexual harassment of employees in the workplace, and in recent years more U.S. courts have relied on these regulations in recognizing the existence of a cause of action for harassment by third parties. This paper examines recent court decisions dealing with allegations of sexual harassment involving third parties, the potential legal and employee relations consequences associated with sexual harassment of employees by third parties, and what organizations can do to minimize the negative consequences and employer liability associated with third party sexual harassment

INTRODUCTION

Since the United States Supreme Court first recognized sexual harassment as a violation of federal law in 1986 in Meritor Savings Bank v. Vinson, employers have struggled in their efforts to create workplaces where employees can work free of unlawful behavior that interferes with their ability to successfully perform their jobs. What was once viewed as "an accepted occupational hazard for many working women" (Ream, 2000), sexual harassment has over time been subject to continued adjudication on numerous occasions resulting in widespread awareness and effort by employers to create work environments free of sexual harassment. While employers have become more sensitized to the harassment issue, expansion of the concept of sexual harassment continues to present new challenges to employers (Aron, 2002). In workplaces where management is unable to effectively prevent or respond to allegations of harassment, negative economic consequences for both employees and employers are the likely result. Legal costs associated with harassment litigation continue to run high in terms of damage awards and attorney fees. Additional and more difficult to measure costs incurred when harassment allegations surface include the diversion of management attention, unfavorable publicity, lower employee morale, and turnover.

Doing "whatever it takes" to satisfy a customer or client is often deemed critical to business survival. While the often repeated phrase “the customer is always right” may be valid in many situations, when a complaint alleging hostile or harassing behavior on the part of a customer is voiced by an employee it is critical for managers to remember the customer is never right.

There is a great deal of literature and case law dealing with co-worker and supervisor harassment. With respect to third-party sexual harassment, there have been relatively few court cases, and academic and practitioner publications have been limited. What has been published in recent years seems to indicate that the problem of sexual harassment by third parties is real and much more pervasive than previously thought. In addition, as the composition of the workforce continues to evolve and as more judicial attention is given to the issue, the potential that third-party sexual harassment “might be the next tide of sexual harassment litigation” is a distinct possibility (Vaughn, 2002).

Early litigation involving third-party harassment was associated with employer policies requiring female employees to wear sexually provocative uniforms (Ream, 2000). Subsequently, a number of cases involving casinos, restaurants and strip clubs have addressed third-party harassment (Folkerson v. Circus Circus Entertainment, Inc. 1998, Lockard v. Pizza hut, Inc. 1998, and McDonald v. B.E. Windows Corp. 2003). More recent cases involving allegations of third-party harassment have involved a health and human service provider and a patient (Van Horn v. Specialized Support Services, Inc., 2003), a relocation consultant and client (Little v. Windermere Relocation, 2001), a store manager and a safety inspector (Weiland v. El Kram, Inc., 2002).

In exploring the prevalence of third-party sexual harassment, Lea Vaughn cites evidence from a number of sources indicating that third-party sexual harassment is much more wide spread than the volume of litigation and academic literature on the subject indicates. For example, Vaughn cites survey research on female attorneys’ experience with sexual harassment reporting that 61.5% of the respondents reported being sexually harassed by clients in the last five years. Vaughn also cites a recent ABA Journal article reporting on the continued prevalence of the behavior (Vaughn, 2002, citing Stevens 1994, and Baker 2000). Vaughn also cites evidence of wide spread third-party sexual harassment in service and retail organizations and among librarians and concluded that

> *…customers and clients harass employees across a wide spectrum of businesses and occupations. No one is immune. This behavior, especially because it tends to be*

> *ignored in the interest of promoting sales or business revenue, means that employees endure yet another unnecessary stress in the workplace* (Vaughn, 2002).

Ream reported on Safeway supermarkets customer service policy that led to allegations of third-party sexual harassment in 1998. Employees claimed that Safeway's customer service policies exposed them to harassment by customers creating a hostile working environment. In this environment, employees alleged that customers felt at liberty to make sexual advances and comments and in some cases assault employees (Ream, 2000).

Daniel Eaton examined the legal consequences of sexual harassment of staff by hotel guests and cited recent state and federal cases reinforcing the severity of the problem in the hospitality industry and "that the law is trending in the direction imposing liability on employers for sexual harassment by non-employees" (Eaton, 2004).

LEGAL BACKGROUND

The Equal Employment Opportunity Commission (EEOC) enforces three statutes that prohibit harassment of an employee. Title VII of the Civil Rights Act (Title VII) prohibits harassment based on race, color, sex, religion, or national origin. The Americans with Disabilities Act (ADA) prohibits harassment based on disability, and the Age Discrimination in Employment Act (ADEA) prohibits harassment of employees who are 40 or older on the basis of age. Additionally, all of the statutes enforced by the EEOC prohibit retaliation for complaining of discrimination or participating in complaint proceedings (EEOC, 1999). Racial harassment has long been recognized by courts as a cause of action under title VII (see Rogers v. EEOC, 1971) with sexual harassment gaining recognition by the Supreme Court in 1986 in Meritor Savings Bank v. Vinson.

In June of 1998, the United States Supreme Court issued two decisions that clarified when employers will be held legally responsible for unlawful harassment by supervisors (Burlington Industries, Inc. v. Ellerth and Faragher v. City of Boca Raton, 1998).

> *The standard of liability set forth in these decisions is premised on two Principles: 1) an employer is responsible for the acts of its supervisors, and 2) employers should be encouraged to prevent harassment and employees should be encouraged to avoid or limit the harm from harassment* (EEOC, 1999).

These two decisions confirm that employers are subject to vicarious liability for unlawful harassment by supervisors. When the supervisor's harassment results in a tangible employment action (job loss, failure to promote, demotion, or undesirable reassignment), the employer is always liable. If no tangible employment action is taken against the alleged victim, an employer may avoid liability or limit damages by establishing an affirmative defense. The affirmative defense includes two necessary elements:

> *1) the employer exercised reasonable care to prevent and correct promptly any harassing behavior, and 2) the employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by the employer or to avoid harm otherwise (EEOC, 1999).*

In assessing the issue of liability, there must first be a determination that unlawful harassment has in fact occurred. This has often proven to be a difficult task for employers, in spite of fairly specific pronouncements in EEOC Enforcement Guidance and U.S. Supreme Court decisions.

> *the anti-discrimination statutes are not a "general civility code" (Oncale, 1998). Thus federal law does not prohibit simple teasing, offhand comments, or isolated incidents that are not "extremely serious" (Faragher, 1998). Rather, the conduct must be "so objectively offensive as to alter the conditions of the victim's employment" (Oncale, 1998). The conditions of employment are altered only if the harassment culminated in a tangible employment action or was sufficiently severe or pervasive to create a hostile work environment* (EEOC, 1999).

In Faragher, the Supreme Court noted further the "mere utterance of an ethnic or racial epithet which engenders offensive feelings in an employee would not sufficiently alter terms and conditions of employment to violate Title VII" (Faragher, 1998). Further the court noted that "discourtesy or rudeness should not be confused with racial harassment and that a lack of racial sensitivity does not, alone, amount to actionable harassment (Faragher, 1998). Courts, in determining whether an environment is sufficiently hostile or abusive, have been directed by the Supreme Court to look at all the circumstances surrounding the allegation, including the

> *"frequency of the discriminatory conduct; its severity; whether it is physically threatening or humiliating, or a mere offensive utterance; and whether it unreasonably interferes with an employee's work performance…simple teasing, offhand comments, and isolated incidents (unless extremely serious) will not amount to discriminatory changes in the terms and conditions of employment* (Faragher, 1998).

The Supreme Court in Faragher made it clear that "conduct must be extreme to amount to a change in the terms and conditions of employment" and that "properly applied, will filter out complaints attacking the ordinary tribulations of the workplace, such as the sporadic use of abusive language, gender-related jokes, and occasional teasing"(Faragher, 1998).

With respect to sexual harassment by third-parties, EEOC regulations make it clear that the identity of the perpetrator of the harassing behavior is irrelevant to a victimized employee. The regulations specifically state:

> *An employer may also be responsible for the acts of non-employees, with respect to sexual harassment of employees in the workplace, where the employer (or its agents of supervisory employees) knows or should have known of the contact and fails to take immediate and appropriate corrective action. In reviewing these cases, the Commission will consider the extent of the employer's control and any other legal responsibility which the employer may have with respect to the conduct of such non-employees* (EEOC, 1999).

Employer liability for sexual harassment by third parties is different than for harassment committed by a supervisor. Employers are subject to vicarious liability for actionable sexual harassment created by a supervisor with immediate or successively higher authority over the employee. An employer may raise the affirmative defense to liability if no tangible job action was taken and it can show that they exercised reasonable care to prevent and promptly correct any sexually harassing behavior and the employee unreasonably failed to utilize any preventative or corrective opportunities provided by the employer. The standard of liability for employers with respect to harassment by a third-party is basically the same that applies to co-worker harassment. An employer may be held liable for customer harassment if they "fail to remedy or prevent a hostile or offensive work environment which management-level employees knew, or in the exercise of reasonable care should have known"(Lockard v. Pizza Hut, 1998). Employers must also be aware of state antidiscrimination laws that allow employees to sue their employers for sexual harassment by guests or clients. Eaton identified thirteen states that recognize employee claims against employers for sexual harassment by guest or customers (Eaton, 2004).

In Lockard v. Pizza Hut, a manager ignored an employee's complaints that a customer verbally and physically harassed her. The physical harassment included the customer pulling the employee's hair and grabbing her breast. The manager ignored the employee's complaints and ordered the employee to continue to wait on the customer. The court held that because the manager failed to take reasonable steps to remedy or prevent the hostile environment, the employer was liable for its manager's failure to act (Lockard v. Pizza Hut, 1998).

