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From the Editor-in-Chief. . . .

This is the 2nd volume of the *Southern Journal of Business and Ethics*, an official publication of the Southern Academy of Legal Studies in Business. The Journal is being published in hardcopy and electronically on the Southern Academy's web page at <http://www.salsb.org>.

All articles that appear in this volume of the *Southern Journal of Business and Ethics* have been recommended for publication by the Advisory Editors, using a double, blind peer review process. A personal thanks is extended to the Advisory Editors for all their hard work and dedication to the *Journal* and the Southern Academy; without their work, the publication of this Journal would be impossible.

This is my second year as Editor-in-Chief, and I wish to express my sincere thanks and appreciation to all the Officers of the Southern Academy for their support, encouragement, assistance and advice throughout this year. I would like to further express appreciation to Will Mawer of Southeastern Oklahoma State University, for his efforts in coordinating the entire process. The publishing of this journal is an intense educational experience which I continue to enjoy.

The papers herein were presented at the Southern Academy of Legal Studies in Business meeting in San Antonio, Texas, March, 2010. Congratulations to all our authors. I extend a hearty invitation to the 2011 meeting of the SALSBS in San Antonio, Texas, March 3-4-5, 2011.

The Southern Academy annual meeting has been voted the "BEST REGIONAL" among all the regions affiliated with the Academy of Legal Studies in Business (ALSB) featuring over 60 authors and 50 papers. I hope to see ya'll in San Antonio! Please check the web site (www.salsb.org) for further information. To further the objectives of the Southern Academy, all comments, critiques, or criticisms would be greatly appreciated.

Again, thanks to all the members of the Southern Academy for allowing me the opportunity to serve you as editor-in-chief of the Journal.

M.P. (Marty) Ludlum

Editor-in-Chief

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Does Risk Reduction Mitigate the Costs of Going Green? – An Empirical Study of Sustainable Investing

Christina C. Benson *
Neeraj J. Gupta **
Ravi S. Mateti ***

I. INTRODUCTION

The relationship between corporate social responsibility (“CSR”) and financial performance has long been debated. A predominant traditional view, most associated with the work of Milton Friedman, argues that being socially and environmentally responsible imposes additional costs and administrative burdens, thereby placing the company at a competitive disadvantage and deterring investors. As infamously stated by Friedman (1970):

There is one and only one social responsibility of business— to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.

According to the above view of social responsibility, one would expect markets to penalize companies for undertaking social or environmental initiatives beyond minimal compliance with legal requirements, because such activities arguably would divert a firm’s limited resources from the central goal of increasing profits to shareholders.¹

In contrast to this traditional outlook, management theory and scholarship in recent decades has come to view CSR more strategically through the lens of “sustainable” business practices. As the literature on sustainability has developed, a growing number of authors have reframed traditional notions of corporate philanthropy and “social responsibility”, encouraging companies to make strategic and structural changes that leverage the interdependence between company and society to build shared value. (e.g., Porter and Kramer 2006). In this way, sustainability theory recognizes that companies can seek to minimize their adverse social and environmental impacts, while also achieving cost reductions and innovating new products and services that enhance value and improve the company’s competitive position. (e.g., Porter and Kramer 2006; Porter and Van der Linde 1995; York J. 2009).

Proponents of sustainability often use the term “triple bottom line” to describe the notion that companies can measure, benchmark, and report company performance based on a three dimensional standard incorporating “people, planet, and profits,” rather than maintaining a

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¹ As Friedman argues in relation to his hypothetical socially conscious manager, “Insofar as his actions in accord with his ‘social responsibility’ reduce returns to stockholders, he is spending their money.” (Friedman 1970).

singular focus on profit-maximization as under the Friedman view.² Sustainable business theory generally emphasizes the need for companies to manage social and environmental impacts more proactively, moving beyond reactive compliance with minimum legal requirements, and to generate long term value by recognizing the interdependence among financial, social, and environmental performance factors. (e.g., Hawken, Lovins & Lovins, *Natural Capitalism*, 1999; Elkington, *Cannibals With Forks*, 1997).

Rather than addressing these expansive theories of business sustainability, our goal is to add to the growing body of sustainability literature by more carefully examining the intersection between sustainability and **risk management** as a key arena where companies can apply sustainability principles to preserve value and gain potential competitive advantage. More specifically, we theorize that a focus on ecologically and socially sustainable business management should also enhance the company's ability to proactively identify and minimize various forms of ecological, social, legal, and regulatory risks.

In seeking to develop an empirical model that would supplement the growing body of research assessing the performance of sustainable companies, we also wanted to go beyond the question of whether sustainable companies perform "better" or "worse" than the market at large. Instead, our goal was to compare the performance of sustainable companies versus the market at large over an extended time period in order to assess: 1) are there any observable patterns of differences in performance trends over time; and 2) if so, can we identify what variables may help explain such trends in performance?

More specifically, we theorize that, if sustainable companies are better at identifying and mitigating a wider range of risks, this should also be reflected in trends of lower volatility coupled with long term continued growth. Thus, we set out to perform a comparison of Dow Jones Sustainability Index US (DJSI-US) data to the market at large to see if the DJSI-US actually demonstrated these trends of lower volatility and long term growth as compared to the US stock market at large.

In Section II of the paper, we further develop the theoretical framework to support our above hypothesis that sustainable companies have better risk management capabilities, leading to less volatility and more stable long-term returns. In particular, we explain that:

1. Sustainable companies are more likely to engage in long-term strategic thinking, resulting in greater stability over time;
2. Sustainable firms have better capacity to strategically manage legal and regulatory risk in adapting to complex and shifting regulatory requirements;
3. Prior studies support the theory that proactive management of environmental and social risks enhances firm value and competitiveness;
4. Managing sustainability risks can also enhance corporate governance and limit potential officer and director liability; and

² Sustainability scholar John Elkington was the first to coin the phrase "Triple Bottom Line" in a 1994 article, and then expanded upon the concept to describe a more holistic theory for measuring company performance as outlined in his book *Cannibals with Forks: The Triple Bottom Line of 21st Century Business*. (Elkington, 1997).

5. Sustainable firms can better manage reputational risks through more transparent sustainability reporting on a wider range of social and environmental information.

In Section III, we describe our empirical model, present the data, and discuss our findings. Finally, in Section IV, we conclude that the empirical results generally support the theory that sustainable firms listed on the DJSI-US have shown less volatility and have an attractive risk-return profile. Data suggest that the DJSI-US stocks provide stable long-term returns comparable to the market over time, and tend to out-perform the market during times of financial downturn.

II. HYPOTHESIS DEVELOPMENT

1. Sustainable Companies Are More Likely to Engage in Long-Term Strategic Thinking

A fundamental reason that one would expect sustainable companies to show stable returns over an extended time horizon, as compared to the wider market, is that sustainability theory is inherently focused on long-term strategic thinking.

Although the term “sustainable” has many different definitions and connotations, the history and literature reflects that most economic theories of sustainability are rooted in notions of longevity and orientation toward the future. In 1987, the World Commission on Environment and Development (i.e., the Brundtland Commission) issued a report setting forth its landmark definition of “sustainable development” as: “*development that meets the needs of the present without compromising the ability of future generations to meet their own needs.*” This definition of “sustainability” has since been cross-referenced and reiterated by international bodies, governments, non-government organizations, academics, and private sector companies too numerous to catalogue here. The Brundtland declaration’s focus on long-term cyclical renewal remains at the core of sustainable business theory today.

Nitin Desai, a senior adviser to the Brundtland Commission and a key draftsman of the Brundtland report describes how the above definition signaled a transformation in thinking about the interdependent relationship between economic prosperity and ecological policy. Desai states:

[T]he Brundtland Report changed sustainable development from a physical notion based on the concept of sustainable yield in forestry and fisheries to a much broader concept that linked economic and ecological policies in an integrated framework. . . . The report came at a time when the oil shocks of the seventies, droughts in Africa, concerns about tropical forests, the depletion of the ozone layer and several other problems were posing great challenges to policy at every level, and it offered a way of looking at these problems in a holistic way. The main long-term impact of the report is that we can no longer talk of economic and environmental policy in separate compartments. (UN Commission on Sustainable Development, April 2007).

In turn, this growing recognition that social, economic, and environmental progress are closely intertwined, has permeated not only economic development policy, but also transformed theories regarding corporate responsibility and the relationship between business and society. In the

more than two decades since the Brundtland Report, the concept of sustainability has fundamentally changed the way many multinational companies integrate ethics and social responsibility into the firm.

David Bent, head of business strategies at Forum for the Future (a nongovernmental organization advising businesses on ethical strategies), emphasizes that use of the term “corporate social responsibility” is declining and focus has instead shifted to “sustainable business.” (Evans, J., February 3, 2010). As Bent explains: “Corporate social responsibility asked the question: what is the impact of this business on the world? Sustainable business asks the question: what is the impact of the world on this business?” Scott Beaudoin, director of cause marketing for public relations giant MS&L Boston, adds that this strategic shift towards long-term sustainable thinking is growing stronger in the wake of the recent financial crisis:

Companies are asking how they can be socially responsible in a way that also moves the business forward. It's no longer about having one corporate social responsibility guy who is supposed to be the moral compass for the company, like a chaplain in an Army regiment. It's about making sustainable business the standard operating procedure. (Evans, J., February 3, 2010).

Chairman of U.K. bank HSBC, Stephen Green, agrees: “There has been a tendency to compartmentalize so-called corporate social responsibility activities as an adjunct to mainstream business activities,” whereas “[sustainability] is about the *raison d'être* of the company itself.”

Finally, the creators of the Dow Jones Sustainability Index have summed up this strategic and future-oriented focus of sustainability in answer to the basic question “What is corporate sustainability?”:

Corporate sustainability is a business approach to create long-term shareholder value. Sustainability leaders **embrace opportunities and manage risks which derive from economic, environmental and social developments**. As the importance of these trends increases, a growing number of investors integrate economic, environmental and social criteria into their stock analysis and **use sustainability as a proxy indicator for innovative and future-oriented management**. (DJSI FAQs).

In light of the fundamental future-orientation of sustainable firms, one would expect such companies to be strategically focused on long-term value creation. Thus, we would expect indices like the DJSI to compare favorably to the broader market when assessed over an extended time horizon on a risk-adjusted basis.

The DJSI's above definition of “corporate sustainability” specifically emphasizes opportunities for improved risk management, which is discussed below as a key factor explaining why sustainable firms can be expected to have financial performance comparable to that of the market at large.

2. Sustainable Firms Have Better Capacity to Strategically Manage Risk by Quickly Adapting to Complex and Shifting Regulatory Requirements

A growing body of recent academic literature has begun to explore the connection between sustainability theory and the more traditional concepts and tools of “risk management”. (Kytte and Ruggie, 2005; Husted, 2005). In explaining the natural linkage between sustainability and risk management, Krysiak (2009) relies upon the Bruntland definition of sustainability quoted above, to explain how companies can integrate risk management into a sustainability strategy in order to minimize the risk that present activities or decisions may have a negative impact of future generations. Krysiak states:

[A]t the core of sustainability lies futurity. However, a necessary implication of futurity is uncertainty. Neither can we possibly know what conceptions of well-being future individuals will have as they are not in existence yet. Nor can we predict the future consequences of present decisions with certainty. All we can do is to assess the risks that present decisions impose on future individuals. So sustainability needs to be stated in terms of risks rather than in terms of certitudes.... Neglecting uncertainty is problematic, because it allocates all risk-related costs to future generations, which contradicts the main tenet of sustainable development. (Krysiak 2009).

Reframing sustainability in term of risk highlights important ethical, legal, and economic dimensions of sustainability in a new way.

From an ethical standpoint, incorporating risk management analyses into a sustainability program can help companies conscientiously evaluate options and assess whether actions or decisions relating to current operations may have an adverse long-term impact on the firm, the planet, and key stakeholders. In other words, viewing sustainability through a risk management lens can serve as a means of integrating theories of applied ethical decision-making and corporate social responsibility. Risk-management tools can provide a more holistic and forward-thinking approach to business strategy and decision making that is consistent with sustainability principles, and in sharp contrast to the types of financial cost-benefit analyses that have led to unethical business decision making in the past.³

Companies in today’s global business environment also face an increasingly complex web of multiple layers of legal regulation, technical standards, and contractual relationships applied across many jurisdictions and also within each market in which the firm operates. Sustainable firms develop better capacity to manage such complexity, because they are more likely to adopt a “systems-thinking” approach. As described by MIT management guru, Peter Senge, “Systems thinking is a discipline for seeing wholes. It is a framework for seeing interrelationships rather than things, for seeing patterns of change rather than static snapshots.”

³ For example, a well-known illustration of the ethical pitfalls inherent in using financial cost-benefit analyses in business is the cost-benefit analysis memo prepared by Ford Motor Company in response to proposed federal regulation relating to incidents of fuel leakage and fires, which came to light during investigation of accidents involving exploding gas tanks on the Ford Pinto. (Birch, D. and Fielder, J.; Center for Automotive Safety). By contrast, sustainable risk management seeks to identify and minimize potential future risks, and thus generally resulting in a more proactive approach to ethical business decision making processes. (Krysiak 2009).

He further explains, “business and human endeavors are systems...we tend to focus on snapshots of isolated parts of the system and then wonder why our deepest problems never get solved.” (Senge, P.M., *The Fifth Discipline*, 1990 and Senge, et al., *The Necessary Revolution*, 2008).

The most sustainable companies are more likely to apply an integrative systems-thinking approach to creating and operating sustainability measurement, benchmarking, and reporting systems.⁴ In turn, such systems should expand management’s ability to identify and manage complex and interconnected risk variables. Instead of focusing only on “snapshots” of the information that feeds directly into financial reporting, sustainable companies are likely to have a more dynamic and multi-faceted view of a wider range of variables that represent both risks and opportunities to the company. Thus, by applying systems-thinking, sustainable companies are more likely to engage in proactive risk management efforts and develop better tools for minimizing potential liabilities relating to environmental, social, reputational, product liability, corporate governance, and other harms for which legal or regulatory action may be taken.

Anderson and Anderson (2009) provide several specific examples of key risks that can be mitigated when sustainability initiatives are proactively integrated with more traditional enterprise risk management and regulatory compliance programs. For example, the hundreds of billions paid by firms to settle asbestos litigation, and the massive costs associated with the Exxon Valdez oil spill (including \$3 billion in cleanup costs, a \$900 billion settlement with the U.S. and Alaska governments, and a \$5 billion punitive damages award) illustrate the potentially devastating financial costs of environmental risks, not to mention the irreparable harm to individuals, society and the natural environment. The potential financial costs and wider impact of such risks are increasing rather than decreasing in recent decades.

By integrating forward-looking risk management assessment into a substantive sustainability program, companies also can adapt more quickly to a shifting regulatory landscape. To illustrate this concept, Anderson and Anderson highlight the pitfalls of the reactive, compliance-driven approach that many companies have taken in the past:

In the hazardous waste area, many firms strategized that they would just throw toxic materials away until the federal government set up rules about their treatment; once rules were in place, firms reasoned they would then start following the rules. However, the Superfund law (or Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)) imposed retroactive liability for hazardous waste on firms. Retroactive liability is very unusual. Suddenly, firms became responsible for the hazardous waste disposal that had occurred for many prior years. Again, damages have been in the \$100 billions, with insurers paying about 50 percent of these damages.

Similarly, in today’s economy, carbon-intensive industries face an increasing risk of being caught unprepared for a regulatory framework on climate change that may shift rapidly. Recent financial studies reflect that, if a country such as the United States were to adopt new regulations limiting greenhouse gas emissions over a short period of time, then companies who have not

⁴ For example, many sustainable companies adopt closed-loop, cradle-to-cradle product life cycle analysis processes that reflect a more integrated systems-based approach to managing stages in the product life cycle.

already implemented extensive sustainability systems laying the groundwork for such a change could have a market value loss of between 30 and 40 percent. (Anderson and Anderson, 2009). A Carbon Disclosure Project report and a separate Innovest Strategic Value Advisors report found similar results, both concluding that the market value of certain heavy carbon emitters may be slashed by as much as 40 percent because of lack of planning for reducing greenhouse gas emissions.

Another timely example of companies caught up in a shifting regulatory landscape relates to the loss of life, projected environmental and economic devastation, and associated cleanup costs of the massive BP oil spill in the Gulf of Mexico. Initial estimates as of May 2010 suggested that BP's direct containment and cleanup costs alone are in the range of \$10 million per day, and are likely to reach the billions within a relatively short time. (Mulkern, NYT, May 3, 2010). As the devastation unfolds in the Gulf, the regulatory landscape is rapidly shifting against BP. The Oil Pollution Act passed in 1990 in response to the Exxon Valdez incident created the Oil Spill Liability Trust Fund and imposed a modest tax on oil companies to finance the fund. Under the Act, the owners of the deep water well have unlimited liability for direct cleanup costs, but the Act caps liability at \$75 million for ruined fisheries, lost tourism revenues, and other damages. As outrage over the spill grows, however, President Obama and Congress have proposed lifting this damages cap retroactively to impose full liability for all damages on BP, Transocean Ltd., and the other companies involved in the project. (Kraus and Rosenthal, May 12, 2010).

BP's CEO has stated that the company is resigned to paying consequential damages well beyond the \$75 million cap, and an onslaught of claims already had been filed against BP within weeks of the incident by lawyers for affected stakeholders, including shrimpers/fisherman, hospitality industries, BP Shareholders, state governments, and family members of workers killed when the oil rig exploded on April 20, 2010. Within two weeks after the incident, BPs stock price had dropped by more than 14%. (King and Chazan, WSJ, May 6, 2010). The debacle is also expected to have a major impact on the entire industry by leading to: 1) likely postponement of Congressional approval for new offshore drilling projects, 2) restructuring of the Minerals Management Service after accusations that regulators are too cozy with industry; 3) increased taxes on all energy companies under the Oil Spill Liability Trust Fund program; and 4) increased scrutiny and enforcement of oil rig safety requirements. (Kraus and Rosenthal, NYT May 12, 2010; Gold, R. and Power, S., WSJ, May 7, 2010). Thus, the regulatory and legal landscape is shifting rapidly not just for BP, but for the entire industry.

The recent gulf oil spill disaster further illustrates the potentially critical role that can be played by effective sustainability risk management systems. Before the massive Gulf spill, BP itself has admitted the need for improvements in its risk management systems, after a BP refinery in Texas City, TX blew up killing 15 employees in 2005, and a poorly maintained pipeline ruptured the following year, spilling over 200,000 gallons of crude oil on Alaska's North Slope. At the time current CEO Tony Hayward took over in 2007, the company had stated, "our operations failed to meet our own standards and the requirements of the law," and specifically pledged to "improve risk management efforts." (Mouawad, NYT, May 8, 2010).

Although it likely can never be proven whether the BP spill could have been avoided if the company had better integrated risk management analyses into a comprehensive sustainability strategy, industry analysts have observed that BP lags behind its peers in systematically applying risk management frameworks to such environmental and sustainability risks. Interestingly, there seems to be agreement among many risk and insurance analysts that Exxon now sets the industry standard for safety and risk management. According to RiskMetrics, a risk management consulting firm that assigns scores to companies based on their performance in various risk categories, Exxon Mobil now benefits from a risk management system that displays an “obsessive attention to detail”, monitoring even the smallest spills and imposing rigorous procedures on managers:

Before drilling a well, for example, [Exxon] runs elaborate computer models to test beforehand what risks the drillers might encounter. The company trains contractors to recognize risky behavior and asks employees for suggestions on how to improve safety. It says it has cut time lost to safety incidents by 12 percent each year since 2000. (Mouawad, NYT, May 8, 2010).

Thus, it appears that Exxon has learned some sustainability risk management lessons from the 1989 grounding of the Valdez, which spilled 11 million gallons of crude oil into Prince William Sound in Alaska. “Whatever you think of them, Exxon is now the safest oil company there is,” says Amy Myers Jaffe, a widely respected energy expert at Rice University. (Mouawad, NYT, May 8, 2010; and El-Gamal M. E. and Jaffe, A.M. 2008). It will be interesting to observe whether BP takes to heart similar risk management and sustainability lessons in its handling of the oil spill crisis, and how the incident may impact investors’ views of BP and the company’s listing on key sustainability indices, such as the Dow Jones Sustainability World Index.

Companies that are able to integrate rigorous risk management tools into a substantive sustainability program should be much better positioned to minimize the likelihood of such environmental disasters occurring. Moreover, they will be better positioned to help proactively shape and comply with shifting government regulation, which inevitably increases substantially following such a disaster.

3. Prior Studies Suggest that Proactive Management of Environmental and Sustainability Risk Enhances Firm Value and Competitiveness

Prior studies also confirm that firm value and opportunity is closely tied to a company’s ability to manage sustainability risks, particularly in sectors such as energy that have a direct environmental nexus. Consistent with the above observations about BP and Exxon, a recent Goldman Sachs study concludes that oil and gas companies with the most proactive recent track record on environmental issues are the same firms that dominate market share for new strategic projects. (Swiss Federal Department of Foreign Affairs and United Nations, 2004). The Goldman study emphasizes that competition is becoming more intense and the external observers and regulators are becoming less forgiving in this rapidly changing industry, where the focus is moving from oil to gas, along with a development of a newer mix of alternative energy sources. The study concludes that, to succeed in this rapidly changing industry environment, companies

must be environmentally and socially aware and have a vision of how the industry is going to evolve towards the “age of gas” and renewables.

Beyond the energy sector, several additional studies further confirm that improved management of sustainability related risks is essential to ensuring a company’s long term value. In a survey by Ernst & Young, 81% of Global 500 executives rated environmental, health, and safety issues among the top ten factors driving value in their businesses. (Swiss Federal Department of Foreign Affairs and United Nations, 2004).

Another survey of European fund managers, analysts, and investor relations officers by CSR Europe, Deloitte, and Euronet, asked the following question: “Based on your experience, how does social and environmental risk management impact on a company’s short-term/long-term market value?” Regarding the impact of social and environment risk management on company’s short term market value, 55% of the respondents felt there would be no impact, 8% felt it would influence in a negative way, 32% felt it would influence in a positive way, and 5% were not sure. Regarding the impact on company’s long term market value, 13% of the respondents felt there would be no impact, 4% felt it would influence in a negative way, 78% felt it would influence in a positive way, and 5% were not sure. This data reflects a widespread belief that strong management of sustainability risks serves as a source of competitive advantage by building long-term value. (Sofres, T., *Investing in Responsible Business*, 2003)

A similar study released by the Global Environmental Management Initiative in February (GEMI) 2004 had the following results: (a) 50 to 90% of a firm’s value can be attributed to intangibles like environment, health and safety (EHS) performance, (b) 35% of institutional investors’ portfolio allocation decisions are based on intangibles like EHS performance, and (c) 81% of Global 500 executives rate EHS issues among the top ten factors driving value in their business. (Poltorzycki, S., 2005; Swiss Federal Department of Foreign Affairs and United Nations, 2004). Other studies have confirmed the interest of institutional investors in socially responsible investing. (Cox, P. Brammer, S. and Millington, A., 2004).

Based on the above studies, there is strong and growing evidence that proactive management of sustainability risks enhances firm value and competitiveness.

4. Managing Sustainability Risks Can Also Enhance Corporate Governance and Limit Potential Officer and Director Liability

Recent developments such as the BP oil spill and the push for regulatory reform in the financial sector in response to the recent banking crisis reflect that sustainability risk management can also play an important role in managing a company’s corporate governance and fiduciary risks, and thus is has become a Board level issue. Environmental, reputational, and regulatory risks are placing increasing pressure on officers and directors. (Anderson and Anderson). According to Matthew Kiernan, CEO of Innovest Strategic Value Advisors, directors’ and officers’ liability is changing as sustainability becomes the new norm for responsible business management with a direct nexus to managing risk:

The 'prudent fiduciary' equation is being turned on its head. Since there is now evidence that superior environmental and social performance improves the risk profile, profitability, and stock performance of publicly-traded companies, fiduciaries can be seen to be derelict in their duties if they do not consider sustainability. (Kiernan, 2005).

For example, just as Sarbanes-Oxley now mandates that the CEO and CFO personally certify financial statements and verify that effective internal controls are in place, companies are also required to identify and disclose material environmental liabilities, thus more companies are implementing formalized environmental risk management and control systems. (Kiernan 2005). In 2001, the EPA updated its guidelines for such disclosures of environmental liabilities following a study that found a 61% non-disclosure rate in 10-K forms of publicly traded companies. (Anderson and Anderson 2009). Officers and Directors of companies failing to adequately disclose such liabilities on their audited financial statements may not only suffer from reputational harm, but also may open themselves up to lawsuits for material misstatements on their audited financial reports.

Tim Copnell, founder of KPMG's Audit Committee Institute in the U.K., explains how the concept of sustainability must be incorporated meaningfully into corporate governance structures and addressed at the highest levels:

Sustainability should be taken fairly literally, not narrowed down to environmental and human rights issues only. It also means sound business practices, investing for the long term, adding value, recognizing the value of society's well-being.... The audit committee can be a catalyst in helping to ensure these issues are getting sufficient agenda time and attention by the company. (KPMG, 2010).

Similarly, Robert Van Altena of KPMG's International Audit Committee Institute states that, in terms of providing oversight of the company's risk management systems, the audit committee should play an important role in challenging management on the extent to which the risks associated with sustainability and CSR have been identified, assessed, and mitigated. (KPMG 2010).

In the case of the BP oil spill discussed above, shareholder derivative lawsuits already have been filed against BP's Board of Directors alleging that BP has a "history of ignoring crucial safety issues related to the operation of offshore submersible rigs." (Calkins, May 10, 2010). Howard Mills, chief insurance advisor at Deloitte, observes that if BP has a history of regulatory problems or violations, it could call the company's risk management procedures into question, potentially imposing liability on directors and officers for how such risk factors were addressed. (Gusman, P. May 11, 2010). Thus, the BP case provides a timely illustration of how sustainability risk management has become an important Board level consideration that directly impacts liability of officers and directors of major companies.

5. Sustainable Firms Better Manage Their Reputational Risks Through More Transparent Reporting on a Wider Range of Information

Finally, a growing number of sustainability authors have also focused on managing “reputational risk” as a significant piece of the sustainability risk management puzzle. Warren Buffet is often quoted as saying: “It takes 20 years to build a reputation and 5 minutes to ruin it. If you think about that, you'll do things differently.” (Lowenstein, R. 1995) As outlined above, BP is now experiencing the sting of these words first hand in relation to its devastating gulf oil spill. Similarly, Nike’s experience with high profile allegations of labor abuses offers a lesson in how quickly public opinion can be magnified and influenced through the use of online and social media to harm to company reputations. John Elkington, sustainability scholar and author of *Cannibals With Forks*, explains the increasing importance of proactively managing reputational risks:

No matter how successful some companies may be in devising “stealth” strategies to mask what they are doing, or intend to do, most businesses will increasingly operate in a high-visibility environment. International business will find that the Internet will enormously increase the geographical reach and magnifying (and distorting) power of the goldfish bowl. (quoted in Anderson, Corporate Survival).

As Judy Larkin, author of Strategic Reputation Risk Management advises: “Work as though everything you say and do is public.”

Sustainable companies have learned that managing reputational risks requires proactively increasing transparency and public disclosure through more formalized sustainability reporting systems. Sustainable companies typically engage in more expansive management, benchmarking, and reporting on a wider range of social and environmental information in their periodic reports to stakeholders, and thus go beyond ordinary financial reporting. Increasingly, sustainable companies are using standardized sustainability reporting methods, such as the General Reporting Initiative’s G3 guidelines. For example, out of the S&P 100 firms in 2008, 93 of them included sustainability information on their web site; sixty-six firms produced a formal sustainability report including actual performance data; and 55 of them utilize the standard GRI guidelines in preparing their sustainability reports. (*S&P 100 Sustainability Reporting Comparison* 2009).

In order to be able to measure, track, prepare, and report data on their “triple bottom line”, companies hailed as the most sustainable often have more fully integrated information systems for tracking, measuring, and benchmarking, environmental and social performance factors. In turn, collecting and benchmarking these additional factors helps management to develop a wider knowledge base they can use to inform company strategy and decision making processes. As management guru Peter F. Drucker famously stated, “you can only manage what you can measure.” (Cohen, 2008). Sustainable companies actually track and measure sustainability factors, and thus are better able to implement integrated decision-making processes and systems based on an expanded set of measurements and benchmarks that go beyond financial performance.

A fully integrated triple bottom line information system can serve as a source of competitive advantage by giving management a wider, three-dimensional set of actual data and performance measurements. (Nidumolu, R., Prahalad C.K., and, Rangaswami, M.R., 2009). Sustainable firms also are likely to have more sophisticated management information systems that are more fully integrated with their environmental and quality management programs such as ISO14001, ISO 9000, or other programs that are relevant in measuring and reporting on social and environmental performance. (Castka, P., Bamber, C., Bamber, D. and Sharp, J., 2004)

Enhanced public reporting of social and environmental performance factors also should lead to greater transparency with investors and the marketplace. In particular, institutional investors have come to demand a deeper transparency and accountability from companies as part of their screening processes. A 2004 study by the Global Environmental Management Initiative concluded that 35% of institutional investors make portfolio allocation decisions are based on factors relating to environment, health and safety (“EHS”) performance, and thus actively monitor sustainability reporting by major companies. (Poltorzycki , S. 2005, Swiss Federal Department of Foreign Affairs and United Nations, 2004).

In short, the above factors reflect that sustainable firms may be ahead of their peers in gathering and utilizing a wider spectrum of information for managing complex interdependent variables that impact their operations, as well as for identifying and managing their uncertainties and risk.

III. EMPIRICAL ANALYSIS

Our hypothesis could be best studied by comparing the financial performance of sustainable firms versus the typical firm to explain possible risk differentials. The finance literature has long used the firm’s listed stock price as a proxy for its financial performance. In an efficient market, prices reflect all available public information, and stock prices immediately impound any incremental change in expected future financial performance. Consequently, the volatility of stock prices is a reasonable measure of firm risk.

A. Data Sets Utilized

In line with this reasoning, we contrast the investment return performance of a portfolio of sustainable companies, represented by the Dow Jones Sustainability United States Index (DJSI-US), versus the US market at large, represented by a value-weighted index of all NYSE, AMEX and NASDAQ stocks in the Center for Research in Security Prices database (CRSP-VW).⁵ Since their launch in 1999, the Dow Jones Sustainability Indexes are widely-used benchmarks in sustainability investing, for both professional money managers and index funds.⁶

⁵ In general, value-weighted indexes, such as the S&P 500 and the CSP-VW index, better mimic the performance of the underlying economy. The finance academic research literature, however, uses CRSP stock indexes, rather than the better known S&P 500 index, since they provide a broader measure of the US economy and the US stock market. Moreover, in unreported tests, qualitatively similar results were found using as benchmark the S&P 500 index.

⁶ From Dow Jones Sustainability Indexes www.sustainability-index.com, their indexes are licensed to 70 assets managers in 16 countries, managing over \$8 billion.

We track the monthly performance of the DJSI-US from January 1999, the first month for which return data is available on the index sponsors' website⁷, through to December 2009.

In **Figure 1**, we present a chart of the return on the DJSI-US index versus the CRSP-VW index.⁸ The two indexes tracked each other closely, with the DJSI-US on aggregate outperforming slightly, till about January 2004. The CRSP-VW did better in the following period till May 2008. The DJSI-US index outperformed in the period between June 2008 and March 2009, after which the CRSP-VW again widened the outperformance gap. In summary, over the January 1999 to December 2009 period, the DJSI-US provided an annualized return of 1.02% as compared to 2.26% for the CRSP-VW.

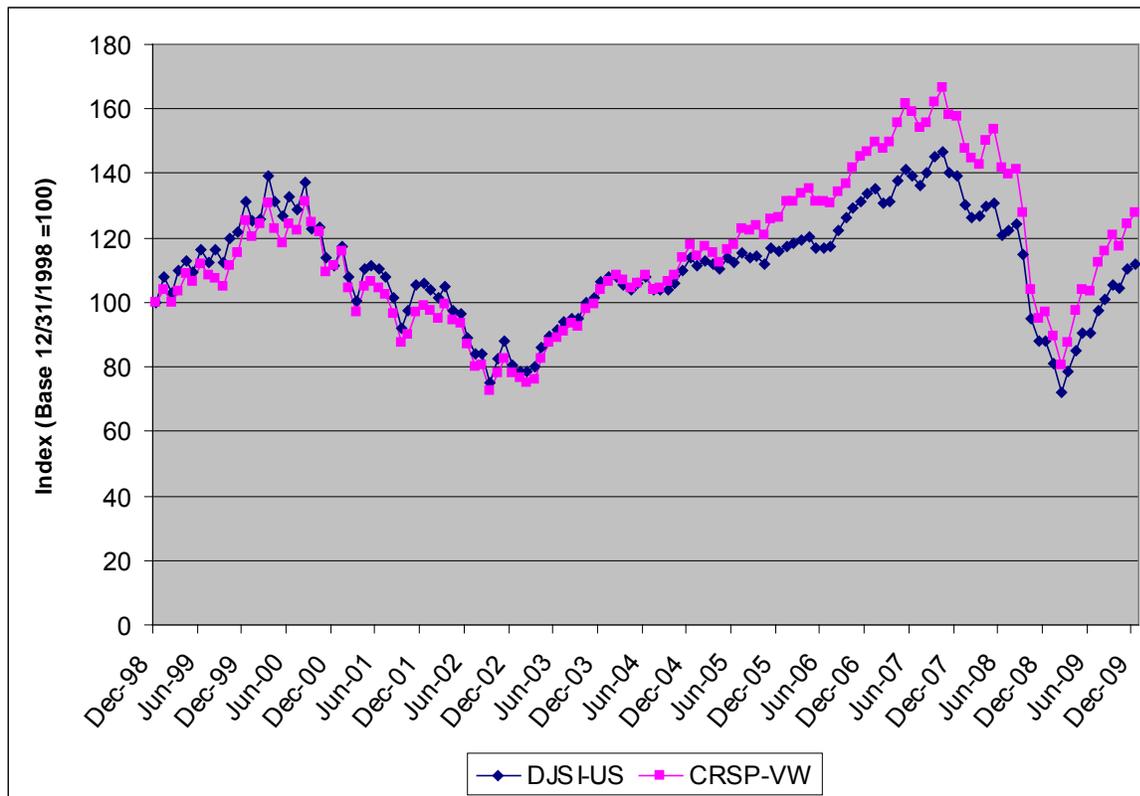


Figure 1. Stock price returns of sustainable companies (DJSI-US index) versus the US stock market (CRSP-VW index).

In **Figure 2**, we present another look at the same data, by charting the excess return on the DJSI-US as compared to the CRSP-VW. The chart suggests that there is little reason to believe that one index systematically outperforms the other - the DJSI-US outperforms in 45% of the months studied, while the CRSP-VW does better in the other 55%.

⁷ From Dow Jones Sustainability Indexes www.sustainability-index.com.

⁸ All return figures in the paper include re-invested dividends.

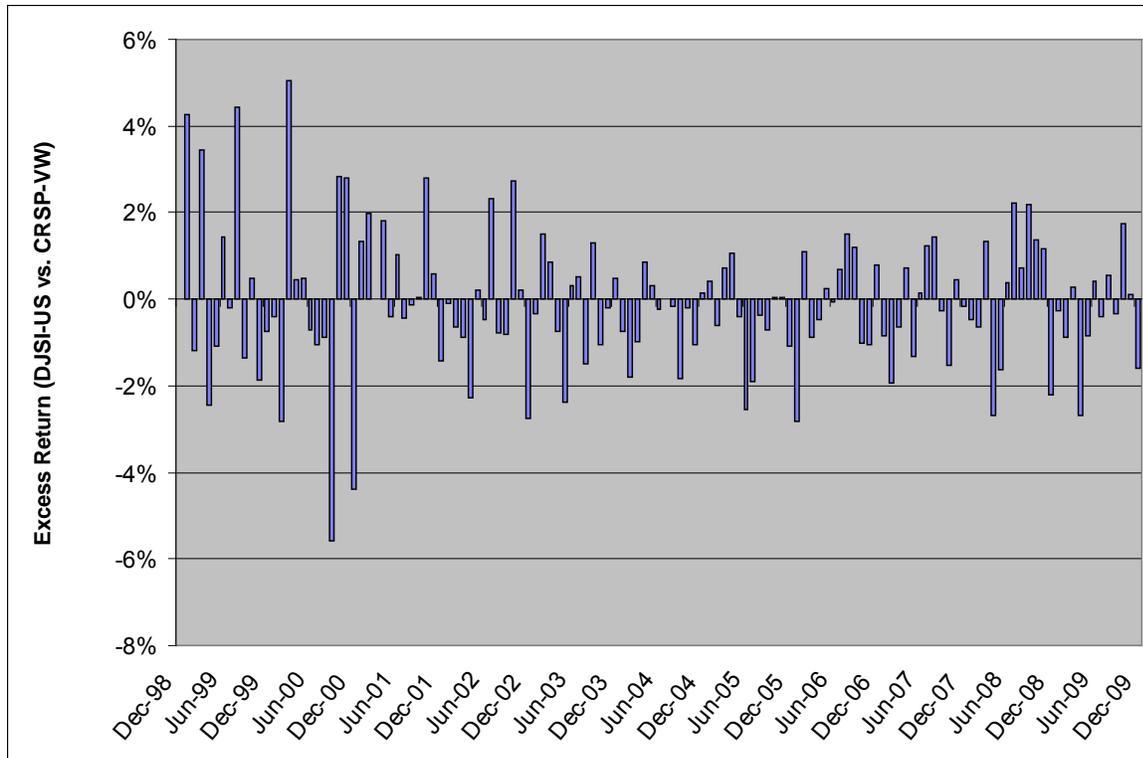


Figure 2. Excess stock price return of sustainable companies (DJSI-US index) versus the US stock market (CRSP-VW index).

These charts provide some intriguing observations about the relative performance of the two indexes. Based on these observations, the DJSI index appears to outperform during periods of weakness in the economy and the stock market, but the CRSP-VW index does better overall. Next, we empirically test whether there is any statistical significance to the difference in return performance, and if risk differentials better explain the variations in performance over time.

B. Empirical Model

We use an empirical model to test our hypothesis that the stock market does not penalize firms for large expenditures on sustainability initiatives; in part because the dollar cost of these expenses is offset by the risk-reduction achieved. This implies that investing in sustainable companies is as profitable as investing in comparable companies with similar risk profiles.

The Capital Asset Pricing (CAPM) is the foremost model in finance literature used to analyze the relation between risk and rates of return of various assets.⁹ We use the empirical specification of the CAPM model to better explain DJSI-US risk and return:

$$r_{DJSI} - r_f = \alpha_{DJSI} + \beta_{DJSI}(r_m - r_f) + \varepsilon_{DJSI}$$

⁹ Various researchers have been credited for independently contributing to the development of the CAPM model in the 1960s.

where,

r_{DJSI} = monthly return on the DJSI-US index,

r_f = monthly risk-free rate of return,

r_m = monthly return on the US stock market,

α_{DJSI} = monthly abnormal return from the OLS model,

β_{DJSI} = beta of the DJSI-US index,

$\varepsilon_{\text{DJSI}}$ = standard errors from regression model.

The dependent variable, R_{DJSI} , is the monthly return on the DJSI-US index, calculated using month-end index values from January 1999 to December 2009. The risk-free rate, r_f , is obtained as the return on one-month US treasury bills. The return on the US stock market, r_m , is calculated using the monthly value-weighted return on all stocks in the CRSP database. α_{DJSI} is the constant parameter obtained from the empirical model, and indicates any possible outperformance or under-performance in returns of the DJSI-US index. The beta of the DJSI-US index, β_{DJSI} is the coefficient of the independent variable in the empirical model, and measures the risk of the DJSI-US relative to the stock market CRSP-VW.

C. Test Results

Table 1 provides a summary of the results of the CAPM model regression. The t-statistic of the α coefficient is low, indicating that the performance of the DJSI-US is not statistically significant as compared to performance of the typical US stock. The β coefficient is less than 1 (the market beta) and the t-static of the β coefficient is statistically significant at the 1% percent significance level, indicating that the DJSI-US index is less risky than the stock market. Finally, the high adjusted R^2 suggests that the CAPM model explains 89.6 percent of the relation between returns on the DJSI-US and the stock market.

	α	β	Adjusted R^2
Estimated coefficient	-0.0010	0.9534	0.8959
(t-statistics)	(-0.71)	(33.58***)	

*** denotes significance at the 1% level

Table 1. Regression results from the empirical model (CAPM).