A difference in how the co-worker sexual harassment standard is applied in third-party cases involves the employer's ability to take remedial action. For example, in a co-worker harassment situation, an employer has the ability to discipline and possibly discharge an alleged harasser while in third-party cases "an employer's options may be more limited" (Shea, 1999). In third-party cases employers are expected to take "reasonable steps" to stop harassment (Morrell, 2000).

In Rodriquez-Hernandez v. Miranda-Velez, a female employee was discharged after complaining of sexual advances from a high-level executive of one her company's most important customers. The female employee complained to the president of her company who promised to deal with the problem. As the advances by the customer escalated, the employee continued to complain. Her company's president defended the harassing customer and even told the female employee to "keep him satisfied" and to respond to him "as a woman"(Rodriquez-Hernandez v. Miranda-Velez, 1998). When she refused, she was eventually terminated for alleged unauthorized use of company property, contracting for services in the company name without authorization, and absenteeism. Prior to receiving her dismissal notice, Rodriguez had never been notified of any of the allegations. In upholding the jury’s verdict, the First Circuit Court of Appeals concluded that employers can be liable for a customer’s unwanted sexual advances, if the employer ratifies or acquiesces in the customer’s demands. In this case, “Rodriquez’s employer not only acquiesced in the customer’s demands, but explicitly told her to give in to those demands and satisfy the customer” (Rodriquez-Hernandez v. Miranda-Velez, 1998).

In Dornhecker v. Malibu Grand Prix, the employer was successful in a case similar to Rodriquez-Hernandez v. Miranda-Velez. In the Dornhecker case, the Fifth Circuit Court of Appeals reversed a district court decision that the company failed to take prompt remedial action. The appeals court noted that Mrs. Dornhecker had been assured by the company president within 12 hours after her first complaint about the consultant that she would never have to work with the consultant again. Instead of giving Malibu Grand Prix a “fair opportunity to demonstrate that it could curb” the consultant’s harassment, Mrs. Dornhecker resigned the next day and promptly sued her employer. The appeals court noted that employers ordinarily require time to respond to sexual harassment claims and that in this case, the company took prompt corrective action to remedy the harassment in a decisive manner. The court did not expect the company to sever all ties with the consultant, and accepted the employer’s promise to Dornhecker that she would never have to work with the offending consultant again as reasonable (Dornhecker v. Malibu Grand Prix Corp., 1987).

RECENT CASES

In recent years numerous U.S. Federal Courts have issued decisions consistent with the EEOC’s position that the employer’s responsibility for harassment includes harassment by customers, clients, vendors, and suppliers. Controversy in California’s courts with respect to employer liability for harassment by third-parties was settled in October of 2003 with the signing into law of AB 76. This statute amended California's Fair Employment and Housing Act which had been interpreted by California's appeals court to "not provide a private right of action for damages by an employee harassed by a non-employee such as a client or customer of the employer" (McKee, 2003 and Sexual Harassment Litigation Reporter, 2003).

Recent cases alleging third party sexual harassment have involved a variety of situations. Betty Van Horn, a member of Specialized Support Services (SSS) patient support staff that provided services to mentally retarded and developmentally disabled clients, was awarded $82,000 in damages after claiming that her employer failed to protect her from sexual harassment by a 21-year old client of the company with Down syndrome (Van Horn v. Specialized Support Service Inc., 2003). Recent cases where plaintiffs have survived employer summary judgment motions involving allegations of sexual harassment involving a third-party include Little v. Windermere Relocation, 2001, Weiland v. ElKRam, Inc, 2002, McDonald v. B.E. Windows Corp. 2003, and Watson v. Blue Circle, 2003. In Little v. Windermere, Maureen Little, a Corporate Services Manager at Windermere Relocation Services accepted a dinner invitation from the Human Resources Director of one of her employer's most important customers. She had been instructed to "do whatever it takes to get this account" and to "do the best job she could". After eating dinner and having a couple of drinks with the customer, Little became ill and passed out. She awoke to find herself being raped by the customer in his car. Ms. Little attempted to escape but was unable and was subsequently raped again by the customer in his apartment. Ms. Little was reluctant to tell her employer about the rape because she "knew how important the Starbucks account was" to her boss. A few days after the attack she did report the rape to Windermere's Director of Relocation Service who advised her not to tell anyone in management. Nine days after the rape she reported it to the vice president of operations who was designated in Windermere's Harassment Policy as a complaint-receiving manager. This individual advised Little that "she thought it would be best that Little try to put it behind her and to keep working in therapy". She did urge Little to discontinue working on the account. The operations vice president did not conduct an investigation of Little's complaint or any follow-up interviews with Little, and later testified in her deposition that because the rape occurred outside the "working environment", she believed that it fell outside the scope of Windermere's Harassment Policy (Little v. Windermere Relocation, 2001). Shortly after upper management was made aware of the attack, Ms. Little was terminated.

Mary Weiland hired as a Pizza Hut restaurant manager in Humboldt, Iowa survived summary judgment in her lawsuit alleging that she was harassed by a safety inspector who was not employed by the company (Weiland v. ElKram, Inc., 2002). In this case, Weiland initially wanted to report the incident to police. She did report the harassment to her direct supervisor who advised her not to complain to authorities and that he would contact human resource personnel to investigate the allegations. He also told her that it would be two weeks before human resources would begin their investigation because the person in charge was on vacation. Weiland subsequently did report the incident to police when her supervisor would not insure her that the safety inspector would be kept out of the restaurant (Weiland v. El Kram, Inc., d/b/a Pizza Hut of North America, Inc., 2002).

In McDonald v. B.E. Windows Corp., bartender Frances McDonald's case alleging that the sexually harassing behavior of patrons of a bar on the top floor of the former World Trade Center was ignored by her supervisor also survived the defendant's motion for summary judgment (McDonald v. B.E. Windows Corp., 2003). Lisa Watson, a concrete truck driver sued her company claiming she was a victim of sexual harassment and a hostile work environment created in part by her employer's customers (Watson v. Blue Circle, Inc., 2003). The EEOC also recently filed a case in a Virginia court against Advance Stores Co., Inc d/b/a Advance Auto Parts. The EEOC claims the Advance Stores took no action to prevent escalating harassment of a female employee by customers (Ryan, 2003).

MINIMIZING EMPLOYER LIABILITY

The Little v. Windermere and Van Horn v. Specialized Support Services cases highlight the complications that can occur when a firm takes its efforts to satisfy its customers too far. The employer's problems in the Van Horn case start with a basic flaw for any firm looking to prevent and properly respond to allegations of sexual harassment by an employee.

> *The Court is equally appalled by the failure of a company as large as SSS to take any steps to address workplace sexual harassment issues more generally. As recently as one year ago, SSS had no policies in place to recognize, confront, or combat sexual harassment in the workplace. SSS failed to train its management staff to investigate and handle allegations of sexual harassment or to advise its supervisors that its disabled clients were capable of engaging in sexual harassment of employees* (Van Horn v. Specialized Support Services, 2003).

Specialized Support Services (SSS) employed approximately 400 employees in Iowa and Missouri. They provided services to mentally retarded and developmentally disabled clients in group settings and in the clients' homes. Ms. Van Horn alleged that a 21 year old client in her care had engaged in increasingly severe sexual behavior toward her that included him grabbing her breasts. Ms. Van Horn had documented the behavior per company policy and properly informed her supervisors as to the nature of the behavior. She requested guidance and self-defense training on several occasions so as to properly respond to the escalating severe nature of the behavior. Van Horn was told that there was training for hitting or pinching, but that there was nothing directly available for sexually aggressive behavior. She received no training of any type in response to her reports.

The incident that eventually triggered Ms. Van Horn's termination, involved the client pinching her breast and refusing to let go. In response, Ms. Van Horn slapped the client in the face causing him to release his grip. Ms. Van Horn properly reported the incident in accordance with company policy and was subsequently terminated for violating another company policy "Respect Every Consumer's Rights" which read in part, never impose punishments on consumers. The Court concluded that Ms. Van Horn's slapping her client was reasonable self-defense against harassment and was therefore protected oppositional activity under Title VII. The Court also concluded that the company is free to maintain its zero-tolerance policy against punishment of its clients, but cannot ignore clear warning signs and then terminate an employee who resists sexual harassment and assault in the workplace. To do so, the court said, "is to deny the employee the basic protection against discrimination which Title VII affords. This the Court is not prepared to do"(Van Horn v. Specialized Support Services, 2003).

As courts continue to appear to be expanding liability for sexual harassment, employers should focus on two issues. First, when employers receive allegations of harassment committed by third-parties, it should treat that claim the same way it would treat any other harassment claim. The response should include a prompt and through investigation by qualified personnel with efforts to insure the need for confidentiality, to stop the harassing behavior, and to guard against retaliation. Most employers today have become "highly sensitized to the harassment issue"(Aron, 2002). Yet, in the Van Horn case, as late as 2002, a company with nearly 400 employees had no policy dealing with sexual harassment, no training for employees on how to respond to sexual harassment from clients, and no training for supervisors on how to respond to allegations from employees. In Little v. Windermere and Weiland v. El Kram, poor responses by managers, one specifically designated as a complaint-receiving manager in the company's harassment policy directly contributed to the courts finding for the plaintiffs.

Employment law and practices training should no longer be a discretionary human resource management activity (Turner & Thrutchley, 2002). In reviewing recent court decisions, it should be clear to employers that preventative efforts are essential if organizations are to effectively respond to allegations of harassment and to limit liability under the affirmative defense. In Kolstad v. American Dental Association, the U.S. Supreme Court “altered the legal landscape by implicitly requiring employers to create and implement policies to prevent, deter and rectify complaints of discrimination and harassment” (McLaughlin and Merchasin, 2001). In its Kolstad two-part decision, the Supreme Court created a new standard for awarding punitive damages under Title VII. In part one, the court ruled that an individual who is successful in a job discrimination lawsuit may collect punitive damages if he or she shows that the discrimination was intentional and that the employer acted with “malice or reckless indifference” to the employee’s rights. In part two, the Court ruled that even if an individual satisfies the criteria in part one, the plaintiff cannot collect punitive damages from the employer if the manager’s actions “are contrary to the employer’s good-faith efforts to comply with Title VII” (Kolstad v. American Dental Association, 1999).

The key for employers to satisfy the Court's good-faith effort standard rests on an employer implementing a quality training program. This conclusion has been reinforced on numerous occasions in Federal Appeals Courts decisions since Kolstad. In EEOC v. Wal-Mart Stores, the 10th Circuit held that "the extent to which an employer has adopted anti-discrimination policies and educated its employees about the requirements of Title VII is important in deciding whether it is insulated from vicarious punitive liability"(EEOC v. Wal-Mart, 1999). Additional appellate court decisions have admonished employers to go beyond training dealing with sexual harassment to include race religion, national origin, and disability (Swinton v. Potomac Corp., 2001). The focus of the training should be on prevention and should include all employees. Additionally, managers must be trained on how to properly respond when allegations are raised or when they observe behavior inconsistent with organizational policy. Training programs must be both accurate and complete, ensuring that the program includes instruction on sexual harassment by third parties including vendors, independent contractors, customers, volunteers, and consultants (Morrell, 2000). Organizations must make sure that competent trainers deliver the training. Those that outsource this training must thoroughly check trainers' references. Timing of training is also critical. New employee orientation is ideal for initial training, but organizations must reinforce the lessons learned in this area on a regular basis. Monitoring the effectiveness of training is also critical and can be facilitated thought the development of effective complaint procedures. At a minimum, these efforts will demonstrate an organizations good faith effort to minimize an organizations exposure to sexual harassment litigation and the possibility that allegations of third-party sexual harassment will become the next tide of sexual harassment litigation.

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CURRENT REALITIES OF ETHICAL ISSUES IN CORPORATE AMERICA: HOW DOES ETHICS EFFECT THE FINANCIAL ARENA

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ABSTRACT

The current ethical dilemmas in Corporate America have caused the subject of ethics to come to the forefront for the people in the United States as well as the world. In an attempt to reveal these ethical issues faced by CEOs, CFO's, accountants, and employees, this study have tried to determine a definition of ethics and its purpose. An overview of a few of the corporate business failures caused by unethical, as well as, illegal practices have been incorporated. This study develops an insight to the evolution of ethical practices in the workplace and differentiates between ethicality and legality.

INTRODUCTION

Modern business and nineteenth century philosophy would seem, on the surface, to have very little in common. However, the increasing complexities of business, in the face of technological advances and globalization, provide a clear indication that they should be considered together as a whole. Ethics is an everyday occurrence in the corporate world as well as one's personal life. Business ethics is the same as normal ethics. In both cases, ethics is knowing what is right or wrong, and/or learning what is right or wrong in the environment in which one is involved. An ethical issue may not have a concrete answer; therefore a person's decision may depend on that person's situation. This may happen because "ethics is a broad and murky area and the workplace is full of ethical dilemmas and issues" (Orsini and McDougal, 1999). Therefore, employees feeling the pressure to perform may resort to unethical decisions in order to meet the goals that they feel are unreasonable. This can happen at any level of management (Orsini and McDougal, 1999).

People within an organization have a responsibility to conduct business in a way that positively benefits the employees as well as the stakeholders who have an interest in the company. The executives at Enron sought only to enrich themselves without any concern for the employees and stockholders. The implosion of Enron was brought about by the unethical, as well as illegal, acts that Enron's corporate management and the auditors from Arthur Andersen had engaged in. Since the implosion of Enron there have been numerous other corporations where the top executive officers have found themselves in trouble for unethical and illegal behavior. It seems as if a new corporate name is added to the list on a daily or weekly basis. These events have eroded the faith of the American people and made them skeptical about the ethics of Corporate America. In fact, most Americans associate business with greed rather than ethics. According to a recent survey cited in *The Wall Street Journal*, seventy nine percent of young Americans believe that there are no absolute standards in ethics. Honesty in business dealings doesn't seem to be at the forefront of people's minds (Calle, 2003).

However, this is not to say that unethical behavior is always illegal. It is not ethically correct to comply with a regulation when the law sometimes does not meet the moral and or ethical minimum and would mean breaking the code of ethics, nor does the absence of regulation justify unethical behavior. Some of the unethical but not necessarily illegal behaviors which employees are faced with in the corporate arena are listed below. These were taken from results of the National Business Ethics Survey:

> One of eight employees feels pressure at work to make ethical compromises.
>
> Two-thirds of those pin the pressure on supervisors and co-workers.
>
> One third of employees observe lying, abuse, discrimination and other forms of misconduct at work.
>
> Nearly half of those do not report it.
>
> One-third fears retaliation by co-workers if they make concerns known (*The Orlando Sentinel*, 2001).

According to Dr. Simon Longstaff the executive director of the St. James Ethics Centre, "organizations face dangers as long as they rely on people who do things because `everyone does it` or because `that's just the way we do things around here` "(*The Australian*, 2001). To enhance the image of business in the public eye, one must think about what choices to make and speak up when they encounter unethical situations. All our actions should be based on the values of good ethical principles. These principles are based on the components of character, which include trustworthiness, respect, responsibility, fairness, caring and citizenship (Verschoor, 2001).

WHAT IS ETHICS?

Today, more than ever before it seems that the definition of ethics is unclear. This ambiguity between what is right and wrong is partly due to the lack of ethical practices in the companies that have built corporate America. In an attempt to describe the meaning of ethics, philosophical and definitive descriptions are incorporated along with current examples. The distinction between ethicality and legality also plays an important role in the definition of ethics. Furthermore, the incorporation of this description within a corporate code of ethics illustrates how important it is for the organization not only to have a good understanding of the meaning of ethics, but also to illustrate this understanding throughout the code.

According to Merriam Webster's Collegiate Dictionary, ethics is the discipline dealing with what is good and bad, and with moral duty and obligation. It also defines ethics as a theory or system of moral principles or values governing an individual or group or a guiding philosophy (Mish, 1997).

Ethics (Greek ethika, from ethos,"character," "customs") is described as follows in the online Encarta dictionary:

> Principles or standard of human conduct, sometimes called morals (Latin mores, "customs"), and by extension the study of such principles, sometimes called moral philosophy. Ethics, as a branch of philosophy, is considered a normative science, because it is concerned with norms of human conduct, as distinguished from the formal sciences, such as mathematics and logic, and the empirical sciences, such as chemistry and physics. The empirical social sciences, however, including psychology, impinge to some extent on the concerns of ethics in that they study social behavior. For example, the social sciences frequently attempt to determine the relation of particular ethical principles to social behavior and to investigate the cultural condition to the formation of such principles. (Microsoft Corporation, 2002).

Webster's dictionary has a very similar definition with a larger emphasis on right and wrong. Ethics is a word that should have new meaning today, after some of the country's major business executives have made headline stories. Unfortunately it was only after these recent incidents that corporations have realized that ethics refers to how the organization deals with its customers, employees, co-workers, and business practices. Regardless of the variation in the definitions, the main thread that is woven throughout each interpretation of ethics refers to principles and values.

Generally speaking, most people believe that they have a good understanding of what it means to be ethical, but far too often the line of what is right and wrong becomes blurred when thrust into the workforce (Smith, 2002). This level of ambiguity tends to vary from industry to industry, from corporation to corporation, and from employee to employee. The day-to-day actual ethics of a corporation are the sum total of the ethics of all their employees (Hayes, 2002). Because business practices reflect the values, attitudes, and behavior patterns of an organization's culture, ethics is as much an organizational issue as a personal one. The problem lies when the meanings of words like honest, integrity, confidence, and trust are forgotten, and the understandings of what values are, (personal and corporate) no longer remains.

What are the values that make up ethics? The Jefferson Center for Character Education identified ten "Universal Values". These values include "honesty, integrity, promise-keeping, fidelity, fairness, caring for others, respect for others, responsible citizenship, pursuit of excellence and accountability" (Navran, 2004). Navran goes on to say that ethics boils down to "choosing the good over the bad, the right over the wrong, and the fair over the unfair"(2004). Even though these choices may sound simple they are oftentimes complex and subtle.

Whether a business is considering how to treat its employees, create its products, serve its customers or participate in the community, the ethical answers all revolve around doing the “right thing” rather than what maybe the most profitable or expedient in the short term. When faced with an ethical dilemma about any action you are considering, the following questions should be posed:

Is it legal? Will you violate any law by taking this action?

Is it balanced? Is it fair to all parties concerned, both in the long and short terms?

Would you be happy with this action if you were in the other party’s shoes?

Is it right? Are you proud of yourself for the course of action you are taking?

The more complex the ethical dilemma, the more important it is to consider each of these questions before engaging in an activity (Smith, 2002).

Ethical standards of decision-making should not be confused with what the legal requirements are governing the situation at hand. Being ethical is more than obeying the law and avoiding harm. There are codified principles and regulations that describe how people are required to act legally, but these stipulations cover behaviors not necessarily covered by ethical standards and values. Standards and values involve personal ethics: beliefs, values, and family background along with a high level of moral development. These personal ethics help to shape the individual’s idea of what to expect in terms of corporate ethics. Decisions that encompass both ethicality and legality are usually much easier to make because the choice is both ethically and legally wrong. Those that fall outside of this combined area are the decisions that most often become an ethical dilemma, and this has been evident by prominent examples displayed in the recent news (LaRue, 2002).

To the right is Figure 1, which is an illustration of how legal requirements are independent from ethical standards and where the two overlap. Figure 1 visually demonstrates that the combined area of legal requirements and ethical standards is very small when compared to the overall area of concern.

Exhibit 1 consists of a four-cell matrix that very simply puts ethical decision-making dilemmas into a new perspective. This matrix was developed by Sanford Krolich as a descriptive tool to be used to show how decisions are made, rather than how they should be made (Navran, 2004). This matrix helps to clarify the definition of ethics.