Our findings support our hypothesis that sustainable firms have lower risk (volatility) than other comparable firms. On a risk-adjusted basis, the long-run performance of the sustainable stocks is not statistically different from that of the typical stock. In other words, sustainable firms provide stock returns that are on average slightly lower than the typical firm, but with significantly lower risk, and lower volatility. Taking risk into account, the sustainable DJSI-US stocks provide stable long-term growth in returns consistent with that of the market at large.¹⁰

¹⁰ These results seem to be consistent with prior studies by Hamilton, Jo and Statman (1993), Goldmeyer and Diltz (1999), Statman (2000), Bauer, Koedijk and Otten (2002), and Simpson and Kohers (2002) which tend to show no statistically significant difference between the returns of socially responsible mutual funds and those of conventional mutual funds.

IV. CONCLUSION

Returning to our introductory quote from Milton Friedman, the above analysis of DJSI data suggests that companies hailed as the most “sustainable” are fully able to provide stable and long-term financial returns to investors, without having to make profit-maximization their sole focus. As legendary management thinker, Peter Drucker, was fond of saying:

Profit for a company is like oxygen for a person. If you don't have enough of it, you're out of the game. But if you think your reason for living is about breathing, you're really missing something. (Cohen, 2008).

Our study supports the theory that sustainable companies generate a steady flow of “oxygen” in the form of long-term, stable returns to investors, while also benefitting from a more holistic view of their impact on the world and relationship to society.

As discussed above, it appears that one important factor underlying the stable, long-term performance of sustainable companies may be that they have developed superior systems for managing overlapping and interdependent social, environmental, reputational, and regulatory risks. In today's increasingly complex and interdependent global economy, superior risk management and adaptability to shifting regulatory requirements can serve as important sources of competitive advantage. The above empirical results showing that the DJSI-US sustainable firms tend to outperform the market during times of economic downturn seem to support this theory, since risk-sensitivity and changes in regulation tend to increase during cycles of economic downturn.

Finally, the relevant inquiry for investors is not whether sustainable companies perform “better” or “worse” than the market at any given time based on raw index performance data (see Figure 1 above), but rather, whether they offer an attractive investment taking into account the risk-return profile. The empirical results reflect that the DJSI-US companies offer stable returns and long term growth that are attractive from a risk-return standpoint. These qualities and performance trends of such sustainable stocks may be particularly attractive to socially responsible and institutional investors and others seeking evidence of corporate responsibility that is coupled with strong performance, lower volatility, and steady long term growth. (McLachlan and Gardner 2004).

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AS SNUG AS A BUG IN SOFTWARE: A CONTRACTS LAW CASE STUDY

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The law is not a series of calculating machines where answers come tumbling out when the right levers are pushed.¹

I. INTRODUCTION

This case study, written for use in an introductory business law course, explores various contracts law issues from the standpoints of the Uniform Commercial Code² (UCC) versus common law. Although the issues presented for discussion are relatively straightforward, the main focus of this case study is comparative. Students will explore how application of the UCC and common law rules often leads to divergent outcomes.

In Part II, a hypothetical fact scenario is presented for consideration. Part III provides a set of questions to prompt and direct a discussion and analysis of numerous issues presented by the hypothetical case. An overview of applicable UCC and contracts law is provided in Part IV. Instructors may wish to supplement these materials with textbook readings and additional cases that will assist students in analyzing the issues. Finally, the teaching notes in Part V outline the pedagogical objectives and suggestions for use of the case, including a detailed analysis of the issues raised by the questions in Part III.

II. THE CASE STUDY

Value Plus Wholesale Corporation operates a national chain of membership warehouses that carry brand name merchandise at substantially lower prices than are typically found at conventional retail stores. Intuit Corporation designs software for business applications. One of its most popular products is the “Accutrak” inventory management program. Although most of its software packages are designed for off-the-shelf purchase, Intuit will also customize its off-the-shelf software for an additional fee or create custom-designed software applications that will meet a client’s specific needs.

After extensive research and discussion, Value Plus’ management decided to purchase new inventory management software and determined that, of all the inventory management programs available on the market, the Accutrak program was best suited to its needs. However, management was concerned that the program would require several

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¹ William O. Douglas, *The Dissent: A Safeguard of Democracy*, 32 J. AM. JUD. SOC’Y 104, 105 (1948).

² Unif. Commercial Code, 1-3B U.L.A. (2002)[hereinafter UCC].

modifications to adapt it to Value Plus' business model. As such, Value Plus contacted Intuit to negotiate the purchase of the software and determine whether Intuit could customize the program in order to satisfy Value Plus' requirements.

After several discussions as to Value Plus' particular requirements, Value Plus agreed to purchase the Accutrak software package, which Intuit agreed to customize and install. The parties agreed on a price of \$15,000, which represented \$4,500 for the Accutrak software package, plus \$7,500 for customization and a \$3,000 installation fee. Value Plus was anxious for Intuit to get started on the project, but Intuit was uncertain as to the full extent and complexity of the modifications necessary to customize the software. As a result, the parties did not specify a firm date for delivery even though they had agreed on all other terms.

Within a short time after starting work on the project, it became apparent to Intuit that it had underestimated the amount of time and labor costs required to tailor the Accutrak program to meet Value Plus' needs. Consequently, two months after beginning work on the task, Intuit notified Value Plus that the contract price needed to be increased to \$20,000. Intuit indicated that the \$5,000 increase was necessary to cover increased labor costs associated with customizing the Accutrak program. Value Plus initially objected to the price increase. However, since Value Plus was anxious to move forward with an inventory control program, Value Plus reluctantly agreed to the price increase.

Six months after beginning the project, Intuit notified Value Plus that the work on the customization project had been completed and that Intuit was ready to have its technicians install the program. Value Plus asked whether Intuit had fully tested the program to determine if it met Value Plus' specifications and needs. Intuit assured Value Plus that the program had been thoroughly tested by its programmers and that it was working perfectly. Relying on this assurance, Value Plus had the program installed by Intuit technicians.

One month after installation, however, Value Plus discovered that the software did not work as promised. Due to a number of "bugs"³ in the customized program, the program consistently under-counted the number of units of certain products in inventory and over-counted others. After repeated attempts by Intuit technicians fix the program, Value Plus asked Intuit to uninstall the program. Intuit refused to uninstall the program and demanded that Value Plus pay the \$20,000 that the parties had agreed upon for the customization and installation of the program. Intuit indicated that if payment was not immediately tendered, it would sue Value Plus for breach of contract. In response, Value Plus argued that the contract was unenforceable. In the alternative, if the contract was enforceable, Value Plus argued that the price modification was ineffective. Value Plus asserted that it had already experienced significant damages as a result of the bugs that were present in the program and that it expected to suffer some future damages.

³ A "bug" is a coding error in a computer program that prevents the program from performing as it was designed to perform. RALPH M. STAIR, ET AL., *PRINCIPLES OF INFORMATION SYSTEMS* 167 (9th ed. 2009).

As to damages, Value Plus indicated that it had already incurred the expense of having employees do a manual inventory; that it would have to pay to have the Accutrak program uninstalled; and that the under-counting and over-counting of items in inventory had resulted in having a shortage in inventory of some products and an over-supply in inventory of other products. Value Plus further indicated that as a result of the shortage it had lost sales on some very popular holiday items and was left with an over-stock of items that could not be returned. Additionally, Value Plus indicated that, based upon prior sales data, it would take Value Plus four years to sell the over-counted products. Lastly, Value Plus indicated that it had lost valuable time in implementing an inventory control system and that it had contacted several other companies that specialized in developing and implementing inventory control systems. Value Plus stated that it had obtained bids from these companies, ranging from \$25,000 to \$40,000, for an inventory control program that was identical to, or substantially identical to, the program that Intuit was supposed to have developed for Value Plus.

III. DISCUSSION QUESTIONS

In resolving this legal dispute, students should be directed to consider the following questions in relation to the facts described above and the legal principles explained in the next section:

1. Is a contract for customized, off-the-shelf software a “good” within the scope of the Uniform Commercial Code, or is the contract governed by the common law?
2. Are the terms of the contract sufficiently definite so as to be enforceable?
3. Is the subsequent modification to the price term enforceable?
4. If Value Plus is successful in its breach of contract suit, what damages are recoverable? How will damages be computed?

IV. OVERVIEW OF APPLICABLE RULES AND CONCEPTS

This section provides a brief summary of the laws that pertain to the various issues raised by the discussion questions. Applicable principles of the common law of contracts and relevant sections of the UCC are discussed and compared. As stated in Part I, instructors may wish to assign appropriate textbook materials and cases to assist the students in addressing the issues presented in the discussion questions.

A. APPLICABILITY OF THE UNIFORM COMMERCIAL CODE

Sales contracts are governed by either the common law or the UCC. Determining whether the common law or the UCC applies is, therefore, a threshold matter. Article 2 of the UCC applies only to “transactions in goods”⁴ and the term “goods” is defined as

⁴ UCC § 2-102. Although certain provisions apply only to merchants, most UCC rules apply to

“all things that are movable at the time of identification to a contract for sale”⁵ Based on this definition, the essence of a contract for the sale of “goods” is that it involves the sale of tangible, movable things. Thus, contracts for the sale of automobiles, television, furniture, clothing, and computer hardware are all contracts involving the sale of goods.

Article 2 of the UCC also applies to contracts for the sale of goods that have been “specially manufactured” by the seller.⁶ A specially manufactured good is one that is fabricated by the seller according to the buyer’s specifications and that is not suitable for sale to others in the ordinary course of business.⁷ Contracts for the sale of services, real estate, or intangible property are not governed by Article 2. Rather, such contracts are governed by the common law of contracts.

A more difficult issue arises in determining whether the contract will be governed by the common law or the UCC when the transaction involves the sale of both goods and non-goods, such as the sale of land along with farming equipment, or the sale of a household appliance with installation service. Such contracts involve a “mixed” or “hybrid” sales transaction. In order to determine whether the transaction falls within the scope of Article 2, most courts apply the predominant purpose test.⁸ Under this test, if the court determines that the sale of goods was the predominant purpose of the parties in entering the contract, then the UCC governs the entire contract.⁹ On the other hand, if the goods aspect of the contract was incidental or secondary to the overall transaction, then the entire contract is governed by the common law.¹⁰ As one court has explained regarding hybrid or mixed contracts:

The test ... is not whether they are mixed, but, granting that they are mixed, whether their predominant factor, their thrust, their purpose, reasonably stated, is the rendition of service, with goods incidentally involved (e.g., contract with artist for painting) or is a transaction of sale,

transactions involving consumers as well as merchants.

⁵ UCC § 2-103(1)(k). Also included are “future goods, specially manufactured goods, the unborn young of animals, growing crops, and other identified things attached to realty” *Id.* “The term does not include information, the money in which the price is to be paid, investment securities ..., the subject matter of foreign exchange transactions, or choses in action.” *Id.*

⁶ *Id.*

⁷ See *Propulsion Techs., Inc. v. Attwood Corp.*, 369 F.3d 896 (5th Cir. 2004); *Webcor Packaging Corp. v. Autozone, Inc.*, 158 F.3d 354 (6th Cir. 1998); *Flowers Baking Co. of Lynchburg v. R-P Packaging, Inc.*, 329 S.E.2d 462 (Va. 1985); *Frank Adams & Co. v. Baker*, 439 N.E.2d 953 (Ohio Ct. App. 1981).

⁸ See WILLIAM H. LAWRENCE, *UNDERSTANDING SALES AND LEASES OF GOODS* § 1.03[C] (1996). The test is also referred to as the “predominant part” or “predominant thrust” test.

⁹ See, e.g., *Pittsley v. Houser*, 875 P.2d 232 (Idaho Ct. App. 1994)(sale of carpeting predominated over installation service); *Bonebrake v. Cox*, 499 F.2d 951 (8th Cir. 1974)(sale of bowling equipment predominated over installation service).

¹⁰ See, e.g., *DiIorio v. Structured Stone & Brick, Inc.*, 845 A.2d 658 (N.Y. Ct. App. 2004)(installation service predominated over sale of stone); *Cork Plumbing Co. v. Martin Bloom Assocs., Inc.*, 573 S.W.2d 947 (Mo. Ct. App. 1978)(construction service predominated over sale of plumbing materials).

with labor incidentally involved (e.g., installation of a water heater in a bathroom).¹¹

As to contracts involving the sale of software,¹² the courts have settled on the conclusion that the sale of mass-marketed “off-the-shelf” software is a transaction in goods.¹³ Where the contract is for the design of software to meet the particular requirements of the purchaser, it has been classified as a service.¹⁴ When the contract has involved the sale of software in addition to services, the predominant purpose test applies.¹⁵ The question of whether a contract is predominantly one for goods or services turns on the facts of the particular case.¹⁶ Unlike off-the-shelf software, customized software is developed “to satisfy the purchaser’s specific needs in order for the application to be of any use or value to the purchaser.”¹⁷ Application of the predominant purpose test to contracts involving the sale of customized software has yielded less predictable results.¹⁸

In *Advent Systems, Ltd. v. Unisys Corporation*,¹⁹ for instance, the contract involved the sale of an electronic document management system, along with installation and training services. In examining the predominance of goods or services in the transaction, the court noted that “[c]omparing the relative costs of the materials supplied with the costs of the labor may be helpful in this analysis, but not dispositive.”²⁰ The court was persuaded that the transaction was within the scope of the UCC because the contract revealed that the parties’ main intent was the sale and purchase of computer software and hardware, and the provisions in the contract for installation and training services was secondary to that for products purchased.²¹

¹¹ *United States v. City of Twin Falls, Idaho*, 806 F.2d 862, 871 (9th Cir. 1986).

¹² Software is a set of instructions to perform a computer operation. See RALPH D. CLIFFORD, *COMPUTER AND CYBERLAW* 10-12 (1999)(explaining how software is developed).

¹³ See, e.g., *Micro Data Base Sys., Inc. v. Dharma Sys., Inc.*, 148 F.3d 649 (7th Cir. 1998); *Olcott Int’l & Co., Inc. v. Micro Data Base Sys., Inc.*, 783 N.E.2d 1064 (Ind. Ct. App. 2003). The assumption that the UCC applies to contracts for the sale of software was not always as generally accepted as it is today. See Andrew Beckerman-Rondau, *Computer Software: Does Article 2 of the Uniform Commercial Code Apply?*, 35 EMORY L.J. 853 (1986).

¹⁴ See *Pearl Investments, LLC v. Standard I/O, Inc.*, 257 F. Supp.2d 326 (D. Me. 2003); *Computer Servcenters, Inc. v. Beacon Mfg. Co.*, 328 F. Supp. 653 (D.S.C. 1970); but see *Downriver Internists v. Harris Corp.*, 929 F.2d 1147 (6th Cir. 1991).

¹⁵ See, e.g., *Conwell v. Gray Loon Outdoor Marketing Group, Inc.*, 906 N.E.2d 805 (Ind. 2009); *Mortgage Plus, Inc. v. DocMagic, Inc.*, 55 U.C.C. Rep. Serv.2d 58 (D. Kan. 2004); *Dealer Mgt. Sys., Inc. v. Design Auto. Group, Inc.*, 822 N.E.2d 556 (Ill. Ct. App. 2005); *Geotech Energy Corp. v. Gulf States Telecomm. & Info. Sys.*, 788 S.W.2d 947 (Mo. Ct. App. 1978).

¹⁶ See *Insul-Mark Midwest, Inc. v. Modern Materials, Inc.*, 594 N.E.2d 459, 464 (Ind. Ct. App. 1992).

¹⁷ See *Drier Co., Inc. v. Unitronix Corp.*, 527 A.2d 875, 879 (N.J. Sup. Ct. 1986).

¹⁸ Compare *Waterfront Properties, Inc. v. Xerox Connect, Inc.*, 58 U.C.C. Rep. Serv.2d 809 (W.D.N.C. 2006)(customized software is a good), and *Huron Tool Eng’g Co. v. Precision Consulting Servs., Inc.* 532 N.W.2d 541 (Mich. Ct. App. 1995)(same), with *Liberty Fin. Mgmt. Corp. v. Beneficial Data Processing Corp.*, 670 S.W.2d 40 (Mo. Ct. App. 1984)(Article 2 does not apply to customized software), and *DSC Communications Corp. v. Pulse Communications, Inc.*, 170 F.3d 1354 (Fed. Cir. 1999)(same).

¹⁹ 925 F.2d 670 (3d Cir. 1991).

²⁰ *Id.* at 676.

²¹ *Id.* at 676. The court added: “The fact that some programs may be tailored for specific purposes need not alter their status as “goods” because the Code definition includes ‘specially manufactured goods.’” *Id.*

By contrast, in *Data Processing Services, Inc. v. L.H. Smith Oil Corporation*,²² the contract was to “design, develop and implement an electronic data processing system to meet [the customer’s] specific needs.”²³ Resorting to the predominant purpose test, the court deduced that the UCC did not apply because it was the service of software design that was the main objective of the parties. According to the court, it was “the skill and knowledge of the programmer which is being purchased in the main, not the devices by which this skill and knowledge is placed into the buyer’s computer.”²⁴

As in any mixed or hybrid transaction, a contract for the sale of customized software must be evaluated in its entirety to determine its predominant part or purpose. In doing so, the relative costs of the labor and goods aspects of the contract are important but not dispositive, as the court in *Advent Systems* pointed out.²⁵ Of more importance is the motivation for the contract: whether the parties intended to transact for software or for customization services, with the other being incidental to the sale.

B. DEFINITENESS OF TERMS

The terms of a contract must be sufficiently definite and specific so that the parties understand their respective obligations. Definiteness of terms is evidence of intent that parties have reached an agreement and are not still negotiating the contract. In addition, should a court be called upon to enforce the contract, definiteness of terms will be necessary to determine if a breach has occurred and, if so, how to fashion an appropriate remedy.²⁶

Occasionally, the parties to an agreement may overlook, omit, or intentionally leave open terms for later bargaining. The reality of most contract negotiations is that the parties seldom anticipate every issue that might arise in the performance of their agreement. However, even where the parties may have had and objectively manifested the intent to enter into a contract, when the terms of a contract are so indefinite that a court would not be able to determine if a breach has occurred, the contract is unenforceable on the basis that the parties did not intend to be bound without further agreement as to those terms.

Under the traditional common law approach, the standard of definiteness is quite demanding. All essential terms must be stated in the offer and must be specific. If not, the courts have held that an agreement has not been concluded.²⁷ The case of *Academy*

²² 492 N.E.2d 314 (Ind. Ct. App. 1986).

²³ *Id.* at 318.

²⁴ *Id.* at 319.

²⁵ *See supra* note 20.

²⁶ For a detailed discussion of the issue of definiteness of contract terms, see JOHN E. MURRAY, MURRAY ON CONTRACTS § 38 (4th ed. 2001).

²⁷ *See, e.g.*, *Diesel Power Equip., Inc. v. ADDCO, Inc.*, 377 F.3d 853 (8th Cir. 2004)(letter of intent too indefinite and conditional to be binding); *Joseph Martin, Jr. Delicatessen v. Schumacher*, 417 N.E.2d 541 (N.Y. 1981)(failure to agree to rental price in commercial real estate lease); *Klimek v. Persich*, 371 P.2d

*Chicago Publishers v. Cheever*²⁸ provides an illustration. The widow of renowned author John Cheever and a publishing company entered into a contract to publish a collection of his short stories. The contract was unclear as to which stories would be included, how they would be selected, and when the book would be delivered for publication. In considering whether the contract terms were sufficiently definite, the court reasoned:

A contract may be enforced even though some contract terms may be missing or left to be agreed upon, but if the essential terms are so uncertain that there is no basis for deciding whether the agreement has been kept or broken, there is no contract. Without setting forth adequate terms for compliance, the publishing agreement provides no basis for determining when breach has occurred, and, therefore, is not a valid and enforceable contract.²⁹

Thus, although it was apparent that Mrs. Cheever and the publisher had intended to enter into a contract, their failure to specify the date for delivery and the content of the proposed book rendered the agreement too indefinite to enforce.³⁰

The traditional common law approach has been mitigated to an extent by section 33 of the Restatement (Second) of Contracts:

- (1) Even though a manifestation of intention is intended to be understood as an offer, it cannot be accepted so as to form a contract unless the terms of the contract are reasonably certain.
- (2) The terms of a contract are reasonably certain if they provide a basis for determining the existence of a breach and for giving an appropriate remedy.
- (3) The fact that one or more terms of a proposed bargain are left open or uncertain may show that a manifestation of intention is not intended to be understood as an offer or as an acceptance.³¹

The focus of the Second Restatement standard is on the parties' manifested intent to enter into a binding contract, rather than on terms that have not been expressly agreed upon. If the parties have manifested an intention to be bound, then the only remaining issue is whether the terms of the agreement are reasonably certain to allow a court to provide an appropriate remedy.³² Even when the parties intend to be bound, however, "[t]he more terms the parties leave open, the less likely it is that they have intended to conclude a binding agreement."³³

956 (Ore. 1962)(no agreement as to price of home remodeling items).

²⁸ 578 N.E.2d 981 (Ill. 1991).

²⁹ 578 N.E.2d at 984.

³⁰ *See id.*

³¹ Restatement (Second) of Contracts § 33 (1981).

³² *See, e.g.,* Triangle Const. v. City of Phoenix, 720 P.2d 87 (Ariz. 1985); Arrowhead Const. Co. v. Essex Corp., 233 Kan. 241, 662 P.2d 1195 (Kan. 1983); Allied Disposal v. Bob's Home Serv., 595 S.W.2d 417 (Mo. Ct. App. 1980).

³³ Restatement (Second) of Contracts § 33 cmt. c.

The lesser degree of specificity called for by the Second Restatement can facilitate the parties' agreement when they intend to enter into a contract and there is sufficient certainty as to the rest of the contract to enforce it.³⁴ According to the Second Restatement, "[w]here the contract calls for a single performance such as the rendering of a service or the delivery of goods, the time for performance is a 'reasonable time.'"³⁵ However, a court will not recognize the existence of a contract where the indefinite or missing terms are so important to the performance of the agreement that they indicate that the parties have not manifested their intent to be bound.³⁶

The standard of definiteness for contracts for the sale of goods under the UCC is much more flexible than that under traditional common law. Section 2-204(3) of the UCC provides: "Even if one or more terms are left open, a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy."³⁷ Thus, even though the parties have left open one or more terms of their agreement, the contract may be sufficiently definite to enforce. This standard is similar to that found in the Second Restatement³⁸ and in keeping with the UCC's purpose to facilitate contract formation.³⁹ Moreover, when there are material terms of a contract left open by the parties, the UCC supplies a series of gap-filling terms that can be inserted to prevent the contract from failing due to indefiniteness.⁴⁰

Accordingly, the UCC recognizes that the parties might conclude a binding contract for the sale of goods without settling on a firm time for delivery. Section 2-309(1) explains: "The time for shipment or delivery or any other action under a contract if not provided in this Article or agreed upon shall be a reasonable time."⁴¹ As such, unless the parties intend not to be bound, their failure to agree on a date for delivery, to defer setting a date until later, or to base the date on some other measure, will not cause the contract to fail.⁴² Rather, where the parties' intention to form an agreement is

³⁴ Restatement (Second) of Contracts § 33 cmt. a ("[T]he actions of the parties may show conclusively that they have intended to conclude a binding agreement, even though one or more terms are missing or are left to be agreed upon. In such cases courts endeavor, if possible, to attach a sufficiently definite meaning to the bargain.").

³⁵ See Restatement (Second) of Contracts § 33 cmt. d ("Valid contracts are often made which do not specify the time for performance.").

³⁶ E.g., *Abbott Labs. v. Alpha Therapeutic Corp.*, 164 F3d 385 (7th Cir. 1999)(too many material terms left open to future negotiation in settlement agreement); *Dodge v. Trustees of Randolph-Macon Woman's College*, 661 S.E.2d 801 (Va. 2008)(contract must obligate parties to sufficiently definite and ascertainable promises).

³⁷ UCC § 2-204(3).

³⁸ See Restatement (Second) of Contracts § 33 cmt. e (citing to UCC § 2-305(1) & (4)).

³⁹ See UCC § 1-103.

⁴⁰ UCC §§ 2-305 (price), 2-308 (place of delivery), 2-309 (time for delivery), 2-310 (time for payment). Nevertheless, courts will wholly construct a contract for the parties where they did not reach an agreement. "The more terms the parties leave open, the less likely it is that the parties have intended to conclude a binding agreement." *Id.* § 2-204 cmt. 3.

⁴¹ UCC § 2-309(1).

⁴² See *Jannusch v. Naffziger*, 883 N.E.2d 711 (Ill. Ct. App. 2008).

otherwise clear, the date “shall be a reasonable time.”⁴³ In most instances, this will depend on the parties’ good faith and “upon what constitutes acceptable commercial conduct in view of the nature, purpose and circumstances of the action to be taken.”⁴⁴ In addition, the court may consider any evidence of course of performance, course of dealing, and usage of trade.⁴⁵

C. CONTRACT MODIFICATION

Many contracts are simple, straightforward, one-time transactions, requiring an exchange of goods or services for money. In instances that require an extended period of time to perform, it may be necessary for the parties to adjust or modify the terms of their original agreement, while leaving intact the original agreement’s overall nature and obligations.⁴⁶ Generally, the modification of a contract involves a change in the original contract that “introduces new elements into the details of the contract and cancels others but leaves the general purpose and effect undisturbed.”⁴⁷

The modification of an existing contract is in reality the creation of a new contract. The modification must comply with the requirements of contract formation – there must exist: (1) an offer to modify; (2) an acceptance of that offer; (3) with consideration.⁴⁸ If the contract is executory in nature and one or both parties wish to modify the terms of the original contract the modification must, therefore, be supported by additional consideration.⁴⁹ The consideration in support of any modification will be present if the promisor receives a benefit⁵⁰ or the promisee undergoes a loss⁵¹ or detriment.⁵² In instances where the parties exchange promises, the presence of consideration is analyzed by asking what the promisee has given in exchange for the

⁴³ UCC § 2-309(1).

⁴⁴ *Id.* cmt. 1. See F.E. Myers Co. a Div. of McNeil Corp. v. Pipe Maintenance Servs., Inc., 599 F. Supp. 697 (D. Del. 1984); *In re Skinner*, 238 B.R. 120 (M.D. Tenn. 1999).

⁴⁵ See *Superior Boiler Works, Inc. v. R.J. Sanders, Inc.*, 711 A.2d 628 R.I. 1998); *Davis v. Suggs*, 460 N.E.2d 665 (Ohio Ct. App. 1983).

⁴⁶ See *Hildreth Consulting Engineers, P.C. v. Larry E. Knight, Inc.*, 801 A.2d 967 (D.C. 2002).

⁴⁷ See *International Bus. Lists, Inc. v. American Tel. & Tel. Co.*, 147 F.3d 636, 641 (7th Cir. 1998); *Hartwig Transit, Inc. v. Menolascino*, 446 N.E.2d 1193 (Ill. 1983).

⁴⁸ See *McIlravy v. Kerr-McGee Corp.*, 119 F.3d 876, 881 (10th Cir. 1997); *Robinson v. Ada S. McKinley Cmty. Serv. Inc.*, 19 F.3d 359, 364 (7th Cir. 1994); *Doyle v. Holy Cross Hosp.*, 708 N.E.2d 1140, 1144 (Ill. 1999); *Brodie v. General Chem. Corp.*, 934 P.2d 1263, 1268 (Wyo. 1997); *Demasse v. ITT Corp.*, 984 P.2d 1138, 1144 (Ariz. 1999). The requirement that the modification be supported by consideration exists in part for the purpose of preventing coercive modifications. See *Contempo Design, Inc. v. Chicago & N.E. Ill. Dist. Council of Carpenters*, 226 F.3d 535 (7th Cir. 2000); *United States v. Stump Home Specialties Mfg., Inc.*, 905 F.2d 1117 (1990).

⁴⁹ See *Cochran v. Quest Software, Inc.*, 328 F.3d 1 (1st Cir. 2003); *GenCorp, Inc. v. American Int’l Underwriters*, 178 F.3d 804 (6th Cir. 1999); *Main St. & A.P.R. Co. v. Los Angeles Traction Co.*, 61 P. 937 (Cal. 1900); *Ross v. Orr*, 69 A.2d 730 (N.J. 1949).

⁵⁰ See *Stovall v. Williams*, 409 P.2d 711 (Ariz. 1966).

⁵¹ See *Iuka Guar. Bank v. Beard*, 658 So.2d 1367 (Miss. 1995).

⁵² Although the courts analyze consideration in terms of a benefit to the promisor or a detriment to the promisee, the Restatement (Second) of Contracts does not find this particular method of analysis useful as a means of defining consideration. See Restatement (Second) Contracts § 79 cmt. b (1981).

promisor's promise or what the promisor has received as a result of his or her promise.

Suppose for example that Lou and Tom have agreed that Tom will lease office space from Lou for three years at a monthly rental of \$2,000 starting March 1st. However, subsequent to entering into the agreement, Lou discovers that the remodeling that was to be completed before Tom took possession of the office will not be achieved by March 1st. Lou asks Tom if the move-in date and rent starting date can be changed to April 1st. Tom agrees.

Under the terms of the modified agreement, Lou promises to deliver possession of the office space one month later than originally agreed in exchange for Tom's detriment in not insisting that Lou deliver possession of the office space on March 1st. Further, Tom promises to take possession of the office space one month later than originally agreed in exchange for Lou's detriment in not insisting on Tom taking possession of the office space. Each promise is supported by consideration in that the parties forego their respective performance on March 1st as originally agreed. Thus the modification is supported by consideration and is an effective change in the original agreement between Lou and Tom.

Pre-Existing Legal Duty Rule - In instances where the benefit or detriment is unilateral and only one party's obligation is modified the presence of consideration presents a much more difficult issue to resolve. The difficulty in resolving the consideration issue stems from the pre-existing legal duty rule. Under the pre-existing legal duty rule, it is well established that a promise to perform an obligation that is owed under an existing contract is not consideration for a reciprocal promise because the promisor is already legally bound to do what is promised.⁵³ Thus, the agreed modification to the contract is unenforceable for lack of sufficient consideration.⁵⁴

Suppose in the example of Lou and Tom that Tom takes possession of the leased property on March 1 as originally agreed and at the end of the first year of the tenancy, Tom informs Lou that since the economy has not been good for his business he will be forced to vacate unless Lou would be willing to reduce the monthly rent to \$1200 a month. Lou agrees. Lou's promise to take \$1200 per month instead of the \$2000 per month is not enforceable because there is no consideration for Lou's promise given that Tom is under a pre-existing legal duty to pay \$2000 per month.⁵⁵

The adverse affects of the pre-existing legal duty rule can be avoided several ways. One way is for the promisee to promise or undertake to do something that he or she is not already legally bound to do thereby providing sufficient consideration to

⁵³ See Restatement (Second) of Contracts § 73 (1981); see also *Salmeron v. U.S.*, 724 F.2d 1357 (9th Cir. 1983); *Herr v. Heiman*, 75 F.3d 1509 (10th Cir. 1996); *Yerkovich v. AAA*, 610 N.W.2d 542 (Mich. 2000); *Kimmons v. James*, 137 So. 2d 912 (Miss. 1962); *Jaynes v. Strong-Thorne Mortuary, Inc.*, 954 P.2d 45 (N.M. 1997); *Goncalves v. Regent Intern. Hotels, Ltd.*, 447 N.E.2d 693 (N.Y. 1983); *Scott v. Savers Prop. & Cas. Ins. Co.*, 663 N.W.2d 715 (Wis. 2003).

⁵⁴ Cf. Restatement (Second) of Contracts § 73 (1981).

⁵⁵ See *Levine v. Blumenthal*, 186 A. 457 (N.J. 1936).

support the promisor's promise to modify the terms of the original agreement.⁵⁶ In our hypothetical case of Lou and Tom, the operation of the pre-existing legal duty rule can be easily avoided if Tom, in exchange for Lou's promise to reduce the rent from \$2000 to \$1200 per month, agrees to do something more than he is already legally obligated to do under the terms of the original contract. Suppose Tom promises to rent the office space for an additional six months beyond the original three-year period. Tom is not legally obligated to rent the office space for an additional six months and thus his promise would be sufficient consideration for Lou's promise to reduce the monthly rental.

What if Tom promised to extend the term of the original rental agreement by one day? Would his promise to rent the office space for one day more than legally obligated be sufficient consideration to support Lou's promise to reduce the rent? Technically, the answer to this question is "yes." However, if Tom's promise to rent for one additional day is viewed as a mere "pretense of a bargain," the Restatement (Second) of Contracts indicates that consideration in support of Lou's promise may not exist.⁵⁷ Although there is concern regarding a "pretense," courts have applied the pre-existing duty rule in ways that are designed to reach fair results as long as the modification has come about from a change in circumstances that were not present at the time the parties entered into the original contract.⁵⁸ Lastly, the mechanical application of the pre-existing duty rule has been criticized and in some states the rule has been rejected.⁵⁹

Modification of Executory Contract Due to Unanticipated Circumstances – Section 89 of the Restatement (Second) of Contracts states:

A promise modifying a duty under a contract not fully performed on either side is binding

- (a) if the modification is fair and equitable in view of circumstances not anticipated by the parties when the contract was made; or
- (b) to the extent provided by statute; or
- (c) to the extent that justice requires enforcement in view of material change of position in reliance on the promise.

The result of this section is that in certain situations, modifications of the original contract are enforceable in spite of the absence of consideration.⁶⁰ If, subsequent to entering into the original contract, circumstances arise that could not have been

⁵⁶ See *Great Plains Equip., Inc. v. Northwest Pipeline Corp.*, 979 P.2d 627 (Idaho 1999); *Hercules Powder Co. v. Harry T. Campbell Sons Co.*, 144 A. 510 (Md. Ct. App. 1929); *Cheney v. Rucker*, 381 P.2d 86 (Utah 1963); *Wakefield v. Champlain Marine Co.*, 13 A.2d 183 (Vt. 1940).

⁵⁷ The Restatement (Second) of Contracts § 73 (1981) states: "Performance of a legal duty owed to a promisor which is neither doubtful nor the subject of honest dispute is not consideration; but a similar performance is consideration if it differs from what was required by the duty in a way which reflect more than a *pretense of bargain*." (emphasis added).

⁵⁸ See *id.* § 73 cmt. c.

⁵⁹ *Id.*

⁶⁰ *Id.* § 89 cmt. a (1981). Under the terms stated in section 89, modifications are also enforceable in the absence of consideration if permitted by statute, *id.* cmt. b, or the application of promissory estoppel, *id.* cmt. c.

anticipated by the parties at the time the contract was originally entered into, no consideration is required to modify the contract.⁶¹ The modification must not be fair and equitable and thus free of coercion.⁶² In addition, the reason for the modification must be “objectively demonstrable.”⁶³ Other factors to be considered include the relative financial strengths of the parties, the formalities present in making the modification, and the extent to which the new promise has been performed or relied upon.⁶⁴ In the earlier example where Lou agreed to reduce the rent and Tom promised noting in exchange, is it possible that the modification is valid despite the absence of consideration? Yes, if the economic downturn, stated as the reason for Tom’s proposed modification, is deemed to have been a circumstance that was unanticipated by the parties at the time the contract was made. However, is an economic downturn really a circumstance that would be unanticipated by the parties? The answer might lie in the significance of the downturn. Also, the absence of consideration to support a modification might be reserved for circumstances significantly more extreme than a change in the economy.⁶⁵

Rescission of the Original Contract - The adverse affects of the pre-existing legal duty rule may also be avoided if the parties agree to rescind their original contract and then enter into a new agreement that contains the modified terms.⁶⁶ In this instance there are three contracts involved in the modification process. The first contract is the original agreement between the parties. The second contract is the agreement rescinding the first contract. Lastly, the third contract is the newly modified agreement.

This approach is based upon the principal that contracts are entered into by the will of the parties. Thus the contracts can be terminated or rescinded by the will of the same parties, whereby one party promises to release the other party from his or her contractual commitments in exchange for the other party’s promise to do the same. The rescission agreement thereby terminates all the obligations that were created in the original agreement. Since all the pre-existing obligations that were created in the original agreement have been terminated any subsequent agreement between the parties is not subject to the pre-existing legal duty rule.

This approach has not been widely accepted by the courts and has been highly criticized as circular in its reasoning and demonstrating little or no understanding of the

⁶¹ See, e.g., Guilford Yacht Club Ass’n, Inc. v. Northeast Dredging, Inc., 438 A.2d 478, (Me. 1981)(yacht club required, as promised, to pay additional compensation to dredging firm for work already required to be done based on conditions making performance of the original contract unusually difficult); Brian Constr. & Dev. Co. v. Brighenti, 405 A.2d 72 (Conn. 1978)(general contractor promised subcontractor extra payment for removal of concrete and steel debris, the presence of which was unknown by either party, from excavation site); Angel v. Murray, 322 A.2d 630 (R.I. 1974)(city promised to pay refuse hauler \$10,000 per year more on contract to collect all refuse in the city because of unanticipated increase of dwelling units within the city).

⁶² Restatement (Second) of Contracts § 89 cmt. b (1981).

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* illus. 1 (1981).

⁶⁶ See Torrey v. Adams, 149 N.E. 618 (Mass. 1925); Siebring Mfg. Co. v. Carlson Hybrid Corn Co., 70 N.W.2d 149 (Iowa 1955).

concept of consideration.⁶⁷ Additionally, this approach is expressly rejected in the Restatement (Second) of Contracts.⁶⁸

Modification of Contracts for the Sale of Goods – The Uniform Commercial Code eliminates the requirement of consideration for the modification of contracts for the sale of goods. With respect to modification of contracts, the relevant part of section 2-209 of the UCC states: “An agreement modifying a contract within this Article needs no consideration to be binding.” The stated purpose of this provision is “to protect and make effective all necessary and desirable modifications of sales contracts without regard to the technicalities which at present hamper such adjustments.”⁶⁹ What are the technicalities that hamper contract modifications? Although not specifically identified in section 2-209, the technicalities should be obvious in light of the prior discussion relating to contract modifications. The technicalities would include the pre-existing legal duty rule; ways to avoid the application of the rule; exceptions to the rule; and contract rescission with subsequent formation of a third contract between the parties.

Underlying the policy of the Code that favors the preservation of contracts and permits the modification of contracts in the absence of consideration is the firm requirement that the parties must at all times be acting in good faith.⁷⁰ In determining whether a modification has been achieved in good faith, the conduct of the parties must indicate “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”⁷¹ Thus, the party seeking the modification must be acting honestly and be able to establish that the request for modification is prompted by a legitimate commercial reason.⁷² The requirement of good faith can be established in instances where the unanticipated circumstances rule of the common law would also enforce the modification absent the presence of consideration.⁷³ Unlike the common law, however, unanticipated circumstances need not be show to enforce the modification.⁷⁴ Thus, in the earlier example, had it involved the sale of goods, Lou’s promise to take \$1200 per month instead of the \$2000 per month would be enforceable in the absence of consideration even under circumstances that could have been anticipated by the parties.

⁶⁷ See *McCallum Highlands, Ltd. v. Washington Capital Dus, Inc.*, 66 F.3d 89, 94 (5th Cir. 1995)(stating that “where an alleged rescission is coupled with a simultaneous re-entry into a new contract and the terms of the new contract are more favorable to only one of the parties, doubt is created as to the mutuality of the agreement to rescind the original contract.” See also, *Recker v. Gustafson*, 279 N.W. 2d 744, 756-59 (Iowa 1979) (discussing Iowa case law that had resulted in blurring the distinction between modification and rescission followed by entry into a new contract in the absence of consideration.) See also 3 WILLISTON ON CONTRACTS § 7:37 (1992); Murray, *supra* note 26, § 64 at 290-292.

⁶⁸ Restatement (Second) of Contracts §89 cmt. b (1981).

⁶⁹ UCC § 2-209 cmt. 1.

⁷⁰ *Id.* § 2-209(1) cmt. 2. See also *Ralston Purina Co. v. McNabb*, 381 F. Supp. 181 (D.C. Tenn. 1974).

⁷¹ See U.C.C. §§ 2-103(1)(j) & 2-209(1) cmt. 2. See also *U.S. for Use and Benefit of Crane Co. v. Progressive Enters.*, 418 F. Supp. 662 (E.D.Va. 1976).

⁷² *E.g.*, *Weisberg v. Handy & Harmon*, 747 F.2d 416 (7th Cir. 1984) (precipitous change in market price); *Roth Steel Products v. Sharon Steel Corp.*, 705 F.2d 134 (6th Cir. 1983)(unforeseen economic exigencies); *Ralston Purina Co. v. McNabb*, 381 F. Supp. 181 (D.C. Tenn. 1974)(unusually heavy rains and flooding causing delay in delivery).

⁷³ U.C.C. § 2-209(1) cmt. 2.

⁷⁴ *Id.*

The modification, however, would still be subject to the Code's requirement that the modification be made in good faith.