Figure 1
Legal Requirements vs. Ethical Standards

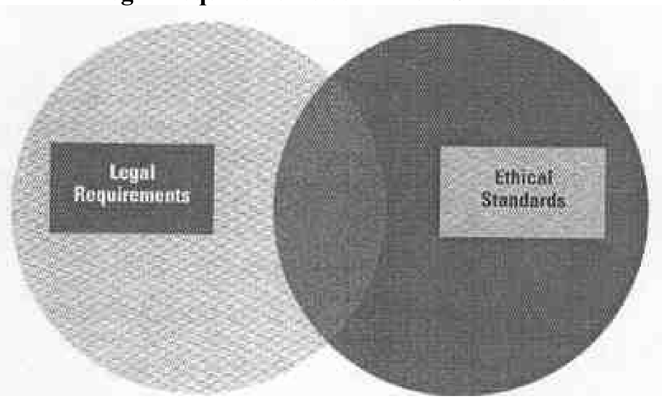

Exhibit 1	
INDIVIDUALISM *WIIFM* (What's in It For Me) The concern for what will happen to ourselves as the result of the decision we make. This is where we find the hidden agendas and concerns for oneself.	ALTRUISM The concern for the impact of our decision on others or on our relationship with others. This is where we find concern for what they will say, think, feel, or do.
IDEALISM The concern for how the decision aligns with our beliefs and values. This is where we find concern with whether a decision is right, fair and good.	PRAGMATISM The concern for the practical consequences of the decision. This is where we find concern for what will happen as a result of the decision. What is the impact of the decisions on goals and objectives?

Krolich argues that every ethical decision involves the four components described in the above matrix. Krolich points out that by examining the impact of a decision, and by looking at individualistic, altruistic, pragmatic and idealistic consequences, individuals find the balance most appropriate to them and then make their decision. The ways in which the criteria are balanced and those balances justified are as unique as the people themselves (Navran, 2002). In other words, two people in identical circumstances may not make the same decision because of the difference in ethical values.

Sociologist Raymond Baumhart confirmed this theory when he asked business people, "What does ethics mean to you?" Following are a few of the replies:

"Ethics has to do with what my feelings tell me is right or wrong."

"Ethics has to do with my religious beliefs."

"Being ethical means doing what the law requires."

"Ethics consists of the standards of behavior our society accepts."

"I don't know what the word means."

Because the definition of ethics is so hard to pin down, the above responses are probably typical (SCU, 2003). According to the Markkula Center for Applied Ethics at Santa Clara University (SCU), ethics consists of two things. First ethics refers to well-based standards of right and wrong that prescribe what humans ought to do, usually in term of obligations, benefits to society, fairness, or specific virtues. Secondly, ethics refers to the study and development of one's ethical standards. Because feelings, laws and social norms can deviate from what is ethical, it is necessary to constantly examine one's standards to ensure that they are reasonable and well focused (scu.edu, 2003). Ultimately it is the individual who has to make the decision on how to determine the definition of ethics and make his decision based on this determination.

CURRENT ETHICAL BUSINESS FAILURES

Over the last few years, America and the world have witnessed widespread corporate failures. These failures have been devastating and tragic to the economy and the hope of the American people. Unethical behaviors on the part of executives have been the primary cause of these breakdowns. Many feel the severity, but the circumstances surrounding the downfalls and the more broad ramifications can only be displayed through examples. The following chapter attempts to shed light on this issue by illustrating several prominent examples including: Enron, WorldCom, Andersen, and ImClone.

Unethical behavior has played a large roll in the business failures over the past four of years. These business failures and restatements of financial statements mount as the days go by. Chief Executive Officers and Chief Financial Officers are being charged with crimes and pleading guilty to these crimes practically on a daily basis. What motivates these people to display this greedy, deceitful, and unethical conduct that eventually causes them and the corporation problems? The motivation for cheating in the business world is financial gain. But, eventually this gain will turn into a loss and possibly the demise of the company as happened in the Enron and Arthur Andersen debacle.

Enron and Arthur Andersen are the names of two organizations that will now be forever a part of the country's vernacular but not for the reasons each had hoped. These unethical business practices reached never before seen heights of scandal in the U.S. Although it would be comforting to say that recent ethical scandals stopped here, it is not quite reality. The unveiling of the gross misrepresentation of both Enron and Arthur Andersen created an entire snowball effect with more and more companies surfacing with shady business practices. Take your pick of the well known: Xerox, ImClone, Enron, WorldCom, and Global Crossing . . . the list goes on and on. Otherwise seemingly profitable organizations are now being scrutinized, and what is revealing itself is the way unethical practices are now the considered the norm in corporate America.

WHAT HAPPENED AT ENRON?

Enron has been described as an illusion of smoke and mirrors created by its upper management. A scheme was designed using the appreciated value of Enron stock to offset investment losses incurred by Enron, thus allowing the overstatement of earnings. According to Arlette C. Wilson, a professor of accounting at Auburn University and Walter M. Campbell, a professor of accounting at the University of North Alabama, in order for this cleverly designed scheme to work it has been determined that seven conditions had to exist simultaneously throughout the transaction period.

> a special purpose entity (SPE) manager who would agree to such unusual transactions,
> outside investors who would not resist such unusual transactions,
> a Board of Directors that would sign off on the transactions,
> management that would not adhere to internal controls,
> SPEs that would qualify for non-consolidation
> outside auditors who would allow improper reporting under generally accepted accounting principles (GAAP), and
> an Enron stock price that would remain strong.(Campbell, Wilson, 2003)

These seven conditions did indeed exist at Enron and worked for a while. The Chief Financial Officer (CFO), Andrew Fastow, proposed the creation of the SPEs, managed the partnerships and was also an investor in them, thus creating the first condition. Fastow was also in charge of finding the outside investors for these SPEs. To take care of the second condition, the CFO recruited friends, family, and Enron employees for these investments. Fastow guaranteed these hand picked investors that their initial investments would be returned, along with a significant return on their initial investment, before the SPE could enter into any hedging transactions with Enron. These returns amounted to approximately 193 percent; therefore the investors had little economic incentive to object to these transactions.

The third and fourth conditions were manipulated by the CFO by putting pressure on the Chief Accounting Officer (CAO), the Chief Risk Officer (CRO), and the Chief Operating Officer (COO). This pressure caused management to do little review of the SPEs and to sign off on whatever the CFO put in front of them. The Chief Operating Officer would approve the transactions and withhold the information from the Board of Directors. The Board did set up controls to mitigate the risk involved in these entities; however, implementation of the controls was inadequate and almost nonexistent.

Arthur Andersen, Enron's outside auditors, created the fifth and sixth conditions. Arthur Andersen agreed that the SPEs did not have to be consolidated with Enron's financial statements. In addition to agreeing to the improper accounting treatment of these transactions, Arthur Andersen helped to develop misleading disclosures with regards to the SPEs. This led up to the final stage of Enron's downfall. Then in 2000 things started unraveling.

At the first sign of doubt about the financial statements and the questioning about their transparency, the CEO, Jeff Skilling, responded with arrogance and derogatory name-calling without answering the questions. These derogatory and arrogant responses only added fuel to the fire causing the market to view the company with more and more skepticism, and eroding the markets trust. In addition, these actions started to tarnish Enron's reputation. Once the market started to react to this situation, Enron's stock began to fall.

When the stock prices began to fall, which was one of the seven conditions listed above, Enron's walls came tumbling down. Enron's rating was downgraded to junk status and stock that had been valued at around eighty dollars was selling for twenty-six cents a share. The story of Enron is still unfolding as the government investigates the criminal activities of the people involved. Currently, Ben Glisan, Jr. the former treasurer of Enron is serving a five year sentence, while Andrew Fastow has struck a deal with prosecutors and plead guilty to two felony charges.

In addition to these two executives, twenty-eight individuals - including former CEO Jeffrey Skilling have been indicted on charges stemming from the Justice Department's ongoing probe of what led to the collapse.

BEYOND ENRON: WHAT ARE THE EFFECTS?

While Enron went down and shocked the world, Andersen took the fall for document shredding and suspicious number crunching at Enron. However, Andersen was not just creatively crunching the numbers at Enron, its list of clientele only began with Enron and included others like WorldCom, Adelphia Cable, Waste Management, Inc., and Sunbeam Corporation. Although Andersen claims that it didn't do anything wrong, nor did it know about the improper accounting tactics that brought down WorldCom, this accounting scandal was about six times larger than its predecessor Enron.

WorldCom, the parent company of MCI, was the No.2 long-distance telephone and data services company in the world. In July 2002, WorldCom filed for the world's largest bankruptcy, $107 billion, after disclosing that it had inflated its profits by improperly booking $3.9 billion in expenses. In the fall of 2002, the company uncovered an additional $3.3 billion in accounting errors dating back to 1999. (Pulliam, 2003). According to the SEC report issued June 9, 2003, the amounts of the fraud uncovered amounts to approximately $11billion. The report also states that the former CFO, Scott Sullivan implemented and directed the fraud with the help of the former controller, David Myers and the former CEO Bernie Ebbers (McLucas, 2003). Myers and Sullivan have both plead guilty to fraud charges, while Ebbers is awaiting trial.

When the admission of the behemoth telecommunications firm, WorldCom, hit the surface investors, customers, the U.S. economy, and the everyday lives of Americans were greatly impacted as they watched yet another corporate giant's stock drop by 90%. WorldCom provides over half of the lines that run the Internet traffic to over 20 million customers. These are customers who depend on this service everyday. Investors like J.P. Morgan Chase co-managed huge WorldCom business ventures like the $11.9 billion bond sale in 2001. To others this meant the postponement or cancellation of initial public offerings (IPOs), while others still found it necessary to close their doors to new business because of the ordeal. WorldCom’s misleading of investors like this, is a clear example of where, if any, ethical standards lie within the corporate culture (Benjamin 2002).