D. REMEDIES

Once a contract is formed it may take some time for the respective parties to fulfill the obligations that have arisen from their promises. Upon complete performance a party will be discharged from his or her contractual obligations. Generally, most contracts are fully performed by the parties and ultimately discharge is complete. However, there are times when a party fails to perform or the manner of the performance is unsatisfactory. In such instances issues arise as to the rights and duties of the respective parties. In resolving these issues it will be necessary to determine whether performance was in fact due or excused, whether the contract has been breached, and if so, is the breach minor or material.

A breach of contract is considered material if the failure to perform as promised results in the promisee not receiving the substantial benefit bargained for in the contract. A material breach "touches the fundamental purposes of the contract and defeats the object of the parties in making the contract."⁷⁵ The process of determining whether one's failure to perform as promised is "material" is imprecise and flexible.⁷⁶ The primary question to answer is whether the breach deprives the injured party of the benefit he or she reasonably expected to receive from the non-performing party.⁷⁷

Assuming that the non-performance is deemed to be a material breach, the question arises with respect to the nature of the remedy that is available to compensate a party for breach of contract. The remedies available for breach of contract can be categorized as legal, equitable or restitutional.⁷⁸ These remedies for breach of contract are concerned with protecting the expectation, reliance, and restitution interests of the parties.⁷⁹

⁷⁵ See *Sokol v. Bruno's Inc.*, 527 So.2d 1245 (Ala. 1988).

⁷⁶ See Restatement (Second) Contracts § 241 cmt. a.

⁷⁷ Restatement (Second) Contracts § 241 lists circumstances that are important to consider in determining whether a failure to render or to offer performance is material stating:

In determining whether a failure to render or to offer performance is material, the following circumstances are significant:

- (a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;
- (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
- (c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;
- (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;
- (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing. *Id.*

⁷⁸ *Id.* § 345.

⁷⁹ *Id.* § 344.

The remedy most commonly applied to protect a party's expectation interest is the legal remedy of awarding monetary damages to compensate a party for his or her losses. In the exercise of its discretion, a court may grant the equitable remedy of specific performance or injunctive relief.⁸⁰ However, these equitable remedies are generally only appropriate when an award of monetary damages would be inadequate.⁸¹ Lastly, the remedy of restitution is available in circumstances where there is no contract between the parties but justice requires that one be compensated for a benefit that he or she has conferred on another.⁸² This restitution remedy is in part a legal remedy (monetary award) based on the equities present (what is fair). The restitution remedy is best exemplified where recovery is based in quasi-contract. Although the equitable and restitution remedies are related to the overall discussion of contract remedies, the remainder of the remedy discussion will only focus on the legal remedy of award of monetary damages under the common law and the Uniform Commercial Code.

1. Common Law

Section 347 of the Restatement (Second) of Contracts provides in general for the measure of damages as follows:

[T]he injured party has a right to damages based on his expectation interest as measured by

- (a) the loss in the value to him of the other party's performance caused by its failure or deficiency, plus
- (b) any other loss, including incidental or consequential loss, caused by the breach, less
- (c) any cost or other loss that he has avoided by not having to perform.

As stated above, a party's right to damages for breach of contract are based on the injured party's expectation interest. The expectation interest is a party's interest in receiving what he or she bargained for or "expected" as a result of the full performance of the contract. In light of this expectation interest, the damage remedy aims to place a party (promisee) to the contract in the position he or she would have been in had the contract been performed as promised.⁸³ The ultimate objective with respect to the award of damages is to compensate the injured party for the losses he or she has undergone as a result of the contract's breach. Compensatory damages include general and special damages.⁸⁴

⁸⁰ *Id.* § 357.

⁸¹ *Id.* § 359.

⁸² *Id.* § 370.

⁸³ *Id.* § 344(1)(a).

⁸⁴ The difference between general and special damage resulting from the breach of contract are relative in that a damage that is deemed general in relation to one contract may be special in relation to another contract. *See* Kerr S.S. Co. v. Radio Corp. of America, 157 N.E. 140 (N.Y. 1927); *see also* Restatement (Second) Contracts § 347 cmt. c.

Loss in Value (General Damages) – General damages are those damages that naturally flow from the breach of a contract.⁸⁵ The general damages that result from a party's failure to perform are deemed to conclusively be a foreseeable consequence of his or her breach.⁸⁶ General damages primarily measure the loss in value to the injured party stemming from the promisor's failed or deficient performance. Therefore, the determination of the loss in the value to the injured party is based on the other party's level of performance. Generally, the loss in value is measured by the difference in value between what was promised and what was received.

If the promisor fails to perform to any degree, the loss in value resulting from the breach of the contract is equal to the value that the performance would have had to the injured party.⁸⁷ In the earlier discussion on contract modification there were several examples dealing with Lou and Tom with Tom leasing office space from Lou for three years at a rental of \$2,000 per month starting March 1. Suppose Tom fails to take possession of the office space. Tom has not performed to any degree. Lou's loss in value measure for the breach of the contract would be 36 months rent at \$2,000 per month or a total of \$72,000. However, as will be seen in the discussion that follows, the final amount that Lou will be entitled to for breach of contract is subject to some further adjustments, possibly for consequential and incidental damages and other limitations on recovery.

If the promisor renders defective or partial performance, the loss in value resulting from the breach of the contract is equal to the difference in the value that was promised and the value of what was actually received.⁸⁸ Suppose in our hypothetical that after agreeing to lease the office space, Tom takes possession of the space. However, after occupying the premises for one year, Tom indicates that his business is not doing well because of the slow down in the economy and asks Lou if he would be willing to lower the rent to \$1200 per month for the remaining term of the lease agreement. Suppose Lou refuses to lower the rent and Tom vacates the premises on March 31, one year after moving into the office space. Lou's loss in value measure for the breach of the partially performed contract would be 24 months rent at \$2,000 per month or a total of \$48,000. However, as previously stated, the final amount that Lou will be entitled to for breach of contract is subject to some adjustments and limitations.

Consequential Damages (Special Damages) - Consequential damages, also called special damages, are damages that are foreseeable within the reasonable contemplation of the parties at the time they entered the contract.⁸⁹ Although special damages naturally flow from a breach of contract, they differ from general damages in that they are unusual and vary with the circumstances of each case and they must be shown to have been actually contemplated or foreseen by the parties at the time the contract was made.⁹⁰

⁸⁵ See *Giampapa v. American Family Mut. Ins. Co.*, 64 P.3d 230 (Colo. 2003).

⁸⁶ See *Hess Die Mold, Inc. v. American Plasti-Plate Corp.*, 653 S.W.2d 927 (Tex. Ct. App. 1983).

⁸⁷ Restatement (Second) Contracts § 347 cmt. b.

⁸⁸ *Id.*

⁸⁹ See *Giampapa v. American Family Mut. Ins. Co.*, 64 P.3d 230 (Colo. 2003).

⁹⁰ See *Hess Die Mold, Inc. v. American Plasti-Plate Corp.*, 653 S.W.2d 927 (Tex. Ct. App. 1983).

Special damages result when a special purpose of the contract is not achieved and or from special or unusual circumstances that were actually known by the parties when they entered the contract.⁹¹

The hallmark case of *Hadley v. Baxendale*⁹² identified this distinction of special damages from general damages. In that case, an iron shaft in Hadley's mill had broken resulting in the mill becoming inoperable. The broken shaft was delivered to Baxendale, a carrier, for transport to an engineer in Greenwich so that a duplicate shaft could be made. Upon delivery of the shaft, the carrier was informed that the shaft needed to be delivered immediately. The carrier promised to deliver the shaft the next day. However, the carrier was not informed that the mill would be inoperable until the new shaft was delivered to Hadley. Baxendale was negligent in transporting the shaft the next day to the engineer. As a result the mill remained shut down for an additional five days. Hadley sued for damages due to lost profits.

The court did not describe the nature of damage recovery in terms of general and or special damages. However, the court did state that the damages that can be recovered for breach of contract would include those damages that naturally arise from the breach of the contract itself (general damages) and those damages that could be reasonably contemplated by both parties at the time the contract was made (special or consequential damages). Specifically, the court stated:

“Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, *i.e.*, according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.”⁹³

In light of the fact that Baxendale did not know the special circumstance that the mill was inoperable and would remain so until the new shaft was delivered to Hadley, the court held that Baxendale was not liable for lost profits. The principle stated in *Hadley v. Baxendale* relating to the determination of the extent of recovery in an action for breach of contract has been universally accepted by courts in the United States.⁹⁴

In the case with Lou and Tom, suppose Tom, after one year of occupancy, vacates the premises on March 31 and fails to provide Lou any advance notice of his vacating the premises. Lou does not discover that Tom has vacated the office space until April 15. Further, assume that Lou has a contract with his property casualty insurance carrier that

⁹¹ See *Wall v. Pate*, 715 P.2d 449 (N.M. 1986).

⁹² 9 Exch. 341, 156 Eng.Rep. 145 (1854).

⁹³ *Id.* at 151.

⁹⁴ See *Midland Hotel Corp. v. Reuben H. Donnelley Corp.*, 515 N.E.2d 61 (Ill. 1987); *Kansas State Bank v. Overseas Motosport, Inc.*, 563 P.2d 414 (Kan. 1977); *Spang Indus., Inc., Ft. Pitt Bridge Div. v. Aetna Cas. & Sur. Co.*, 512 F.2d 365 (2nd Cir. 1975); *Kerr S.S. Co. v. Radio Corp. of Am.*, 157 N.E. 140 (N.Y. 1927). See also *Restatement (Second) Contracts* § 351.

if, on April 1, all of the office space in Lou's building is fully occupied, Lou will receive a 5% reduction in his insurance premiums for the next year. The premium savings for Lou would amount to \$10,000. However, since Tom has vacated the premises on April 1 and Lou does not discover this until April 15, Lou is unable to take advantage of the 5% reduction in premiums and loses the \$10,000 savings. Can Lou recover \$10,000 from Tom as consequential damages? Most likely the rationale of the court in *Hadley* will prevent Lou from recovering \$10,000 in consequential damages. There are no facts indicating that at the time the parties entered into the lease agreement there existed unusual or special circumstances, known to both parties, that vacating the premises would result in the lost opportunity for Lou to save \$10,000 in insurance premiums.

Incidental Damages – Incidental damages are those costs that the injured party incurs following a breach of the contract in an effort to avoid further loss. Incidental damages usually include such expenditures as the costs associated with inspecting or storing defective goods, insurance or interest payments, expenses incurred in attempting to procure substitute employment following employer's breach of employment contract, or paying brokerage fees in order to arrange a substitute transaction.⁹⁵

Limitations on Recovery for Damages in Contract Cases – The recovery by the injured party of damages for breach of contract is limited by three principles. First, recovery of damages is limited to only those that the injured party can prove with reasonable certainty. Second, the breaching party's liability is limited to only those damages that were foreseeable to him or her at the time of entering into the contract. Lastly, the injured party has a duty to mitigate or minimize the damages that he or she suffers as a result of the breach of the contract.

Proof of Damage with Reasonable Certainty – The recovery of damages for breach of contract is allowed only to the extent that the damages can be established with reasonable certainty in light of the evidence.⁹⁶ The injured party must present evidence that establishes in certain terms, first, that in fact he or she has suffered a loss and second, the amount of the loss.⁹⁷ The reasonable certainty limitation is not intended as a bar to recovery if the injured party is unable to establish the total amount of his or her loss.⁹⁸ The limitation only excludes recovery for those damages that are merely speculative or conjectural and thus cannot be proven with reasonable certainty.⁹⁹ This limitation has its greatest impact in those instances where the injured party seeks recovery for lost profits stemming from the breach of the contract.¹⁰⁰ The difficulty in recovering for lost profits is a result of several factors including: whether the business is an older established

⁹⁵ Restatement (Second) Contracts § 347 cmt. c.

⁹⁶ *Id.* § 352 (damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty). See also *Merion Spring Co. v. Muelles Hnos. Garcia Torres, S.A.*, 462 A.2d 686 (Pa. 1983).

⁹⁷ See *Schon-Klingstein Meat & Grocery Co. v. Snow*, 96 P. 182 (Colo. 1908); *Winston Cigarette Mach. Co. v. Well-Whitehead Tobacco Co.*, 53 S.E. 885 (N.C. 1906).

⁹⁸ Restatement (Second) Contracts § 352 cmt. a.

⁹⁹ *Id.* See also *Fera v. Village Plaza, Inc.*, 242 N.W.2d 372 (Mich. 1976); *Griffin v. Colver*, 16 N.Y. 489 (1858).

¹⁰⁰ Restatement (Second) Contracts § 352 cmt. a.

business with a track record of profit earnings or a newly formed business or business activity lacking a record of profit earnings; and the difficulty of specifically identifying the losses as resulting from the breach of the contract or a variety of other factors that affect the bottom line profit earnings.

Recovery Limited to Foreseeable Loss – The liability of the party breaching the contract is limited to those losses that could be foreseen to be the probable result of the breach of the contract when the contract was made.¹⁰¹ A loss is foreseeable if it can be expected to occur in the ordinary course of events as a probable result of the breach of the contract or if the breaching party knew or had reason to know of special circumstances that would most likely result from breaching the contract.¹⁰² The information presented earlier relating to the nature of general and special damages included discussion relating to the foreseeability issue.

Mitigation of Damages – This third principle prevents the injured party from recovering damages that he or she could have avoided without incurring undue risk, expense of humiliation.¹⁰³ However, the injured party's effort to avoid loss need not be successful. All that is required is that he or she undertakes reasonable efforts in attempting to avoid any loss resulting from the contract's breach.¹⁰⁴

Although sometimes referred to as a "duty to mitigate," this reference is not entirely accurate. The injured party is not under any duty or obligation to the breaching party to avoid or lessen the damages suffered as a result of the breach of contract. This is because the injured party does not incur any liability for the failure to act.¹⁰⁵ The extent of the loss that is experienced by the injured party is merely reduced by the amount of loss he or she could have reasonably avoided. Thus, as to the examples above, upon Tom vacating the office space he has leased from Lou, Lou should make reasonable attempts to re-let the premises to avoid damages that he will suffer as a result of Tom's breaching the lease contract.¹⁰⁶ Lou's failure to make reasonable attempts to re-let the premises may result in a reduction of the loss that Lou experiences as a consequence of Tom's vacating the leased office space.

¹⁰¹ *Id.* § 351 (1) (damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made). Note that there is no requirement of foreseeability on the part of the injured party. *Id.* cmt. a.

¹⁰² *Id.* § 351 (2) (a) & (b) (loss may be foreseeable as a probable result of a breach because it follows from the breach [a] in the ordinary course of events, or [b] as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know).

¹⁰³ *Id.* § 350 (1).

¹⁰⁴ *Id.* § 350 (2) cmt. a.

¹⁰⁵ *Id.* § 350 cmt. b.

¹⁰⁶ Damages recoverable by commercial landlords have historically been governed by property law that does not require the landlord to make reasonable efforts to mitigate damages. Although unclear, the trend appears to be to abandon the traditional approach of property law in favor of the contract law principle of mitigation. See Murray, *supra* note 26, at § 122 n. 154.

2. Uniform Commercial Code (UCC)

The UCC specifies in general the remedies available to the seller¹⁰⁷ and the buyer¹⁰⁸ when a contract for the sale of goods has been breached. However, a party's ability to pursue his or her remedies is contingent upon there being: a repudiation of the contract;¹⁰⁹ or a failure of performance;¹¹⁰ or a rejection of the goods;¹¹¹ or a revocation of the acceptance of the goods.¹¹²

Seller's Remedies Under the UCC – The buyer may breach a contract for the sale of goods by: repudiating the contract in stating an unwillingness to perform although performance is not yet due; failing to pay for goods when the payment is due; wrongfully rejecting the goods; wrongfully revoking acceptance of the goods.¹¹³ The seller has several remedies available when the buyer breaches the contract. Depending on the circumstances, the remedies include the right to: cancel the contract;¹¹⁴ withhold delivery of undelivered goods;¹¹⁵ identify to the contract any conforming finished goods or in the exercise of reasonable commercial judgment, complete unfinished goods;¹¹⁶ cease the manufacture of unfinished goods and resell for scrap or salvage;¹¹⁷ resell the goods and obtain damages from the buyer;¹¹⁸ recover damages for non-acceptance of the goods;¹¹⁹ stop, upon discovering the buyer's insolvency, delivery of the goods that are in transit to the buyer;¹²⁰ and recover the purchase price for accepted goods or goods identified to the contract.¹²¹

The circumstances involved in the facts of this case study indicate that the performance and damage issues revolve around a breach of the contract by the seller. Therefore, the discussion that follows with respect to remedies will attempt to deal in some depth with the remedies available to the buyer upon the seller's breach of the contract for the sale of goods.

¹⁰⁷ See UCC § 2-703.

¹⁰⁸ See *id.* § 2-711.

¹⁰⁹ See *id.* § 2-610.

¹¹⁰ See *id.* § 2-310. The obligation of the seller is to transfer and deliver the goods and that of the buyer is to accept and pay for the goods in accordance with the contract.

¹¹¹ See *id.* § 2-601. The buyer's right to reject non-conforming goods. The rejection by the buyer must, however, conform to the requirements stated in UCC § 2-602. If the goods are rightfully rejected the buyer has a cause of action against the seller. *Id.* § 2-711. If the buyer wrongfully rejects the goods, the seller has a cause of action against the buyer. *Id.* § 2-703.

¹¹² See *id.* § 2-608. The buyer's right to revoke his or her acceptance upon discovering that the goods do not substantially conform to the contract. If the buyer's revocation of acceptance is proper, the buyer has a cause of action against the seller. *Id.* § 2-711. If the buyer's revocation of acceptance is improper, the seller has a cause of action against the buyer. *Id.* § 2-703.

¹¹³ See *id.* § 2-703(1).

¹¹⁴ See *id.* § 2-703(2)(f).

¹¹⁵ See *id.* § 2-703(2)(a).

¹¹⁶ See *id.* §§ 2-704(1)(a) & 2-704(2).

¹¹⁷ See *id.* § 2-704(2).

¹¹⁸ See *id.* §§ 2-703(2)(g) & 2-706(1).

¹¹⁹ See *id.* §§ 2-703(2)(h) & 2-708(1).

¹²⁰ See *id.* §§ 2-703(2)(b) & 2-705(1).

¹²¹ See *id.* §§ 2-703(2)(j) & 2-709(1)(a) & (b).

Buyer's Remedies Under the UCC – The seller may breach a contract for the sale of goods in several ways. Some of the ways the seller may breach are by: repudiating the contract by stating an unwillingness to perform although performance is not yet due; failing to deliver the goods; or delivering nonconforming goods.¹²² The buyer has a variety of remedies available when the seller breaches the contract. Depending on the circumstances of the case, the buyer may: cancel the contract;¹²³ “cover” with the purchase of substitute goods and recover damages;¹²⁴ recover damages for non-delivery of the goods or repudiation of the contract;¹²⁵ recover damages for nonconforming goods that have been accepted by the buyer;¹²⁶ recover, upon discovering seller’s insolvency, from the seller goods that have been identified to the contract;¹²⁷ or obtain specific performance of the contract if the goods are “unique.”¹²⁸

Right to Cover – If the seller does not deliver goods as required in the contract, the buyer can without unreasonable delay make a reasonable purchase of or contract to purchase substitute (cover) goods for those goods that were due from the seller.¹²⁹ If the buyer chooses this remedy, he or she can recover damages from the seller measured by the difference between the cost of the substitute goods and the contract price.¹³⁰ For example, Burt and Sam have agreed that Sam will sell Burt his used Sunny Bravo LDK-52RBX 52-inch flat screen HDTV for \$5000. It is also agreed that the sale will be completed on the day before the Super Bowl at which time Burt will proffer the \$5,000 and pick-up the TV from Sam’s home. On the day before the Super Bowl, Burt proffers the \$5,000 but Sam refuses to deliver possession of the TV. In seeking to “cover,” Burt is able to purchase a comparable used Bravo LDK-52RBX 52-inch flat screen HDTV for \$5,500 plus \$250 for shipping/handling/delivery. Burt can recover \$500, which is the difference between what he paid for the substitute (\$5,500) and the contract price (\$5,000).

The buyer may also recover any incidental or consequential damages suffered as a result of the seller’s breach.¹³¹ The buyer is required, however, to credit the seller for any expenses that the buyer may have saved as a consequence of the breach.¹³² Incidental damages include “expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.”¹³³ Thus in our example above, in addition

¹²² See *id.* § 2-711(1).

¹²³ See *id.* § 2-711(1).

¹²⁴ See *id.* §§ 2-711(2)(d) & 2-712(1) & (2).

¹²⁵ See *id.* §§ 2-711(2)(e) & 2-713(1)(a) & (b).

¹²⁶ See *id.* § 2-714(1).

¹²⁷ See *id.* § 2-711(2)(g); the recovery of the goods to occur as provided in UCC § 2-502.

¹²⁸ See *id.* §§ 2-711(2)(h) & 2-716.

¹²⁹ See *id.* § 2-712(1).

¹³⁰ See *id.* § 2-712(2); see also *KGM Harvesting Co. v. Fresh Network*, 42 Cal.Rptr 286 (Cal. Ct. App. 1995).

¹³¹ See § 2-712(2).

¹³² *Id.*

¹³³ See *id.* § 2-715(1). The incidental damages listed in this section are not intended to be all inclusive but

to recovering the cost of cover (\$500), Burt can recover the \$250 paid for the cost incurred for shipping, handling, and delivery of the television as a cost “in connection with effecting cover,” or as a “reasonable expense incident to the ... breach.”

Consequential damages are defined by section 2-715(2)(a) of the UCC to include: “any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise.”¹³⁴ Thus, in order to recover consequential damages resulting from the seller’s breach, the buyer must establish that the seller either knew or should have known at the time the contract was made that the buyer would suffer consequential (special) damages if the seller breached the contract.¹³⁵

Damages for Nondelivery or Repudiation of the Contract – If the seller does not deliver or refuses to deliver the goods as required in the contract the buyer may, but is not required to, purchase substitute (cover) goods for those goods that were due from the seller.¹³⁶ Instead of purchasing substitute goods the buyer has the option of recovering damages. In this circumstance, the measure of damages is the difference between the market price at the time the buyer learns of the seller’s breach and the contract price.¹³⁷ Also, the buyer may recover any incidental and consequential damages less expenses that the buyer has saved as a consequence of the breach.¹³⁸

It is important to understand that the measure of the damage suffered by the buyer can differ depending upon whether the buyer chooses the cover remedy or the damage remedy. It is possible that the buyer may pay more than the market price for the substitute goods purchased in pursuing a cover remedy. Instead of limiting the buyer’s measure of damage to the market price, the cover remedy provides a more precise measure of the actual damage suffered by the buyer. Once again, however, it is important to remember that the UCC does not require the buyer to cover.

Damages for Breach as to Justifiable Revocation of Accepted Goods – In some instances the nonconformity of the goods to the contract is evident to the buyer at the time the goods are tendered or delivered. In this case the buyer has the right to reject the nonconforming goods.¹³⁹ The rejection, however, must occur within a reasonable time after the goods have been tendered or delivered.¹⁴⁰ If the buyer fails to reject the goods within a reasonable time, the buyer has in essence accepted the goods.¹⁴¹

are stated as illustrative of the usual kinds of incidental damage that may be suffered. *Id.* § 2-715 cmt. 1.

¹³⁴ *Id.* at § 2-715(2)(a).

¹³⁵ The rule with respect to the buyer’s recovery of consequential damages contained in UCC § 2-715(2)(a) adopts the foreseeability standard of *Hadley v. Baxendale*, discussed *supra*.

¹³⁶ *See id.* § 2-712(1) & (3).

¹³⁷ *See id.* § 2-713(1)(a). The market price is the price for goods of the same kind and in the same branch of trade. *Id.* § 2-713 cmt. 5

¹³⁸ *See id.* § 2-713(1)(a).

¹³⁹ *See id.* § 2-601.

¹⁴⁰ *See id.* § 2-602(1).

¹⁴¹ *See id.* § 2-606(1)(b).

In some instances the nonconformity of the goods to the contract is not evident to the buyer at the time the goods are tendered or delivered. In this case the buyer accepts the goods because he or she believes them to conform to the contract. However, although the goods have been accepted, the buyer may revoke his or her acceptance placing the buyer in the position he or she would have been in if the goods had originally been rejected upon tender or delivery.¹⁴² However, in order for the buyer to revoke his or her acceptance certain conditions must be present. First, the nonconformity of the goods must substantially impair the value of the goods to the buyer.¹⁴³ Second, if the nonconformity was not discovered prior to acceptance, the nonconformity must have been either difficult to discover or the seller must have assured the buyer that the goods were conforming.¹⁴⁴ Third, alternatively, if the nonconformity was known at the time of the acceptance the buyer must have accepted the goods on the reasonable assumption that the nonconformity would be cured by the seller and the seller has failed to cure the nonconformity within a reasonable time.¹⁴⁵ Lastly, the revocation of acceptance must be accomplished within a reasonable amount of time after the buyer discovers or should have discovered the nonconformity.¹⁴⁶

If the revocation of acceptance is justified, the buyer's remedies are the same as those that were stated earlier, including: cancelling the contract; or covering by purchasing substitute goods and recovering damages; or recovering damages for breach of the contract. In addition to recovering general damages, the buyer would also be entitled to recover any incidental or consequential damages suffered as a result of the breach of the contract.¹⁴⁷

Damages for Breach as to Accepted Goods – Breach of Warranty - In cases where the buyer has not rejected the goods nor revoked his or her acceptance and a reasonable time has elapsed for revoking the acceptance the buyer may still have a cause of action based on a breach of express or implied warranty.¹⁴⁸ In order to recover damages under these circumstances the buyer must give the seller notice of the nonconformity within a reasonable time after it is discovered or should have been discovered.¹⁴⁹ The damages are determined by "the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted."¹⁵⁰ In addition, the buyer may be entitled to recover incidental and consequential damages.¹⁵¹

¹⁴² See *id.* § 2-608(3).

¹⁴³ See *id.* § 2-608(1).

¹⁴⁴ See *id.* § 2-608(1)(b).

¹⁴⁵ See *id.* § 2-608(1)(a).

¹⁴⁶ See *id.* § 2-608(2).

¹⁴⁷ See *id.* § 2-711(c)(d)(e); § 2-712 & § 2-713.

¹⁴⁸ See *id.* § 2-714(1). The warranties may arise expressly (§ 2-313) or implicitly as a warranty of merchantability (§ 2-314) or a warranty of fitness for a particular purpose (§ 2-315).

¹⁴⁹ See *id.* § 2-607(3)(a).

¹⁵⁰ See *id.* § 2-714(2)

¹⁵¹ See *id.* § 2-714(3).

Specific Performance – If unique goods are the subject matter of the contract the buyer may seek to have the contract specifically performed.¹⁵² In this instance the seller is required to give the buyer the goods that are covered by the contract. Specific performance is an equitable remedy that may only be used in cases where the legal remedy of money damages is inadequate. In contracts involving the sale of goods, the inadequacy of the legal remedy is based on the unique nature of the goods.

Historically, specific performance was available in only those instances where the goods were truly unique as in the case of heirlooms or priceless jewels or works of art. However, the UCC expands the availability of this remedy to “other proper circumstances.”¹⁵³ Such proper circumstances might include an “inability to cover.”¹⁵⁴ In addition the concept of what makes a good unique is expanded beyond the traditional case of heirlooms or priceless jewels or works of art.¹⁵⁵ It is suggested that the expansion might include “[o]utput and requirements involving a particular or peculiarly available source or market.”¹⁵⁶

V. TEACHING NOTES

A. TEACHING OBJECTIVES

This case study is intended to lead students to appreciate a few of the legal issues that arise between businesses and consumers and that implicate contract law and commercial litigation. The main objectives for teaching the case are to challenge students to:

1. Appreciate the legal aspects of business transactions;
2. Recognize the importance of assessing legal risk in business decisions;
3. Acquire a comparative understanding of the differences between the common law of contracts and the Uniform Commercial Code;
4. Identify legal issues in commercial transactions involving contract formation, breach of contract, and remedies;
5. Apply relevant legal principles to a fact situation in order to reach a conclusion;
6. Explain or interpret the results of their analysis in a clear, concise, and technically correct manner.

B. POTENTIAL USES OF THE CASE

As a pedagogical tool, this case study can be used to supplement introductory or advanced business law courses that include treatment of contracts law and commercial

¹⁵² See *id.* § 2-716(1).

¹⁵³ See *id.*

¹⁵⁴ See *id.* § 2-716 cmt. 2.

¹⁵⁵ See *id.*

¹⁵⁶ See *id.*

transactions. In addition, use of the case study will promote awareness of legal risk in business decisions and enhance the development of students' critical thinking and legal analysis skills

C. DISCUSSION

1. APPLICABILITY OF THE UNIFORM COMMERCIAL CODE

Whether the customized software is a "good" is a definitive question that must be answered before the other issues in this case may be analyzed. If the contract in this case involves a transaction in goods, then the UCC supplies the governing law for the contract. If not, then the contract will be governed by the rules of common law. The contract in this case involves a mixed or hybrid transaction of goods and service. Value Plus is purchasing software from Intuit, as well as the customization and installation of the software. In such cases, the court will apply the predominant purpose test to determine whether the contract is governed by the UCC or common law.

As a general matter, off-the-shelf software is considered to be a good within the meaning of Article 2 because it is a tangible, moveable thing. The question at hand, however, is whether the customization and installation services part of Intuit's contract with Value Plus predominates over the goods aspect. The resolution of this threshold matter will be outcome-determinative as to the other issues in this case study.

In applying this test, it can be argued that the predominant parts of the contract are really the customization and installation of the software, which are services. As support for this position, students can employ the reasoning in *Advent Systems*¹⁵⁷ and point to the original allocation of 70 percent of the purchase price to the customization and installation components of the transaction. The initial price of \$15,000 was composed of \$4,500 for the Accutrak software package, plus \$7,500 for customization along with a \$3,000 installation fee.

Another argument that students can make in support of the position that services predominate is that Value Plus was not interested in purchasing the software unless it could be modified and adapted to fit its needs and would be installed by Intuit. Therefore, as in *Data Processing Services*,¹⁵⁸ the main purpose of the contract was for Intuit's customization of its mass-marketed software package, followed by its installation, rather than the software itself. It is unlikely that Value Plus would have purchased the Accutrak program unless Intuit had also agreed to customize it.

Conversely, it can be asserted that the predominant part of the contract is software. As to the customization, the Accutrak program was customized to serve the specific needs of Value Plus and thereafter would not be suitable for sale to other purchasers in the ordinary course of business. Consequently, the customized version of the Accutrak program can be considered a specially manufactured good within the scope

¹⁵⁷ See *supra* notes 19-21 and accompanying text.

¹⁵⁸ See *supra* notes 22-24 and accompanying text.

of Article 2. It is likely that Value Plus' primary motivation to enter into the contract was the purchase of software, customized to its specification, and that its installation was a secondary or incidental part of the transaction. Indeed, Value Plus could have contracted for the development of an inventory management program from scratch, but chose instead to purchase the Accutrak package if it could be modified to suit its needs.

2. DEFINITENESS OF TERMS

The issue presented by the facts is whether the contract between Intuit and Value Plus is sufficiently definite as to its terms, or whether the failure to concur on a fixed delivery date renders the agreement unenforceable. The traditional common law view is that indefiniteness as to the essential terms is fatal to contract formation. Applying this approach, time for performance is an essential term that cannot be left open, so the contract between Intuit and Value Plus is indefinite and unenforceable. Even where it is evident that the parties intend to be bound, however, the court must be able to resolve the question of whether the parties have performed. Therefore, traditional common law would conclude that the contract fails for indefiniteness because an essential term is missing.

Turning to the modern common law view, as enunciated in section 33 of the Restatement (Second) of Contracts, the contract will not fail for indefiniteness where the parties intended to enter into a contract and the terms are definite enough to permit a court to determine if a breach has occurred and frame an appropriate remedy. The focus of the Second Restatement is on the parties' intent to contract, rather than the omission of an essential term.

In the context of the contract between Intuit and Value Plus, there is clear evidence of the parties' intent to be bound from their negotiations and the extent of their agreement. Value Plus agreed to purchase the Accutrak software package, which Intuit agreed to customize and install. The contract stated a definite price, with a breakdown as to items included in the total price, as well as other material terms. Because Intuit was uncertain as to the full extent of modifications necessary, the parties did not agree on a delivery date at the time they concluded the agreement. Rather than not reaching an agreement as to time for performance, the parties agreed to leave the delivery term open for the time being. Under the Second Restatement, "[w]here the contract calls for a single performance such as the rendering of a service or the delivery of goods, the time for performance is a 'reasonable time.'"¹⁵⁹ In contrast to the traditional common law approach, therefore, the modern common law approach would conclude that a contract was formed and that the terms are not indefinite.

As with the Second Restatement, the parties' underlying intent to be bound is the touchstone under the UCC for determining whether they have formed an enforceable contract. The UCC allows that the parties may conclude a binding contract for the sale of

¹⁵⁹ See Restatement (Second) of Contracts § 33 cmt. d ("Valid contracts are often made which do not specify the time for performance.").

goods without settling on a firm time for delivery. According to section 2-309(1), “[t]he time for shipment or delivery or any other action under a contract if not provided in this Article or agreed upon shall be a reasonable time.”¹⁶⁰ What constitutes a reasonable time will depend on relevant usage of trade and commercial standards for performance, as well as the parties’ course of dealing.¹⁶¹ As such, if the agreement between Intuit and Value Plus involves a sale of goods rather than services, it is likely that the contract is sufficiently definite as to its terms under UCC § 2-204.

3. CONTRACT MODIFICATION

The issue presented in discussion question 3 is whether the agreement to modify the price from \$15,000 to \$20,000 is binding on Value Plus. At the time of the price change the contract was fully executory since neither party had completed their performance. In such an instance the contract can be modified. However, under the common law, any modification of the contract must be supported by consideration. The presence of consideration for a modification is determined by asking what detriment the promisee has undergone in exchange for the promisor’s promise or what benefit the promisor has received in exchange for his or her promise. Under the pre-existing legal duty rule a promise to perform an obligation that is owed under an existing contract is not consideration for a return promise because the promisee is already legally bound to do what is promised.¹⁶² The promisor does not receive any benefit for his or her promise because the promisee is not promising to do anything more that he or she is already obligated to do. The promisor does not receive any benefit and the promisee does not undergo any detriment.

In this case, did Value Plus receive any benefit in exchange for its promise to pay Intuit \$5,000 more than it had originally agreed to pay or did Intuit undergo any detriment in exchange for Value Plus’ promise to pay \$5,000 more than it had originally agreed to pay? Value Plus did not receive any benefit in exchange for its promise to pay the additional \$5,000. It received nothing more than what it was originally entitled to receive – the Accutrak program customized by Intuit to satisfy Value Plus’ needs and installed on its computer by Intuit technicians. In exchange for Value Plus’ promise to pay an additional \$5,000 Intuit did not undergo any detriment. It promised nothing more than what it was already under a legal obligation to perform by the terms of the original contract. Thus in light of the pre-existing legal duty rule the modification agreement is not enforceable.

Intuit could have avoided the application of the pre-existing duty rule if it had simply promised to do something that it was not already obligated to do. The original

¹⁶⁰ UCC § 2-309(1).

¹⁶¹ See UCC § 1-204(2) (“What is a reasonable time for taking any action depends on the nature, purpose and circumstances of such action.”); see also *Inter-Américas Ins. Corp., Inc. v. Imaging Solutions Co.*, 185 P.3d 963 (Kan. Ct. App. 2008)(applying UCC § 2-204 to a contract for software); *Jamestown Terminal Elevator, Inc. v. Hieb*, 246 N.W.2d 736, 740 (N.D. 1976)(applying UCC §§ 2-204 & 1-204(2)).

¹⁶² See Restatement (Second) of Contracts § 73.

price of \$15,000 was broken down to specific costs of \$4,500 for the Accutrak software package, plus \$7,500 for customization and a \$3,000 installation fee. Intuit could have easily agreed to lower the price it was charging for the software package or the installation fee. Lowering the price of either of these items would have been a detriment to Intuit. It would have given up its right to insist on the original price set for the software package or the installation fee. In such an instance Value Plus, in return for its promise to pay more for the customization of the program, would have received a benefit – lower cost for the software package or the installation fee. The only caveat under this circumstance is that Intuit must be certain that the promised performance differs from what was required under the original contract in a way that reflects more than a mere pretense of a bargain.¹⁶³

In addition to promising a performance that differed from what was originally required of Intuit under the original contract, Intuit could argue that due to unanticipated circumstances Value Plus' promise to pay \$5,000 more is enforceable in the absence of consideration.¹⁶⁴ If, subsequent to entering into the contract, circumstances arise that could not have been anticipated by the parties at the time they entered into the contract, no consideration is required to modify the contract. The facts indicate that Intuit after beginning work on customizing the program it became apparent to Intuit that it had underestimated the amount of time and labor costs required to tailor the Accutrak program to meet Value Plus' needs. The issue here is whether the additional amount of time and labor costs needed to customize the Accutrak program was a circumstance that Intuit could not have anticipated at the time it entered into the contract. An argument by Intuit that the additional time and costs were truly "unanticipated circumstances" is very weak. It is more likely that the additional time and costs is precisely what the parties anticipated at the time of entering into the contract. Certainly Value Plus would argue that the reason it agreed to the original price was to guard against any future increases that might result from a variety of circumstances (e.g., potential increase in the cost of the Accutrak program or an increase in time and labor costs associated with the customization process or an increase in the cost of installing the program for Value Plus). The increased cost, in Value Plus' view, is precisely what it was contracting to avoid.

Under the common law, the modification agreement is most likely unenforceable due to the absence of consideration in light of the pre-existing legal duty rule. In addition, it is most likely that the modification in the absence of consideration will not be effective because the circumstances that gave rise to the need to modify the contract were not "unanticipated."

If the agreement between Value Plus and Intuit is governed by the UCC, a conclusion different than that reached under the common law would result. The UCC eliminates the requirement of consideration for the modification of contracts for the sale of goods.¹⁶⁵ Thus, the modification agreement between Value Plus and Intuit is enforceable. Value Plus will be held to the modification of the agreement to pay the

¹⁶³ *See id*

¹⁶⁴ *See id.* § 89.

¹⁶⁵ *See* U.C.C. § 2-209 (1).

additional \$5,000. The only restriction placed on the enforcement of the modification is that the parties must at all times be acting in good faith.¹⁶⁶

4. REMEDIES FOR BREACH OF CONTRACT

The parties to an agreement are required to substantially perform their duties according to the contract. When a party fails to perform, or his or her performance falls substantially short of what was promised, there is a material breach of contract. A breach is deemed to be material if the breach deprives the injured party of the benefit he or she reasonably expected to receive from the non-performing party. Value Plus expected to receive from Intuit an Accutrak inventory management program customized to meet Value Plus' specifications. In the end the software contained a number of "bugs" that prevented the software from meeting Value Plus' specifications. In addition, all attempts by Intuit to remedy the problems were unsuccessful. Clearly, Value Plus did not receive the benefit of the customized inventory control program that it expected to receive from Intuit. Therefore, Intuit's failure to remedy the problems is viewed as a material breach of the contract.

The non-breaching party has the right to invoke those remedies allowed by the common law or, in the case of a contract for the sale of goods, the UCC. Remedies for breach of contract are designed to protect a non-breaching party's expectation, reliance and restitution interests. Under the common law, the remedy most commonly applied in breach of contract cases is the legal remedy of damages to protect a party's expectation interests. The expectation interest is a party's interest in receiving what he or she bargained for as a result of full performance of the contract. The objective of the legal remedy of damages is to place the non-breaching party in the position he or she would have been in had the contract been performed as promised.¹⁶⁷ Included in the damage recovery are general, incidental, and consequential damages.

General damages measure the loss in value to the injured party that results from the breach of the contract. Generally, the measure of the loss in value is the difference in value between what was promised and what was received. Intuit promised to deliver to Value Plus an Accutrak inventory control program customized to Value Plus' specifications. The original contract price of \$15,000 was itemized to include \$4,500 for the Accutrak software package, plus \$7,500 for customization of the program and a \$3,000 installation fee. After commencing work on the program customization, Intuit sought to modify the contract by increasing the total contract price to \$20,000. The modification reflected an increase in the cost of customizing the program from the original price of \$7,500 to a modified price of \$12,500. The other items of the contract price, i.e., the Accutrak software package and the installation fee, were not modified. In the previous analysis relating to the enforceability of the modification agreement under common law principles, it was determined that the modification was unenforceable due to a lack of consideration. The analysis of the legal remedy for damages that follows

¹⁶⁶ See *id.* § 2-209 cmt. 2.