In scarcely more than one month, ten large firms disclosed hundreds of billions of dollars in accounting errors. Yet even a dozen big bankruptcy filings probably wouldn’t seriously hurt U.S. capital markets. While WorldCom had $28 billion in debt, it is not much compared to the $3.92 trillion U.S. corporate debt market. However, because investors had their fill of corporate duplicity they started taking their funds elsewhere, causing huge market and dollar implications.

Although the market can handle a great deal from one corporation gone bust, but when so many others follow suit, the market begins to reach a breaking point. The ill effects of these unethical business practices are further passed on to the American public through higher consumer costs, the loss of trust in corporate America, the loss of jobs, and a depressed economy in which to survive. It can easily be said that, “A crisis of confidence in corporate America has resulted,” (Jackson, 2003).

Among the changes WorldCom has made since its billion dollar accounting fraud came to light in the summer of 2002 is the creation of an ethics office. The ethics department was formed in October 2002, and is staffed by three veteran WorldCom employees, including Brian Levey. A 1984 graduate of Notre Dame, he was the featured speaker at Ethics Week for the College of Business. This eight-year veteran of WorldCom pointed to the creation of the ethics office as one sign that the culture at WorldCom is changing for the better.

The company is also planning continual ethics training for employees, which is an extremely essential portion of the new ethics program. Levey says that, “Today, WorldCom is a company committed to doing the right thing. We’re emphasizing to all employees that preventing ethical violations is a responsibility.” Some employees have greeted the ethics office with skepticism, using phrases like “ethics Gestapo” and “puppet of the regime” to describe Levey and his colleagues.

However, Levey thinks this is a real opportunity for the company to change. Under the new Chairman and CEO Michael Capellas the WorldCom culture is changing to one in which ethics and communication are valued (McCall, 2003). Apparently things are going well as WorldCom under the name of MCI, Inc. came out of Chapter 11 Bankruptcy in April 2004 (McLucas, 2004).

Another quite notorious case involving unethical business practices is that of the biotechnology firm, ImClone's, founder Samuel Waksal and the scandal involving insider trading. Sam Waksal has been charged with numerous offenses, mainly arising from his attempts to sell shares in the company prior to the announcement of the FDA's rejection of the company's upcoming, experimental, colon cancer drug, Erbitux; he sold shares before the decision was made public. The company's share price plummeted on the announcement, prompting allegations that Waksal had known about the rejection and had tipped off friends to sell shares before the information was made public. He has since entered a guilty plea for the unethical charges of insider trading and bank fraud totaling somewhere near $16 million dollars (Countryman, 2003). Although he showed no hesitancy to resist the unethical business deception of insider trading when the issue took place, when he was arrested in June of 2002 he expressed remorse before pleading guilty. He is currently in prison serving an 87 month sentence.. (Usborne, 2004).

This brings to the table another set of issues. Not only did Waksal deceive the stakeholders and the public about the company's value prior the FDA rejection of Erbitux, but by passing along insider information to other investors he ultimately caused another multi-billion dollar corporation to be involved. Martha Stewart was one of the investors that sold stock before the decision was public. Ms. Stewart sold 4,000 shares of ImClone one day before the FDA announcement was made. When the debacle surfaced Stewart's company stock prices fell 60% within days. Ms. Stewart has since been convicted and is seeking a new trial. (Countryman, 2004).

The unethical practices on the part of ImClone's CEO and Martha Stewart have impacted all of those that work for both corporations, and all that invested in both. These actions have threatened the organizational structures if not destroyed them all together. The lack of an ethics program within the corporate culture was demonstrated by examples of leadership, which were strongly lacking in ethical values. The results of the shoddy ethics displayed within the management of these two corporations, as well as, WorldCom, Enron, Arthur Andersen, and many others' have proven extremely damaging and far-reaching. The full impact is yet to be seen.

THE EVOLUTION OF ETHICS

It is hard to get your arms around the Enron situation. Even the experts don't seem to understand what really went on. Effecting change will be far more difficult than changing auditing regulations and empowering the SEC (Jackovics, 2002). We are all going to pay for what a few bad eggs did. Now, even those companies that have already set high standards for honesty and ethics—those with a built-in integrity factor will face even more government scrutiny (Blank, 2002).

Employees look to their leaders for guidance. If CEOs and presidents focus on the bottom line, above all else, as Enron executives did, employees will do the same. No corporate ethics-training program or values statement will be successful without the involvement and modeling of leadership. In addition it is not just top management that makes a difference. Research demonstrates that immediate supervisors and peers have a strong influence on workplace ethics (Hamed & Sutlliff, 2003)

Leaders can have the best of intentions, but unless their values are voiced on a regular basis, their employees see them as ethically neutral, at best (Hamed& Sutlliff, 2003). Ethically neutral are leaders that are ethical in word, thought, and deed, but do not openly talk about ethics. These leaders may not be perceived as ethical from a distance and are often viewed as not paying adequate attention to the ethical components of their decisions. These ethically neutral leaders can have just as devastating an effect on employees and business as the hypocritical leader who deliberately choose to act unethically.

According to Jennifer Saolpek a freelance writer for the American Society for Training and Development (ASTD) a return -on- culture creates a real return-on- investment. It was determined through a study of 300 large firms that those companies that made an explicit commitment to follow an ethics code provided more than twice the value to share holders than the companies that did not commit to a code of ethics (2001). This holds true with Johnson and Johnson, where core values have long held center stage and ethics is an ongoing challenge of developing good habits.

Johnson and Johnson employees periodically survey and evaluate how well the company is adhering to its code of ethics. At Johnson and Johnson this is referred to as "Credo" responsibilities. Their opinions are then relayed to senior managers, and any possible shortcomings in the Credo are promptly addressed. Due to these ethical values instilled in Johnson and Johnson managers, when the Tylenol scare hit in the eighties, and seven Chicago residents died after ingesting cyanide laced capsules, there was a a joint consensus agreement that the Tylenol must be removed from the shelves and the production must be immediately stopped. This was done against the advice of their consultants and attorneys. They were warned that this would ruin the Tylenol name. However, because of the ethical and caring way they handled the situation, the sales of Tylenol has not waned. This is just one example of how living ones values pays off (Saolpek, 2001).

SUMMARY AND CONCLUSION

In the forefront of most American's minds along with those abroad is the plague of ethical debacles that have been attacking the sanctity of American culture and ethics. As displayed in the previous chapters, I have attempted to examine the recent trend in companies that are and have currently undergone serious ethical issues. This is exemplified in relation to the CEOs, CFO's, accountants, employees, and the market.

Changes in corporate culture and advancements in corporate America can only lend itself to changes in the ethical climate of today's organizations. Information technology and the trend of organizational globalization have been prime indications that there is a serious need for integration between today's modern corporation and yesterday's ethical values. Recent businesses have appeared to be following a movement of ethical degradation. In fact, the failures have almost become an everyday occurrence. The issue of values and knowing what is right or wrong is particularly personal when defining the meaning of ethics. Values including honesty, integrity, promise keeping, fidelity, and fairness among others are often complex decisions for employees and management to make. This parallel between business and personal is closely drawn.

It seems that the headlines of unethical business practices are never ending. Therefore, a determination was made that an examination of the business ethics in the corporate world might lead to an insight as to why so many failures are occurring. Several issues were examined, including what effects unethical business practices have on different parties such as the stakeholders, public accountants, corporations and professionalism as a whole.

The problem arises when corporations interpret the gray areas of the law and ethics to suit their own purposes. It appears that corporate America has taken on the Hollywood image portrayed in the movie *Wall Street*. The CEOs, CFOs and senior partners of these current scandals are taking to heart, Michael Douglas's infamous words, "Greed is good". The business executives currently making the headlines appear to have no reservations about taking unethical steps, disregarding the harm to employees, investors, their profession, or even themselves during their pursuit of wealth and prosperity.

Recent ethical failures in corporate America have shown how the lack of corporate culture and ethical values has lead to the downfall of the organization. Enron, World Com, and Andersen are just a few of the highly publicized examples of companies dissolving due to this ethical predicament. Each executive made decisions and judgments based on their personal outcomes rather than what was in the best, ethical interest of the corporation as a whole. Such obvious misuse of corporate power proved detrimental to the company, its stakeholders, and the image of corporations in the United States.

Enron was nothing more than a ponzi scheme designed to overstate the company's earnings in order to increase the price of Enron's stock. In addition, off balance sheet special purpose entities were created in order to hide Enron's actual debt and to increase the executives' and their families and friends, wealth as part of these creations. Not only were these creations unethical, they were apparently fraudulent. It is apparent that the ethical values referred to in Enron's code of ethics were only window dressing. When employees questioned the validity of transactions within the company, they were either ridiculed in public and/or fired. This created a hostile atmosphere that intimidated the lower level employees.

The Enron story has produced many victims. Enron's core values of respect, integrity, communication, and excellence, stand in satirical contrast to allegations now being made public. Enron is now in bankruptcy and struggling to survive. Hundreds of the employees and stockholders have lost their life's savings and are struggling to survive. All of this is the result of unethical business practices conducted by a few of the top executives of the corporation.

Arthur Andersen forgot the lessons it learned in the 1980's when it was involved in the Savings and Loan scandals. Once again Andersen set aside the basic auditing requirements of independence in order to increase profits. Andersen's lucrative consulting contract was apparently more important to the company than upholding its own code of ethics as well as the code of ethics provided by the American Institute of Certified Public Accountants. In addition to dismissing these two codes of ethics, Andersen apparently ignored some of the classic risk factors associated with management fraud as outlined in SAS no. 82. It appears that Andersen became too closely involved with the client and lost its objectivity and independence. Due to this loss of independence, and lack of ethical judgement, Arthur Andersen no longer exists. Once again there are numerous victims, including former employees of Andersen, the businesses that relied on Andersen to perform independent audits, and once again the stockholders of the companies involved.

Andersen did not limit it unethical practices to likes of Enron, it also had its hand in the demise of many others including WorldCom. WorldCom or sometimes more commonly known as MCI WorldCom was six time larger than Enron and was one of the largest telecommunications suppliers in America. However, this did not stop those at the top from becoming greedy and jeopardizing the sanctity of the institution by inflating profits and miscalculating accounting issues to the tune of $11 billion. Yet again poor ethical practices and an accounting relationship with Andersen have proven detrimental. Enron, Andersen, WorldCom, and ImClone, these are all vast organizations that got caught doing wrong and hurting thousands of people in the process; however, these costly examples also serve as red flags for all the real corruption that is lurking within corporate America, big and small alike.

With the downfall of these billion dollar companies it is easy to see the damage that is left behind. The losses of employment, the loss of money, and the loss of a reputation, are all effects, which can be seen very plainly. To most, the cause of all of this is quite obvious. Clearly, the cause behind these scandals is poor ethical practices.

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INFORMATION TECHNOLOGY PROFESSIONALS MEET SARBANES-OXLEY

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ABSTRACT

The Sarbanes-Oxley Act of 2002 (SOA) is a law that will affect the lives of top level company officers along with finance and accounting professionals. Top level officers are responsible for the veracity of financial reporting under the SOA. Finance and accounting professionals have traditionally been the corporation's experts regarding financial and operational controls. However, in today's world, information technology (IT) professionals play a key role in designing and maintaining the systems that enforce those controls. This paper examines the challenges that IT professionals will face as they find themselves face-to-face with the provisions of the SOA, a law that could put executives in jail and cause middle managers to lose their jobs.

INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOA) was passed in the United States (U.S. Code, 2002) in response to a series of significant failures in corporate governance, including Enron (Schwartz, 2001) and the related failure of accounting firm Arthur Andersen (Eichenwald, 2002), HealthSouth (Day, 2003), Tyco (Sorkin, 2002), and WorldCom (Moules & Larsen, 2003). Even Europeans, many of whom were convinced that this rash of management frauds were a result of American's hyper-capitalism mania and could never happen in the refined atmosphere of the continent, found that they were not immune when Parmalat's $15 billion in understated debt and huge overstatements of sales and earnings were exposed.

The SOA imposes a number of reporting and compliance requirements on companies, their managers, and their directors. It also imposes a number of requirements on the systems of internal control used in companies. In this paper, we examine how IT professionals will need to be involved with SOA compliance activities in companies that are subject to the law.

IT REPORTING LEVELS IN THE ORGANIZATION

In many organizations, IT professionals report to a Chief Information Officer (CIO) who reports, in turn, to a Vice President of Finance or Administration. This traditional reporting path places the top IT officer of many companies below the senior decision making level. Companies that do this see IT as a service function and not as a source of competitive advantage (Laudon & Laudon, 2004; Oz, 2004). The senior finance or administration officer often has an accounting background. In many cases, this means that the person to whom the CIO reports knows little about IT issues. An increasing number of companies, including Novell and FedEx, have taken a different tack. These companies have placed responsibility for IT investments and IT strategy in the hands of their boards of directors (Hoffman, 2004). These companies have realized that there is significant legal risk involved if IT projects are not managed properly because inadequate controls can result from IT project failures (Hardesty, 2004). An understanding of internal control demands an understanding of the underlying accounting and administrative systems of the company (Hall, 2004). As every business of any size has computerized its accounting and administrative systems, the people who know these systems well and who understand their design are increasingly members of the ranks of IT professionals. IT professionals, both inside the company and in consulting firms outside the company, can provide valuable services to the company as it attempts to comply with the internal control standards set by the SOA.

DOCUMENTATION OF CONTROLS

The Sarbanes-Oxley compliance deadlines that most large companies will face in 2004 and 2005 for the first time include a major challenge. Section 404 of the SOA requires that companies subject to the law document their internal controls, including internal IT controls. However the SOA is unclear about which controls need to be documented and how the documentation should be accomplished.

The control documentation must include a risk assessment process and must result in the documentation of controls. Company internal IT auditors have been doing this type of work, documenting and testing general and application controls over software, for years (Gelinas & Sutton, 2002; Hall, 2004). Audit firms have begun to explore ways to monitor their clients' IT risk assessment procedures and assess the information systems audit work that is done by clients' internal IT audit staff. Hoffman (2004a) notes that the Public Company Accounting Oversight Board (PCAOB) has not told companies to use any specific method or approach when documenting IT controls. A number of options exist (such as COBIT, COSO or ISO 17799), which makes it difficult for the audit firms to provide advice to their clients about which controls need to be documented (Hoffman, 2004b).

SAS 70 REPORTS

Suppliers of IT services, such as software vendors, system integrators, and system design and implementation consultants, provide their customers with annual reports, called SAS 70 reports (so named after the Statement on Auditing Standards Number 70, which established internal control guidelines many years ago). These SAS 70 reports describe the accounting and operational controls that exist in the systems they sell or have designed and installed. Not all vendors and consultants produce these reports and many SAS 70 reports do not include enough detail to satisfy SOA requirements. In some cases, the SAS 70 reports are sent too late to be included in the annual audit work and financial statement preparation. Some companies who have outsourced their software development work to offshore contractors are now finding that their contractor has no IT testing or revision controls. To the extent that these contractors create financial or key information systems for companies, they could put the outsourcing company at risk with respect to SOA compliance (Hoffman, 2004a).

SPECIFIC IT RISKS UNDER SOA

Although SOA is, at its base, legislation designed to control financial activities, the main way it accomplishes this goal is to require companies to produce better financial reports. Oversight of internal controls has long been seen as a good way to do this (Romney & Steinbart, 2002; Winters, 1994). SOA's focus on internal controls does appear, however, to go beyond the policy reviews, procedures and external financial audits that companies have relied on in the past. The SOA gives the Securities and Exchange Commission (SEC) the responsibility for defining exact compliance regulations for internal control sufficiency, but it is virtually certain that IT controls will be included in the list (Kubilus, 2003). To date, IT professionals have been standing by as CEOs, CFOs, lawyers and company auditors identify and deal with SOA compliance issues. CIOs will soon need to enter the fray and bring IT controls into the picture.

One classic risk area is in the failure to adequately segregate duties. In IT, separation of program development, testing, and implementation can be critical. Many IT organizations are unaware of the importance of segregation of duties as a control concept. Developing a process for identifying segregation of duties controls and evaluating them is something that IT professionals can do as well as internal audit staff. Many times, companies have systems that were constructed internally without adequate controls. When these systems are used for financial information processing, they become potential sources of SOA violations. Even companies that purchase packaged applications can be vulnerable. When the purchased software is modified, built-in controls can be neutralized or eliminated in the customization process. Very few organizations have procedures in place that provide for an automatic review of controls in modified systems.

The costs of failed IT projects are legendary (Wallace & Keil, 2004). A leading cause of IT project failure is poor project management. Thus, project management methods and systems become key elements in a good system of internal control. IT professionals must develop processes that monitor the selection and implementation of systems that affect the financial processing or reporting of the company. If they fail to do so, they subject the company to SOA sanctions.

IT also can be deeply involved in records management (Kubilus, 2003). Whether it is maintaining copies of current e-mail messages and instant messaging files, or retention of backup information regarding old transactions that might have been fraudulent. The IT professional is often in a position to enforce controls that have a bearing on SOA-related concerns. Lanza (2004) notes that two of the most important elements of any SOA compliance program is the proper use of data analysis tools and data mining software. Data analysis functions include the use of query tools that allow users to ask questions of the enterprise-wide information system (Gelinas, 2002). In large organizations such as those subject to SOA, this system will, in most cases, have been designed and implemented by the company's IT staff. It will definitely be maintained by IT staff. The people who know the most about the enterprise-wide information system will always be IT professionals. Many companies have undertaken major knowledge management initiatives in recent years (Angus, 2003; Awad and Ghaziri, 2003). These initiatives have, in most cases, been designed and implemented by IT professionals. As SOA requirements become part of the fabric of large companies, they will be included as part of these companies' knowledge management systems (Lanza, 2004).

AN IT ACTION PLAN

IT industry analysts such as Johnson (2003) recommend a series of steps that IT professionals should include in an SOA compliance action plan. First, they recommend that IT professionals do some research. IT professionals are not accountants and they are not auditors. They do not know about basic control concepts such as segregation of duties. They seldom understand the significant differences between financial systems and other company IT systems.

The second step is to do some benchmarking. Find out what other IT professionals are doing to comply with SOA. In many companies, CIOs are sitting on the sidelines while the accountants and lawyers scramble to meet the challenges of the SOA (Hoffman, 2004b). IT is an integral part of the control landscape in any company. The CIO and senior IT managers must be proactive in pushing the importance of IT processes and the risks inherent in ignoring IT controls.

Step three is to become familiar with software vendor and consultant offerings. Some software vendors are offering upgrades that include documented controls. Some of these products are even keyed to specific SOA elements. Vendors of software reporting tools, supply chain management tools, and document management systems are also working to offer systems that can help with internal control documentation.

Step four is analyze ongoing IT projects for control weaknesses and failure risks. If the software project has any financial implications, the risk of failure of the system implementation effort can be a control weakness in itself, under SOA.

CONCLUSION

IT professionals have been left out of the scramble to comply with SOA provisions. As the deadlines for compliance approach, more and more companies will find that they need to turn to their IT professionals to document controls, and to develop processes that will allow them to identify and evaluate controls. Proactive CIOs and senior IT managers can help their companies by taking the initiative and moving forward with an action plan that will help them be ready when the other members of the management team wake up and realize the important resource they have in the IT function.