¹⁶⁷ Restatement (Second) Contracts § 344(1)(a).

assumes that the modification agreement is not enforceable and thus the contract price will remain \$15,000. This assumption is only important with respect to the final amount of monetary damages that may be recovered by Value Plus. More importantly, the common law rules applied in determining damages remain the same regardless of the bottom line monetary recovery.

In determining the loss in value to Value Plus, the difference in value between what was promised and what was received must be determined. Intuit promised to deliver and install an Accutrak inventory control program customized to Value Plus' specifications in return for a payment by Value Plus of \$15,000. Value Plus received a customized and installed program. However, the program contained several bugs that resulted in some inventory items being under-counted and other items being over-counted. What is the value to Value Plus of the program that it in fact received? Arguably, the program as installed was worthless to Value Plus. Therefore, the damage that Value Plus experienced was \$15,000 or the difference between the contract price (\$15,000) and the value of the program that it received (\$0). The \$15,000 in damage merely negates the \$15,000 that Value Plus would have been obligated to pay Intuit in the absence of the breach of contract. Thus Value Plus owes Intuit nothing on the contract.

Although the measure of the damage here is technically correct, the question that is presented, after awarding \$15,000 as a damage, is whether Value Plus is really in the position that it would have been in had the contract been performed by Intuit as promised? Clearly, the answer to this question is no. Although Value Plus does not owe any money to Intuit, Value Plus still does not have an inventory control program that meets its needs.

A more accurate measure of the damage that Value Plus has suffered in this instance would be the difference between what it would cost to have another company develop and install an inventory control program to the specifications of the original contract and the contract price Value Plus agreed to pay Intuit. Value Plus has indicated that it had contacted other companies and obtained bids on the cost of an installed inventory control program. The bids received ranged from \$25,000 to \$40,000. Assume the lowest responsible bid is \$25,000. The measure of the damage in this instance would be the difference between the subsequent responsible bid of \$25,000 and the \$15,000 price that Value Plus had agreed to pay Intuit on the original contract. Thus the damage in this instance would be \$10,000. The \$10,000 in damage coupled with the \$15,000 that it did not have to pay Intuit would provide Value Plus with the \$25,000 needed to have installed on its computer a bug free inventory control program that meets its needs. If the bids that Value Plus had obtained from other companies were less than \$15,000, then Value Plus would suffer no damage with respect to a loss in value.

In addition to being able to recover the damage resulting from a loss in value, Value Plus may also recover incidental damages. Incidental damages include costs incurred by the injured party in an effort to avoid further loss following a breach of contract. Value Plus has stated that following the breach of the contract it experienced some expenses that can be identified as incidental damages. In an effort to avoid further

loss following the breach, Value Plus requested that Intuit uninstall the customized Accutrak program from Value Plus' computer. Intuit refused to do so. In order to avoid any future loss associated with the use of the Accutrak program Value Plus would need to have the program uninstalled. The cost of having the program uninstalled is an incidental damage and recoverable from Intuit. In addition, Value Plus indicated that, in order to avoid further loss resulting from the Accutrak program under-counting and over-counting inventory, it needed to have its employees conduct a hands on manual inventory of all items in stock. The cost of the manual inventory might be considered an incidental damage and recoverable from Intuit. The facts did not indicate the extent of the costs incurred by Value Plus to avoid further loss. Regardless, whatever the costs, they are recoverable as incidental damages.

Lastly, with respect to damages recoverable by Value Plus, it may recover consequential damages that are suffered as a result of the breach of the contract. Consequential damages are those damages that are foreseeable within the reasonable contemplation of the parties at the time they entered the contract. Although consequential damages naturally flow from the breach of the contract, they are unusual and vary with the circumstances of each case. In addition, in order for Value Plus to recover consequential damages, it must establish that the special damage was actually known or foreseen by the Intuit at the time the contract was entered.

Generally, lost profits are recoverable as a consequential damage. The question presented here is whether Value Plus will be able to recover lost profits resulting from not having in stock inventory that could have been sold if the Accutrak program had not under-counted the specific inventory items. In order to recover for lost profits Value Plus must establish several points. First, Value Plus must establish that at the time the contract was formed, Intuit either knew or should have foreseen that a breach on its part would result in lost profits for Value Plus. Second, given that Intuit either knew or should have foreseen that Value Plus would lose profits if the contract was breached, Value Plus must establish the loss with reasonable certainty.

At the time of entering into the contract, did Intuit know or could it foresee that Value Plus would suffer lost profits if Intuit breached the contract? The facts do not indicate that Intuit in fact knew that a breach on its part would have resulted in lost profits for Value Plus. Thus, the question that must be answered is whether Intuit should have know or foreseen that a breach on its part would have resulted in lost profits for Value Plus? Value Plus would certainly argue that, although Intuit did not have actual knowledge that a breach on its part would result in lost profits, Intuit should have foreseen the possibility of lost profits stemming from a breach of contract. Intuit was customizing an inventory control program for Value Plus. An inventory control program clearly has a number of objectives. One objective, and possibly the most important objective, would logically seem to be to have a program that accurately tracks inventory. The purpose for tracking would be to assure that Value Plus did not have too much of, or too little of, a stocked item. Accurate inventory counts would assure that proper levels of items were being held in inventory for sale to Value Plus' customers. Having too little of

an item that is in high demand would result in lost sales. Having too much of a low-demand item would result in excessive storage costs.

The most likely aim of any company that has inventory for resale is to have an accurate count of inventory commensurate with demand. A computerized inventory control program would facilitate achieving necessary inventory quantities for all stocked items. It would appear that at the very least Intuit should have foreseen that installing an inventory program that did not accurately reflect the number of items held in inventory could result in Value Plus suffering lost profits. Value Plus has indicated that as a result of the defects in the Accutrak program popular holiday items that it could have sold were not in stock resulting in lost sales and thus lost profits.

If Intuit should have foreseen lost sales due to under-counting of inventory, it should also have foreseen that over-counting of inventory would result in an overstock of items that would not sell in a reasonable time. The inability to sell the overstocked items within a reasonable time would certainly result in extra storage costs for Value Plus. However, even assuming that Intuit should have known that its failure to customize the Accutrak program to meet specifications would result in lost profits or extra storage costs, Value Plus must establish, with reasonable certainty, the profits that it in fact lost or the extra expenses that it in fact incurred. Establishing the amount of these damages is difficult but not impossible. Value Plus must present data indicating inventory levels and sales numbers from prior years. Estimates of inventory levels, sales and lost profits could then be extrapolated from the data. All that can be stated at this time is that Value Plus would be able to recover consequential damages for lost profits and storage cost. What cannot be determined at this point, without further information, is the exact amount of the damage incurred.

If the contract between Value Plus and Intuit is determined to be one that predominately involves the sale of a good, then the remedies available to Value Plus will be governed by UCC. The remedies available are substantially the same as those available under the common law. However, the UCC specifies several technical requirements that must be satisfied in order for a party to be able to obtain relief for a breach of contract.

The remedies available depend upon whether the non-breaching party is the seller or the buyer. Based upon the facts of our case, Intuit, the seller, has breached the contract. Therefore the discussion that follows will deal with the remedies that are available to Value Plus, the buyer. The nature of the remedy that may be sought by Value Plus is based upon whether the seller has repudiated the contract or failed to perform on the contract or whether Value Plus, as the buyer, has rightly rejected the goods or justifiably revoked its acceptance of the goods.

When Intuit completed the customization project it notified Value Plus that it was ready to have its technicians install the program. Value Plus asked whether Intuit had fully tested the program to determine if it met Value Plus' specifications and needs. Intuit assured Value Plus that the program had been thoroughly tested by its programmers

and that it was working perfectly. Relying on this assurance, Value Plus had the program installed by Intuit technicians. This action by Value Plus amounted to an acceptance of the customized program. However, one month after the program was installed, Value Plus discovered that the program contained “bugs” that consistently under-counted some items and over-counted other items. It appears that within a reasonable time, Value Plus notified Intuit of the problem. Intuit’s technicians made several unsuccessful attempts to correct the defect. Based on the lack of success in correcting the program, Value Plus requested that Intuit uninstall the program. Intuit refused to do so and demanded to be paid, indicating that if Value Plus failed to pay Intuit, it would sue for breach of contract. The sequence of events is critical in determining whether Value Plus has revoked its acceptance in accord with the rules of the UCC and if so what remedies are available following its revocation.

In order for the revocation of acceptance to be effective Value Plus must establish several points. First, it must establish that the defect or bugs in the program present a nonconformity that substantially impairs the value of the program to Value Plus. Given that the program consistently under-counts and over-counts items of inventory of what value is the program? Value Plus needs to have an inventory control program that is consistent and accurate. Otherwise the program is of little value. Second, since the nonconformity was not discovered when Value Plus had the program installed (thus accepting the program), Value Plus must establish that the nonconformity was either difficult to discover at the time the program was accepted or that Intuit had assured Value Plus that the program conformed to the required specifications. Value Plus will be able to easily establish both of these points. The nonconformity results from bugs in the program that could not be detected by a visual inspection and could only be discovered by testing the program. In addition, prior to having the program installed, Value Plus asked Intuit if it had fully tested the program and was assured “that the program had been thoroughly tested by its programmers and that it was working perfectly.”

Lastly, Value Plus’ revocation of acceptance must be accomplished within a reasonable amount of time after discovering the nonconformity. The facts indicated that Value Plus requested that the program be uninstalled following several unsuccessful attempts to correct the problems. This request by Value Plus was made within a reasonable amount of time after discovering the nonconformity. Thus, Value Plus has justifiably revoked its acceptance.

Once it is established that Value Plus has justifiably revoked its acceptance the next step is to determine what remedies Value Plus may pursue. The remedies available to Value Plus include the right to cancel the contract, “cover” by purchasing substitute goods and recover damages, recover damages for nonconforming goods, or seek specific performance of the contract.

Value Plus could merely cancel the contract and forego any further remedy. Since Value Plus had not paid any amount of money to Intuit at the time it revoked its acceptance, cancelling the contract is a viable remedy. However, Intuit will most likely sue Value Plus for breach of contract. Value Plus has indicated that it has suffered

damages as a result of the breach of contract. Given that Value Plus will most likely be sued by Intuit and that Value Plus has incurred damages as a result of the breach, merely cancelling the contract is not the best remedy.

Value Plus should consider one of two possible remedies. One remedy is to cover by purchasing substitute goods and recover damages including incidental and consequential damages. The other remedy would be to recover damages for nonconforming goods including incidental and consequential damages. With respect to the cover remedy, the measure of general damage would be the difference between the cost of the substitute goods and the contract price. The facts indicate that Value Plus has obtained cost estimate bids for purchasing a substitute inventory control program. The bids range from \$25,000 to \$40,000. If Value Plus chooses the cover remedy, the general damage recovery would be between \$5,000 and \$20,000, representing \$25,000 to \$40,000 (cost of the substitute program) less \$20,000 (the modified contract price).¹⁶⁸ In addition to the general damage, Value Plus may recover incidental and consequential damages as discussed earlier in this section on remedies.

If Value Plus decides not to pursue its cover remedy, it may still recover on a general damage basis. In this case, the measure of damages is the difference between the market price at the time the buyer learns of the seller's breach and the contract price. The facts do not indicate what the market price was at the time Value Plus discovered Intuit's breach of contract. However, for purposes of illustration, if the market price at the time of the breach was \$30,000 then the general damage would be \$10,000, representing \$30,000 (market price at the time the breach is discovered) less \$20,000 (the modified contract price). In addition to the recovery of the general damage, Value Plus may also recover incidental and consequential damages.¹⁶⁹

Finally, although unlikely, if Value Plus fails to or is unable to revoke its acceptance, it may still have a cause of action based on a breach of implied warranty. Value Plus must provide Intuit with notice of the nonconformity of the goods within a reasonable time after it discovered the breach. In this instance the measure of damages would be determined by "the difference at the time and place of acceptance between the value of the goods as accepted and the value they would have had if they had been as warranted. Also, as with the previous remedies, Value Plus would be entitled to recover incidental and consequential damages.

¹⁶⁸ The measure of the general damage is based upon the original contract price of \$20,000. The \$20,000 figure is used in light of the earlier decision that the agreement to modify the original contract price from \$15,000 to \$20,000 was an enforceable modification under the UCC.

¹⁶⁹ The measure of general damage in this instance may appear to be equivalent to the measure of general damage if the buyer elects to choose the cover remedy. Depending upon the circumstances this may or may not be true. The buyer may choose the cover remedy because he or she is in urgent need of having in its possession substitute goods. Under other circumstances, the urgency may not exist. Given the urgency, Value Plus may be required to pay a cover price that is greater than the market price.

VI. CONCLUSION

This case study uses a hybrid contract as a springboard to provide students with a comparative understanding of the differences between the common law of contracts and the Uniform Commercial Code. The issue as to whether the hybrid contract between Intuit and Value Plus predominately involves a service (customization of the Accutrak program) or a good (specially manufactured) is not one that is easily resolved. Strong arguments can be presented to characterize the contract as predominately involving service and thus common law principles will control the outcome of the dispute. However, a stronger argument exists that the customized Accutrak program was a specially manufactured good that would require UCC rules to control the outcome of the dispute. Regardless of which view prevails, the important point is that students recognize the issue to be resolved, i.e., whether goods or services predominates, and present solid arguments in support of whatever conclusion they reach.

Some students will conclude that services are the predominant aspect of the contract and that the common law will apply in resolving the remaining issues between the parties. Other students will conclude that a specially manufactured good is the predominate aspect of the contract and thus conclude that the UCC will apply in resolving the remaining issues. Given the divergent conclusion as to which rules will be applied, common law or UCC, the answers to the last three questions depend upon how the initial problem was resolved.

If the common law is determined to apply to the contract the following conclusions should be reached. First, the issue of definiteness under the modern rules would conclude that the time for delivery was reasonably certain and that an enforceable contract exists. Second, the modification of the contract price from \$15,000 to \$20,000 is not enforceable due to the absence of consideration in light of the pre-existing legal duty rule, and that the extra time and labor need to complete the customization was not an unforeseen circumstance that would permit the modification to be enforceable in the absence of consideration. Lastly, Value Plus will be able to recover legal damages for loss in value in addition to incidental and consequential damages.

If the UCC is determined to apply to the contract the following conclusions should be reached: first, the issue of definiteness would be resolved by providing the time for delivery to be a reasonable time in light of the gap filling provision of the Code and, therefore, concluding that an enforceable contract exists; second, the modification of the contract to \$20,000 would be enforceable since no consideration is required to modify a contract under UCC rules; and lastly, Value Plus has several remedies available under the Code, including cover and an award of damages, or merely recover an award for damages. Value Plus would also be able to recover incidental and consequential damages.

This case study has presented an integrated learning tool for analyzing several issues regarding contract formation, breach of contract, and remedies. The approach demonstrates how the outcomes may change depending on whether the rules of the UCC

or the common law of contracts are applied. Use of this case study as a pedagogical tool can advance student awareness and understanding of the legal responsibility for contract performance and the related business disciplines of economics and statistics. Furthermore, use of the case study can enhance the development of students' critical thinking skills within the business environment.

FIGHTING FUTILITY: TOOLS FOR MEDIATION SUCCESS

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I. INTRODUCTION

Mediation has developed into a successful conflict resolution tool often used as an alternative to the formal process of litigation. Business leaders need to be more aware of mediation's dynamics because only when they have some insight into those dynamics can they prepare for and manage a successful mediation. Drawing from various proven tools in the field of group dynamics, this paper outlines four vital skills for success in preparing for and managing a successful mediation. The extent to which business leaders master these essential skills will determine whether mediation succeeds or fails. Before considering these skills, it is important to examine the meaning of mediation, its success in resolving conflict, and its use.

II. THE USE OF MEDIATION

The use of mediation has exploded over the past two decades as business leaders have discovered it to be a valuable, cost-effective alternative to litigation in the traditional adversarial system. In Texas and Oklahoma, the number of mediation cases is staggering. As shown in Table 1, mediation cases have exploded in Texas in recent years. Mediation cases received by Texas alternative resolution centers in the most recent three-year period for which records were kept total an average of almost 20,000 cases per year, with a total of more than 58,000 cases from 2003 to 2005.¹ The same growth holds true in Oklahoma. As shown in Table 2, more than 6,000 cases have been referred to the alternative dispute resolution system annually, with 38,000 cases referred through the most recent six-year period available.² Equally impressive is Oklahoma's settlement rate, which averages 64 percent over the most recent six-year period available.³ Settlement rate data is not available for Texas, but as Table 2 shows, in

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¹ Annual Report of the Texas Judiciary, Office of Court Administration, 2005 (last year reported).

² Annual Report of Alternative Dispute Resolution System, Supreme Court of Oklahoma Administrative Office of the Courts, 2008.

³ Ibid.

Oklahoma almost two-thirds of all mediation cases were settled. Thus, the widespread use of mediation and its potential for cost-effective conflict resolution are well established.

Table 1: Texas Alternative Resolution Centers – Cases Received

<i>Date</i>	<i>Cases</i>	
2003	20,356	11 of 14 Centers Reporting
2004	19,845	12 of 14 Centers Reporting
2005	18,280	11 of 17 Centers Reporting
2006	N/A	Office of Court Administration ceased
Total	58,481	

Source: *Annual Report of the Texas Judiciary*, Office of Court Administration

Table 2: Oklahoma Alternative Dispute Resolution System Cases Referred and Settlement Rate

<i>Date</i>	<i>Cases</i>	<i>Settlement Rate</i>
2003	6,800	64%
2004	6,353	64%
2005	6,328	68%
2006	7,968	62%
2007	5,139	64%
2008	5,766	64%
Total	38,354	64%

Source: *Annual Report Alternative Dispute Resolution System* from the Supreme Court of Oklahoma Administrative Office of the Courts

III. THE MEANING OF MEDIATION

What are the characteristics of mediation? Texas statutory law defines mediation as:

- (a) Mediation is the forum in which an impartial person, the mediator, facilitates communication between parties to promote reconciliation, settlement, or understanding among them.
- (b) A mediator may not impose his own judgment on the issues or that of the parties.⁴

Unfortunately, this statutory definition offers little insight into what mediation can and should be. When successful, mediation can be characterized as proactive, forward-looking, and problem-solving in nature. Mediation is catharsis-producing, flexible, confidential, and, typically, evokes less stress than does formal litigation. It is not a drastic action and does not involve the surrender of freedom that arbitration dictates, as the latter requires an impartial third party who breaks a deadlock by issuing a final

⁴ Section 154.023 Texas Civil Practice and Remedies Code, Vernon, 2000.

binding ruling.⁵ Mediation basically involves negotiation through a disinterested third party, and it effectively can defuse emotional time bombs. One drawback mars this otherwise rosy picture: neither side is bound by anything in mediation. Arbitration binds; mediation intervenes benevolently. If the parties involved remain stubborn, intervention can sour, and mediation then becomes an exercise in futility.

Proactive use of mediation can help businesses keep conflict out of costly litigation and can even help settle conflicts already in litigation. For this to happen, business leaders must know what should happen in mediation and how to prepare for it.

IV. PURPOSE

Businesses of all sizes need to be aware of mediation's dynamics, because unless they are, the process can become a waste of time and effort. Only when business leaders have some insight into those dynamics can they both prepare for and manage a successful mediation. We offer four useful tools to ensure that mediation does not devolve into an exercise in futility. These "skills for success" are based upon sound models spanning almost 70 years of research in group dynamics and communication. They involve, in order of discussion, building trust, managing conflict, managing perceptions, and listening.

V. FOUR SKILLS FOR SUCCESS IN MEDIATION

A. BUILDING TRUST

The first vital foundational step in successful mediation is establishing trust, without which, mediation will fail. Schindler and Thomas' (1993) model of trust dynamics enumerates several dimensions underlying the concept of trust.⁶ As shown in Figure 1, these dimensions are organized as a type of perceptual flow process, beginning with *integrity*, and flowing through *competence*, *consistency*, *loyalty*, and *openness*, finally culminating in *trust*.

Figure 1: Trust Dynamics

INTEGRITY → *COMPETENCE* → *CONSISTENCY* → *LOYALTY* → *OPENNESS* → *TRUST*

Source: P.L. Schindler and C.C. Thomas, "The Structure of Interpersonal Trust in the Workplace," *Psychological Reports*, October 1993, pp. 563-573.

The relative importance of these five dimensions lies in their order. In building an effective mediation dynamic, the factors leading to trust generally are cultivated in this order, with openness and trust being the ultimate outcomes. Under the mediator's leadership, the parties must first practice honesty and truthfulness (*integrity*). Then,

⁵ Peter Lovenheim, *How to Mediate Your Dispute*, Boston, Irwin-McGraw Hill, 1998, p. 386.

⁶ P.L. Schindler and C.C. Thomas, "The Structure of Interpersonal Trust in the Workplace," *Psychological Reports*, October 1993, pp. 563-573.

technical and interpersonal skills must be in place (*competence*). The mediator can serve as a role model, demonstrating these skills. Next, reliability, predictability, and good judgment are manifested (*consistency*). Eventually, the parties become willing to save face and protect each other (*loyalty*). Over time, shared experiences, beginning with initial opening details and ending with a free sharing of ideas and feelings (*openness*), result in successful mediation of significant and difficult issues.⁷ Trust has been established when mediation is structured along these lines. While trust is a vital prerequisite to successful mediation, conflict is bound to arise between parties at some point in the overall process. This leads to the second necessary skill for mediation success.

B. MANAGING CONFLICT

The way in which conflict is managed profoundly impacts mediation success. Figure 2 outlines five styles, or approaches, to handling conflict: avoiding, accommodating, competing, compromising, and collaborating. Each style is defined in terms of assertiveness (concern for self) and cooperativeness (concern for other's needs).⁸ Few parties to mediation choose **Avoiding** (neither assertive nor cooperative) because it involves escaping the conflict. At times, one party may choose to yield to the other using the **Accommodating** (not assertive, but highly cooperative) style. The assertive styles are far more common, but not equally effective. **Competing** (highly assertive and uncooperative) is the most inflexible, least-effective approach. Here one party insists on having its way—"my way or the highway." A better alternative is the middle-of-the-road **Compromising** (somewhat assertive and somewhat cooperative) approach. While it is often used, it has the disadvantage of forcing both sides to give up, or compromise, some objectives to reach agreement. The most intense approach leading to the most beneficial solution is **Collaborating** (highly assertive and highly cooperative), as it blends full focus on both parties' positions.

Mediation works because it is collaborative. A neutral mediator is selected to assist parties in resolving a dispute voluntarily. The mediator's role is to help the parties resolve the grievance through a collaborative process that is more satisfying than compromise and more inclusive than accommodation. Collaboration and a search for a mutually beneficial outcome occur when the parties to conflict each desire to satisfy fully the concerns of all. The intention of the parties is to clarify differences and to find a win-win solution. Both parties' goals are to be achieved totally, and the valuable insights of both parties are incorporated.⁹ Robert Bush put it well: "... Mediators can do things that will

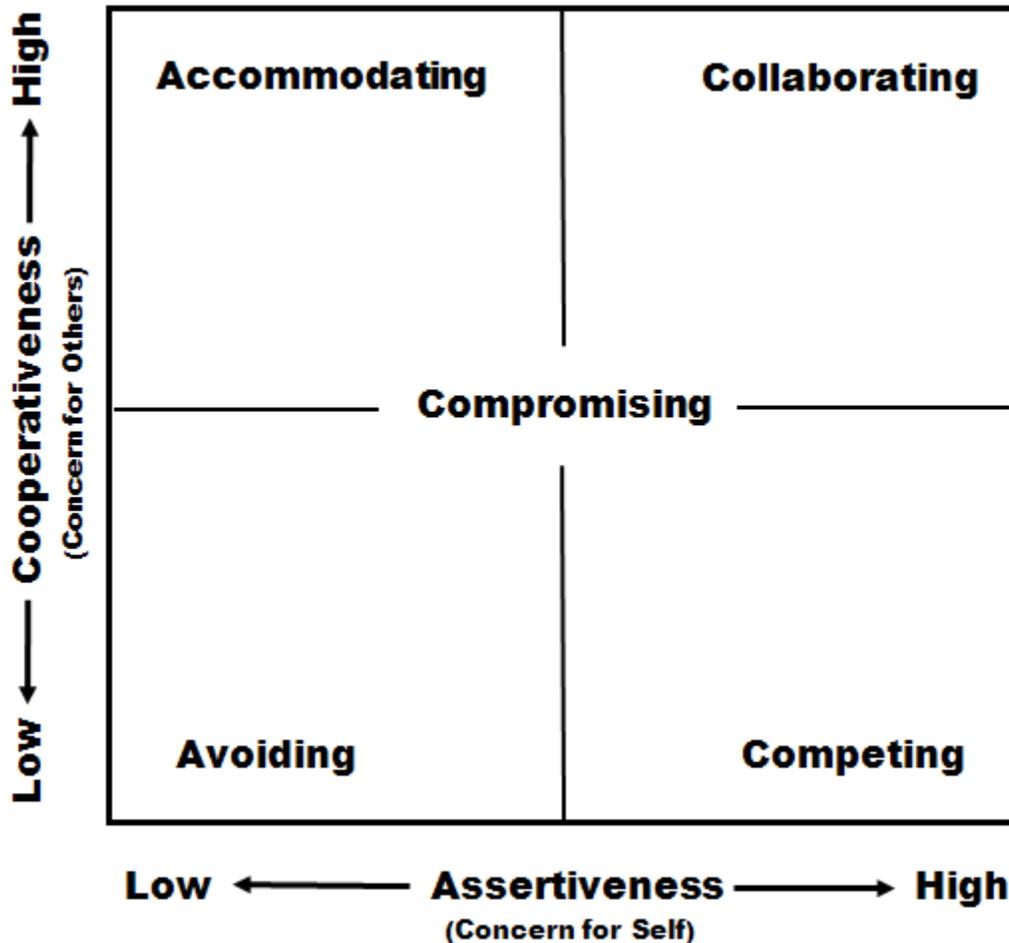
⁷ S.P. Robbins, *Organizational Behavior: Concepts, Controversies, Applications*, Upper Saddle River, New Jersey, Prentice-Hall, 1998, pp. 293-295.

⁸ K. Thomas, "Conflict and Negotiation Processes in Organizations," in M.D. Dunnette and L.M. Hough (eds.) *Handbook of Industrial and Organizational Psychology*, 2nd ed., Vol. 3, Consulting Psychologist Press, 1992, p. 668.

⁹ Robbins, *op cit*, pp. 441-442.

remove or reduce the parties' cognitive distortions of ... information as they process it and make decisions."¹⁰

Figure 2: Conflict-Handling Styles



Source: K. Thomas, "Conflict and Negotiation Processes in Organizations," in M.D. Dunnette & L. M. Hough (eds.), *Handbook of Industrial and Organizational Psychology*, 2nd ed. Vol. 3 (Consulting Psychologist Press, 1992, p. 668)

Skillful mediators can increase the amount of reliable information available to all at the negotiation table and, at the same time, help the parties perceive each other more accurately. If compromise is a 50%-50% process, collaboration is a 100%-100% process.

¹⁰ Robert A. Baruch Bush, "What Do We Need a Mediator For? Mediation's 'Value-Added' for Negotiators," in R.J. Lewicki, D.M. Saunders, and J.W. Minton, *Negotiation*, 3rd ed., Boston, Irwin-McGraw Hill, 1999, pp. 434.

Two plus two *can* equal five in this process, which obviously involves creative problem-solving. The approach is to bring the parties to a “common ground of acceptance or to bring about an understanding between the parties regarding the facts of the case.”¹¹ With this insight as to conflict management, the success of mediation is facilitated. But, the mediation process does not end with building trust and using a collaborative approach to managing conflict. Even when a collaborative approach is used in an environment of mutual trust, perceptual distortions can derail the process. Thus, a third skill for mediation success is vital: managing perceptions.

C. MANAGING PERCEPTIONS

Perceptual processes, which impact the way in which one party views the other, may thwart both parties’ best efforts to establish trust and to use a collaborative approach in mediation. The parties in mediation may not find common ground or reach agreement because of the way in which they view each other. A valuable perceptual tool that has profound implications for the success of mediation is Reilly’s “Mental Level” Hierarchy, first presented almost 70 years ago.¹² This hierarchy, depicted in Figure 3, proposes that people operate on one of four mental levels in relation to every person they know.

Figure 3: Reilly’s Mental Levels

Mental Level 1 – The Closed Mind – “The Adversary”

No matter what is said, the other party is against it, closed to any suggestions.

Mental Level 2 – The Open Mind – “The Cynic”

The “show me” level. People listen but need plenty of supporting evidence.

Mental Level 3 – Confidence – “The Partner”

Encompasses a cooperative and friendly attitude. People are willing, but they want to know the main reasons for what they are being told, and these must make sense to them.

Mental Level 4 – Belief – “The Friend”

Anything said is okay, with no questions asked. No evidence or proof is needed. The parties believe in each other.

Source: Adapted from William J. Reilly, *Successful Human Relations, in Business, in the Home, in Government*, New York, Harper and Brothers, 1942, 1952, p. 8-9. Adversary, Cynic, Partner, and Friend labels added by the authors.

¹¹ *Ibid.*

¹² William J. Reilly, *Successful Human Relations, in Business, in the Home, in Government*, New York, Harper and Brothers, 1942, 1952, p. 14.

The four mental levels outlined in Reilly's model shed explanatory light on mediation, more specifically on the mental phases that serve as a backdrop to the process. When mediation is first planned or when it actually starts, **Mental Level 1** is the probable beginning point. An adversarial relationship prevails as one or both parties are closed to what the other party says. As an effective process works itself forward, the **second**, **third**, and possibly even the **fourth** mental levels are attained, first between each party separately with the mediator, then between the parties themselves. The relationship matures, as seen by progression in mental-level engagement. Authentic communication emerges when mediation provides a framework wherein these levels become virtual steps in the process.

The philosophy behind these mental levels, or stages, and advancement through them is complex. Reilly noted when he first proposed this model in 1942 that a person can be right and can be loaded with facts. However, not until that person displays a tendency to agree with the other party, rather than to engage in broad opposition, does he tend to open the other party's mind.¹³

No one wants to be wrong. If a person could, Reilly said, be given the secret of opening the other's mind, the two parties could finally reason together over solid information and arrive at beneficial agreement.¹⁴ "When two people open their minds -- each to the other's side -- they are well on the way toward a common agreement ..."¹⁵ Fundamental in the art of human relations is the reality that if someone is helped to achieve his objectives, the helping person opens up his own chances of getting the other's support and sponsorship, more so than if open competition had been engaged in.¹⁶ The insights of this mental-level hierarchy are thus another tool in fostering successful mediation. Even when the mind is open and a collaborative approach is used in a trusting environment, poor communication can short-circuit the mediation process. This leads to the final skill needed for mediation success.

D. LISTENING

Moving from Reilly's (1942) Mental Levels¹⁷ to Stephen Covey's (2004) *The 8th Habit: From Effectiveness to Greatness*¹⁸ is a 62-year jump, but the theme of facilitating meditative processes is continuous, without break. Covey offers insight about the dynamics of the mediation process. His ideas serve to enrich the effectiveness of mediation, team-building, and conflict-resolution. He states that people should deal "...with the 'third alternative'—not your way, not my way, [but] *our* way..."¹⁹

¹³ *Ibid.* p. 14.

¹⁴ *Ibid.* p. 15.

¹⁵ *Ibid.* p. 19.

¹⁶ *Ibid.* p. 27

¹⁷ William J. Reilly, *Successful Human Relations, in Business, in the Home, in Government*, New York, Harper and Brothers, 1942, 1952, p. 14.

¹⁸ Stephen R. Covey, *The 8th Habit: From Effectiveness to Greatness*, New York, Free Press, Franklin Covey, 2004

¹⁹ *Ibid.* p. 187.

This incorporates a “mind set of mutual respect and mutual benefit...”²⁰ Covey describes a “listening continuum,” comprised of five specific types of listening that can be viewed as a progression of levels, as shown in Figure 4. The first four levels—Ignoring, Pretending to Listen, Selectively Listening, and Actively Listening—engage only the recipient’s frame of reference. The fifth level, Empathetic Listening, actually engages the sender’s frame of reference.²¹ Empathetic Listening is described as open and sincere listening to reach understanding of what the other person(s) sees and why.²² Covey says:

“Once each of the parties feels understood, an amazing thing usually happens. Negative energy dissipates, contention evaporates, mutual respect grows and people become creative. New ideas emerge. A mental level progression is, amazingly, likely occurring as an underpinning. Third alternatives appear...”²³

Covey adds the cautionary note that “...to understand does not mean to agree with...”²⁴ But a train of agreement is surely approaching. Covey further adds that to actuate this understanding one must draw from the “Talking Stick” idea. “... no one can make their point until they restate the last person’s point to his or her satisfaction. ...no one can make his or her point until the other can say, I feel understood...”²⁵

Figure 4: Covey’s Listening Continuum

Listening Level 1 - Ignoring

Listening Level 2 – Pretending to Listen

Listening Level 3 – Selectively Listening

Listening Level 4 – Actively Listening

Listening Level 5– Empathetic Listening

Source: Based on Stephen R. Covey, *The 8th Habit: From Effectiveness to Greatness*, Free Press Franklin Covey, 2004.

Searching for the third alternative, a vital tenet of Covey’s approach, is closely related to the essence of Reilly’s approach and reflects definite communication insight for use in everything from mediation to team building of all kinds. Covey’s ideas embody the essence of trust building, conflict management, personal perception, as well as listening, all necessary for successful mediation.

²⁰ *Ibid.* p. 187

²¹ *Ibid.* p. 192.

²² *Ibid.* p. 195.

²³ *Ibid.* p. 197.

²⁴ *Ibid.*

²⁵ *Ibid.* p. 198, 201.

To summarize, decades of proven theory in group dynamics and communication show the necessity of developing four skills for success in mediation. Each of these skills involves a progression or continuum that can be used as a tool to enhance mediation success. Business leaders can use these four tools to assess their readiness for mediation and to guide their efforts toward more effective mediation. Mediation is more likely to succeed when:

- The mediation parties are open and trusting,
- A collaborative approach to handling conflict is used,
- Perceptual processes are properly managed, and,
- Empathetic listening is used to foster effective communication.

VI. SUCCESSFUL MEDIATION IN BUSINESS

While there is room to improve mediation through application of the skills presented in this paper, there is no doubt that mediation has become a highly effective tool for conflict resolution even without the improvements that could be obtained with application of the skills noted above. The vast number of cases and the impressive settlement rates seen in Texas and Oklahoma demonstrate mediation's importance already to individuals, organizations, entrepreneurs, and managers of both small and large businesses. Beyond the numbers, however, mediation's success in business is also evident in the wide variety of cases settled with this process. As shown in Table 3, successful mediation has occurred in various conflict situations ranging from medical, insurance, and patent disputes to cases involving toxic products, infectious diseases, human antibodies, and high-performance engines. The variety of disputes that have been mediated is striking.

VII. CONCLUSION

The success of mediation and its application across a wide spectrum of conflict situations have been noted, and four skills for success in mediation, each involving a progression or continuum that can be used as a tool to evaluate and enhance mediation success, have been supported. Business leaders can use these four tools to assess their readiness for mediation and to guide their efforts toward more success in the process. Mediation need not be an exercise in futility. It is most likely to succeed when the parties are open and trusting; when conflict is resolved in a collaborative (win-win) manner; when perceptions are managed to open the minds of both parties; and when empathetic listening leads the parties to consider the third alternative (our way).

The volume, variety, and impressive settlement rates of mediation cases suggest a bright future for this form of conflict resolution. With the use of mediation on the rise, it is more important than ever for business leaders to master skills necessary to take full advantage of the opportunities this process offers. Mediation is an effective tool when business leaders prepare for and navigate the process with a clear understanding of the dynamics of trust, conflict resolution, perceptual processes, and effective listening.

Table 3: Examples of Successful Mediation in Business

Cases Mediated by Bruce Meyerson²⁶

- A contract dispute involving payments between former partners in the publishing industry.
- A dispute between a manufacturer and a distributor over product pricing.
- A disability discrimination claim by a health-care worker with the HIV virus.
- A bad-faith claim against an insurance firm.
- A claim of age discrimination against a large health-care provider.
- A dispute involving defamation regarding toxic products.

Cases Mediated by World Intellectual Property Organization²⁷

- A consulting contract negotiation with a major manufacturer over patents.
- A U.S. company in a biotech dispute involving a human antibody for treatment of a major disease and involving a German partner.
- Telecom patent license disputes.

EUCON Case Examples²⁸

- A consumer-goods manufacturer quality-control dispute.
- A dispute between an engineering firm and a manufacturer of high-performance engines.
- A dispute between an energy operator and an energy user with deregulation ramifications.

RESOLVE Case Examples²⁹

- A dispute involving National Drinking Water Advisory Council and regulation protocols.
- A dispute among the State of Alaska, oil shipping companies, local government and fishermen concerning oil-spill contingency plans for Prince William Sound.
- A dispute involving a core group of 30 representative stakeholders concerning the impact of a proposed titanium mine on an adjacent national wildlife refuge.

²⁶ See Examples of Cases Mediated, http://www.brucemeyerson.com/ec_mediation.html (last visited 3/30/2010; lead author retains a copy).

²⁷ See WIPO Mediation Case Examples, <http://www.wipo.int/amc/en/mediation/case-example.html> (last visited 3/30/2010; lead author retains a copy).

²⁸ See Concrete Examples in Detail, EUCON (Europaisches Institut fur Conflict Management e.V.), http://www.eucon-institute.com/mediation_beispiele.html (last visited 3/30/2010; lead author retains a copy).

²⁹ See RESOLVE: Mediation Examples of Work, <http://resolv.org/about/services/mediation/examples.htm> (last visited 3/30/2010; lead author retains a copy).

**AFFIRMATIVE ACTION – RICCI V. DESTEFANO – DOES THE FIREFIGHTER CASE
THROW COLD WATER ON UNINTENTIONAL (DISPARATE IMPACT)
DISCRIMINATION CLAIMS**

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JOEY ROBERTSON***

Abstract:

A 5-4 Supreme Court decision counts the same as a 9-0 decision to the complainant. A series of 5-4 decisions seems to indicate a consistent trend or policy, slender as the majority may be. Since Justice Sandra O'Connor's Michigan cases on affirmative action in *Gratz* and *Grutter* in 2003, the Supreme Court has (i) overturned a school district case in 2007; and (ii) in 2009,¹ reversed lower decisions in *Ricci* indicating both that "race" is not the only factor in assigning students to public schools and an employer must have a strong basis in evidence based on racial discrimination to believe it will be subject to liability.²

Is *Ricci* an important sign post or is it just another decision when Justice Kennedy leaves for the complainant. Another issue to be explored in this paper is what level is "strong basis" is evidence to take a "race-conscious" decision by an employer?

I. RICCI FACTS/BACKGROUND

In late 2003, the New Haven, Connecticut Fire Department gave exams for promotions to Lieutenant and Captain. A written exam would count 60% of an applicant's score and an oral exam 40%. A passing score was set at 70%.³

For the seven captain vacancies, the top nine scorers on the exam included seven white applicants, two Hispanics and no blacks. For the eight vacancies for lieutenant, the top ten scorers were all white. The Civil Service Board, which must certify the test results, held five meetings in early 2004 on the issue of whether to certify the test results or were the results racially biased reflecting a disparate impact on minorities.⁴ Opinion at the hearings varied as to the fairness of the exams; at the final hearing, legal counsel for New Haven spoke strongly

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¹ *Gratz v. Bollinger*, 539 U.S. 244, 123 S.Ct. 2411 (2003); *Grutter v. Bollinger*, 539 U.S. 106, 123 S.Ct. 2325 (2003).

² *Meredith v. Jefferson County Board of Education*, Docket 05-915 (2007).

³ *Ricci, et al. v. DeStefano, et al.*, (Nos. 07-1428 and 08-328) 530 F3d 87, reversed and remanded (2009).