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ATTITUDES TOWARD COUNTERFEIT PRODUCTS: AN ETHICAL PERSPECTIVE

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ABSTRACT

Counterfeit products cause a considerable amount of damage in the free market economy. Moreover, future investment in research and development is placed at risk from the unfair competition generated by counterfeit products. Despite the importance of this phenomenon, there is lack of understanding of the factors that may influence customers to buy and evaluate these counterfeit products. The purpose of this study is to empirically investigate some ethical and personal traits, plus product characteristics, to assist in understanding and ultimately addressing this phenomenon. Some cross-cultural comparisons are made between Anglos and Hispanics.

A cross section of consumers in a small city in south Texas was surveyed about their preferences for and buying intentions regarding counterfeit products. A total of 211 usable questionnaires were gathered. Results show that consumer ethics and locus of control are strong predictors of the evaluation of counterfeit products. The results also suggest that the more evaluation the subject has for the counterfeit products, the more intention the subject would have to purchase the counterfeit product.

INTRODUCTION

A company's product brand is often its most valuable asset. (Green and Smith, 2002). Unfortunately, the success of the brand breeds counterfeit practices (Delner, 2000; Nill and Shultz, 1996). Brand image is the part of the brand that is related to the perception of the customer about a specific brand. The symbolism and elements that are constructed around a brand are important factors that determine the propensity of a product to suffer this type of unfair competition (Nia and Zaichkowsky, 2000; Cordell, Wongtada, and Kieschnick, 1996).

The total losses estimated every year for counterfeiting is about $200 billion dollars worldwide (Chaudhry and Walsh, 1996). The consequences are not only economic for the company, there also is a great number of job looses within companies affected by counterfeiting (Chakraborty et al., 1997). The majority of counterfeit products are manufactured in countries where legal sanctions are not as strong as in the US (Grossman and Shapiro, 1988). The countries that are more frequently associated with the production of counterfeit products are Taiwan, China, Singapore, and Thailand (Gentry et al., 2001).

Despite the worldwide legal sanctions against the manufacturing and the consumption of counterfeit products, the problem is expanding rapidly (Cordell, Wongtada, and Kieschnick, 1996). Many companies even employ a team of lawyers and investigators to work to addressing this problem (McDonald and Roberts, 1994). A number of articles can be found in the literature that deals with anti-counterfeit strategies that are implemented worldwide to try to protect industries from the practices of illegally producing and selling brand name products (Chaudhry and Walsh, 1996; Olsen, 1992; Delner, 2000).

The problem is not related only to the manufacturers of counterfeit products. The demand for these types of fake name brand products is a key element in the increase in the trade in counterfeit goods (Chakraborty, Allred, and Bristol, 1996; Gentry et al., 2001; Bloch, Bush, and Campbell, 1993). This study will analyze the factors that influence customers to purchase counterfeit products. These factors include demographic factors such as gender and income, product characteristics, like the type of product (hedonic or utilitarian), and other personal traits that may affect the intention to purchase counterfeits items. These traits include locus of control, perception of risk, and price consciousness. In addition, the study investigates the purchase intention and the post-purchase feeling of counterfeit products.

Our research involves four elements: 1) individual ethical factors, 2) perception of financial risk, 3) product characteristics (hedonic and utilitarian), and 4) personality factors such as locus of control and value consciousness. Results of this research will shed light on the reasons consumers create a market for counterfeit goods, knowledge that will be beneficial in controlling the sale of such products. Figure 1 presents the theoretical model for this study.

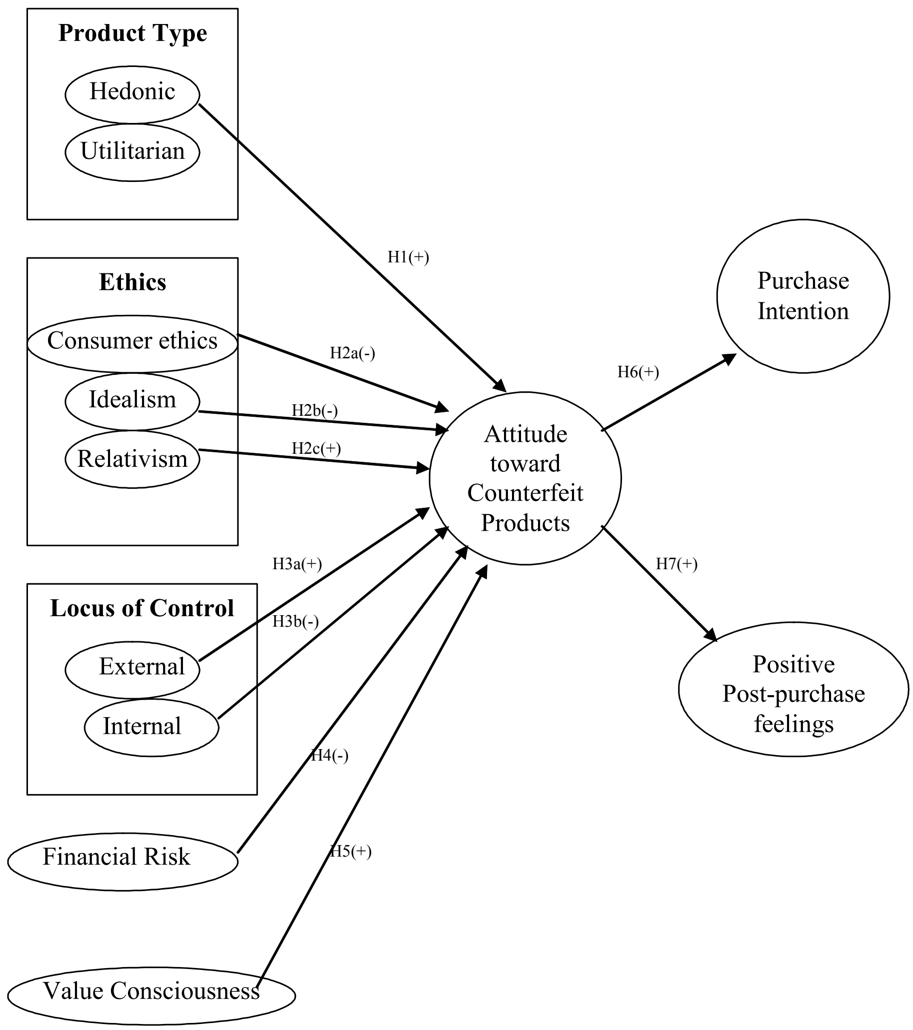
The remainder of this paper is organized as follows. First the literature review is presented along with the development of the hypotheses. This is followed by the methodology section where a description of how the analysis was conducted. The results section is describing how the data were collected and how the analysis was conducted. The results section is then presented, followed by section suggesting future research and discussing some implications of the findings of this study.

LITERATURE REVIEW AND HYPOTHESES

Type of Products

Several typologies are considered in the marketing literature when classifying consumer products. Hedonic and utilitarian products are typologies that are considered when evaluating

Figure 1. Theoretical Model



differences in types of products. Hedonic products are those that create pleasure in its consumption and utilitarian products are those that are considered a necessity in the everyday life. The literature deals also with other typologies in the classification of types of products. These include public vs.

private usage and luxury vs. necessity (Chapa, Minor, and Maldonado, 2003), where it was found that counterfeit watches (luxury) are more evaluated by consumers than counterfeit tennis shoes (necessity). In addition, using luxury products trends to impress others (Nia and Zaichkowky, 2000), and creates prestige for the owner (Grossman and Shapiro, 1988). This study hypothesizes that luxury or hedonic counterfeit products are more evaluated than utilitarian or necessity counterfeit products:

H1: Hedonic counterfeit products are evaluated at a higher level than utilitarian counterfeit products.

Ethical Perception

Research in consumer behavior is very important in marketing literature. Ethics in consumer behavior has been greatly researched, especially concerning counterfeit products (Nill and Shultz, 1996; Ang et al., 2001; Albers-Miller, 1999). In this study, consumer ethics refers to the judgment, intentions, and perceptions of individuals as they relate to consumption. Four elements that are integrated in the consumer ethics construct: 1) actively benefiting form illegal activity, 2) passively benefiting, 3) actively benefiting form questionable actions, and 4) no harm/no foul (Muncy and Vitelle, 1992). We expect that those individuals with high scores in consumer ethics tend to have a lower evaluation for counterfeit products than those with lower scores in consumer ethics. Therefore the following hypothesis is presented.

H2a: The higher score on consumer ethics the respondent has, the less evaluation the individual will exhibit toward counterfeit products.

A deeper topic in ethical perceptions is ethical ideology. According to Forsyth (1980), consumers tend to be an ethical relativist or idealist. The relativist scale measures rejections of universal moral principles, meaning that decisions on morality are situation specific. Conversely, the idealist scale measures the acceptance of moral absolutes where, no matter the situation, what is right is right and what is wrong is wrong.

Consumer ethics ideology in the two measurements (relativist and idealist) is determinant in forming ethical judgments by individuals (Vitelle, Singhapakdi, and Thomas, 2001). In this study we expect that the more idealistic consumer would be more ethical and therefore would less evaluate counterfeit products, and those more relativist consumers would evaluate more counterfeit products. The following two hypotheses are presented.

H2b: The higher on the scale of ethical idealism the individual is rated, the less evaluation the individual will exhibit toward counterfeit products.

H2c: The higher on the scale of ethical relativism the individual is rated, the more evaluation the individual will exhibit toward counterfeit products.

Locus of Control

Locus of control is a trait that refers to the extent to which individuals believe they control their own fate and accept responsibility for the outcomes of their action. Those with an internal locus of control believe that life's rewards or punishments are determined by one's own efforts. External locus of control refers to the belief that life's rewards and punishments are determined by fate or other powers. In consumer behavior research, locus of control has been studied extensively (Busseri, Lefcort, and Kerton, 1998; Busseri and Kerton, 1997). LOC is determinant in ethical or moral judgment (Guthrie, 1984; Trevino and Youngblood, 1990; Hume, Smith, and Davis, 2001; Chiu and Erdener, 2003) where it has been found that individuals with internal locus of control have more ethical judgments and responses. In this study we expect that individuals who have more internal locus of control will evaluate counterfeits less than those with high an external locus of control. Therefore we hypothesize:

H3a: The higher external locus of control rating the subject has, the greater evaluation the subject will exhibit toward counterfeit products.