⁴ Title VII, 42 U.S.C. §2000e-2(a)(1) (disparate treatment).

against certifying the exam results because the exams and other selection factors would “create a situation in which African-Americans are excluded from promotional opportunity on both the captain and lieutenant positions and Latinos are excluded from promotional opportunity on the lieutenant examination.”⁵

A Civil Service Board vote of 2-2 did not certify the exam, and the city threw out the test and promoted no one, choosing to avoid a conflict with Title VII of the Civil Rights Act of 1964.⁶ Frank Ricci and eighteen other white examinees plus one Hispanic (New Haven 20) sued the City of New Haven and Mayor John DeStefano, Jr.⁷

Ricci, who has dyslexia, paid for help to read text books onto audio tapes, made flash cards, took practice exams, worked with study groups and practiced interviews; his efforts led to a sixth place finish out of seventy seven examinees for the lieutenant promotion.⁸ The plaintiffs alleged that by throwing out the test results, the City et al had discriminated against the plaintiffs based on their race, in violation of Title VII and the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. The City et al defended that That Title VII would have been violated if the test had been certified due to the adverse or disparate impact on the minority examinees.⁹

On September 28, 2006, Federal District Court Judge Janet Bora Arterton granted the City’s Motion for Summary Judgment.¹⁰ On February 15, 2008, on appeal, the three-judge panel of the Second Circuit Court of Appeals (Pooler, Sack and Sotomayor, C.J.J.) affirmed the district court’s ruling in a summary order without opinion.¹¹ The Supreme Court granted certiorari, heard oral arguments on April 22, 2009, and published its 5-4 decision to reverse and remand the Second Circuit opinion on June 29, 2009.¹²

The 5-4 majority predictably had Chief Justice Roberts and Justices Scalia, Thomas and Alito voting in the majority with Justice Kennedy making the deciding vote and writing the majority opinion. This continues a trend of Justice Kennedy being the important vote to form a 5-4 majority, particularly in “Affirmative Action” cases where decisions come down to “race” as the factor (not just a factor) in a governmental (school district or municipality) decision.¹³

II. MAJORITY OPINION

Justice Kennedy concludes that New Haven’s discarding of the tests was in itself a violation of Title VII:

⁵ Brief for Respondent *John DeStefano et al*, at 6.

⁶ Liptak, Adam, *Justices to Hear White Firefighters Bias Claims*, The New York Times, July 26, 2006.

⁷ *Id.*

⁸ *Id.*

⁹ *Ricci v. DeStefano*, 554 F.Supp 2d 142, 151 (D.Conn., 2006).

¹⁰ *Id.*

¹¹ *Ricci v. DeStefano*, 530 F3d 87, (Conn, 2003).

¹² *Ricci v. DeStefano*, 129 S.Ct. 2658, (U.S., 2009)

¹³ *Supra*, note 2.

The race-based decision/action has a standard that the employer must “demonstrate a strong basis in evidence that, had it not take the action, it would have been liable under the disparate-impact statute;” and the City of New Haven did not meet the threshold standard.¹⁴

What went into J. Kennedy’s opinion that did not occur to the lower courts?

1. The City engaged in disparate treatment discrimination. The City’s decision was “express, race-based decision making”, i.e., the City used the statistical disparity based on race (how minority candidates performed when compared to white candidates).
2. According to analogous Equal Protection cases, permissible justifications for disparate treatment must be grounded in the strong-basis-in-evidence standard. “Once a process has been established and employers have made clear their selection criteria, they may not then invalidate the test results, thus upsetting an employee’s legitimate expectation not to be judged on the basis of race. Judging on the basis of race, absent a strong basis in evidence of an impermissible disparate impact, creates an unintended racial preference against the notion of a workplace where individuals are guaranteed equal opportunity regardless of race.”¹⁵

Other itemized rejections by Kennedy of the City’s assertions included:

- a) Congress has expressly prohibited both unintentional and intentional discrimination;
- b) Employees will hesitate before taking voluntary action for fear of later being proven wrong in the course of litigation and then held to account for disparate treatment;
- c) Respondents’ policy would encourage race-based action at the slightest hint of disparate impact (tossing out results of a lawful and beneficial exam based on a little evidence of disparate impact discrimination, a de factor quota system;
- d) There is tension between doing away with segregation and discrimination versus doing away with all governmentally imposed discrimination based on race;
- e) Applying the “strong basis-in-evidence” standard to Title VII gives effect to both disparate treatment (intentional) and disparate impact (unintentional). In other words, Congress imposes liability on employers for practices that may be fair in form but discriminatory in operation, and likewise prohibits employers from taking adverse employment actions “because of” race.¹⁶

¹⁴ *Wygart v. Jackson Bd. of Ed.*, 476 U.S. 267 at 277 (1986).

¹⁵ *Ricci*, supra.

¹⁶ *Id.*

Employment tests can be an important part of a neutral selection system that safeguards against the very racial animosities Title VII was intended to prevent. The firefighters saw their efforts (substantial time, money and personal preparation) invalidated by the City solely upon race-based statistics.

If an employers cannot rescore a test based on the candidates' race, then it may not take the greater step of discarding the test altogether to achieve a more desirable racial distribution of promotion-eligible candidates – *unless* a strong basis in evidence that the test was deficient and that discarding the results is necessary to avoid violating the disparate-impact provision.¹⁷

III. STRONG BASIS IN EVIDENCE?

In this case there would appear to be no evidence in Justice Kennedy's (majority's opinion) opinion, that the tests were flawed because they were not job-related or because other, equally valid and less discriminatory tests were available to the City. Fear of litigation alone cannot justify an employer's reliance on race to the detriment of individuals who passed the examinations and qualified for promotions.

It is true that a prima facie case of disparate-impact liability was shown by the test results, i.e., a significant racial adverse impact, which did compel the City to take a strict/hard look at the exam results and the exam itself. However, a prima facie case is the threshold level of evidence and without more, is far from a strong basis in evidence. The City could be liable for disparate-impact discrimination only if the exams were not job-related and consistent with business necessity, or if there were an equally valid, less-discriminatory alternative that the City refused to adopt.¹⁸

The City would have avoided disparate-impact liability based on the strong basis in evidence that, had it not certified the results, it would have been subject to disparate-treatment liability.¹⁹

IV. SCALIA CONCURRENCE

Scalia prefers additional clarification between Title VII's disparate-impact provision and the U.S. Constitution's guarantee of equal protection. Employers are often required to evaluate racial outcomes of their policies and to make decisions based on those racial outcomes. "This type of racial decision making is . . . discriminatory. . . and the Federal Government should not mandate that third parties (all employees) discriminate on the basis of race."²⁰

V. ANALYSIS OF LESSONS FROM *RICCI*:

Evidence from the City's outside testing from that would have explained the processes and methodologies and analyzed the results was not allowed by the City's legal counsel. The

¹⁷ §2000e-2(h); cf. *AT&T Corp v. Hulteen*, 129 U.S. 1962, 1969 (2009).

¹⁸ §2000e-2(l); also *Chicago Firefighters Local 2 v. Chicago*, 249 F3d 649, 656 (CA 7 2001).

¹⁹ *Ricci*, supra.

²⁰ *Ricci*, supra.

courts were left to make conclusions about the test's validity without the "owner's manual." Politics played a greater role in the initial decisions of *Ricci* than analysis of the law based on the evidence.

VI. RICCI LESSONS: (FROM HUMAN RESOURCE MANAGERS)

1. Valid and legally defensible tests will, occasionally have adverse impact against protected groups;
2. Design an exam/system of selection that is based on testing/validation principles;
3. Implement the "sound" system and use statistical analysis to evaluate the results for numerous reasons including adverse impact;
4. Listen to validation and development experts and resist political influences to change results or processes;
5. Let the results stand on their own if they are demonstrably "job-related for the position in question and consistent with business necessity;"
6. The "strong basis in evidence" standard should be thoroughly explained by expert legal counsel; and
7. All races are protected by Title VII. If the results of an exam are not what were expected or desired, do not, without careful analysis, simply throw out the exam.²¹

VII. CONCLUSION:

Since the Michigan cases, *Graty* and *Grutter*, the Supreme Court has tried to emphasize, in 5-4 decisions, to two public school districts and a city that "race" cannot be the sole or almost sole reason for enforcing the law in trying to equalize racial percentages in the classroom or throw out job-related exams based on who passes or fails without a substantially compelling reason.

On libertarian²² critic observed that the Court has carved out a precedent that diversity can be beneficial, but not by the use of racial quotas and not at the cost of fundamental liberties such as equal protection of the law.

Perhaps a debate should take the form of whether Title VII should be repealed. Firms that promote diversity (affirmative action) should do so for its inherent merits to all parties. Should firms be put under the disparate impact microscope? Companies that go back to segregation days will be committing economic suicide as both invisible hands and very visible boycotts take place. Trust the rationality of the private sector versus the irrationality of unelected government regulators in their powerful oversight positions. Just the reduction in litigation alone would be a relief to the private sector.

²¹ Supreme Court of the United States at <http://www.supremecourt.gov/opinions/08pdf/07-1428.pdf> (last visited April 20, 2010).

²² Epstein, Richard A., *Getting Back to the First Principals of Affirmative Action*, Forbes, December 2, 2009.

METADATA IN MICROSOFT OFFICE: AN ESSENTIAL CONSIDERATION IN A THOROUGH AUDIT

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I. Introduction

There is no such thing as a “pleasant surprise.” The essence of the audit function is, to the extent possible, to *prevent* surprises whether pleasant or not. While it is well recognized, even outside the profession, that it is an auditor’s responsibility to strive to ensure that an entity’s financial data fairly represent the results of its operations for the period under review, fewer recognize that this function also includes ensuring that future audits are as accurate – and unsurprising. Doing so requires assuring the client has properly designed financial information, maintenance, and control systems; resources which are needed not only to prepare accurate financial statements or satisfy management queries, but also to facilitate responses to unexpected external information demands, such as SEC compliance requirements, other regulatory reports and even discovery requests arising in litigation.

The familiar functions of data collection, storage and retrieval, however, invariably involve the routine creation of buried bits of data overlooked by auditors and others, and which can provide surprises that might be very unpleasant, indeed. These are the automatically created and surreptitiously retained digital records of the source, development, and even revision of every data file produced using popular word processing, presentation, and spreadsheet software. This information, known as “metadata,” can carry with it specifics a business does not wish to have disclosed, facts that can cause unanticipated harm when revealed.

Internally, an auditor can – and therefore must – take steps to prevent the future unintended exposure of metadata. The external auditor, of course, would need to know where metadata is and what it might reveal in order to examine an entity’s records. This article will examine the metadata retained in the most widely used, commercially available, software provide by Microsoft whose products are Word, Excel, and PowerPoint, and examine some ethical and legal implications of choices regarding the management of metadata.

II. AUDITOR’S RESPONSIBILITY

The Public Company Accounting Oversight Board (PCAOB) established an auditor's responsibility for public companies and by the American Institute of Certified Public Accountants (AICPA) Auditing Standards Board (ASB) for audits of non-public companies. The “Standards of Field Work” require an auditor to “obtain a sufficient understanding of the entity and its environment” and “obtain sufficient appropriate evidence” to support the auditor’s

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opinion on the financial statements.¹ Auditors have a dual responsibility for the financial statements on which they have rendered an opinion. They owe an obligation to the client to complete the engagement thoroughly, professionally and competently, and an additional obligation to those individuals or entities that have reasonably relied, or may rely, on the auditor's opinion.

In addition to meeting the needs of these two important constituencies, there are also compliance standards promulgated by various governmental and regulatory entities to satisfy, as well as requirements by financial institutions, not to mention the client's responsibility to provide reliable and adequate information to its own shareholders. Each of these groups and interests is protected by various rules and principles for the assignment of responsibility, rules necessitated by the volume and complexity of the data upon which the auditor's opinions are informed. These rules create potential liabilities for the auditors that, in turn, lead the prudent auditor to take pains to assure compliance.

Accordingly, auditors must address the data to be retained by their clients to assure the background material, which formed their opinions, will be available. Of course, the gathering and archiving of data bears a cost to the organization, making the natural tendency to err on the side of caution by requiring the retention of too much data, a source of unnecessary cost to the client. Moreover, the "too-much-information-syndrome" can possibly prove detrimental to the entity if sued. Not only does a storehouse of unused (and likely unmonitored) information provide a potentially rich pool for a fishing expedition by an opposing counsel during discovery as discussed below, the clear danger exists that (not knowing it is there) a party might deny the existence of the data. A subsequent discovery of the theretofore-unknown records can lead to costly – and unnecessary – sanctions.²

On the other end of the information-retention scale, of course, is the failure to record and retain *essential* data. Clearly, to assess the cost of retaining versus the benefit attained by doing so requires an evaluation by careful and competent informational audits. The reviewer's examination, however, has failed if the reviewer is content to deal with only the bits of information seen on the computer screen, disregarding the hidden surprises in the form of metadata.

III. METADATA IN GENERAL

Metadata is structured information that describes, explains, locates, or otherwise makes it easier to retrieve, use, or manage an information resource. Working through the extraordinarily logical and precise process of programming is exacting work which necessitates keeping meticulous track of a large amount of information. From the very beginning of the profession, programmers and analysts have made it a practice to explain the logic of what they have done (and why) by leaving "comments" or little notes strewn through the code. These annotations are visible only when viewing the program instructions themselves, and thus are unknown to the ordinary user. The embedded remarks are essential for future programmers attempting to deal with and make sense of a prior programmer's work if it is ever in need of correction or modification. As programming tasks evolved from custom-designed single purpose efforts to the complex general applications known today, the habit of leaving these hidden messages in

¹ American Institute of Certified Public Accountants, GENERALLY ACCEPTED AUDITING STANDARDS, AU §150.02 (Dec. 15, 2001).

² See, e.g., FRCP, Rule 37

program code was naturally extended to invisibly providing information of a similar nature in the files produced by the applications. Thus, from the start, the practice of labeling and classifying nearly everything in ways only visible to the initiated has been part of the cyber world.

These little “trails of breadcrumbs” make it possible to sort, store, classify and retrieve the product of the software, itself, as well as understand the logic of the instructions in the program code. Accordingly, virtually all commercially produced software for office use is, and has been, written to include these useful bits. Naturally, since they do not add to the understanding of the output for the user, they are “hidden” from ordinary view. Among other things, these invisible labels make it possible to sort and retrieve stored files. In essence, these tags, called “metadata”, serve the same purpose as labels on file folders or file cabinet drawers.

The term “metadata” literally means “data about data” or “information about information.”³ Obviously, this simple definition is not very helpful. Unfortunately, it is difficult to be more specific in defining metadata since there is no standard, rule or other set procedure for identifying what is to be retained and how.⁴ Metadata come in various types and functions. For example:

- “descriptive metadata” describe the contents of a digital file – what kind of file, its name, the date it was created, by whom and so on;
- “structural metadata” tell about the dimensions of a file, information such as file length and whether and how it is divided into sections or chapters;
- “technical metadata” specify the system used to create the file, character coding, encryption, if any, and other information that might be useful, or even essential, to restore a “lost” file in the future; and
- “administrative metadata” provide the resources necessary for the use of the file itself.⁵

Finding, translating and making use of these pieces of information is virtually impossible without the use of specialized software packages or other tools (plus, naturally, a sophisticated level of technical knowledge).⁶ Once revealed, metadata can be useful, indeed. For example, a perusal of the metadata in a typical word processing file (such as a simple document) can reveal when the last modification occurred, and by whom, thus identifying who knew what was in the document and when they knew it. Importantly, this information would be usable in litigation to reveal, for example, attempts made to modify or suppress discoverable content, resulting in the possibility of serious sanctions.⁷ Or the metadata in documents exchanged during negotiations could inform the receiving party of negotiation strategies. Worse yet, if the “change tracking” feature of the program used to create the document had been enabled, not only would the metadata reveal the time and date of changes, they could show exactly what changes were made.⁸ This feature is necessary to allow reconstructions (i.e., to permit one to “undelete” changes). To provide for “undeletes” the software stores the characters that were deleted to make them available for restoration if needed. This means that under certain circumstances, the

³ National Information Standards Org. (NISO), UNDERSTANDING METADATA, (NISO Press, 2004), 1

⁴ Id.

⁵ Id. at 2-5.

⁶ Craig Reinmuth, *It and Computer Forensics: Being Proactive With Electronic Discovery*, 43 ARIZ. ATTY. 28 (2007).

⁷ A situation which is not limited in its applicability to American courts. See, e.g., Simon Dawson, *The Power of Metadata*, 23 THE BARRISTER, at <http://www.barristermagazine.com/articles/issue23/metadata.htm> (last visited Nov. 6, 2008). Copies retained by the authors.

⁸ *Supra*, note 3.

previous version can be reconstructed in its entirety. It should go without saying that providing all the previous drafts of a document along with the final could be extremely undesirable. Inadvertent in-house dissemination of such surprises is bad enough, but the impact of letting them get into the hands of rivals, whether in business or litigation, can be *truly* unpleasant.

IV. METADATA IN LITIGATION

While it may be natural to assume that one's documents, files and business records are confidential, once parties enter the litigation arena nothing could be further from the truth. A process called "discovery" essentially opens all the parties' files for inspection by their opponent (it also, among other things, requires all prospective witnesses and parties be made available for questioning under oath – a tool called the "deposition"⁹). In order to reduce the cost and time involved in litigation to both the parties and the courts, the law grants surprisingly wide latitude in learning the other side's secrets. These "fishing expeditions" allow access to most everything, but only if counsel knows what to ask for.¹⁰ In the matter at hand, it appears lawyers have begun to understand the potential of metadata and increasingly are specifically demanding its production during the discovery process and taking advantage of what they do find – especially since the ethical consequences of doing so remain unsettled.¹¹ Thus, the Federal Rules of Civil Procedure now provide that a litigant may specify the electronic format in which discovered documents are to be produced.¹² Under this rule, savvy litigants are sure to demand "native" formats which preserve metadata.

To make discovery rights worthwhile, the law provides sanctions – including criminal penalties – for the intentional withholding of data subject to a discovery order. These penalties can be harsh. In *Vela v. Wagner and Brown, Ltd.*¹³ the court imposed a \$75,000 sanction on a *winning* defendant, finding that even though no damages were to be awarded to the plaintiff, a substantial penalty payable to the plaintiff was called for as a result of the defendant's disruption of the discovery process by intentionally failing to comply. The court essentially held that since sanctions are intended to assure compliance, prevent misconduct and punish violators, the outcome of the case is immaterial. In its order, the court noted the defendant had engaged in a pattern of misconduct, including failure to properly preserve and produce "lost" data, a description that can clearly apply to the removal of metadata after issuance of a discovery order. In other words, removing metadata from files (sometimes called "stripping") after receipt of an order for discovery of the electronic file could be at least a civil violation, if not a criminal one.¹⁴

⁹ FRCP, Rule 30.

¹⁰ See, generally, FRCP Part V, DISCLOSURES AND DISCOVERY.

¹¹ John Shampton and David Ritter, *You Don't Say: Ethical Considerations Regarding Inadvertent Communications in the Electronic Age*, 19 SOUTHERN L. J. 73 (2009)

¹² FRCP, Rule 34b.

¹³ 203 S.W.3d 37 (Tex. App. 2006)

¹⁴ Many sources exist for software to perform this function. See, e.g., Ann Bednarz, *Software Cleanses Sensitive Documents*, 23 NETWORK WORLD 23 (2006); Randall Farrar and Susan McClellan, *Esquire Innovations, Inc. White Paper, Metadata Management in Microsoft Office: How Firms Can Protect Themselves Against Unintentional Disclosure and Misuse of Metadata*, at <http://esquine.com/Content/WhitePapers/MetdataManagementMicrosoftOffice.php> (last visited Nov. 6, 2008) Copies retained by the authors.

Other recent articles and cases have also emphasized the importance of metadata.¹⁵ For example, in a civil rights action filed by thirty Latino individuals against the United States Department of Homeland Security the court granted a part of the plaintiff's application to specifically compel the release of metadata after the parties' unsuccessful attempt to resolve their dispute regarding whether metadata should be subject to the demand.¹⁶

In *United States v. Zerjav, Sr., et al.*¹⁷ the Internal Revenue Service brought an action against the defendant and several companies over the preparation of allegedly fraudulent tax returns. In discovery, the government demanded production of any false information used in the preparation of returns, as well as all correspondence between defendant and individuals who utilized its services, training manuals, and other business related documents.¹⁸ While holding part of the government's request to be overly broad and denying the request for production, in *dicta* the court did specifically address metadata, noting that the government already had much of the information in its files and suggesting that while parties may exchange metadata by agreement, the court would not require its production. This comment seemed to indicate that at least in that court, metadata can be obtained if requested in the early rounds of discovery requests.

In another case, directly applicable to audit engagements, Kingsway Financial Services, Inc. sued Pricewaterhouse-Coopers LLP.¹⁹ The plaintiffs requested that Pricewaterhouse-Coopers LLP produce the metadata with its electronic documents. The court denied Plaintiff's request stating: "Plaintiffs do not identify the type of metadata they seek nor do they explain why metadata is relevant in this matter. In addition, plaintiffs do not raise any question about the authenticity of any documents produced by PwC nor do they claim that any document has been improperly 'doctored' or modified."²⁰ This holding indicates that if properly requested, production of the information would have been required. This case further qualified the metadata request by reference to *Zerjav* in which the court stated, in part, "In the absence of an issue concerning the authenticity of a document or the process which it was created, most metadata has no evidentiary value."²¹ This language might be argued to restrict the ability to obtain metadata.

The point, of course, is that even though the creator of a document may not intend, desire or even anticipate particular information carried by metadata to be disclosed, the software will nonetheless record information that is likely discoverable and which not only may be embarrassing, but which most likely cannot be removed after litigation commences without costly consequences. Unfortunately, the software can slip in invisible and unpleasant surprises, ones it is necessary to guard against.

¹⁵ Annie Dike, *Comment: A Lucky Break or an Ethical Dilemma? Assessing the Appropriate Response in the Face of Inadvertent Disclosure*, 31 J. LEGAL PROF. 279 (2007), 282; Susan Ardisson, *Mining for Metadata: Ethical Considerations*, 10 LAWYERS J. 7 (2008); David Hricik, *Mining for Embedded Data: is it Ethical to Take Intentional Advantage of Other People's Failures*, 8 N.C.J.L. & TECH 231 (2007), David Hricik, *I Can Tell When You're Telling Lies: Ethics and Embedded Confidential Information*, 30 J. LEGAL PROF. 79 (2005); and especially, Crystal Thorpe, *Notes; Metadata: the Dangers of Metadata Compel Issuing Ethical Duties to 'Scrub' and Prohibit the 'Mining' of Metadata*, 84 N. DAK. L. REV. 257 (2008).

¹⁶ *Adriana Aguilar, et al. v. United States*, 07 Civ.8224 (JGK) (FM), 255 F.R.D. 350; 2008 U.S. Dist. LEXIS 97018.

¹⁷ Case No. 4:08CV00207 ERW, 2009 U.S. Dist. LEXIS 60113

¹⁸ *Id.*

¹⁹ *Kingsway Financial Services, Inc., et al. v. Pricewaterhouse-Coopers LLP, et al.*, 03 Civ. 5560 (RMB)(HBP), 2008 US Dist. LEXIS 105222

²⁰ *Id.*

²¹ *Supra*, note 17.

V. METADATA IN MICROSOFT OFFICE

Accordingly, it would be a good idea to examine just what it is that our computers are storing up without our knowledge. While it would be possible to merely “read the manual” and see what the developers have to say, a more reliable and empirical approach would be to create some test files, make changes to those files, and then examine the results.

The applications tested were Microsoft Word 2007, Microsoft Excel 2007, and Microsoft PowerPoint 2007, which are, respectively, the most popular (i.e. the most often used) word processing, spreadsheet, and presentation products available. These products can handle a variety of different file formats which, by convention, are designated by distinctive labels appended to the names of the files.²² Thus, native (i.e. default) word processing files created by the version of Word that was tested (Word 2007) have file names ending in “.docx” (e.g. document.docx) while similar files created by earlier versions would end with “.doc” (similarly, document.doc). The following table is the result of testing files formatted with each of the extensions recognized by the individual programs. The testing process involved creating files of the specified types, adding information to them, saving them, and then making changes to the reopened files, saving them again and examining the results for hidden evidence of the changes made.

The examination of the applications included their handling of (1) changes to data, (2) treatment of macros²³ introduced into the document, and (3) the adding and alteration of comments.²⁴ A “Y” indicates the types of file extensions that preserved and revealed each instance of editing. An “N” indicates those types that did not maintain evidence of editing.

Word 2007

File Extension	Saves Macros	Saves Changes (tracking)	Saves Comments
docx	Y	Y	Y
docm	Y	Y	Y
doc	Y	Y	Y
dotm	Y	Y	Y
dot	Y	Y	Y
pdf	N	N	N
xps	N	N	N
mht/mhtml	N	N	N
htm/html	N	N	N
rtf	N	N	N
txt	N	N	N
xml	N	N	N
2003xml	N	N	N

²² These “extensions” are often hidden from view by the software, resulting in file names that appear to have no extension. If desired, the extensions can be set to be visible.

²³ A macro is a “shortcut” or set of instructions that can be executed by entering a single command.

²⁴ Beginning with its “Office 2007” products, Microsoft has provided an application called “Document Inspector” which helps remove any comments from the final document. The tests were performed without use of this tool.

odt	N	N	N
wps(works)	Y	Y	Y

Excel 2007

File Extension	Saves Macros	Saves Changes (tracking)	Saves Comments
xlsx	Y	Y	Y
xlsm	Y	Y	Y
xlsb	Y	Y	Y
2003xls	Y	Y	Y
xml	N	N	N
mth/mthml	N	N	N
xltx	Y	Y	Y
xltm	Y	Y	Y
2003xlt	Y	Y	Y
txt	N	N	N
2003xml	N	N	N
5. 0 xls	Y	Y	Y
csv	N	N	N
prn	N	N	N
mac txt	N	N	N
dos txt	N	N	N
mac csv	N	N	N
dos csv	N	N	N
dif	Y	N	N
Symbolic link sylk	N	N	N
addin xlam 2003	Y	N	N
Addin xla	Y	N	N
pdf	N	N	N
ods	N	N	N

PowerPoint 2007

File Extension	Saves Macros	Saves Changes (tracking)	Saves Comments
pptx	Y	Y	Y
pptm	Y	Y	Y
ppt	Y	Y	Y
pdf	N	N	N

xps	N	N	N
potx	Y	Y	Y
potm	Y	Y	Y
pot	Y	Y	Y
thmx	N	N	N
ppsx	Y	Y	Y
ppsm	Y	Y	Y
2003pps	Y	Y	Y
addin ppa	N	N	N
xml	N	N	N
mht/mhtml	N	N	N
htm/html	N	N	N
gif	N	N	N
jpg	N	N	N
png	N	N	N
tif	N	N	N
bmp	N	N	N
wmf	N	N	N
emf	N	N	N
rtf	N	N	N
odp	N	N	N

VI. CONCLUSION

A basic fact of life is expressed in the observation *tempora mutantur* – times change. Letters handwritten on paper with pens have given away to typed, printed or even e-mailed messages. Carbon paper appears to be a mystery to younger generations. Double entry journals have been discarded in favor of personal computers and years worth of financial records can now be carried around in our pockets. But “tricks of the trade” that have made programmers’ lives easier in the past remain to haunt us, creating a danger of inadvertently revealing more than we intend. This is not, of course, anything new – the problem has existed as long as word processing has. Those “in the know” have for some time been at least theoretically able to gain an advantage by “digging into the code” and revealing the metadata stored therein. These “secret bits,” used by programmers to assure documents can be archived, sorted, retrieved and otherwise managed without regard to their content also reveal such interesting tidbits as when and how often the files were opened, by whom, and the like, and might even disclose editorial changes made in the process of drafting the document.²⁵ These revelations can be surprises and are very unlikely to

²⁵ Microsoft Office Online, “Find and Remove Metadata (Hidden Information) in Your Legal Documents,” at <http://office.Microsoft.com/en-us/help/HA010776461033.aspx> (last visited Feb. 2, 2009). Copies retained by the authors.; Microsoft Support, “How to Minimize Metadata in Word 2003,” at <http://support.Microsoft.com/default.aspx?scid=kb:EN-US:825576> (last visited Oct. 30, 2008). Copies retained by the authors.

be pleasant ones. In addition, auditors today know – or *should* know – the implications of metadata and the litigation risks its existence presents. Even without the heightened responsibilities imposed by Sarbanes-Oxley,²⁶ the auditor’s errors and omissions carrier will be very interested in seeing that this source of potential liability is examined. If nothing else, clients should be cautioned to retain documents, at least once they have been finalized, in a format that does not preserve metadata.

²⁶ Sarbanes–Oxley Act of 2002, 116 Stat. 745, (July 30, 2002)

AVOIDING LAWSUITS IN ACADEME: THE CUSTOMER SERVICE SOLUTION

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INTRODUCTION

The relationship between students and universities has evolved dramatically over the past four decades, and the courts have played a significant role in that evolution.¹ Courts traditionally viewed the relationship between students and universities as one where universities were largely in control. Although they had sometimes intervened in disputes between students and institutions, only in recent years have courts heard such cases in large numbers. The law increasingly views students as consumers with expectations of colleges and universities for the acceptable provision of programs and performance of services based on an implied contract. Courts have come to recognize higher education as less of a privilege and more of a necessity.² The long-standing doctrine of *in loco parentis* – in which the institution is charged with the rights, duties, and responsibilities of parents in supervising students – essentially had been the relationship between the student and the institution until the court's rejection of the doctrine in *Dixon v. Alabama State Board of Education*.³ That case marked the beginning of a movement away from the doctrine.⁴ Through a combination of social change, legislation, and other court decisions in the years following *Dixon*, students came to be viewed more as adults.⁵ They have also become more demanding and consumer oriented. The purpose of this article is to provide some basic information to help faculty, staff, chairpersons and other academic administrators recognize some of the problem areas that lead to student discontent and to assist them in becoming better providers of appropriate levels of customer service. This understanding will be helpful, as failure to do so can result in student retention problems, strained relationships with alumni, and yes, even litigation.

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¹ WILLIAM A. KAPLIN & BARBARA A. LEE, *THE LAW OF HIGHER EDUCATION* (3D ED. 1995).

² J. DOUGLAS TOMA & RICHARD L. PALM, *THE ACADEMIC ADMINISTRATOR AND THE LAW: WHAT EVERY DEAN AND DEPARTMENT CHAIR NEEDS TO KNOW* (1999).

³ *Dixon v. Alabama State Board of Education*, 294 F.2d 150 (5th Cir. 1961).

⁴ Kaplin & Lee, *supra* note 1.

⁵ Toma & Palm, *supra* note 2. The age of majority is established by state law. Until the 1970s, twenty-one was typically the age of majority in most jurisdictions. However, since the ratification of the Twenty-Sixth Amendment in 1971, lowering the voting age to eighteen, most states have lowered the age of majority to eighteen for many purposes. The age of majority statutes can significantly affect institutional regulations and policies. For an in-depth discussion of this issue, see WILLIAM A. KAPLIN & BARBARA A. LEE, *THE LAW OF HIGHER EDUCATION* (3d ed. 1995).

Higher education institutions have historically remained insulated from the lawsuits that are prevalent in the American society. There is, however, evidence to suggest that this trend may not continue.⁶ Thus, college and university faculty and administrators need to become aware of the steady erosion of the traditional protections against lawsuits on which institutions have relied. Faculty and academic administrators must be kept informed of the legal consequences of their actions or inaction. As the scale and complexity of individual institutions have increased, consensus has been more difficult to achieve and the courts have taken a more active role in resolving the inevitable disputes.

Higher education professionals need to understand how this growing litigious environment will impact on their roles. To help academic staff, faculty and administrators understand their responsibilities when dealing with students, this article highlights some of the most important areas of concern. In their roles, they must learn how to deal with a growing number of legal problems. Institutions need to consider whether or not their rules, regulations and policies adequately minimize their exposure to litigation. Deans and department chairs are the ones most often on the front line, with responsibility for legal issues involving students. Deans' and department chairs' administrative activities must be examined and considered daily in the context of legal issues that might be related to those activities. Most handbooks from human resources personnel or even from legal counsel will not adequately prepare an academic administrator for this job.

Judicial activity has produced a sizable body of school law with which educators should be familiar if they wish to conduct themselves in a legally defensive manner.⁷ Those educators who *fly by the seat of their pants* or who act on the basis of what they think the law 'should be' may be in difficulty if sufficient thought is not given to the legal implications and ramifications of their policies or conduct.⁸ These various sources point out to us the importance of being knowledgeable about the statutory and case law relating to the major issues surrounding students in higher education.

Changes in structure, such as the modification of traditional selection and acculturation processes, greater recognition of constitutional and contractual rights, the decline of career mobility for faculty, a greater array of service functions for higher education institutions, the increase in both internal and external regulations, and the technology revolution, have contributed to colleges' and universities' increased susceptibility to litigation.⁹ As a result, many campuses are changing their affirmative action, sexual harassment, disciplinary, due process, and discrimination policies as recent court cases provide additional guidance in these areas of law.

In any event society is more litigious today than in the past, and an institution's statistical likelihood of facing a lawsuit either as plaintiff or as defendant has increased. That does not mean that law is intruding more on higher education. It means that academic disputants in greater numbers are seeking legal resolutions to their disputes.¹⁰ As a matter of law, the college or university is generally responsible and liable for the acts of its employees, including members of the faculty, staff and administration. In all

⁶ Kaplin & Lee, *supra* note 1; Toma & Palm, *supra* note 2.

⁷ M. W. LaMORTE, *SCHOOL LAW: CASES AND CONCEPTS*, 6ed. (1999).

⁸ *Id.* at xxi.

⁹ Toma & Palm, *supra* note 2.

¹⁰ W. C. HOBBS, ed. *UNDERSTANDING ACADEMIC LAW* (1982).

of their roles – evaluator, policy maker and curriculum designer—faculty, staff and administrators make critical decisions that can generate litigation.¹¹

Although the traditional legislative and judicial deference to academic decision making has eroded over time, it remains pronounced across higher education. It is because of this steady erosion, however, that it has become increasingly important for faculty, staff and academic administrators to not only know what the law is, but also to understand their roles in the context of the procedural safeguards imposed by law.¹² Although higher education may not enjoy the same legal autonomy it once did, colleges and universities, according to Toma & Palm,¹³ continue to enjoy great independence. Various means are available by which to identify and guard against legal hazards that can visit liability on an institution. Knowing the law and adopting preventive measures is the best way to cope with the law and to prevent legal challenges and reduce exposure.¹⁴ Secondly, keeping students happy through the provision of good customer service may serve to lessen the likelihood of a lawsuit, as a happy customer – even as in business – is less likely to sue when something doesn't go her way. Injuries that can be avoided should be avoided.

The main purposes for exploring legal issues for academic administrators are: 1) to provide supervisors with the general background necessary to recognize legal issues when they emerge, 2) to encourage active participation in resolving legal issues as they arise, and 3) to prompt administrators to consider implementing preventive law strategies.¹⁵

STUDENT ISSUES IN HIGHER EDUCATION: THE COMMON PROBLEM AREAS

The essence of the relationship between colleges and universities and the students who attend them has been based on a contract theory.¹⁶ Toma and Palm¹⁷ indicate that the courts have increasingly decided cases involving students using implied contract theories, having moved away from the traditional doctrine of *in loco parentis*. According to Toma and Palm, *Institutions are no longer necessarily assumed to have a parental-type relationship with students.*¹⁸ *Students are viewed as consumers who have reasonable expectations of institutions in the areas of programs and services. In addition, although the traditional deference to academic decision making persists, courts are ever more willing to intervene in campus disciplinary actions involving both academic matters and disciplinary matters.*¹⁹

¹¹ K. M. WEEKS, FACULTY DECISION MAKING AND THE LAW: PUBLIC INSTITUTIONS (1991).

¹² Toma & Palm, *supra* note 2.

¹³ *Id.*

¹⁴ Weeks, *supra* note 11.

¹⁵ Some of these preventative law strategies are not really legal strategies at all. Some of these preventative strategies may simply involve providing good and effective customer service to the students who attend the institution.

¹⁶ It is important to remember that contract protections extend to colleges and universities and students alike. Contract theory is applied in much the same way in public and private institutions, since both types of institutions provide educational programming and services in exchange for payment from the students.

¹⁷ Toma & Palm, *supra* note 2.

¹⁸ *Id.* at 85.

¹⁹ *Id.*

Other common problem areas relating to students in higher education involve matters concerning student records, First Amendment free expression, negligence, and issues associated with admissions.²⁰

Because colleges and universities are more susceptible to lawsuits filed by students, it becomes increasingly important that institutions – including faculty, staff, and academic administrators – keep their promises. The courts have often interpreted stipulations in catalogs, handbooks, and university brochures as implied contractual provisions that can be enforced just as any other contract. Thus, regular audits of these materials are important to ensure that colleges and universities are actually doing what they should be doing.²¹

Increasingly, students have become more sophisticated in this area. Most of us have heard the media coverage involving the student who graduated from Monroe College in New York in April 2009 with a bachelor of business administration degree in information technology, who filed suit against the college, alleging that Monroe's Office of Career Advancement did not help her with a full-time job placement.²² In another less noted case, a University of Kentucky student filed a lawsuit against her school because she could not find a job after searching for 20 years.²³

THE LAW, THE COURTS, AND HIGHER EDUCATION: AN HISTORICAL PERSPECTIVE

Traditionally, the law's relationship to postsecondary (or higher) education was much different from what it is now. Kaplin and Lee indicate that there were few legal requirements relating to the educational administrator's functions, and they were not a major factor in most administrative decisions. The higher education community tended to think of itself as removed from and perhaps above the world of law and lawyers. The roots of this traditional separation between academia and law are several.

Higher education was often viewed as a unique enterprise that could regulate itself through reliance on tradition and consensual agreement. It operated best by operating autonomously, and it thrived on the privacy afforded by autonomy. The academic

²⁰ The courts are more willing to hear cases that have been filed by students against colleges and universities. Students have brought a variety of such cases. For a full discussion of these and related issues, see J. DOUGLAS TOMA & RICHARD L. PALM, *THE ACADEMIC ADMINISTRATOR AND THE LAW: WHAT EVERY DEAN AND DEPARTMENT CHAIR NEEDS TO KNOW* (1999) and WILLIAM A. KAPLIN & BARBARA A. LEE, *THE LAW OF HIGHER EDUCATION* (3d ed. 1995).

²¹ Toma & Palm, *supra* note 2.

²² CNN.com reported that on July 24, Trina Thompson, a 27 year old graduate of the college, filed an action seeking \$70,000 in reimbursement for her tuition and \$2,000 to compensate her for the stress of her three-month job search. She claims that Monroe's career services department did not put forth sufficient effort to help her secure a job after graduation. Interestingly, Thompson did not hire an attorney to represent her prior to filing the suit because she could not afford one. See Alumna Sues College Because She Hasn't Found a Job, CNN.com, Tuesday, August 4, 2009.

[Http://www.cnn.com/2009/us/08/03/new.york.jobless.graduate/](http://www.cnn.com/2009/us/08/03/new.york.jobless.graduate/)

²³ The student was a 1987 graduate of the University of Kentucky. In her lawsuit, she claims that she received a degree under false pretenses and now seeks to recover damages in the amount of \$44,000, which includes the cost of her tuition along with interest that has accrued on her student loan since then. She also seeks an additional unspecified amount for emotional distress. The student claims to have spent 3,300 hours looking for a job. She stated that her undergraduate survey courses had *no real world application*. See Student Sues University of Kentucky for Being Unemployable, *The Colonel*, August 6, 2009.

community was not to be disturbed by the involvement of outside agents in its internal governance.²⁴

According to Kaplin and Lee not only was the academic environment perceived as private; it was also thought to be delicate and complex. Kaplin and Lee further indicate that an outsider would, almost by definition, be ignorant of the special arrangements and sensitivities underpinning this environment. Lawyers and judges as a group, at least in the early days, were clearly outsiders. *Interference by such 'outsiders' would destroy the understanding and mutual trust that must prevail in academia.*²⁵

The law reflected and reinforced those attitudes. Federal and state governments generally avoided extensive regulation of higher education. Legislatures and administrative agencies imposed few legal obligations on institutions and provided few official channels through which their activities could be legally challenged.²⁶ The legal oversight that existed was generally centered in the courts.

In private institutions faculty members, like students, could assert no constitutional rights against the institutions since the constitution had no application to private activity (Thigpen, 1979). In the public institutions the judicial view was that employment, somewhat like student attendance, was a privilege and not a right. Thus, as far as the constitution was concerned, employment could also be extended or terminated on whatever grounds the institution considered appropriate.²⁷

As further support for the courts' hands-off attitude, higher education institutions also enjoyed immunity from a broad range of lawsuits alleging negligence or other torts. For public institutions, this protection arose from the governmental immunity doctrine, which shielded state and local governments and their instrumentalities from legal liability for their sovereign acts.²⁸ For private institutions a comparable result was reached under the charitable immunity doctrine, which shielded charitable organizations from legal liability that would divert their funds from the purposes for which they were intended.²⁹

Traditionally, the immunity doctrines substantially limited the range of suits maintainable against higher education institutions. And because of the courts' hands-off posture, the chances of prevailing in suits against either the institution or its officers and employees were minimal.³⁰ Reinforcing these limitations was a more practical limitation on litigation. Kaplin and Lee note that before free legal services were available, few of the likely plaintiffs—faculty members, administrators, and students—had enough money to sue.

²⁴ Kaplin & Lee, *supra* note 1.