H3b: The higher the internal locus of control rating the subject has, the less evaluation subjects will exhibit toward counterfeits.

Risk

There has been much research concerning risk and attitudes toward counterfeits (Bloch, Bush, and Campbell, 1993; Chakraborty et al., 1997; Delner, 2000; Cordell, Wongtada, and Kieschnick, 1996). There are many types of risk involved in the consumption of counterfeit products. These include criminal, social, performance, and financial risk (Wee, Tan, and Cheok, 1995). However, only financial risks are considered in this study. Financial risk is the perception that the individual has regarding the possible loss of the money invested in the acquisition of a product. It has been found that type of product is determinant in the perception of risk, especially when it involves health issues such as drugs, or safety-related products such as auto parts. In these cases, counterfeit products are less frequently chosen by consumers. In this study it is expected that when people perceive risk in the consumption. It is expected in this study that when people perceive risk in the consumption of counterfeit products that would tend to less evaluate these products, so the hypotheses are:

H4: The higher the perception of financial risk the lower the evaluation toward counterfeits.

Value Consciousness

For counterfeit products, price is a key element that determines the propensity to purchase these products. It was found that people tend to sacrifice ethics when the price is low enough (Albers-Miller, 1999). Value consciousness is related to the price of the product and is the extent to which the consumer perceives that the value of the product is equivalent to the cost to the consumer. Vitelle, Singhapakdi, and Thomas (2001) examined the relationship between value consciousness and ethical judgment but did not find any significant relationship between the two. Nevertheless, since value consciousness is a key element in decision making and formation judgment, we expect that when people are high in this construct, the person would evaluate counterfeit products more high. The following hypotheses is presented.

H5: The more value consciousness the individual has, the higher the evaluation that it would be exhibited toward counterfeits.

Purchase intention and Post-Purchase Feelings

The more evaluation an individual has for a counterfeit product, the more purchase intention that person will have (Nia and Zaichkowsky, 2000; Cordell, Wongtada, and Kieschnick, 1996). So we expect that the higher evaluation a person has for the counterfeit, the greater the purchase intention he or she will have in the purchase intention. We hypothesize that:

H6: The greater the evaluation the subject has for the counterfeit the higher the intention to purchase the counterfeit.

By the same token, post-purchase negative feelings of guilt, unethical, and illegality are associated with the perception and attitudes toward the counterfeit products (Chakraborty et al., 1997; Chakraborty, Allred, and Bristol, 1996), Consequently it is expected that the greater the perception is about the about the counterfeit product, the less guilt the respondent would feel. Therefore we hypothesize:

H7: The more favorable the evaluation the subject has for the counterfeit, the more positive are the post-purchase feelings concerning purchase.

METHODOLOGY

A cross section of individuals in a small Texas city was surveyed regarding their perceptions of counterfeit products. Demographic data was also collected on the survey, and participants were assured anonymity. A total of 211 usable questionnaires were gathered. Table 1 shows the demographic data of the participants.

Table 1. Demographics of the data.

Variable	Specific Answer	Quantity
Gender	Male	84
	Female	117
	Missing	10
Income	0-25,000	50
	25,000 – 50,000	53
	50,000 – 75,000	52
	75,000 – 100,000	22
	More than 100,000	12
	Missing	22
Education	High School or Less	38
	Some College Education	134
	Graduate	30
	Master or Doctor	9
	Missing	1
Age	Below 20	60
	20 – 29	91
	30 – 39	22
	40 – 49	25
	50 – 59	10
	60 and Over	3
Race	White/Caucasian	46
	Hispanic/Latino	150
	Black/African American	4
	Asian/Asian American	2
	Native American	2
	Other	5
	Missing	2

To distinguish the different types of products in this study (hedonic vs. utilitarian) we choose for the hedonic product a leather wallet/purse of a very prestigious brand, and for the utilitarian product we choose a software package that needed to be used for work- or school-related jobs. We specify for both products the same price for the original brand ($300.00), and the same price for the counterfeit ($30.00) to have the same comparison basis in the analysis.

Instrument

To ensure validity of the questionnaire, questions were selected from established instruments reported in the literature. The questionnaire measures the following variables:

LOC (Roter, 1964), 3 items.
Consumer Ethics (Muncy and Vitelle, 1992)
Actively benefiting from illegal activity, 3 items
Passively benefiting, 2 items
Actively benefiting from questionable actions, 5 items
No harm/no foul, 6 items
Ethics Position Questionnaire (Forsyth, 1980)
Idealism scale, 10 items
Utilitarian scale, 10 items
Value Consciousness (Lichtenstein et al., 1990), 7 items
Performance Risk (Shimp and Bearden, 1982), 4 items
For the two types of products: utilitarian and hedonic
Perception of quality, durability, value, etc. (Wee, Tan, and Cheok, 1995)
Willingness to buy (One 7-point Likert item)
Post-purchase feelings (ethical, illegal, guilty)

RESULTS

To evaluate the hypotheses, ANOVAs, correlation matrixes, and T-tests were used, and the results are shown in Table 2. Reliability was computed, and overall we found high values in the measurements (CA > 0.80). A set of new values was computed from the original data. For example to consider the overall evaluation of each one of the different products, a summation of all the individual evaluation was computed. The same treatment was conducted with regard to value consciousness, locus of control, consumer ethics, etc.

Type of Product

For testing if there is significant difference in the evaluation of the two types of products (utilitarian and hedonic), pair-sample t-test was used. The original hypothesis was that hedonic products are more evaluated than utilitarian products. Results indicate not only that this expectation was not found, but a significant difference in the opposite direction was found. The finds suggest that utilitarian counterfeit products were more evaluated than hedonic counterfeit products with a $p < .01$. Therefore, Hypothesis 1 was not supported.

Table 2. Results.

Hypothesis	Variables	Result	Comments
H1	Type of product	Not Supported	
H2a	Consumer ethics	Supported	
H2b	Ethical Idealism	Non supported	
H2c	Ethical relativism	Partially Supported	Only Utilitarian products
H3a	External LOC	Supported	
H3b	Internal LOC	Supported	
H4	Financial Risk	Supported	
H5	Value Consciousness	Partially supported	Only Hedonic products and only the male population and those whose household income is more than $75,000 yearly.
H6	Purchase Intention	Supported	
H7	Post Purchase Feelings	Partially supported	Only Utilitarian products

Ethical Perception

The ethical measurements for the subjects include consumer ethics, ethical relativism, and ethical idealism. Hypothesis 2 tests whether higher scores on ethics measurements (any of the measurements) predicts lower evaluations toward counterfeit products. For consumer ethics, it was found that this variable is a strong negative predictor of the evaluation of the products (both utilitarian and hedonic), such that Hypothesis 2a is supported. For the other variable, ethical idealism was not found to be a statistical predictor of the evaluation of counterfeit products. In this sense, Hypothesis 2b must be rejected. On the other hand, ethical relativism was found to be is a strong negative predictor in the evaluation of counterfeit products, but only for the utilitarian product (software), such that Hypothesis 2c is partially supported.

Locus of Control

Locus of Control was found to be a significant prediction of the evaluation of the counterfeit products. For respondents with a high score of internal locus of control it was found that counterfeit products are less evaluated. Consequently, for people that have high external locus of control, it was found that counterfeit products are more evaluated. Therefore Hypotheses 3a and 3b are supported.

Risk

Financial risk was found that is a strong predictor in the evaluation of the counterfeit products in both types: utilitarian and hedonic products. The statistical results support Hypothesis 4.

Value Consciousness

Another variable considered in this study that may influence the evaluation of the counterfeit products was value consciousness. The results show significant predictive power of this variable on the evaluation of counterfeit products. However the predictive power held true for hedonic products only, in the case of male participants only, and those whose household income is more than $75,000 yearly. The statistical results partially support Hypothesis 5.

Purchase Intention and Post Purchase Feelings

Purchase intention and post purchase feelings are consequences of the evaluation of the counterfeit products. In this case we had hypothesized that the more evaluation the subject would have for the counterfeit products the more purchase intention and the less post purchase feelings of guilty, unethical and illegal actions would be perceived. Results show that evaluation of counterfeit products is a strong predictor of the purchase intention of the products, so Hypothesis 6 is supported. In Hypothesis 7, i.e. the greater the respondents evaluation of the counterfeit product, the less post purchase feeling the individual would exhibit, we found only partial support since the utilitarian product (software) was the only one for which respondents indicate this behavior.

Other results not considered in the hypotheses

Another variable that we were interested in about the perception of counterfeit products was the ethnicity of the respondent. However we did not found any significant difference between Anglos and Hispanics in the evaluation of counterfeit products.

IMPLICATIONS AND FUTURE RESEARCH

Contrary to our expectations, the data of this study suggests a strong evaluation for utilitarian counterfeit products. This may be the result of the product example selected for the study (software needed for work or school), since information technology is strongly diffused in our society. This confirms the magnitude of the problem facing the software industry, along with the music industry. Increasing ethical awareness in consumers is viewed as a possible solution to reduce counterfeit products demand. The results of this study suggest that consumer ethics is a strong predictor of the demand for counterfeit products. The other measurements of ethical values (idealism/relativism) have weak support in the evaluation of counterfeit products, since only ethical relativism is a predictor (and only for utilitarian products) on the evaluation of counterfeit products.

Results of this study are only partially conclusive, and further research is necessary to better understand better this phenomena. Ideas for future research include varying the types of products to determine which types of products consumers respond to in an ethical context. Studies which include a more diverse population of subjects and a larger sample size are also recommended.

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