²⁵ *Id.* at 5. Kaplin and Lee further state: *The special higher education environment was also thought to support a special virtue and ability in its personnel. The faculties and administrators (often themselves respected scholars) had knowledge and training far beyond that of the general populace, and they were charged with the guardianship of knowledge for future generations. Theirs was a special mission pursued with special expertise and often at a considerable financial sacrifice. The combination spawned the perception that ill will and personal bias were strangers to academia and that outside monitoring of its affairs was therefore largely unnecessary* *Id.*

²⁶ Kaplin & Lee, *supra* note 1.

²⁷ *Id.*

²⁸ H. G. NEAL, PERSONAL LIABILITY OF ADMINISTRATORS; A NEW EMPHASIS, in HIGHER EDUCATION: THE LAW AND THE 1980S IN PERSPECTIVE, 22-29 (D. P. YOUNG ed. 1979)

²⁹ Kaplin & Lee, *supra* note 1.

³⁰ Neal, *supra* note 28.

ACADEMIA AND THE LAW: A NEW REVOLUTION

Legal issues involving higher education have grown significantly over the past few decades. For example: In 1961, just 50 colleges had legal counsel offices. Most of them employed only one lawyer. By 1981, the National Association of College and University Attorneys, to which most lawyers who practice higher education law belong, reported having 2,058 members. Today, the association's membership totals more than 3200 lawyers.³¹

Kaplin and Lee report that since the mid-twentieth century, events and changing circumstances have worked a revolution in the relationship between academia and the law. The federal government and state governments have become heavily involved in postsecondary education, creating many new legal requirements and new forums for raising legal challenges. Students, faculty, other employees, and outsiders have become more willing and more able to sue postsecondary institutions and their officials. Courts have become more willing to entertain such suits on their merits and to offer relief from certain institutional actions, according to Kaplin and Lee. The most obvious and perhaps most significant change to occur since World War II has been the dramatic increase in the number, size and diversity of postsecondary institutions. But beyond the obvious point that more people and institutions produce more litigation is the crucial fact of the changed character of the academic population itself.³² The GI Bill expansions of the late 1940s and early 1950s and the *baby-boom* expansion of the 1960s brought large numbers of new students, faculty members, and administrative personnel into the educational process. In 1940 there were approximately 1.5 million degree students enrolled in institutions of higher education; by 1955 the figure had grown to more than 2.5 million and by 1965 to more than 5.5 million; and by 1992 the number of students had increased to nearly 14.5 million, according to Kaplin and Lee. The expanding pool of persons seeking postsecondary education prompted the growth of new educational institutions and programs, as well as new methods for delivering education services. Great increases in federal aid for both students and institutions further stimulated these developments.³³

As new social, economic, and ethnic groups entered this broadened arena of higher education, the traditional processes of selection, admission, and academic acculturation began to break down. Because of the changed job opportunities and rapid promotion processes occasioned by rapid growth, many persons new to the academy did not have sufficient time to learn the old rules. Others were hostile to traditional attitudes and values because they perceived them as part of a process that had excluded their group or race or sex from access to academic success in earlier days. For others in new settings—such as junior and community colleges, technical institutes, and experiential learning programs—the traditional trappings of academia simply did not fit.³⁴

As a broader and larger cross section of the world passed through colleges and universities, institutions became more tied to the world outside of academia. Government

³¹ P. H. Ruger & R. D. Bickel, Legal Issues: The Ubiquitous College Lawyer, *THE CHRONICLE OF HIGHER EDUCATION*, June 25, 2004, at B1-B4.

Ruger and Bickel indicate that *from academic freedom to technology transfer, legal issues now reach into almost every corner of campus life*. *Id.* at B1.

³² Kaplin & Lee, *supra* note 1.

³³ *Id.*

³⁴ *Id.*

allocations and foundation support covered a larger share of institutional budgets, *making it more difficult to maintain the autonomy and self-sufficiency afforded by large endowments*.³⁵ Competition for money, students, and outstanding faculty members focused institutional attentions outward. According to Kaplin and Lee:

As institutions engaged increasingly in government research projects, as large state universities grew and became more dependent on annual state legislative appropriations, and as federal and state governments increasingly paid tuition bills through scholarship and loan programs, postsecondary education lost much of its isolation from the political process. Social and political movements—notably the civil rights movement and the movement against the Vietnam War—became a more integral part of campus life. And when these movements and other outside influences converged on postsecondary institutions, the law came also³⁶ (pp. 7-8).

In the 1980's the development of higher education law continued to reflect, and be reflected in social movements in higher education and in the world outside of the campus. Various trends and movements begun in the 1970's and extended in the 1980's have materially altered higher education's relationship to the outside world and *have carved new features into the face of higher education law*.³⁷

Unlike the old days of *self-regulation*, when institutions governed their actions by tradition and consensus, this new development has spawned an increase in institutional guidelines and regulations on matters concerning students and faculty. It has led to the adoption of grievance processes for airing complaints. By creating new rights and responsibilities or making existing ones more explicit, the impact has been to give members of campus communities more opportunities to press claims against one another.

Both the state and federal governments have increased the scope and pervasiveness of regulation of postsecondary education through the 1990's and into the twenty-first century. At the state level, demands for assessment and accountability persist, and new pressures are placed on research universities to demonstrate their devotion to teaching and service. At the federal level, reformation of the federal student assistance programs and declining reliance on regional accrediting associations to certify the eligibility of institutions for participation in federal student aid programs have changed long-term relationships among these organizations and institutions of higher education.³⁸

Closely related to government regulations of postsecondary education is the issue of government financial support. Where once the trend was toward increasing aid at federal and state levels, both for students and institutions, the trend is now reversing. As governmental funds are shrinking, colleges and universities are drawn further into the political process in a scramble for funds. Kaplin and Lee indicate that as the burden of diminishing support is perceived to fall on minority and low-income students, whose numbers will decrease if governmental aid is not forthcoming, or on the minority and women faculty newcomers most subject to layoffs prompted by budget cuts, new civil rights issues are emerging.

³⁵ Kaplin & Lee, *supra* note 1 at 7.

³⁶ *Id.* at 7-8.

³⁷ Kaplin & Lee, *supra* note 1 at 8.

³⁸ Kaplin & Lee, *supra* note 1.

The technology revolution on college and university campuses is yet another trend that has legal ramifications.³⁹ The use of computers creates new issues of privacy, copyright disputes, and free speech concerns.⁴⁰ Similarly, as a result of private industry's interest in university research and the universities' interest in private sources of funding for research efforts, new alliances have been established between the campus and the corporate community.⁴¹

In addition to these new trends, the post-World War II movement toward diversity in higher education has continued. The growth of institutions and expansion of student bodies has brought more diversity of students and more special educational programs to serve their needs.

STUDENTS AS CUSTOMERS

Whether or not students attending colleges and universities should be considered as customers is an ongoing debate. But, increasingly, colleges and universities are recognizing them as such.⁴² According to Toma and Palm, *students are viewed as consumers who have reasonable expectations of institutions in the areas of program and services.*⁴³ Colleges and universities are no longer necessarily viewed by the courts as having a parental-type relationship with students.⁴⁴ In Georgia, for example, *On January 25, 2006, Governor Sonny Perdue signed an Executive order creating the Governor's Office of Customer Service for the purpose of coordinating, managing and implementing a customer service initiative to elevate the level of customer service experienced by Georgians when interacting with their state government.*⁴⁵ This was the first such initiative in the state. As part of this initiative, all state agency heads, including the head

³⁹ Kaplin & Lee, *supra* note 1; J. B. RASKIN, WE THE STUDENTS: SUPREME COURT CASES FOR AND ABOUT STUDENTS (2000).

⁴⁰ (J. B. RASKIN, WE THE STUDENTS: SUPREME COURT CASES FOR AND ABOUT STUDENTS (2000).

⁴¹ Kaplin & Lee, *supra* note 1.

⁴² The legal status of students in institutions of higher learning has changed dramatically over the past 40 years or so and is still evolving. Students are no longer view as second-class citizens under the law. They have enforceable constitutional rights. They are deemed to be adults, with all of the rights and responsibilities of adults, under most state and federal laws. Both public and private colleges and universities have developed express and implied contractual relationships with students. When problems arise, reference must be made to any written contract and institutional regulations that may be incorporated by reference into the contract, as a source of legal guidance. The courts have used the contract theory for both public and private colleges and universities to resolve disputes involving both academic and disciplinary matters. For a full discussion of this issue, see Kaplin & Lee, *supra* note 1 and Toma & Palm, *supra* note 2.

⁴³ *Id.* at 85.

⁴⁴ Toma & Palm, *supra* note 2.

⁴⁵ Governor's office of Customer Service, Governor's Office of Consumer Affairs, http://consumer.georgia.gov/00/article/0,2086,5426814_39039081_52640468,00.html

of the University System of Georgia,⁴⁶ are committed to focusing on the theme of *Faster, Friendlier and Easier*⁴⁷ service to customers.

In response to the governor's initiative, the Chancellor of the University System of Georgia asked each institution within the system to appoint an on-campus Customer Service Champion.⁴⁸ The University System of Georgia has clearly defined students as *our ultimate and most important customers*.⁴⁹

At Savannah State University, a University System of Georgia institution, the university is attempting to impose its service by requesting that employees courteously greet their customers and take their requests within three minutes of walking into an office. The expectation is that voice mail and email should be answered within 24 hours, and letters should be responded to within 48 hours.⁵⁰

In Texas, The University of Texas at El Paso has implemented *A Compact with Texans*,⁵¹ which sets out expectations for customer service at that university. Other universities have implemented similar programs. And, this trend is likely to continue.

SECRETS TO GOOD CUSTOMER SERVICE

The secrets to good customer service center around five proven points, according to Albert Schindler.⁵² Schindler suggests that good customer service is the bread and butter for any business. This, of course, includes institutions of higher education. Schindler's five secrets are: 1) Build business to customer loyalty;⁵³ 2) Provide true customer

⁴⁶ The University System of Georgia consists of 35 colleges and universities, and the Georgia Public Library System. The programs and services provided by the University System of Georgia affect a diverse consumer base. Its total revenues exceed four billion dollars; it employs over 40 thousand employees; and has a student population of over 250,000.

⁴⁷ Governor's office of Customer Service, *supra* note 43.

⁴⁸ The primary responsibility of the Customer Service Champion is to guide and manage customer service improvement throughout their institution and to develop a customer service improvement plan that will address the specific needs of customers within each unit. The plans, according to the Governors' Office of Consumer Affairs, are to be customer-focused and goal-oriented.

⁴⁹ Customer Focus, Board of Regents of The University System of Georgia, <http://customerfocus.usg.edu/>.

⁵⁰ Greg Gelpi, University Targets Customer Service, ASU Implements Statewide Plan to Reduce Complaints, The Augusta Chronicle, Friday, August 4, 2006, http://chronicle.augusta.com/cgi-bin/print_story.pl. According to the article, with only 62 percent of its first-time students completing school within six years, the Savannah State University Customer Service Champion believes that Georgia's statewide *faster, friendlier, easier* customer service initiative *will lead to happier students and better graduation rates*.

⁵¹ The Compact with Texans sets out the mission of the University of Texas El Paso, the customer service principle, goal and objectives. It also provided the expected standard for customer service, which is *we are committed to treating each other and all visitors as we would like to be treated ourselves. Every part of the UTEP community plays a role in achieving the University's mission. Each individual and office contributes to the achievement of our common goals and the creation of a positive campus climate by being responsive, efficient, and effective*. See UT El Paso Customer Service Statement at <http://www.utep.edu/customerservice.aspx>.

⁵² Albert E. Schindler, Five Secrets of Good Customer Service, About.com: Small Business: Canada, (2010), <http://sbinfocanada.about.com/cs/marketing/a/custserviceas.htm>.

⁵³ In the context of the college or university environment, this concept may simply mean that you handle complaints timely and efficiently. A well-handled complaint will pay dividends for your institution; whereas, a poorly handled one will likely create disgruntled customers who are more likely than not to

service;⁵⁴ 3) The customer is always right;⁵⁵ 4) Be honest with your customers;⁵⁶ and 5) Educate your staff to be equally as concerned about your customers as you are.⁵⁷

In addition to knowing the secrets of good customer service, it is also important that an institution recognize the need to periodically assess its own service delivery. It is important to know what the level of service delivery is currently before any improvements can be made.⁵⁸

Institutions must be aware that customers will often gain an impression of an institution based on the experiences they have with the people and the systems that they encounter there. One constant annoyance that customers find is often referred to as the *run-around*.⁵⁹ Eliminating the run-around is essential to the development of an appropriate service culture in a college or university environment. The run-around makes a college or university appear to be disorganized, bureaucratic, and impersonal. Customers who experience the run-around are more likely to become irritated or angry and may become difficult to work with or to ultimately satisfy.

In addition to assessing its service delivery, an institution needs to develop a service recovery⁶⁰ plan for those inevitable customer service issues that will arise. Just as

spread news of their bad experience. Therefore, institutional staff should treat customers as they would desire to be treated.

⁵⁴ The way Schindler put it, *one size shoe does not fit all feet. Nor is one type of customer service suitable for all your customers*. Schindler encourages you to be creative. He suggests that you get to know your customers and recognize their individual needs. Above all, he says, make sure that what you are offering your customers is something that they can value. That, he calls, *the key to good customer service*. Albert E. Schindler, *Five Secrets of Good Customer Service*, About.com: Small Business: Canada, (2010), <http://sbinfocanada.about.com/cs/marketing/a/custserviceas.htm>.

⁵⁵ Now this one, if taken literally in a university environment, could get a little hairy. What Schindler suggests here is that if the customer comes to you with a complaint, you should take it seriously. The customer's complaint should be treated seriously and professionally, even if it is obvious that the customer is wrong. Remember, a dissatisfied customer tells 10 to 25 others about a bad experience. Therefore, it is important that the customer have a good experience. See also, Michael Hill, *Customer Complaints Can Be Great or Bad for Business*, Eric Fraterman, Customer-Focus Consulting, (2010), http://www.customerfocusconsult.com/articles/articles_template.asp?ID=42.

⁵⁶ Honesty is often the best policy. Remember, however, that it is best to be guided by your institution's legal counsel in those circumstances where the possibility of litigation is looming large. The point to remember here is that your customers can often tell if you are trying to pull something over on them, or being disingenuous with them.

⁵⁷ This one speaks for itself. Schindler believes very strongly in the importance of training your staff to ensure that they understand the importance of providing great customer service and that they set out to do so with each and every encounter with customers.

⁵⁸ As part of assessing the level of quality of the service currently being delivered, an institution may wish to ask questions such as: 1) Do you and your staff consistently provide a level of service greater than that which may be expected? 2) Are customers routinely sent to another department or division in order to get what they need? 3) Are customers, especially students, a welcome part of your day, or an interruption of it? 4) Do you and your staff value the time that you spend assisting customers with a problem?

⁵⁹ It goes by several different names such as *red tape*, *the shuffle*, or the *run-around*. The effects are always the same – customers do a lot of unnecessary shuffling from one office to the next before getting a matter resolved, if at all. This can happen either in person or on the phone.

⁶⁰ Disgruntled customers can cause problems for any institution. The key is to actively uncover as many problems as possible; then, work to resolve them. It does not matter what kind of problem it is, how severe it is, who's to blame, or if the problem is merely perceived, if the customer is unhappy, the institution has an opportunity to engage in service recovery. So, what is service recovery? Service recovery involves the

customers have certain expectations regarding the traditional services they will receive from an institution, they will also have expectations of what will or should happen when something goes wrong.

CONCLUSION

Providing good customer service often distinguishes one institution from a competing institution.⁶¹ Thus, it is important for an institution to have appropriate systems in place to ensure the ongoing delivery of good customer service. To do otherwise may lead to student retention problems, strained relations with alumni, and even litigation.

What generates lawsuits is not the act itself, but rather the cover up that often follows. Further compounding the situation is the lack of explanation, the failure to apologize, and the fact that very often nothing is done to change anything to prevent the incident from happening to someone else. Generally speaking, an apology is the cheapest way out of a given situation, unless it is done incorrectly. An apology often reduces defensive thinking.

The customer is most often interested in two things: 1) the outcome or the final resolution of his or her problem; and 2) the process, including how painful or painless it is to reach a final resolution of his or her problem. Thus, it is important for institutions to make a sincere effort to go the extra mile to make sure that things progress smoothly from the time the problem presents itself until it is resolved.

For any successful service recovery plan, it is extremely important that problems are resolved at the earliest opportunity by the staff member who discovers the problem, when possible.⁶² The staff members must show genuine concern for the customer. Service providers need to have both the authority and the responsibility to solve problems. The response strategy should include both a fair resolution and some atonement for the inconvenience to the customer.⁶³

positive, proactive steps taken to undo damage created when a customer perceives a problem. It means turning the customer's dissatisfaction into satisfaction – transforming a negative impression into a positive one. Another way of saying it is problems make customers feel bad; service recovery helps them feel good again. The components of a good service recovery plan often include: 1) an acknowledgement of the problem, 2) an apology, 3) an offer of a fair resolution for the problem, which may be as simple as a careful explanation and a sincere effort to provide the expected level of service the next time around, 4) treatment of the customer in a way that suggests care for his or her concern for fixing the problem, 5) the offer of some value-added atonement for the inconvenience, 6) Implementation and follow-up. See Customer Service Practices: Making the Case for Service Recovery – Customer Retention, GreatBrook, (2010), http://www.greatbrook.com/service_recovery.htm

⁶¹ Do not under estimate the power of word-of-mouth. Outstanding customer service not only makes your customer want to come back and do more business with your organization. It also encourages your customer to recommend your business to his or her friends.

⁶² This helps to eliminate the run-around.

⁶³ After you have acknowledged the problem and apologized for the confusion, you are ready to begin looking for an acceptable solution. Making yourself clear and helping the customer to understand what the solution means to them is very important. Spell out everything for your customer, from what is going to happen to what it all means in the end. Your customers are more likely to be satisfied with the service they receive, even if the outcome is not what they wanted, if they understand what was involved in delivering that service. The same is true for providing atonement or making amends. Explain fully to your customer what is involved and how they will benefit from the solution that you are offering.

An institution's commitment to quality service is most rigorously tested over time. Implementing solutions for your customers and providing comprehensive follow-up is often what separates excellent service from mediocre service. It is easy to be concerned about customers' problems when they are right in front of you, but the real test comes when they leave. This is where most service recovery efforts fall apart. Keeping up your commitments to your customers over time demonstrates your conscientiousness and can dramatically influence their view of your service.

Always remember to work toward customer satisfaction even when you cannot immediately change the system. Demonstrate genuine caring and a desire to make things better in the future. Accept the authority and the responsibility to implement service recovery. Collaborate to resolve conflict. Every service provider has the responsibility to search for ways to prevent problems and to assist in the resolution of those that do arise. It is sometimes advantageous to bring in another service provider when you are confronted with a difficult customer service challenge. There is no harm in seeking help. Do not hesitate to do so if the need arises.

Maybe the University of Texas El Paso has it right. Perhaps the best standard for determining the appropriate level of customer service during our interactions with customers is to ensure that the customer is being treated as we would like to be treated ourselves.

GROSS V. FBL FINANCIAL SERVICES: A MAJOR SEA CHANGE IN AGE DISCRIMINATION OR MERELY MAINTAINING THE STATUS QUO

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I. INTRODUCTION

On June 8, 2009, the U.S. Supreme Court ruled in *Gross v. FBL Financial Services, Inc.* that the mixed motive theory of employment discrimination does not apply to complaints based on age arising from the Age Discrimination in Employment Act (ADEA). This ruling marks a shift from previous decisions which indicated an effort to reconcile the ADEA with Title VII of the Civil Rights Act of 1964. Previously, in *Smith v. City of Jackson*, the Court had brought the two statutes into harmony by permitting the application of disparate impact theory to situations involving age.

Both the ADEA and Title VII contain comparable language in their respective antidiscrimination provisions. This similarity often results in the misconception that what applies to one statute, applies to the other. However, this is not the case, as mixed motive, though actionable under Title VII, is not under the ADEA.

This paper discusses the rationale offered by the Court for its decision to exclude mixed motive theory from ADEA enforcement. To assist the reader's understanding, the theoretical underpinnings of mixed motive discrimination under Title VII are provided, as well as an examination of the burden of persuasion such claims impose on employers. Finally, the authors provide an analysis of the shift away from Title VII and ADEA reconciliation which the *Gross* decision points toward, and the consequences which this swing is likely to bode for employment practices.

A. Mixed Motive Discrimination

The concept of mixed motive discrimination has been authorized under Title VII to cover situations in which the employment decision is affected by at least two motives: a legitimate (job-related) reason and an illegitimate (i.e., based on race, color, religion, sex,

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or national origin) reason.¹ As Title VII states:

Except as otherwise provided in this subchapter, an unlawful employment practice is established when the complaining party demonstrates that race, color, religion, sex, or national origin was a motivating factor for any employment practice, even though other factors also motivated the practice.²

To illustrate how mixed motives involving sex discrimination occur, let's examine a scenario in which a decision maker is overheard saying they would prefer to place a man in a particular middle-management position. Assume one of the applicants is a woman, and she was not selected for the position.

As part of the selection process, a panel of managers is convened to review and discuss the qualification of each candidate and to make a recommendation to the employer as to which applicant should receive a job offer. Assume during these deliberations, one of the panel members remarked that they did not feel comfortable with a woman holding this position as she may not be perceived as being tough enough to handle disruptive employees. The decision maker's remarks are relayed to the female applicant who then files a complaint with the Equal Employment Opportunity Commission (EEOC).

In the ensuing investigation, the employer argues that more than one reason motivated the final promotion decision. Although the one manager's remark indicated that they were biased toward a male candidate, there was also evidence that the female applicant's job performance was mediocre and clearly inferior to that of the other candidates. The employer contends, based on her job performance, they would not have promoted the female candidate anyway. This is a classic instance of mixed motive decision-making; one unlawful (sex stereotyping), the other legitimate (job performance).

1. Price Waterhouse v Hopkins

This was precisely the circumstances in the Supreme Court's 1989 decision, *Price Waterhouse v Hopkins*.³ In this landmark Supreme Court case, a female senior manager was evaluated for partnership in a national accounting firm. During her evaluation for the promotion, several evaluators (partners in the firm) expressed negative reservations about her personality because Hopkins was a woman.⁴ According to the findings of fact, she was known to be very aggressive, often to the point of abrasiveness.

Several evaluators voiced concern that Hopkins conduct in the office was inconsistent with what they believed was appropriate behavior for a woman (this was sex stereotyping). Among their comments were: she was "macho," "overcompensated for being a woman," and needed to take "a course in charm school," as well as objections

¹ Miller v CIGNA Corp., 47 F.3d 586 (3rd Cir. 1995).

² 42 U.S.C. § 2000e-2 (m) (2009).

³ 490 U.S. 228 (1989).

⁴ *Id.* at 235.

about “a lady using foul language.”⁵ One evaluator went as far as to advise that she needed to “walk more femininely, talk more femininely, dress more femininely, wear makeup, have her hair styled, and wear jewelry.”⁶ All of these comments were sufficient to establish sex stereotyping, and had the decision been based *only* on the comments, the case would have been simple disparate treatment.

Sex stereotyping is an approach which treats sex-specific trait discrimination as actionable sex discrimination if the gender norms driving the discrimination are ones that society has an equality-based interest in eliminating.⁷

Consider, for example, the gender norm that makes aggressive women seem bitchy. An employer may have no objection to hiring women generally, but may refuse to hire aggressive women while not objecting to, and perhaps even prizing, aggressive men.⁸

It does not matter if the employer is motivated by ill-will or malice toward the individual because of this stereotyping. If an employer systematically or deliberately excludes women (or any other class protected under Title VII for that matter) from certain positions, the employer would be liable under Title VII for disparate treatment.⁹

In *Price Waterhouse v Hopkins*, the employer maintained the final decision not to grant a promotion to Hopkins was predicated on legitimate business reasons. As in any instance of intentional discrimination, the employer’s rebuttal to the complaining party’s *prima facie* case is that the employment decision was predicated on a “legitimate nondiscriminatory reason.”¹⁰ In *Hopkins*, the employer contended the decision not to promote the complaining party was the result of her poor interpersonal skills—she was unduly harsh with her staff and was difficult to work with.¹¹ The dilemma confronting the Court was: First, had the employer engaged in an unlawful practice when it impermissibly considered sex in making an employment decision? Next, would the employer have arrived at the same conclusion had it used only legitimate nondiscriminatory criteria? Prior to the Civil Rights Act of 1991, had the response to the second question been “no,” regardless of the answer to the first question, a court would have concluded that there was no Title VII violation.

Today, if the answer to the first question is “yes,” Title VII is held to have been violated regardless of the answer to the second question. The Civil Rights Act of 1991 states that an unlawful employment practice is established once a complaining party demonstrates that race, color, religion, sex, or national origin was (merely) a motivating factor for *any* employment decision or outcome, even though other legitimate factors may have also motivated the outcome.¹² The Act is very clear in holding that *all* mixed motive

⁵ *Id.*

⁶ *Id.*

⁷ Kimberly A. Yuracko, *Trait Discrimination as Sex Discrimination: An Argument against Neutrality*. 83 Tex. L. Rev. 167, 172 (2004).

⁸ *Id.*

⁹ EEOC v. Joe's Stone Crab, Inc., 220 F.3d 1263, 1284 (2000).

¹⁰ McDonnell-Douglas Corporation v Green, 411 U.S. 792, 802 (1973); Texas Dept. of Community Affairs v. Burdine, 450 U.S. 248, 252 (1981).

¹¹ Hopkins v. Price Waterhouse, 618 F.Supp 1109, 1113 (D.C. D.C. 1985).

¹² 42 U.S.C. § 2000e-2(m).

employment decisions are automatically a violation of Title VII.

Before continuing, the authors wish to clarify one point regarding mixed motives. Too often there is confusion between mixed motive and constructive discharge. Some Human Resources practitioners use the terms as though they are synonymous. They are not. In a true mixed motive situation, the decision maker considered at least one legitimate criterion and one unlawful one. Let us say an employer had considered an employee's industrial sales experience (a legitimate reason) *and* the customer's preference for male sales representatives (an unlawful criterion) when deciding who would be hired. This would be a case of mixed motive, as both criteria were evaluated in making the decision. In contrast, constructive discharge occurs when an employer or his/her representative intentionally makes an employee's working conditions so unpleasant that a reasonable person would feel obliged to quit and seek employment elsewhere.¹³

2. Direct v. Circumstantial Evidence

Direct evidence of a discriminatory motive is any written or verbal statement by a respondent official that they undertook the challenged action because of the complaining party's protected class status. A common way to establish direct proof of unlawful discrimination under Title VII occurs when a decision-maker makes a declaration before credible witnesses which indicates an intention to unlawfully discriminate. For example, an executive states, "as long as I am in charge, XYZ Company will never hire a Latino supervisor." This would be direct evidence that the reason a qualified Latino applicant was not hired was because of his or her race.

Circumstantial evidence is also known as indirect evidence. It is distinguished from direct evidence, which, if believed, proves the existence of a particular fact without any inference or presumption required. Circumstantial evidence relates to a series of facts other than the particular fact sought to be proved. The party offering circumstantial evidence argues that this series of facts, by reason and experience, is so closely associated with the fact to be proved that the fact to be proved may be inferred simply from the existence of the circumstantial evidence.

Circumstantial evidence, in the context of Title VII, is most commonly demonstrated by the burden shifting method. This burden shifting, or indirect method, is based upon the complaining party's ability to produce sufficient circumstantial evidence to indicate that Title VII may have been violated. This is most often accomplished by a four-part set of proofs which will be discussed shortly in this paper.

Under Title VII, the complaining party needs only to present sufficient evidence for a reasonable jury to conclude, by a preponderance of the evidence, that "race, color, religion, sex, or national origin was a motivating factor for any employment practice." Direct evidence of discrimination is not required under Title VII.¹⁴

B. Title VII and ADEA

¹³ Young v. Southwestern Savings and Loan Assoc., 509 F.2d 140, 144 (5th Cir. 1975).

¹⁴ Desert Palace, Inc. v. Costa, 539 U.S. 90, 101 (2003).

Note that the Age Discrimination in Employment Act is technically not an Equal Employment Opportunity law,¹⁵ but rather a Fair Labor Standards law.¹⁶ This may appear to be splitting hairs to some, but it will play an important role in the *Gross* decision.

The ADEA is actually an amendment to the Fair Labor Standards Act. Its antidiscrimination provisions read:

It shall be unlawful for an employer—

(1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age.¹⁷

Now note the similarity between the language of the ADEA and Title VII's prohibitions in employment discrimination (the non-similar wording has been italicized by the authors):

It shall be an unlawful *employment practice* for an employer—

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's *race, color, religion, sex, or national origin*.¹⁸

II. RECONCILING TITLE VII AND ADEA CLAIMS

A. ADEA and Disparate Treatment

Because the anti-discrimination language of the ADEA parallels that of Title VII, federal courts have held that the burden shifting method for determining disparate treatment under *McDonnell Douglas v. Green* applies to the ADEA.¹⁹

The ADEA was enacted in 1967; only three years after the Civil Rights Act of 1964 had become law. As previously discussed, the language of each Act's nondiscrimination provision was virtually identical.

The ADEA makes it unlawful for an employer to discriminate against an employee "because of" that individual's age. Title VII makes it unlawful for an employer to discriminate against an employee "because of" race, color, religion, sex, or national origin. Since the relevant language of the two statutes is identical and the substantive provisions of the ADEA were derived in *haec verba*, (meaning "in these words", which refers to incorporating text verbatim from one statute to the other) from Title VII, court precedent and the rules of construction and interpretation require the words to have the

¹⁵ 42 U.S.C. § 2000e et seq. (2009).

¹⁶ 29 U.S.C. § 621 et seq. (2009).

¹⁷ 29 U.S.C. § 623a)(1) (2009).

¹⁸ 42 U.S.C. § 2000e-2(a).

¹⁹ *O'Connor v. Consolidated Coin Caterers*, 517 U.S. 308, 110,111 (1996).

same meaning and import and to apply “with equal force in the context of age discrimination.”²⁰ Therefore, the burden shifting approach for determining disparate treatment under the ADEA should be the same as that employed in determining disparate treatment under Title VII.

It was, therefore, not surprising that once *McDonnell-Douglas v. Green*²¹ was decided and the burden-shifting method had been established for assessing circumstantial evidence under Title VII, that it would be applied in a similar fashion to ADEA claims.²²

Establishing disparate treatment under the ADEA follows the same formula. First the complaining party must establish that he or she is a member of a class protected under the Act. In cases involving the ADEA this is very simply done, the individual only has to prove that he or she is forty years of age or older.

Next, the complaining party had to be qualified and applied for the job in question where the complaint involves a selection decision; or was qualified and held the job in question where the issues involve a termination, demotion or similar action. This is required because an unqualified person would not have been considered for the employment action regardless of protected class status.

The complaining party must also have experienced an adverse employment consequence. Typically this is demonstrated by showing that the individual was not hired, failed to be promoted, was denied career enhancing training, was terminated, laid off, or suffered the loss of some other tangible job benefit. In the absence of an adverse employment outcome, the individual lacks “standing.”

Finally, and critically, the complaining party must demonstrate that another individual who was not a member of his or her protected class and was similarly situated (had equal or fewer qualifications) received different treatment. Under the ADEA, this means that someone with fewer qualifications who was under 40 years of age received a tangible job benefit when the over 40 employee or applicant did not.

B. ADEA and Disparate Impact

Disparate impact, sometimes called unintentional discrimination, occurs when a selection standard, which on its face appears to be neutral, actually has the effect of disqualifying a disproportionate number of members of a particular class from further consideration. Nationally, this standard was first applied to Title VII in the 1971 decision, *Griggs v. Duke Power Company*.²³ In this case, successful applicants had to pass two employment conditions: possess a high school diploma or its equivalent and attain a passing score on two cognitive abilities tests. What was argued in *Griggs*, was even though the standards were applied neutrally, without regard to the applicant’s race (all those who passed, regardless of race, were considered for employment), they had the effect of disqualifying a disproportionate number and percentage of African Americans

²⁰ *Trans World Airline, Inc. v. Thurston*, 105 S. Ct. 613 (1985).

²¹ *Supra*, note 10.

²² *McDonnell-Douglas Corp. v. Green*, 93 S. Ct. 1817 (1973).

²³ 401 U.S. 424 (1971).

from the selection process. The education requirements disqualified three times as many African Americans as it did whites and the cognitive abilities tests disqualified more than ten times as many.²⁴ Because the employer could not demonstrate a connection between the education and minimum test score requirements and job performance, the Supreme Court held that they had the effect of denying access to jobs for African American applicants.

Again, the similarity in language between the two statutes resulted in federal courts applying disparate impact theory to ADEA claims. However, this created a problem, in that the employer's defense under disparate impact is to demonstrate that however neutral the employment standard is, the disparity is a business necessity/job-related (the terms are synonymous).²⁵ The problem this presents under the ADEA is that the physical and mental abilities within the class vary greatly. Since the protected class is all those in the workforce who are older than 40 years of age; a 40 year-old woman and an 80 year-old man would both be included, even though the likelihood of marked differences in their abilities may be great. However, these would be lumped together in any validation analysis which is likely to occur. To resolve this problem, the Supreme Court fashioned a compromise.

In *Smith v. City of Jackson*, the Supreme Court affirmed that disparate impact is a cognizable theory of discrimination under the ADEA, but with a different defense.²⁶ "[R]easonable factors other than age, not 'business necessity,'" is the appropriate model for the employers' defense against an impact claim under the ADEA.

In essence, a complaining party can use a statistical imbalance created by a specific employment criterion to establish a *prima facie* case of discrimination under the ADEA, but the employer's defense is essentially a legitimate nondiscriminatory reason for the selection decision.

The Supreme Court ruled the ADEA authorizes recovery in disparate-impact cases comparable to Title VII; however, two textual differences between ADEA and Title VII make it clear the scope of the ADEA is much narrower.²⁷ First, the ADEA Section 4(f)(1) significantly narrows the scope of liability and coverage by permitting any "otherwise prohibited" action "where the differentiation is based on reasonable factors other than age" (hereinafter RFAO provision). The RFAO provision was held consistent with the fact that age, unlike the protected classifications of Title VII, not uncommonly has relevance to the individual's capacity to engage in certain types of employment.²⁸ The other textual difference, more esoteric, but no less important, found the amendment to Title VII in the Civil Rights Act of 1991 modified a previous ruling of the Court wherein it narrowly construed the scope of liability in a disparate-impact claim.²⁹ The 1991 amendment expanded Title VII's coverage, but did not amend the ADEA or even speak

²⁴ *Griggs v. Duke Power Co.*, 420 F.2d 1225, 1239-40 n. 6 (4th Cir. 1970).

²⁵ HERMAN BELZ, *EQUALITY TRANSFORMED: A QUARTER CENTURY OF AFFIRMATIVE ACTION* (Transaction Publishers 1991).

²⁶ *City of Jackson v. Smith*, 544 U.S. 228 (2005).

²⁷ *Id.*, at 238-240.

²⁸ *Id.*, at 240-241.

²⁹ *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642, 656 (1989).

to age discrimination. In doing so, the Congress left open considerations that are relevant to an individual's capacity to engage in certain types of employment.

C. ADEA and Mixed Motive

Because the trend has been to apply Title VII's disparate treatment and disparate impact claims to age discrimination issues, it was only a matter of time before mixed motive was applied by some of the federal courts. At least three circuits (the Third,³⁰ Fourth³¹ and Fifth Circuits³²) had recognized mixed motive under the ADEA following the *Price Waterhouse* decision.

III. GROSS V. FBL FINANCIAL SERVICES, INC.

This brings us to the case at hand, *Gross v. FBL Financial Services, Inc.*³³ In January 2001, after nearly 30 years with his employer, Gross, the complaining party was promoted to claims administration vice president. Following a corporate reorganization in January 2003, Gross was reassigned from that position to claims project coordinator with many of his duties being transferred to the claims administration director. This was, in essence a demotion.³⁴

Gross filed a complaint with the EEOC alleging that his employer demoted him, he was 54 at that time, and gave his duties to a female, the claims administration director, who was in her early forties. There was no innovation in this as previously, in *O'Connor*, the Supreme Court had ruled that an over 40 year-old employee may establish a *prima facie* case of age discrimination if he or she could prove that they were replaced with a substantially younger over 40 year-old employee.³⁵ The novelty which Gross introduced was not that his age had been the sole factor (the "but for" factor) driving the employment decision, rather that it had been a contributing or motivating factor in violation of the ADEA.³⁶ He was attempting to get his case heard as a mixed motive issue.

The District Court for the Southern District of Iowa chose to apply *Costa* to this case. The question not being whether mixed motive was appropriate under the ADEA, but whether the complaining party has to present direct evidence or circumstantial evidence that the impermissible discussion of the employee's age had tainted the employment

³⁰ *Griffiths v. CIGNA Corp.*, 988 F.2d 457 (3d Cir.), cert. denied, 1993 U.S. App. LEXIS 8015 (1993).

³¹ *Baqir v. Principi*, 434 F.3d 733, 745 (4th Cir. 2006); *EEOC v. Warfield-Rohr Casket Co., Inc.*, 364 F.3d 160, 164 n.2 (4th Cir. 2004); *Hill v. Lockheed Martin Logistics Mgmt., Inc.*, 354 F.3d 277, 285 n. 2 (4th Cir. 2004).

³² *Rachid v. Jack in the Box, Inc.*, 376 F.3d 305 (5th Cir. 2004).

³³ 129 S.Ct. 2343 (2009).

³⁴ *Id.* at 2347.

³⁵ *Supra* note 19 at 308.

³⁶ *Supra* note 33 at 2347-48.

decision.³⁷

Over the employer's objections, the District Court for the Southern District of Iowa instructed the jury to enter a verdict for Gross if he proved, by a preponderance of the evidence, that he was demoted and his age was a motivating factor in the demotion decision.³⁸

Both lower courts seemed to conclude that mixed motive was actionable under the ADEA, but disagreed on the evidentiary standard. The argument in *Gross* initially was whether a plaintiff must "present direct evidence of discrimination in order to obtain a mixed-motive instruction in a non-Title VII discrimination case." The 8th Circuit believed direct evidence to be the proper standard, while the District Court held that circumstantial evidence was appropriate. This resulted in the 8th Circuit reversing and remanding the district court's decision for a new trial on those grounds.³⁹

According to the Supreme Court, neither direct nor circumstantial evidence was the critical issue, but whether mixed motive theory can even be applied to an ADEA claim. What is essential, according to the Court, in any disparate-treatment claim under the ADEA, is that for the complaining party to prevail, he or she must prove that age was the "but-for" cause of the employer's adverse decision. That is to say there must be direct evidence that the individual's age was the determining factor. Ultimately, the Supreme Court, in a 5-4 decision, held that there is no mixed motive analysis available under the ADEA.

To make the point that the ADEA is not Title VII and is not subject to the exact same interpretation, the Court noted that when Congress amended Title VII in the Civil Rights Act of 1991 by adding 42 U.S.C.S. §§ 2000e-2(m) [mixed motive] and 2000e-5(g)(2)(B), though it had the opportunity to add these same provisions to the ADEA, it chose not to do so.⁴⁰

In its decision on this matter, the language of the Court is quite clear, "[t]his Court has never held that this burden-shifting framework applies to ADEA claims. And, we decline to do so now."⁴¹

VI. CONCLUSION

The Supreme Court has ruled there is no mixed motive for age discrimination complaints. In so holding, the Court has made it clear that in an ADEA complaining party must bring forth evidence that age was the determining "but for" factor and cause of the employment action, irrespective of any other reason. This ruling alters the evidentiary landscape and requirements for a complaining party in ADEA claims. Now an individual has to produce the proverbial "smoking gun," whose practical affect is to make it significantly more difficult for an ADEA complaining party to succeed in a mixed motive, disparate treatment claim.

³⁷ *Gross v. FBL Financial Services*, 526 F.3d 356, 360 (8th Cir. 2008).

³⁸ *Id.*

³⁹ *Id.* at 363.

⁴⁰ *Supra* note 19 at 2348-49.

⁴¹ *Id.* at 2349.

Interestingly, as we have seen above with the Court's decisions in *Price Waterhouse* and *Wards Cove*, the Congress could choose to legislatively respond, or even overrule the Court. It could do so again, provided that the political majority believes that the Court's decision in *Gross* has imposed an excessive burden of persuasion on complaining parties. It is yet to be seen if this is the tack that Congress may take.

TAX PLANNING AND WEALTH ACCUMULATION WITH PERSONAL RESIDENCES

DAVID RITTER*
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INTRODUCTION

Without any threat of accusations of hyperbole, it can be said that the economic conditions at the time of this writing -- and especially the potential for changes in the tax system -- are breathtakingly volatile. The ten-year wind-down of certain taxes provided in the Economic Growth and Tax Relief Act of 2001¹ is about to reach its preprogrammed expiration, holding out the prospect of tax levels returning to those existing at the beginning of this millennium. It goes without saying that estate planning as a service to clients is likely to become more important than ever before.

A brief review of the current situation would be appropriate. As it now stands, decedents' estates are entitled to an exemption of up to \$3.5 million for 2009². For 2010, the estate tax is eliminated³. However, in 2011 the tax will be automatically resurrected with an exemption of no more than \$1 million.⁴ Although Congress is fully capable of extending, or even making permanent, the abolition of estate taxes there is little likelihood such will be done.

If "being wealthy" means having to pay estate taxes, then the ranks of the wealthy will probably vary widely in composition over the next two years. Besides reinstating the low exemptions from years past, the return of the estate tax in 2011 may also bring with it an escalating tax rate. The current state of the economy and the mounting public debt may result in a new tax on estates and at much higher rates than in the past. Many economists opine that current federal spending levels will inevitably result in confiscatory taxes if continued, others emphatically disagree. In any event, uncertainty must necessarily continue until the Congressional elections of 2010, and perhaps for years after that. In the meantime, the potential variations in outcome for those attempting to make choices are nontrivial, and the planning problems are obvious. The tools we discuss, however, do not depend on tax policy as the sole reason for their existence.

To further exacerbate the estate tax burden, the value of the estate is stepped up to the fair market value of the taxable assets⁵ at the date of death of the owner. This means the realization, for tax purposes, of in some cases a lifetime of capital gains and an

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¹ Public Law 107-16, June 7, 2001, 115 STAT. 381

² IRC § 521 (a)

³ IRC § 2210(a)

⁴ IRC § 521 (b) 1, (c) 1

⁵ IRC §1014(a)

accompanying huge increase in taxes, possibly without warning to the testator. In essence this means that if, under present and announced tax law changes, an unmarried person dies in 2010 with a house having a stepped up fair market value of \$1 million and \$1 million in other taxable assets, including life insurance, there will be no tax. If the same person dies in 2011, there will be an estate tax liability of \$450,000. Since, in this example, half of the assets are tied up in illiquid real estate, the burden on the survivors could be distressing, indeed.

In the case of a married couple with a surviving spouse, however, there is an unlimited spousal transfer exemption at death,⁶ and *intervivos*⁷, which means there will be no estate tax payable until the surviving spouse dies. The estate tax liability of \$450,000 at the death of the surviving spouse, also, can be mitigated and perhaps reduced to zero with some before-death estate planning. In addition, under present law there is a \$1 million dollar gift tax exclusion⁸ which, theoretically, could allow a husband and wife in the above example the ability to gift their entire estate with no tax consequences. This theoretical solution, however, is usually rendered impractical by the need to retain resources to support the parties during their joint lives.

THE TRUST AS A TAX PLANNING TOOL

The wholesale resurrection of the 20th century estate tax system would, however, have one tarnished silver lining, that being that the tools developed in years past to deal with estate planning and taxation issues will once again be usable. In spite of recent downturns in the real estate markets, real estate -- and especially residential property -- remains one of the principal types of asset held by American decedents. Accordingly, one of the old tools worth reexamining is the Trust.

The arrangement called a trust, including its ancient designation of the "use" (and various other names), has long been a favored tool for tax planning and avoidance.⁹ A trust, of course, is a contractual relationship characterized by the management and control of property by an agent (the "trustee") who takes record title on behalf ("for the benefit of") the "true owner" (variously called such things as the "grantor" or "settlor" or the like). Under current law, trusts may be created to perform a variety of functions, including the ownership and management of either real or personal property. The trust depends for its existence entirely on a contractual arrangement between the trustee, who is the record owner of the property (referred to as holding "bare legal title") and who has no right to benefit from it (other than compensation for services), and the "real" owner ("beneficiary") who receives or directs the disposition of the benefit of the property. This

⁶ IRC § 2056 (a), § 1041

⁷ IRC § 2523 (a)

⁸ IRC § 521 (c)

⁹ In a stellar example of the application of the Law of Unintended Consequences, in 1535 Henry VIII (desiring to do no more than eliminate a method of escaping transfer and estate taxes) obtained from Parliament passage of the *Statute of Uses* (27 Hen. VIII, c. 10, 1535), which stripped many trustees of their record title and vested it directly in the beneficiary, thus canceling their expected tax savings. This legislation, however, was eventually turned to the benefit of landholders and within a short time totally laid to rest the last vestiges of feudalism (along with the notion that the Crown owned all the land), giving rise to the "allodial system" of land titles existing in the Anglo-American world today. In trying to plug a tax leak, Henry lost the ultimate claim on all the land of England.

relationship, being a matter of contract, is entirely a creature of State law or the law of the jurisdiction in which the trust is domiciled.

TRANSFER OF RESIDENCE TO AN IRREVOCABLE TRUST.

While the Internal Revenue Code does not specifically define a trust in general terms, trusts are governed by sections 641 through 692 of the code that allow extensive use of trusts for tax planning.¹⁰ Common law principles of trust law, therefore, may guide additional strategies for dealing with residential real estate. For example, the familiar "Irrevocable Trust" under the common law is one which may not be modified or revoked by the grantor after its creation. This relinquishment of control by the grantor has the same effect as a sale or absolute transfer, and removes the trust assets from the grantor's estate.¹¹

Thus, a grantor can remove a residence from his or her estate by an *inter vivos* transfer (i.e., one made during the grantor's life, not by Last Will and Testament) to an irrevocable trust. The transfer would constitute an immediate gift, and the value of the gift would be the fair market value of the residence, \$1 million in the example at hand, under §§ 2511 through 2519 and the applicable Regulations. This would use the entire Gift Tax Exclusion of a single grantor or one-half of each spouse's Gift Tax Exclusion for a married couple. For the married couple each would have a \$500,000 gift tax exclusion remaining.

While no immediate benefit is obtained, an appreciating asset such as a personal residence can be transferred out of the estate to continue to grow in value without any estate tax consequences to the grantor. No tax will be paid until the residence is sold at which time, assuming present tax law is still in force, the gain on sale would be a long term capital gain, liable for only a 15% tax rate or less, rather than the 41% or up estate levy. After an irrevocable transfer to a trust, the grantor(s) could rent or lease the property from the trust and the rent paid would inure to the benefit of the beneficiaries of the trust.

QUALIFIED PERSONAL RESIDENCE TRUST (QPRT)

A more specialized, and less well known, planning tool that exists only for residential properties is the Qualified Personal Residence Trust (QPRT)¹². This interesting, though somewhat limited, vehicle bears particular consideration for older clients with appreciated residential properties that might create extreme estate tax liabilities in the coming few years.

¹⁰ IRC §§ 641 through 692

¹¹ When a trust does not have this character, the death of the beneficiaries or other failure of the purpose of the trust results in the return ("reversion") of the corpus to the grantor. This possibility is referred to as a "reversionary interest" and it satisfies the unbending requirement of Anglo-American law that all aspects of ownership of real assets must ultimately reside ("vest") in some person or entity. That is, once the beneficial interest is no longer "owned" by an existing entity, it has to go somewhere – and that somewhere will be back to the grantor if not otherwise provided.

¹² IRC § 2702(a)(3)(A) and § 25.2702-5(c)

Current Treasury Regulations¹³ provide that each person can create a QPRT for one principal residence and for one additional residence.¹⁴ Under this provision an individual would create a qualifying trust by executing a proper trust agreement and then placing the principal residence into the QPRT by conveying title to a trustee (subject to the terms of a formal, written trust agreement). The fair market value of the residence at the date of transfer would establish the trust's basis for tax purposes¹⁵. This action would remove the residence from the grantor's estate, both for estate tax purposes and for probate, the latter providing an additional material advantage in many States.

After transferring the residence to the QPRT, the grantor may occupy it rent-free for a set time specified in the trust agreement, not to exceed ten years.¹⁶ During this period, under Rev. Proc. 2003-42, the grantor would be responsible for all of the expenses such as normal repairs and maintenance and taxes, incurred while occupying the residence even though not paying rent.¹⁷ The grantor can remain in the residence after it passes to the beneficiaries and pay reasonable rent and expenses for the time occupied thereby sparing the beneficiaries from having any expenses. At the end of the specified period the residence would pass to the designated non-grantor beneficiary free of estate tax. If desired, the grantor may remain in the house after expiration of the designated time, but must pay the distributee a "fair" (market-based) rent¹⁸. This income will be taxed at ordinary rates to the recipients.¹⁹

In spite of the favorable estate tax treatment, the gratuitous transfer of the home is a gift²⁰ and if its value is in excess of \$1 million per grantor during 2009, but not yet defined for 2010 and latter, it will be taxable.²¹ The amount of the gift is the actuarial value of the property determined using tables published by the IRS.²² These tables take into account the age of the grantor and a monthly interest rate that will be established by the IRS for the month in which the transfer to the QPRT takes place.²³ For example, assuming the \$1 million residence mentioned above, a grantor who is fifty years of age and an IRS-established interest rate of 5.6%, the actuarial (and taxable) value of the gift to the trust would be \$537,010 rather than \$1 million. The gift-tax impact of this \$537,010 can be reduced by resort to the grantor's Gift Tax Exclusion under §§ 2511 through 2519 and the applicable Regulations.²⁴

IRC §2036(a)(1), however, presents a potential danger in the use of the QPRT. In the event the grantor should die before the specified term ends and title passes to the ultimate distributee, the entire value of the residence comes back to the grantor's estate.²⁵ In that

¹³ Treas. Reg. Subchapter B, Sec. 25.2702-5

¹⁴ Treasury Regulations section 25.2702-5(c)(2)

¹⁵ IRC § 102

¹⁶ Rev. Proc. 2003-23, I.R.B. 993, §4, Art. II(B)(2)

¹⁷ Rev. Proc. 2003-42

¹⁸ Id.

¹⁹ Although the distributees can achieve some tax relief by sheltering such income with depreciation, the possibility remains high that liability for additional ordinary income will be unwelcome and some additional planning will be required.

²⁰ IRC § 102

²¹ IRS Publication 950

²² IRC § 7520 and IRS Publication 1457

²³ Id.

²⁴ IRC §§ 2511-19

²⁵ IRC § 2036(a)(1)

case the taxable estate remains the same as before the transfer to the QPRT resulting in no savings on estate taxation and in the loss of the considerable expense of establishing and administering the trust. Once the property reverts to the grantor the grantor's Gift Tax Exclusion is restored, however, so at least there is no reduction in the estate tax exemption. This serious pitfall makes it of paramount importance for the grantor to specify a term he or she is likely to survive!

If the residence is owned by a married couple jointly, the benefits of a QPRT are enhanced. Each spouse can transfer a one-half interest in the residence to the QPRT, and both could retain the right to live rent-free in the residence for the 10 year period selected. This would also reduce the amount of the individual gift tax exclusion each would be required to utilize, due to the additional discount on the value of the gift due to the lower market value of such an undivided interest in real property.

TAXABILITY OF TRUST INCOME.

An important consideration for the use of trusts as tax planning tools (for residential real estate or any other asset) is the taxation of the income of the trust, itself. The IRS classifies all trusts as either simple or complex. A simple trust is a trust which is required to distribute its entire income to beneficiaries each year, cannot have any charitable organization as a beneficiary, and does not distribute any of the trust corpus during the year; a complex trust is any trust which is not a simple trust.²⁶

Since the simple trust distributes all of its income to beneficiaries who include their share of the trust distributions in their own income, the trust does not pay any tax. That is, information returns (on Form 704) must be filed by the trustee and schedules K-1 delivered to the beneficiaries, meaning the tax consequences fall on the distributees. Electing to be treated as a simple trust would mean the beneficiaries may have an income stream from the trust each year, and, naturally, the tax consequences of this must be considered. A complex trust, on the other hand, pays tax at the rate of 15% on income at its lowest bracket and this rate quickly rises to 35% for amounts over \$11,500 in 2009.²⁷ Other matters of tax accounting for entities such as trustees must also be taken into account.

OVERSEAS TRUSTS

Some potential planning benefits can be achieved through the use of a trust created outside the jurisdiction of the Internal Revenue Service. A "Foreign Trust" is a trust which has productive assets or income sources outside of the United States, where such sources are not connected with a trade or business in the United States (so the income is not taxed within the United States).²⁸ In order for a United States citizen to escape taxation on a foreign trust the citizen must give up all matters of direction and/or ownership of the trust, now and in the future, utilizing an irrevocable trust. Once all title or benefits from property has been transferred to a new owner the transferring owner,

²⁶ Id., § 651(a)1

²⁷ IRS, Tax Rate Schedules and Tables, Form 1041 and Instructions

²⁸ IRC §301.7701(31)(a)

grantor, has no further interest in the property and is therefore not liable for any taxes on the property.

A United States citizen cannot set up an offshore bank account, trust, or other entity to serve as an alter ego in an attempt to evade United State taxes. A US citizen is required to file a Form 3520 return annually for transactions with a foreign trust. A failure to file penalty of 35% of the gross value of property transferred to the trust as well as a 5% per month additional tax, not to exceed 25% on certain foreign gifts is also required.²⁹ An irrevocable trust set up as a Foreign Trust, however, removes the trust assets from the grantor's estate by transferring ownership to the trust.

A trust set up outside of the United States and in a manner conforming to the laws of the country in which it is resident is then a legal entity residing in a foreign country. This trust can own property in the United States and must account for its United States earnings according to the law of the United States. However, once it has paid taxes on its United States income and the income is transferred outside the United States it is no longer subject to taxation other than in the country in which it is resident. Differences in rates and taxation of estates or capital gains may present interesting opportunities for tax planning strategies.

Furthermore, if the trust is set up in a country where there is no Rule Against Perpetuities the trust can last for an unlimited time, allowing the "dead hand" of the grantor to guide disposition of the property for generations. Countries such as Liechtenstein, for example, offer an environment where an individual can still establish a legal dynasty trust which benefits all future generations without the interference of tax authorities.³⁰

FAMILY LIMITED PARTNERSHIP (FLP)

Although the trust, especially the QPRT, is the focus of this article, it is appropriate to at least mention the Family Limited Partnership (FLP). Transfer to a FLP could also effect the removal of a personal residence from an estate (again, for probate purposes as well as taxation). Numerous issues (beyond the scope of this article), however, regarding the determination of basis and involving direct control by limited partners have been, and are still continuing to be challenged by the IRS³¹. If a final determination of these questions favors a reduced value for property transferred into a FLP, the amount of gift tax exclusion used would be reduced. This would not, of course, be the only reason a FLP might be useful to the matter under consideration.

Even if the residence must be transferred at its full fair market value, thus reducing or eliminating part or all of the \$1 million gift tax exclusion per individual, gift tax exclusion, the FLP remains a potentially valuable estate planning vehicle. In the example we have been considering, the grantor can create the FLP, contributing the entire value of the residence up to \$1 million per grantor but realizing no taxable event. The grantor, as

²⁹ IRS, Instructions for Form 3520.

³⁰ See, generally, John Shampton and David Ritter, *Avoiding the Rule Against Perpetuities With Foreign Based Trusts – Why, How and Whether (Ethically Speaking)*, JOURNAL OF FINANCE AND ACCOUNTANCY, (2009)

³¹ Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, VIRGINIA TAX REVIEW, Winter, 2009

general partner, can control the use of the property and can distribute limited partnership interests to the intended beneficiaries as gifts. The grantor may make yearly gifts of partnership interests up to \$13,000 in value to each family member (out of the indexed annual gift exclusion, currently \$13,000 for 2009).³² Thus, if there are four children and six grandchildren, the grantor could give \$130,000 in annual gifts to the limited partners, or a total of \$260,000 per year if the grantors are married.

Limited partnerships have been successfully used by Sam Walton for distributing and controlling Walmart stock. In 1953 when his business was starting to grow he created a family limited partnership which included his wife and their four children. He transferred his interest in Walmart to his children and when he died his stock went to his wife saving the family over \$13 billion in estate taxes.³³ An important planning feature of the FLP is that conditions on the limited interests may be used to prevent any heir from selling or otherwise diluting the interest of the entity as a whole, thus ensuring an ongoing entity to produce and distribute maximum revenues. This same feature can also ensure that a residence is retained for all future generations of the family and their enjoyment.

CONCLUSION

Undoubtedly, the ancient fiduciary relationship of grantor and trustee will again become a much-needed tool for tax and estate planning should the estate tax return in familiar or modified form in 2012. A traditional irrevocable trust has its uses in the tax planning arena, but so also does the specialized Qualified Personal Residence Trust (QPRT) allowed under IRS rules. The QPRT, among other benefits, permits the total avoidance – not just deferral – of imputed rental income on a principal and an additional residence for up to ten years, a feature not available to the “ordinary” trust. No strategy is perfect, however, and the QPRT features a significant downside – it can only be used to shelter imputed rental income and defer transfer of the property to beneficiaries for a predetermined period of ten years or less. It then passes to the putative heirs for their disposal, unless the grantor elects to pay fair market rent. Other tools can achieve other results. An irrevocable overseas trust, for example, could hold property for the benefit of future generations into perpetuity – far longer than the ten years allowed a QPRT, but can create other problems regarding the ownership of foreign assets or repatriation of offshore income. As in the past, the needs of the client remain paramount but the need for planning remains critical.

³² IRC § 2503(b)(2)

³³ Robert L. Mosham, Esq., *FLP vs. LLC & Sam Walton's FLP Estate*, THE ESTATE ANALYST (June 2008).

THE CASE OF BB&T AND *ATLAS SHRUGGED*: CURRICULUM FOR SALE?

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Abstract

The BB&T Charitable Foundation has donated over \$10,000,000 to institutions of higher education. In many cases the BB&T Charitable Foundation donation came with a stipulation of incorporating Ayn Rand's Atlas Shrugged into the curriculum. Is this a case of the free market economy taking control of the faculty domain – control of the curriculum? This case study explores this issue of target donations changing the curriculum at some higher education institutions.

Key Words

Commercialization of Curriculum, Faculty Control of Curriculum, Targeted Corporate Giving

The economic downturn is forcing higher education institutions to seek a greater proportion of its funding from private donors. (Cheslock and Gianneschi, 2008) As universities seek more non-governmental financial sources to meet their budgetary shortages from reduced public funding, the ethical issue of donation or influence peddling could become more prominent. A basic tenet of higher education is that the faculty controls and monitors the curriculum, which in turn guides the instruction of students. Is it ethical for outside forces to dictate specific content coverage in the curriculum as part of a donation? Since 2005, the Branch Banking and Trust (BB&T) Charitable Foundation, the philanthropic arm of BB&T Corporation, a regional bank headquartered in Winston-Salem, NC has made over \$10,000,000 in donations to colleges and universities. Many of BB&T's donations stipulate the receiving institution offer a course or curriculum requiring students read *Atlas Shrugged* by Ayn Rand (Kelly and Rexrode, 2008; Craver, 2008), support speakers, or establish a center that espouses the political philosophies of Ms. Rand, including objectivism, and the opportunity to examine the ethical and philosophical basis for free market economies (Yesko, 2006). See Table 1 for some examples of the donations that BB&T has made to institutions and the respective requirements for the donations, which includes both business schools and philosophy departments supporting curricular changes promoting Ayn Rand's beliefs. (www.guidestar.org) Is this Ayn Rand in action, where free market economy is taking hold in higher education curriculum? This case only discusses the ethical control of the curriculum and does not consider other types of donations which may have an ethical component, such as control of funded research results ("Survey", 2005), product placements on campus (Miller, 2003), or access to students or student information (Glater, 2009), or the funding of athletic endeavors. The following background information is relevant to this case study: how curriculum decisions are generally made in higher education is provided; key ethical guidelines used by universities in seeking donations; and issues related to curriculum and accreditation is presented. The case presents basic facts about the BB&T Charitable

Foundation and an introduction to the writing of Ms. Rand. Finally, two ethical issues are presented for readers to consider.

In higher education, curriculum decisions, including individual courses and programs, are almost always driven up from the faculty level to the board of trustees. The change, addition or deletion of curriculum usually begins with a faculty member or group of faculty. The premise is that faculty best know the discipline or field of study, including how the discipline/field is changing. Faculty know the pedagogy for structuring the courses or programs for student learning. The next steps in the review and approval process would be the academic department, the college, the university curriculum review committee, the faculty senate or conference, the highest academic office of the university (such as the provost), the president, and then the board of trustees. As with any type of organization, the final decision on any matter lies with the board. If there were curriculum program changes at a state university, the review process would likely also involve a state level assessment to insure that there are no overlaps or gaps in what offerings across the state system. When faculties are not involved in curricular change process, they will usually express their dissatisfaction. (Kelley and Rexrode, 2008; Thornton, 2008). Also, students can recognize concerns about “Academia being auctioned off to the highest bidder” (Stone, 2007). Clearly academic institutions do not operate as islands by themselves. Academic institutions that do not change to meet the ever-changing challenges relative to students, ideas, technology, etc. soon become stagnant and irrelevant. Regionally accredited academic institutions must have in place a due process to address the continuing challenges that relate to curriculum matters. The establishment of this due process is in part an effort by faculty to establish a structure to address curriculum changes in a manner that professoriate and administration can meaningfully participate.

While the faculty usually controls the curriculum, most universities have a development or advancement office that serves the university in fundraising. These offices seek donations from individuals, foundations, and corporations. The professionals in this area may belong to the Council for Advancement and Support of Education (CASE), which provides an extensive list of ethical standards and principles for fundraising (www.case.org). Three of the CASE ethical guidelines relate to donations made to control curriculum. First, the CASE Statement of Ethics says “nor do they solicit or accept favors for their institutions where a higher public interest would be violated”. In the traditional method of curriculum review and change, there is thoughtful (and sometimes lengthy) review of the impact of the changes to the students and the institution. In the situation where the donor drives the change, it is not clear how the review of the impact on public interest is considered. A related CASE ethical standard is part of the Principles of Practice for Fundraising Professionals at Educational Institutions, “pursue only gifts that fall within, or advance, the institution’s mission and/or approved priorities”. Again, it is not clear how the fit of the changes with the mission and other offerings of the institution would be reviewed, if the change were simply donor driven. However, if the institution accepts a gift with the donor’s requirement, then CASE’s Donor Bill of Rights states that the donor must “be assured their gifts will be used for the purposes for which they were given”.

Academic institutions that must change to meet the ever-changing challenges relative to students, ideas, technology, etc. or soon become stagnant and irrelevant. Regionally accredited academic institutions are required to have in place a due process to address the continuing challenges that relate to curriculum matters. The establishment of this due process is in part an

effort by faculty to establish a structure to address curriculum changes in a manner that professoriate and administration can meaningfully participate. In the Southeastern region of the country, the area where most of the BB&T contributions have been made, the accreditation standards of the Southern Association of Colleges and Schools (SACS) are applicable. At least two of those standards are relevant to the ethical issues surrounding BB&T's contributions. The Southern Association of Colleges and Schools (SACS) standard on Governance and Administration 3.2.3 states "The governing board is free from undue influence from political, religious, or other external bodies and protects the institution from such influence". In addition SACS's standard on Programs 3.4.10 reads "The institution places primary responsibility for the content, quality, and effectiveness of the curriculum with its faculty". Unlike narrowly focused trade or vocational schools, the mission of most universities is to provide students a broad spectrum of ideas and philosophies, thereby creating an environment where critical analysis and inquiry can take place, free from outside influence. The acceptance of gifts by universities contingent upon curriculum changes potentially threatens the *raison d'être* of higher education.

Without having access to the BB&T contractual agreement with the various institutions and the minutes of the various curriculum committees, it is not possible to determine whether these institutions may have violated SACS standards. However, a scale could ascertain whether the Universities complied with the standards. One end of the scale is compliance and the other end is noncompliance. Clearly, if there was not faculty approval of a curriculum-reading requirement, or a faculty member is simply told to include the reading in his/her class, SACS academics standards were violated. At the other end of the scale, faculty approved the curriculum changes without duress from administration in the form of carrots or sticks. In addition, the board must have approved these curriculum changes without "off the record or executive sessions" discussions of the potential donation lost if the curriculum change was not approved. Somewhere along the scale continuum, there could be situations where the potential loss of a donation did indeed influence the curriculum decision of the board and or curriculum committee. In addition, administrative duress could have played a role in an affirmative decision to include the material in the curriculum, particularly for an institution addressing budgetary challenges. Over the past several years, states have significantly reduced their funding for higher education (Cheslock and Gianneschi, 2008). As universities seek more non-governmental financial sources to meet their budgetary shortages, the ethical issue of donation or influence peddling could become more prominent. The fact that these universities accepted the donations is an *ex po* admission that their curriculums did not provide the broad spectrum of idea and philosophies necessary for the critical inquiry required of the students.

It is common for donors, such as alumni, to have their names associated with a university building or a program, but it is somewhat unusual for a donor to require that their funds dictate curriculum. As noted previously, BB&T Charitable Foundation donated to higher education institutions stipulating curriculum additions or changes. It is important to note BB&T Charitable Foundation is an IRS recognized tax-exempt foundation. BB&T Corporation operates in 11 states and Washington, D.C. with 1500 financial centers and \$152 billion in assets ("Facts and Figures", 2008). In 2008, J.D. Power and Associates recognized BB&T for their satisfaction ratings from mortgage customers. During the recent banking crisis, they have seen some decline in earnings, but not to the extent of others in their industry. John A. Allison, IV was named chairman and CEO of the bank in 1989, and he was the driving force in the bank's support of Ayn Rand's philosophies. He sent a copy of Rand's *Atlas Shrugged* to all employees who were

promoted to senior vice president or above (Rexrode, 2008), and he had a framed print from the cover of Rand's *The Fountainhead* outside his office (Craver). Mr. Allison retired at the end of 2008 as CEO, but he retains his position as Chairman of the Board.

As a follower of Ayn Rand's Principles, John Allison has said, "*I know from talking to a lot of Fortune 500 C.E.O.'s that 'Atlas Shrugged' has had a significant effect on their business decisions, even if they don't agree with all of Ayn Rand's ideas...It offers something other books don't: the principles that apply to business and to life in general. I would call it complete,*" (Ruben, 2007). Additionally, Allison argues for the virtues of profits, self-interest and production. His definition of justice, one of the core values of his firm, is that those who produce more, get more. He argues that Bill Gates would do more for the world improving Microsoft than running his foundation and giving away money. Allison praises *Atlas Shrugged* and refuses to let his bank make loans to companies that use eminent domain to acquire property (Allison, 2007).

Who was Ayn Rand? Ayn Rand was born in Russia and immigrated to the U.S. in 1926. She worked as a screenwriter and script reader in Hollywood, and her first play, *Night of January 16th* was produced on Broadway in 1935. Her third novel *The Fountainhead* was made into a movie, but her fourth novel *Atlas Shrugged* (1957) has been called her magnum opus, since it is over 1,000 pages has been widely read. While her novels have a fictional story imbedded in them, they were the conduit for her to espouse her philosophical beliefs, particularly the idea of objectivism. In 1964 she published the collection of essays, *The Virtue of Selfishness: A New Concept of Egoism*. Ms. Rand died in 1982, but her work continues through The Ayn Rand Institute, which provides training and support to help people understand and apply Ms. Rand's ideas and the distribution of her books.

Table 2 provides a comparison of some of the key terms from Ayn Rand's description of her philosophy of objectivism and key terms from the company information found on BB&T's web page ("Values," 2008). Many banking organizations would have similar terms in their columns, as they must be data driven, rely on rational management, provide returns for shareholders, and all parties must honor their agreements. The difference lies in what is missing. Listed below are the BB&T Corporation's 10 Values:

1. Reality (Fact-based)
2. Reason (Objectivity)
3. Independent Thinking
4. Productivity
5. Honesty
6. Integrity
7. Justice (Fairness)
8. Pride
9. Self-Esteem (Self-motivation)
10. Teamwork/Mutual (Supportiveness)

Consistent with the Rand Philosophy, the BB&T website (www.bb&t.com & <http://bbt.mediaroom.com/index.php?s=18&item=124>) does not mention any obligation for charitable support of less financially stable community members. The closest mention of support for others is "The community's 'quality of life' impacts its ability to attract industry for growth." In looking at the web pages of other regional banks that compete with BB&T, differences are

evident. First, the other banks provide more coverage to what they call the issues of community commitment, social responsibility, community involvement, and community investment. For example, “RBC Bank is committed to being a responsible corporate citizen. This affects the way we operate our business in terms of ethics and governance, how we treat our employees and clients, and how we care for the environment and society” (“Corporate Responsibility”, 2009 <http://www.rbcbankusa.com/company/cid-96909.html>). Another example, is from Southern Bank “We are dedicated to the communities we serve, both in spirit and support. We provide a progressive and rewarding working environment for our employees that encourage the investment of their time, energy, and talents to the betterment of their communities (“About Us”, 2008 http://southernbank.com/sbt808/phppages/aboutus_ourmission.php). These other banks not only mention company financial donations, but they also describe programs that encourage employees to donate time to a variety of causes including health organizations and the arts.

The BB&T Charitable Foundation pattern of giving requiring academic institutions use the philosophy of Ayn Rand in course raises the following questions:

- Should academic institutions allow outside influence on curriculum by donors?
- Is a donor promoting a political/social agenda different from any other donation, such as naming a building after an alumnus?

Date	Reference	University	Amount	Use of funds
6-5-03	<i>Black Issues in Higher Education</i>	Clemson University	\$1,000,000	BB&T Center for Economic Education and Policy Studies
5-6-08	<i>Morning Edition</i>	Marshall University	\$1,000,000	“courses at the business college based on the economic philosophy of Ayn Rand”
3-23-08	<i>Charlotte Observer</i>	UNC Charlotte	\$1,000,000	“ <i>Atlas Shrugged</i> is included in a course as required reading”
3-23-08	<i>Charlotte Observer</i>	N.C. State		“ <i>Atlas Shrugged</i> is included in a course as required reading”
3-23-08	<i>Charlotte Observer</i>	Johnson C. Smith Univ.		“ <i>Atlas Shrugged</i> is included in a course as required reading”
6-26-08	<i>Winston-Salem Journal</i>	Winston-Salem State Univ.	\$1,250,000	“Ayn Rand is required reading”
12-10-03	<i>Lexington Herald-Leader</i>	University of Kentucky	\$2,500,000	“speaker series and learning laboratory on capitalism...the moralism or the philosophy of capitalism”
1-11-06	<i>Europe Intelligence Wire</i>	Wheeling Jesuit University	\$700,000	“the teaching of free market capitalism”
12-8-06	<i>Dominion Post</i>	West Virginia University	\$1,750,000	“establish a BB&T Chair in Free Market Thought ...discussion of the moral foundations of capitalism”

12-9-06	<i>Daily Press</i>	Christopher Newport University	\$250,000	“the moral and ethical foundation of capitalism”
2006	<i>UFF</i>	University of Florida		“support ...an understanding of Ayn Rand's philosophy of Objectivism ... in the related coursework, speaker series, and research competitionsfoundations of Capitalism.”
11/2/06	<i>UNC Greensboro, Univ.Press Release</i>	UNC Greensboro	\$1,000,000	“course and to provide faculty members with curriculum-development grants for courses that advance students’ understanding of the moral foundations of capitalism.”
12/13/08	<i>The Roanoke Times</i>	Radford University	\$750,000	“the only assigned reading in the course will be Ayn Rand’s 1957 novel, <i>Atlas Shrugged</i> ”
10/30/07	<i>Collegiate Times</i>	VA Tech	\$1,000,000	“create a new undergraduate and graduate course where BB&T is allowed extensive freedom to choose the curriculum and syllabus”
Fall 2008	<i>College of Business Administration Newsletter</i>	University of Tennessee	\$1,500,000	“to increase student understanding of the moral foundations of capitalism.”

Table 1. Some Examples of BB&T Contributions and Their Respective Stipulations

Rand’s Objectivism	BB&T Company Information (www.bbandt.com)
Reality exists as an absolute – facts are facts.	Fact based management style.
Reason is man’s only way of perceiving reality, his only source of knowledge, his guide to action, and his basic means of survival.	Employees must be rational and objective.
Pursuit of self interest is the highest moral purpose of life.	Ultimate purpose is to create superior rewards for shareholders.
Capitalism is a voluntary exchange to mutual benefit.	Partners must keep their agreements.

Table 2. Comparison of Objectivism and BB&T

Teaching Notes

Case overview – this case covers the role of an outside donor influencing the business curriculum. In this scenario, curriculum coverage of a somewhat controversial subject, Ayn Rand’s *Atlas Shrugged*, is tied to a higher education institution receiving a donation. At a minimum, as part of the donation, students are required to read *Atlas Shrugged*, which at over 1100 pages would add considerable to any courses reading material.

From the authors’ perspective this is a viable teaching case because it begs the question – is it ethical for an outside source to control the curriculum, especially in a business ethics class. Or perhaps is the administration at fault for accepting this donation? What are the limits of acceptable donations? This case also has an application for other not-for-profit organizations.

As with most cases involving business ethics there is not one correct answer but many shades of gray. Answers can range from accepting BBT Foundation donations are completely ethical and appropriate to accepting BBT Foundation donations are egregiously unethical for higher education institutions. The answer is to be found in the discussion.

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THE ROLE OF SHARED VISION AND ETHICS IN BUILDING AN EFFECTIVE LEARNING ORGANIZATION

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ABSTRACT

With the demise of companies such as Enron and WorldCom it is no surprise that a call for ethical leadership is in high demand. This paper elaborates on the need for establishing ethics within a structured hierarchical culture. First, we will elaborate on organizational culture. Next, the following paragraphs explore the relationship of ethics and its connection with an organization's shared vision. We examine the military, and specifically the United States Army, as an example of a successful, high performing organization because of its emphasis on ethics as a major part within its collaborative environment. We seek to demonstrate that once ethics is part of a shared vision, organizational culture will have accountability that will ensure ethical decision making.

Keywords

Ethics, shared vision, learning organization, military hierarchy

Introduction

"Most definitions of organization consist of at least two components: (a) a source of order which consolidates, unifies, or coalesces diverse elements or fragments and (b) elements or fragments, which are consolidated, unified, or coalesced by a source of order" (Orton & Weick, 1990, p. 216). It is this source of order in which an organized structure is based. A need for security within this structure is obtained by a dependency on bureaucracy (Diamond, 1984). Organizational instabilities creates feelings of anxiety within the organization and a bureaucratic structure offers stability. The human perception of familiarity will always have influence on social norms, because humans feel most secure with what they know and understand. Having an organization with strict guidelines that influence behavior will establish and maintain organizational understanding.

An awareness or understanding of one's social foundations could develop into an intrapersonal security beyond that of what is served by the structured bureaucracy of the organization. Gioia and Poole (1984) state that "organizations present many predictable settings with reasonably predictable actions, events, and behaviors" (p. 454). They reference script processing or a conscience or unconscious decision making systems that will be based on the perceptions of one's surroundings and the information that it provides. These familiar situational patterns begin to develop a sense of security. The managerial decisions begin to form a cultural climate which, over a period of time, will further shape the organizational culture and set a strategic direction for the organization.

Schein (1990) references the dilemma in organizational understanding by stating "we need to find out what is actually going on in organizations before we rush in to tell managers what to do about their culture" (p.110). Organizational culture will be better understood and also influenced through management by an intensive observation of an organization's artifacts, values, and assumptions (Shine, 1990), which directly influences an organization's daily routine. It is the daily routine of individual interactions in the organizational environment that influences and continually shapes an organization's culture. The daily interactions of an organization's leadership with its workers is continually shaping the organizational environment and directs the organization's vision.

Shared vision

Liedtka (2007) emphasizes the importance of authenticity for achieving a "perceived" (p.246) strategic intent. Individuals often confuse what is real with what is being perceived. It is the managerial decision making and the behavioral examples set by those managers that can shape the reality to be consistent with organizational perceptions. Senge (1990 b) states the importance of organizational awareness as an ability to identify an organization's reality. This is required so a vision can be established. A clear understanding of the current reality is needed in order to motivate a group toward a vision or perhaps a change to a more ethical vision.

This ethical shared vision can be achieved by the understanding of the environment or the acute perceptions of one's own awareness as well as those around them. However, "bureaucracy's emphasis on compliance with rules, regulations, and procedures supports active security operations that often thwart effectiveness and encourages resistance to change" (Diamond, 1984, p.208). This resistance to change, within a highly bureaucratic environment prevents an organization from being adaptive, thus it loses its competitive advantage. It is this conflict that is the true challenge in the implementation of successful ethical leadership. Security is found in bureaucracy and an ethical shared vision may require a change of direction from the current environment that is so firmly established in bureaucratic surroundings.

Organizations must strive for organic or participative decision making to avoid the hierarchical control of the more mechanistic structure typical in bureaucratic settings. By "decentralizing" the decision making process, all individuals are part of the organization's strategic vision (Gordon, 2002, p.404). Change and adaptability are closely related in that they both serve the establishments of culture within an organization and are essential attributes for an efficient organization. Buytendijk (2006) states that a common characteristic amongst high performance organizations is the achievement of objectives through shared values, both internal and external to the organization itself. These shared values help bind the organization and create an environment ideal for adaptation.

The learning organization

The learning organization, a successful model for a high performing organization, is defined as "an organization that is continually expanding its capacity to create its future" (Senge, 1990, p. 14). There is no question that our economic society is forever changing and so must an organization to keep its competitive edge. (Hamel & Prahalad, 1989) Senge (1990), states that shared vision, personal mastery, mental models, and

team learning are essential disciplines or competencies that are needed to create an adaptive organization or learning organization. Winstanley and Woodall (2000) reference the "community of purpose" (p. 14) as an equilibrium standard in a learning organization. This purpose is one that is participative and is synonymous with a unified community; this is essentially defined as the shared vision. For establishing stability, or having equilibrium, it must be ethically sound. The unified ethical vision of the organization must be well communicated and understood by all participants of the organization. This understanding and communications comes from the organization's leadership. Naturally, this equilibrium can be disturbed by unethical managers who communicate their own self interest based message to the rest of the organization. Again, this is the challenge with highly structured organizations.

Personal mastery

The socialization of human capital in an organization needs to have an ethical standard in order for the organization to have continued adaptability and a successful strategic intent. To control the daily routines, a manager must possess a clear understanding of his or her decision making process. To be successful, this process must contain a strong ethical basis. Senge (1990) describes personal mastery as an essential discipline in the structure of the learning organization. Personal mastery is a detailed study of the intrapersonal skills of oneself. The concept to better oneself, ethically, will directly impact the entire society of which we interact. The ability to learn and understand ethical norms is critical to the learning organizations. "Organizations learn only through individuals who learn" (Senge, 1990, p. 139). One's continued ambitions, commitments, compassions, and intuition will no doubt shape the decision making process of an organization for the better. Knowledge of oneself is complex and a leader must "find a balance between expressing their personalities and managing those people they aspire to lead or at least influence" (Goffee & Jones, 2005, p.88). The leader, as they make decisions and influence those in the organization, must have an intrapersonal ethical standard.

Mental models

Mental models, another discipline that one will observe in a successful leaning organization, could simply be defined as the intuitive understanding and interactions of an organization in its environment. These are the successful interpersonal interactions that will aid an organization in its decision making process. Senge (1990), states "the learning organization of the future will make key decisions based on the shared understandings of interrelationships and pattern change" (Senge, 1990, p. 204). All managers possess a set of assumptions about their current working environments. The successful manager must be willing to inquire about their presumed environment and make corrective shifts in thinking for continued success. Relying on enhanced personal mastery will ensure authenticity with the organization's reality and keep actions consistent to set social norms that are easily identified as ethical. Research conducted by Armstrong and Foley (2003) concluded that: learning from surrounding environments, identifying, meeting and applying the developmental needs of employees, and applying learning in the workplace will have beneficial outcomes to an organization. A learning organization will facilitate an environment of adaptability gained from the understanding

of an environment filled with personal relations and human interactivity. Management has a great influence that clearly needs to communicate a shared vision of ethical norms.

Ethical decision making

Robert Gordon, a CEO of Dairy Farmers of Australia cited in Guttman (2007) stated:

It is a horizontal organization in which everyone operates by a clearly defined set of decision making protocols; where people understand what they are accountable for and then own the results. It means moving to an action-and results- driven workforce – not one that waits for instructions or trips over functional boundaries. (p.12)

"In today's changing environment, organizations that encourage individual ability and hold employees accountable for achieving goals are more likely to succeed" (Gordon, 2002, p. 409). Accountability is a key feature and is strongly rooted in ethical discussion. It is ethical decision making that plays a crucial role in an organization's strategic intent. Wriston (2007) cites both a collaborative environment and accountability as key components in a high performing organization. The participative environment "reinforces" (p.11) accountability. The team environment restricts a self serving vision and establishes the shared vision. If the environment is participative and the accountability is ethical, the shared vision will be communicated via the ethical standard set forth by management.

Adaptability

Organizational renewal or transformation is the process an organization is continually going through to adapt to its ever changing environment. "The renewing or transformational manager is constantly fighting atrophy and proactively building for the future" (Brown, Harvey, 2006, p.39). Spiritual leadership is the key to bringing an organization to an understanding of a shared strategic vision so important in the transformational and adaptability of an organization. Fry, Vitucci, and Cedill (2005) state "spiritual leadership theory as a model of organizational/professional development that fosters systematic organizational transformation from the bureaucratic to the learning organizational paradigm that seems to be required for organizations to be successful in today's chaotic, global, Internet age environment" (p. 859). Spiritual leadership is a key factor for motivating one's self and others "through a calling of membership"(p. 836). People on all levels of the organization must be empowered and have a sense of membership or belonging. Moving away from the traditional top- down management style associated with many functional organizations is the key for developing the high performance learning organization.

Collaboration

The success of the learning organization is for the bureaucratic structure to give way to collaboration and a goal oriented unity, particularly in decision making. A need for personal responsibility is increased as organizational decisions become less hierarchal and more participative. Hernandez (2007) states the importance of the manager's commitment to uphold a "broader commitment to societal and universal moral norms" (p.122). Those moral norms can be substantiated by members working within an

organization. Supported by a participative environment team members are more likely to act ethically if their leader is perceived as having a foundation in ethical behavior (White, Lean, 2008).

Social capital truly defines the behavioral interactions within the workplace. Adler and Kwon, (2002) reference many definitions of social capital which have a common likeness to: networking, relationship building, sharing values, and developing trust. This truly becomes the foundation within the organizational culture rich with participation. Employee and management behavior becomes deeply rooted in these ethical norms of trust, accountability, and value sharing. As a leader, one needs to establish a "collective-oriented society" (Ferraro, 2006, p.103) focused on the achievements and success of the organization where individuals are part of a collective whole.

Organizational wholeness, maximizing employee potentials, and creating an internal environment that encourages risk taking and experimentation must be communicated into the organization's culture. It is the values and ethics of the human capital within the organization that will drive this learning and adaptation to occur in a productive and strategically benefiting way rather than an organizationally threatening manner. Management will reward employees for effectively implementing their influenced directives. This results in keeping the momentum for the organizational wholeness intact. "The leadership role includes those symbolic actions concerning ethics and ethical behavior, and in ways in which followers perceive those actions" (Gottlieb & Sanzgiri, 1996, p.1278).

Spector and Lane (2007) point out that a high performance organization needs transparency, accountability, and dialogue. The shared vision of the organization and the communication of intrinsic values that will keep the organization competitive must become a part of the workforce culture. Charismatic leadership, as described by (Northouse, 2004), is very closely related to transformational leadership. A negative characteristic of transformational leadership is a "strong impression that the leader is acting independently of follower or putting himself or herself above the followers' needs" (p.186). The charismatic leader has the ability to focus others on a new strategic intent where accountability through collaboration become the checks and balances for motivating change.

"Cults often use coercive persuasion and establish a shared belief system to indoctrinate and retain their members..." (Spector & Lane, 2007 p.19). Enron may have appeared like a high performance organization however, their organization was lacking accountability. Lay and Skilling did not create an environment for long term success or a "sustainable society" (Spector & Lane, 2007 p. 21). Their own self interest and elitism was hidden by their charisma and ability to get their organization moving forward building on its own success. A lack of participation failed the organization because the moral character of the few could not have been influenced by the many. Also, the strict hierarchal control with no accountability allowed for the socialization process to be stifled, interpersonal and intrapersonal interactions were limited when dealing with organizational developmental issues.

Creating an environment of trust through accountability within a functionally structured organization, like the military, is a true challenge. Accountability will deter a cult like culture and decrease the chances for a demoralizing decline in organizational

performance. "Trust between the leader and follower facilitates a follower's ability to accept responsibility..." (Hernandez, 2007, p. 123).

The U.S. Army culture

Maloney (1981) stated that military culture at times can seem very similar in characteristics to a cult. "The trust soldiers and civilians have for each other and the trust of the American people, all depend on how well a soldier embodies the Army values" (FM 6-22, 2006, p. 4-2). Influencing others by gaining trust through one's interactions, based on firm ethical beliefs, will bind the organization and create collaboration. The military structure ensures that teamwork or a participative environment will decrease the occurrences of self interest biases or cult like interactions. Claudts (1999) concluded that goals and values in an organization need to be both goal and task oriented so all participants can engage in shared values. This would substantiate the axiom that an organization works as a sum of its parts. Garsombke (1988) states "militarism is then, an organizational culture itself, one in which managers collectively take military principles as their own beliefs and make assumptions, goals, and plans for organization based on military concepts, behaviors, myths, and language" (p.47). The misconception of these assumptions are associated with "win lose dichotomy, limited array of solutions, absence of creative/ innovation, authoritarianism, emotional traits: social irresponsible, impulsive, egotistic, treats/fear to control and deter, orientation towards violence and devaluation of human life" (Garsombke, 1988, p.51).

Learning organization leaders strive to "listen, experiment, improve, innovate, and create new leaders" with a participative culture (Fry, Vitucci, et al, 2005, p.840). Fry, Vitucci, et al (2005) referred to the Army of One recruiting campaign which promotes the following: each individual can make a difference, the soldier is strong in mind, body and soul, greatest strength is the united, physical, moral, and metal character of the teamwork in an Army of One organization, and personal growth, opportunity, and pride (p.840). Today's more recent recruiting campaign of Army Strong communicates the very same attributes of the American soldier. Thus, one can conclude that Army culture, as described by its recruiting campaigns, is similar to a learning organization.

Vogelaar (2007) states that for military commanders / leaders under the extreme pressures of the life and death situations are required to be a "thinking commander" (p.27). Leaders need to have the empowerment to make decisions in a changing environment but still have a sense of accountability or "stewardship" (Hernandez, 2007, p.122) from acting on his or her own self interest. Due to this accountability commanders often feel a need to have "in-depth insight" (p.38) and are reluctant to delegate authority. The hierarchical culture of the military also creates boundaries between subordinates and supervisors. When management dictates to lower levels of corporate hierarchy "employees fail to identify with corporate goals or involve themselves deeply in the work of becoming more competitive" (Hamel & Prahalad, 1989, p.160). Trust and empowerment of others in a team environment stimulates learning and adaptability.

Ethical standards, continued learned

It is essential that the military culture's non participative, highly authoritative misunderstandings give way to the realistic organic culture that is the accurate reality.

The organizational recruitment process must entail an ethical evaluation to determine if an individual is exhibiting ethical behavior and has the potential to understand and synthesize ethics as part of the socialization process. Training is also an essential part for ethics integration especially in larger organizations where socialization is spread over a large population. Ethical policy as a formal control is necessary (Grojean, Resick, Dickson, Smith, 2004). The Army values of: loyalty, duty, respect, selfless service, honor, integrity, and personal courage are first introduced to new soldiers during their basic combat training and from then on they are expected to live them every day in everything they do "whether they're on the job or off"

(http://www.goarmy.com/life/living_the_army_values.jsp). Ethical training will continue for the soldier's duration in the military and emphasis will be placed on these values as a structure for all decision making in the Army.

Education and continued learning is an essential objective in keeping a military organization ethical about its decision making. There is no question that in a combat environment there will be operational decision making that contains "gray areas" (p.16). VanVactor (2007) defines this gray area as operations that "are inherently complex, often very dangerous, and usually exceptionally fluid and dynamic" (p.133). VanVactor (2007) illustrates that the military risk management program has instilled a continued learning process by its evaluation and improvements process. The military is a learning organization continually adapting to its environment with a heightened sense for ethical standards ensuring accountability.

The Army, as a learning organization, harnesses the experience of its people and organizations to improve the way it operates. Based on their experiences, learning organizations adopt new techniques and procedures that get the job done more efficiently or effectively. Likewise, they discard techniques and procedures that have outlived their purpose. (FM 6-22, 2006, p. 8-3)

This can be further defined as a value system as part of the continued learning process directly affecting the decision making process.

Leader development is the deliberate, continuous, sequential, and progressive process, grounded in Army values that grow soldiers and civilians into competent and confident leaders capable of decisive action. Leader development is achieved through lifelong synthesis of the knowledge, skills, and experiences gained through institutional training and education, organizational training, operational experience, and self-development. Commanders and other organizational leaders play the key role in leader development that ideally produces competent, confident, and agile leaders who act with boldness and initiative in dynamic and complex situations. (AR-600-100, 2007, p. 4)

Liedtka (2007) states managers must "manage the rules of engagement in the strategic conversation, rather than controlling the content of the strategies themselves" (p.243). Liedtka (2007) places an emphasis that intrapersonal awareness or the "authentic self" (p.239) is more about actions. The example set by leaders has moral implications and can easily transcend into a participative environment.

Military culture can have an impact on today's corporate environment. As participation and collaboration on bottom up management becomes realized it is "assumed to increase morale and job satisfaction" (Cludst, 1999, p.160). The feeling of belonging can have an impact on the efficiency of the organization. This will only be in a

positive nature if the ethical norms that are being set by management of the organization are sound and in keeping with organizational goals. A shared vision will emerge as part of the organization's culture. The competitive advantage found in the shared vision will keep the organization agile and relevant as well as continued training on ethical values that communicate the organization's objectives.

Conclusion

In the complex environment of a high performing organization individual responsibilities are increased and a calling for ethical behavior is required. A competitive advantage needs to be communicated through the organization's shared vision. The manager must understand their awareness as well as the reality that exists in the organization to engage the employee's sense of belonging. The shared vision, which reflects participation from the entire organization, is an essential part of a high performing learning organization. Ethical decision making, if effectively communicated, can easily be accepted into the social norms of the organization.

The Army illustrates an excellent example of a learning organization requiring ethical behavior. The military, because of its strict hierarchical and functional nature, can easily develop many characteristics of a cult like culture. Due to the life and death situations and the rapidly changing environments of combat, it is essential that spiritual leadership is part of the charismatic attributes of the organization's human capital.

The necessary adaptability of decisions made by battlefield military commanders is similar to the changing environmental demands of managers working in our changing global economy. Participative environments are part of the high performing characteristics. For an organization to be truly high performing, ethical standards must be part of the cultural norms. Accountability and trust will deter any self interest and will further communicate an ethically based shared vision. Organizational involvement for all participants, both managerial and employee will flatten the hierarchical control and reduce self interest from influencing organizational goals. A participative culture allows for a sense of membership, continuity and commitment from its members, and acts as a guiding collation for a shared vision that will directly impact the strategic intent of the organization. To summarize ethical values and its impact on a participative shared vision the Army's leadership field manual (2006) states:

The Army values firmly bind all Army members into a fellowship dedicated to serve the Nation and the Army. They apply to everyone, in every situation, anywhere in the Army. The trust soldiers and civilians have for each other and the trust of the American people, all depend on how well a soldier embodies the Army values (FM 6-22, 2006, p.4-2).

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WORKPLACE BULLYING: AN ETHICAL CONTEXT APPLYING DUTY AND OUTCOME BASED APPROACHES TO HUMAN RESOURCE FUNCTIONS

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Abstract

Workplace bullying is a noted phenomenon that is sweeping across countries within various organizations. The workplace bullying concept is related to the field of ethics in that it involves identification, assessment, monitoring and control, and outcome evaluations. The authors present a workplace bullying framework within the context of ethics by presenting two approaches to workplace bullying including duty and outcome based reasonings. The underlying foundations of the approaches are further used to support a framework for preventing and mitigating workplace bullying issues. The authors discuss human resource functions and a workplace bullying policy that are enacted in order to assist organizations in avoiding litigation related to workplace bullying infractions.

I. Introduction

As applied in the modern corporate workplace, bullying may be characterized by activities such as “the gaggle of workers who go to lunch and snub one of their coworkers; the saboteur who undermines another’s success; and the employee who engages in the silent treatment or spreads rumors” (Gardner & Johnson, 2001, p. 23). Human resource professionals have stated that abusive or intimidating behavior is the most outlandish type of ethical misconduct currently happening in the workplace (Society of Human Resource Management, n.d.). Furthermore, these types of actions are more widespread and common than many may suspect. A poll conducted by Zogby International for the Workplace Bullying Institute reported that an estimated 54 million American workers (37 percent of the U.S. workforce) have been bullied at work (Deschenaux, 2007). That number would be increased to an incredible 71.5 million if it included the number of persons that witnessed the workplace bullying.

“Workplace bullying is more specifically noted as a repeated, health-harming mistreatment of one or more persons (the targets) by one or more perpetrators that takes one or more of the following forms: verbal abuse, offensive conduct/behaviors (including nonverbal) which are threatening, humiliating or intimidating, and work interference — sabotage — which prevents work from getting done” (Workplace bullying defined by the workplace bullying institute,” n.d.). Workplace bullying terminology has been synonymous with psychological violence, psychological harassment, personal harassment, and emotional abuse at work.

The phenomenon of workplace bullying is becoming more common nationwide and can be viewed within the lens of ethics. “Ethics is defined as rules of conduct or moral principles that guide individual or group behavior. The focus in business ethics is on awareness of organizational values,

guidelines and codes, and behaving within those boundaries when faced with dilemmas in business or professional work” (“Introduction to the Human Resources Discipline of Ethics and Sustainability,” n.d.). The ethical issue that is related to workplace bullying is whether the conduct that the bullying individual has engaged in is immoral and extends beyond organizational values, principles, guidelines or codes. Human resource professionals, including ethics officers, are charged with the responsibility of maintaining environments that demand ethical behaviors which include developing, monitoring, and enforcing ethics policies.

The practice of workplace bullying is not limited to the United States and has become more prevalent in other countries. The high occurrence of workplace bullying has been so pervasive that Australia and the United Kingdom have established a non-profit organization and a government task force to support mitigation of the behavior (Vega & Comer, 2005). For example, the United Kingdom has established the Andrea Adams Trust to promote awareness and support for workplace bullying. The trust serves as a model format for organizations in other countries. Australia has instituted a task force to study the trends in workplace bullying. The research by the task force documented the common behaviors of workplace bullying and included recommendations to mitigate workplace bullying including reminders about laws protecting employees. Research has also been widely conducted in Scandinavia documenting workers’ experiences with bullying.

Vega and Comer (2005) reported that workers in the United States “are marginally more comfortable with autocratic bosses than workers in the other countries studied” (p. 104). However, as workplace bullying becomes more prevalent in the United States, 16 states have some aspect of an anti-bullying Healthy Workplace Bill. In 2009, 12 states enacted some type of active legislation. However, the most aggressive part of these bills doesn’t require the employer to take any action. The employers may possibly avoid litigation if policies against workplace bullying are established and enforced.

This paper explores workplace bullying within the context of ethics by presenting two approaches to workplace bullying. The underlying foundations of these approaches are used to develop a framework for preventing and mitigating workplace bullying issues. The paper also discusses the human resource functions and policy that are enacted in order to assist organizations in avoiding litigation related to workplace bullying infractions.

II. Workplace Bullying Approaches

Human resource professionals, including ethics officers, need to incorporate policies and human resource functions that will not only prevent workplace bullying; but, also mitigate bullying once there has been an occurrence. When individuals are confronted with ethical situations, the individuals partake in a reasoning process that includes examining the situation in the context of ethical and moral convictions and standards. The reasoning has historically been grounded in theoretical approaches (Cross & Miller, 2009). The two theoretical approaches that guide the policies and procedures of organizations as well as the human resource functions include duty-based and outcome-based ethics.

A. Duty-Based Approach

The duty-based approach focuses on prevention of workplace bullying and the outcome-based approach is geared towards mitigating the act. Duty-based ethics is rooted in the idea that ethical dilemmas should be driven by the idea of “to whom do I owe a duty and what duty do I owe them” (“Deciding What’s Right: Ethics for Daniels Scholars,” n.d.). The main proponent of this framework was Immanuel Kant. “Kant believed that human beings are qualitatively different from other physical objects and are endowed with moral integrity and the capacity to reason and conduct their affairs rationally. Therefore, a person’s thoughts and actions should be respected” (Cross & Miller, 2009, p.88). The duty-based approach considers ethical dilemmas within the context of “fairness” and “respect” for others (“Deciding What’s Right: Ethics for Daniels Scholars,” n.d.).

The duty-based theory, as defined by Immanuel Kant, supports the idea that individuals have basic rights. The duty-based theory is focused on the idea that humans are different from other types of species and that humans are born with moral integrity and possess knowledge for reasoning and rationalizing. Thus, the rights of individuals, as it relates to workplace bullying, may include a place (1) that avoids insulting or bullying others; (2) that establishes policies and procedures that are applicable to all equally; and (3) that promotes the good of others environmentally (“Internet Encyclopedia of Philosophy,” n.d.).

A key factor in determining whether an act constitutes workplace bullying is how that act may impact the rights of others. The others in this situation include people who are either involved in the encounter or people that actually witness the incident. Thus, workplace bullying sometimes escalates to employees siding with the bullying party either by force or voluntarily (“Definition of Workplace Bullying,” n.d.).

Another consideration for duty-based ethics is that individuals should make behavioral decisions in light of the consequences if every individual in society acted similarly. For example, if one employee is deciding whether to engage in workplace bullying, the individual will decide not to engage in the bullying behavior because the workplace would be filled with the outcomes of numerous bullying events and the organization would not create value and thus not be a viable entity to continue to employ and terminate employees (Cross & Miller, 2009).

B. Outcome-Based Approach

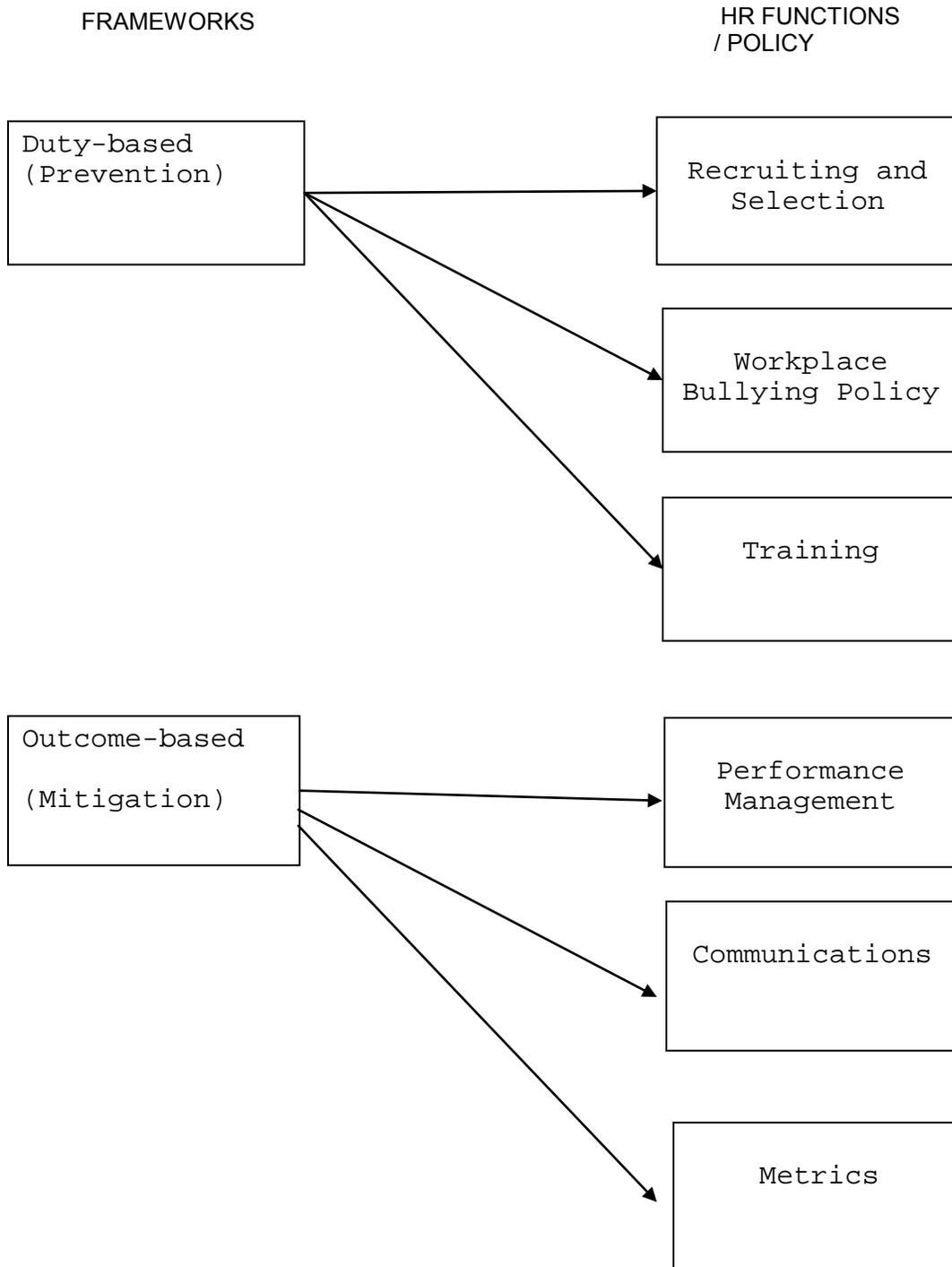
Outcome-based ethics is focused on benefitting people based on things that are good and bad. This would utilize the notion of “the greatest good for the greatest number” (Cross & Miller, 2001, p. 89). The underlying goal of this approach is to maximize good and minimize bad. This approach concentrates on the consequences of the act as more important than the behavior itself or moral values or rules. Thus, an act is morally correct if it benefits the majority in a positive manner and conversely morally incorrect if it impacts the majority of people in a negative manner. Two of the supporters of the outcome-based approach to ethics are Jeremy Bentham and John Stuart Mill. Both of the aforementioned supporters stress the following questions in ethical situations: (1) “What is my

goal?” and (2) “what outcome should I aim for?” (“Deciding What’s Right: Ethics for Daniels Scholars,” n.d.).

Outcome-based “focuses on the consequences of the action, not on the nature itself or on any set of preestablished moral values or religious beliefs” (Cross & Miller, 2001, p. 89). Additionally, applying the approach includes “(1) a determination of which individuals will be affected by the action in question; (2) a cost-benefit analysis, which involves an assessment of the negative and positive effects of alternative actions on these individuals; and (3) a choice among alternative actions that will produce maximum societal utility (the greatest positive net benefits for the greatest number of individuals)” (Cross & Miller, 2001, p. 89).

Some of the critiques of the outcome-based approach indicate that the reasoning associated with ethical or unethical practices is reduced to considering the pros and cons of actions that impact the welfare of employees (Cross & Miller, 2001)). In considering the pluses and minuses, the bullying act sometimes “undermines legitimate business interests when bullies’ personal agendas take precedence of work itself” (“Workplace Bullying Defined by the Workplace Bullying Institute,” n.d.). What follows is the authors’ workplace bullying framework that organizations should adopt in order to prevent and mitigate the impacts of workplace bullying. The details of the framework are discussed in section III of this paper.

Figure 1 Workplace Bullying Framework



III. Workplace Bullying and Human Resource Functions and Policy

Human resource professionals play key roles in preventing and mitigating workplace bullying situations. One of the most important factors in mitigating workplace bullying is if organizations are viewed by employees as proactively promoting a workplace free bullying environment (Caponecchia & Wyatt, 2009). If workplace bullying environments are allowed to continue to perpetuate “a cycle of demoralization begins; the victim may feel incompetent to combat or even confront the bully. As the victim becomes less and less confident, the bully pushes more and more. This cycle often continues until the victim gives up and resigns” (Vega & Comer, 2005, pp.105-106).

Bullying can also impact employees’ health and well-being. Thus, it is not only important to discuss and mitigate workplace bullying, but it also important to identify the impacts of bullying. Impacts to workplace bullying not only include costs to employees and organizations but also costs to society. The costs to society may include “unemployability, disaffection, and court involvement” (Vega & Comer, 2005, pp. 106-107). To alleviate or minimize the impact of workplace bullying human resource professionals need to be involved in ensuring employees’ behaviors are aligned with ethical practices. Human resource professionals need to manage the performance review process and the communication flows to ensure alignment with expectations (Krell, 2010).

Some authors suggest that there are motivating and enabling structures and processes that support the likelihood that workplace bullying will occur. These structures and processes include low perceived costs, reward system and expected benefits, perceived power imbalances, and dissatisfaction and frustration (Salin, 2003). Human resource professionals need to align their policies and functions to prevent and mitigate the aforementioned motivating and enabling structures. Additionally, human resource professionals need to be aware that creating and maintaining a workplace free of bullying is predicated on the behaviors and attitudes of the senior leadership team. For example, employees usually follow the leadership of senior management and if employees see management adhering to workplace bullying policies and procedures then workers will more than likely adhere to the policies as well (Cross & Miller, 2009).

The human resource management department, in consultation with the legal department/advisor, is charged with creating a culture and environment that does not foster bullying activities. The culture includes noting that workplace bullying behaviors will not be tolerated and may result in dismissal depending on the severity of the infraction. Duty-based approaches to handling workplace bullying issues include recruiting and selection, policy, and training functions. Outcome-based approaches to combating workplace issues include performance management, communications, and metrics.

A. Duty-based Approaches To Handling Workplace Bullying Issues

1. Recruiting and Selection

Recruiting and selection is one of the key human resource functions that can be used to defray workplace bullying issues. As employees are screened and interviewed, organizations should communicate the expectation about personal behavior within the workplace. This communication

includes apprising prospective new hires that courteousness, politeness, and respect are mandatory in the workplace (Vega & Comer, 2005). This expectation should not only be communicated but should also be modeled and targeted as one of the activities that the organization mandates a zero tolerance mandate. Thus, the zero tolerance rule is sending a message related to the importance of not allowing workplace bullying issues. Additionally, background and reference information should be checked and verified in order to gleam whether there has been past infractions or there is a chance for future infractions (Glendinning, 2001). The recruitment and selection functions should be focused on bullying as an important organizational issue and as such should be identified and prevented (Wyatt, 2009).

2. Workplace Bullying Policy

A workplace bullying policy (sometimes called code of ethics) serves as a means to prevent bullying behavior, raise awareness to behaviors, legitimize dialogue about what constitutes bullying, and to provide an avenue for enforcement related to accountability for one's actions (Society of Human Resource Management, n.d.). The behaviors may be intentional or unintentional. A policy serves as a key resource for employees before, during, or after a bullying encounter. Additionally, a policy describes the general value systems, principles, and practices of an organization.

Salin (2003) states that "if there is no policy against bullying, no monitoring policy and no punishments for those who engage in bullying, it might be interpreted that the organization accepts it, and a possible perpetrator will perceive the cost and dangers of bullying as very low (pp. 1220-1221). Thus, a written bullying workplace policy needs to include a statement about what constitutes bullying behavior including verbal, physical, gesturing, exclusion, and cyber-bullying. Additionally, the policy needs to include a statement of the purpose of the policy which is to communicate the policy including repercussions for noncompliance that may extend for a verbal or written reprimand to termination. The policy also needs to give examples of bullying and a few are listed below.

- **“Verbal Bullying:** slandering, ridiculing or maligning a person or his/her family; persistent name calling which is hurtful, insulting or humiliating; using a person as butt of jokes; abusive and offensive remarks.
- **Physical Bullying:** pushing; shoving; kicking; poking; tripping; assault, or threat of physical assault; damage to a person's work area or property.
- **Gesture Bullying:** non-verbal threatening gestures, glances which can convey threatening messages.
- **Exclusion:** socially or physically excluding or disregarding a person in work-related activities". (Workplace Bullying Policy, n.d.)
- **Cyber-bullying:** "Use of information and communications technology to support deliberate and hostile attempts to hurt, upset or embarrass another person. Examples

include sending abusive e-mails and phone calls, posting comments on websites such as Facebook or Twitter, hacking into other people's accounts and sending viruses" (Personneltoday, 2009).

The cyber-bullying workplace policy needs to include recent, effective information technology processes and procedures and specific consequences for non-compliance (Personneltoday, 2009). For example, one section of the policy should state that employees should not post comments on websites such as Facebook or Twitter at work. The policy should also indicate that the behavior of this matter may be considered as gross misconduct and could result in dismissal. Additionally, if the cyber-bullying behavior "involves illegal content or contains threats of a physical or sexual nature, employers should inform the police" (Personneltoday, 2009). Other preventative practices to avoid cyber-bullying include: (1) protecting employees passwords, pins, and contact information from other employees and other non-employees; and (2) being aware that online conversations are not confidential and can be copied, printed, and disseminated (i-SAFE America, n.d.).

One important aspect that should be enacted as it relates to policy is that the policy should be consistently enforced across all individuals within an organization (LaVan & Martin, 2007). Another consideration that is related to policy execution is a nonretaliation policy to safeguard against employees who report a perceived workplace bullying infraction (Society of Human Resource Management, n.d.).

The Sarbanes-Oxley Act of 2002 requires organizations to develop a means to report workplace bullying and an anti-retaliation statement that must be communicated to the employees ("Introduction to the Human Resources Discipline of Ethics and Sustainability," n.d.). For example, some organizations enact hotlines to report violations of the workplace bullying policy confidentially or anonymously. Additionally, the hotline will allow employees to report the issues to a third party (Krell, 2010). A written nonretaliation policy also needs to be communicated to employees before and after a perceived workplace bullying infraction has occurred.

3. Training

A workplace bullying policy not only needs to be developed and communicated, but the policy also needs to be enforced through training. Training awareness programs need to expose and reinforce employees to the policies as well as the behaviors that constitute workplace bullying. Administrative training needs to also be conducted for supervisors and higher levels within the organization. For example, administrative training topics may include "proper use of grievance procedures, and training in issues of confidentiality, conflicts of interest and due process" (Caponecchia & Wyatt, 2009, p. 446). The training needs to be ongoing and tailored to the roles of the employees.

Another aspect of training may include the awareness and training of peer listening individuals. These individuals need to be trained to support employees who have experienced workplace bullying by expressing compassion and communicating policies and procedures (Vega & Comer, 2005). The peer listening staff are recruited, selected, and trained to serve as compassionate counselors.

B. Outcome-Based Approaches To Combating Workplace Issues

1. Performance Management

Human resource professionals and appraising staff need to ensure workplace bullying goals are tied to annual performance reviews. As performances are assessed and rewards and benefits are allocated, organizations need to be careful not to promote an employee that has achieved by manipulating or harming other employees (Salin, 2003). Appraising staff need to also consider the performance goals that are assigned to employees. For example, managers can minimize the likelihood of unethical bullying behavior by setting realistic performance goals including production and sales quotas. Some employees may view the goals unrealistic and feel the need to succeed at the expense of bullying others to steal old or new customer sales as well as to increase productivity. Thus, the employee feels that the performance goals can only be met through high-pressure, unethical tactics (Cross & Miller, 2009). Additionally, in organizations that institute force ranking of employees, there should also be caution as not to support one employee sabotaging another in order to receive a higher rank.

Disciplinary actions need to be tied to the performance appraisal process (Krell, 2010). Appraising staff should not ignore the workplace bullying transgressions. The staff needs to show employees that bullying will not be tolerated and as such execute consequences for behaviors. For example, workplace bullying actions need to be documented in the performance appraisal as well as the disciplinary actions associated with the behaviors. For example, some organizations enact disciplinary actions that range from dismissal of the employee to a verbal warning depending on the degree of bullying.

2. Communications

The human resource professionals may use ethics issues for lessons learned in communications and training (Krell, 2010). This communication includes defining exactly what is included as workplace bully and reporting the number and types of bullying incidents. The communication may also include other metrics including “whether turnover, absenteeism rates, productivity, benefit costs, and recruiting and retention issues could be tied to bullying problems” (Business and Legal Reports, Inc., 2008). The communications may include disseminating the types of workplace bullying issues that have occurred as well as implementing ethics hotlines. These practices may serve as avenues to remind employees that the organizational climate does not condone that one dissatisfaction and frustration transferred to intentional or unintentional behaviors.

Communication needs to also include feedback from employees and not just information from employers disseminated to employees (Business and Legal Reports, Inc., 2008). For example, employees need to listen to feedback from employees as it relates to workplace bullying in the environment. The feedback can be obtained from exit interviews, fellow co-workers, managers and supervisors, as well as from customers and clients. Additionally, organizations may conduct periodical open forums in which employees communicate their workplace bullying experiences. For

example, the employees openly discuss workplace bullying infractions without any negative consequences and the human resource professionals share the organization's policies and procedures as it relates to solving the bullying issues.

3. Metrics

Organizations need to track the costs that are associated with workplace bullying issues (Glendinning, 2001). These costs justify implementing policies and human resource functions to defray workplace bullying situations. These costs may include (1) a rise in health insurance premiums and employee absences due to stress-related or other health issues, (2) reduced productivity, (3) legal remedies sought by bullied employees, and (4) additional costs to recruit and hire new employees to replace bullied employees (Glendinning, 2001).

Workplace bullying metrics need to also consider the rewards and benefits structures outlined in the performance review process (Salin, 2003). Metrics need to be tracked to see if there is a correlation between employees that are ranked high in performance and whether those same employees are involved in a workplace bullying incident. High ranking employees may result to bullying or sabotaging the work performance of co-workers to improve ranking. The aforementioned example is indicative of work environments that foster a culture of power imbalance.

Another major cost that is sometimes overlooked when considering the impact of workplace bullying is the cost associated with losing the individual bullying (Glendinning, 2001). These individuals are often slated for senior leadership positions and if and when the bully leaves there are impacts to succession planning. The bullying party usually holds a position of high authority and in most situations has been mentored and professionally developed for other future leadership positions within the company.

IV. Conclusion

There has been a prevailing amount of press coverage dealing with workplace bullying issues. Much of the press has been garnered based on a "unison survey suggesting that bullying at work has doubled in the past 10 years, with one in three staff claiming they've been bullied in the past six months" (Thomas, 2010, p. 4). Human resource professionals need to look for ethical guidelines within and outside of the organization in order to develop the organization's overall strategic approach to preventing and mitigating workplace bullying. Since 2003, 28 states have some aspect of an anti-bullying Healthy Workplace Bill. However, the bill does not require the employer to take any action. Thus, it is incumbent upon the organizations to enact policies and human resource functions to prevent workplace litigation issues.

Workplace bullying infractions need to be mitigated because of the impacts to the organization, employees, and society. Bullying can result in poor company moral, absenteeism, low productivity, overall poor job performance, unemployability, and court involvement. Thus, human resource practitioners need to not only consider recruiting and selection, a workplace bullying policy, training,

performance management, communication, but also metrics tracking and reporting. Metrics tracking and reporting should be ongoing and should be refined based on the issues reported within the organization.

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FOOD FOR THOUGHT: THE ASSESSMENT OF BUSINESS ETHICS

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*“Our output is not teaching; it is, in fact, student learning.”
(AACSB, 2005, ¶ 2).*

As educators, we have strived to teach our students about ethical and unethical behavior. However, the teaching involved more than simply reciting current events. We desired to teach our students to behave ethically. This has been an ominous task.

Ethics, especially business ethics, is in crisis. There were obviously many ethical problems prior to Enron, but for this generation of students, that is the controversy which initiated them into the topic of business ethics. Enron's exploits read like a soap opera (Ludlum and Moskalionov, 2008). On the heels of Enron, came Worldcom, Tyco, the automobile industry, executive bonuses, the foreclosure crisis, the Wall Street financial crisis, and the list grows and grows. Some people will not behave ethically, and society must be ready to correct unethical behavior through legal constraints. In fact, much of consumer protection law, and shareholder protection legislation, such as the recent Sarbanes-Oxley in the U.S., has occurred because of ethical abuses by businesses (Robin, 2009).

Recent studies in the United States shows a link between unethical views during college and unethical behavior in the workforce (Nonis and Swift, 2001a; 2001b; Knotts, Lopez and Mesak, 2000; Sanders, 2002; Silver and Valentine, 2000, Johns and Strand, 2000; Rawwas and Isakson, 2000). These preliminary findings point to the importance of this line of research. The attitudes students have now translate into behaviors they will have in the business world. “Today's college students will be the next generation of business employees, owners, managers, and regulators” (Ludlum, Moskalionov, and Machiorlatti, 2008 at 1).

Accordingly, if we as educators are to have any effect on business students' views of ethics, we had to be pro-active. The curriculum changed rapidly. Schools mandated ethical components and separate ethics classes. Textbooks entitled “Business Ethics” emerged from every publisher. However, few had anything in common.

At the same time, but influenced by other events, the accrediting bodies demanded that business schools assess the results of their teaching. Administrators wanted to know that their students were getting a quality education, which matched or exceeded the expectations of peer institutions. The academic community, divided by discipline, generated tons of data, spreadsheets and reports, and the discipline of business ethics was no exception.

However, our eagerness to jump into the fray on business ethics, and the subsequent need to assess that process has resulted in some impulsive actions. Three large questions loom. What are we teaching in business ethics? How can we assess that process? Finally, does the final result look like our original justification for action? I suggest that our results do not look anything like our original intentions.

First, what is ethics? Academics have developed science-based models to explain business ethics behavior but have done so without a universal definition of “ethical” (Robin, 2009). For example, business disciplines have developed useful science-based models of how and why business people behave ethically using personal views of what the concept “ethical” means (e.g., see Ferrell et al., 1989; Goolsby

and Hunt, 1992; Hunt and Vitell, 1986, 1993; Jones, 1991; Trevino, 1986). These models lack a universally agreed on definition of “ethical.” Our discipline needs a consensus.

Second, why is assessment of ethics important? The Association to Advance Collegiate Schools of Business (AACSB) International and other professional accreditation agencies are placing a high priority on assessment (Stivers & Phillips, 2009). The AACSB has adopted Palomba and Banta’s (1999) definition of assessment: “Assessment is the systematic collection, review, and use of information about educational programs undertaken for the purpose of improving student learning and development” (p. 4).

Third, can we assess ethics? Most assessment occurs with pencil and paper tests. In business ethics, this would be questions about the definitions of the principle of rights, utilitarianism, etc. We cannot test for business ethics knowledge. The field of business ethics has not developed a generally agreed upon body of knowledge or an applied ethical perspective for the discipline (Robin, 2009). While there are a multitude of books on business ethics, there is no unified body of knowledge on the subject. Each book seems to take its own approach, with many of the “textbooks” being a collection of readings and cases used to illustrate certain points.

Within other business disciplines, as well as the physical sciences, social sciences, and the humanities, there are usually many textbooks on the subject that are very similar and deliver the mostly unified body of knowledge in their areas. There is nothing similar in business ethics (Robin, 2009). There is no universal, specific formula for establishing the boundaries for business ethical commitment. Only a general guideline can be created, and that guideline must be applied within the specific history, time, and context of the situation (Robin, 2009).

Finally, assessing ethical knowledge should not be our goal. Ethics cannot make the lives of people perfect, but ethics can prevent, or decrease the amount of, certain harms. Business ethics can and must provide an approach for improving the lives of the stakeholders who live in an imperfect world (Robin, 2009).

There is a great deal of research on business ethics and attitudes towards different behaviors (see Ludlum, Moskalionov, and Machiorlatti, 2008; Ludlum and Moskalionov, 2005; 2004; 2003; and Ludlum and Ramachandran, 2007). There are hundreds more research papers involving a variety of tools and scenarios testing undergraduate and graduate students. This type of applied assessment will be far more telling than quizzing students to see if they know a definition for utilitarianism.

It is imperative that business schools provide students with the skills and competencies that organizations seek in their employees (Abraham & Karns, 2009). Porter and McKibbin (1988) discussed that business school graduates are not considered well prepared for employment in business following undergraduate school education. Many researchers have echoed this contention (Barksdale, 1998; Bennis & O’Toole, 2005; Campbell, Heriot, & Finney, 2006; Ghoshal, 2005; Mintzberg, 2004; Moberg, 2006; Pfeffer & Fong, 2002).

This is not meant to be an indictment of current business ethics teaching and practices. However, as the body of knowledge starts to develop, we need to be certain what needs to be taught to our students and share the best methods for that process. This will not be the last word on the subject. It is hoped that this discussion will encourage others to contribute to the discussion about our goals and practices in the process of teaching business ethics.

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Notes for Authors:

The focus of the **Southern Journal of Business and Ethics (SJBE)** is to examine the current trends and controversies in business, law and ethics, both domestic and international. In addition, future issues will include a new section, *Short Notes*, which will consist of shorter articles focusing on pedagogical ideas for the new business law instructor.

All authors promise that any submission is original work, and has not been previously published.

Since the topics of **SJBE** cross into many different academic areas, the **SJBE** does not have a specific format. Authors are free to use Chicago style, Harvard style or the APA, as long as the application is consistent throughout the paper.

The maximum size for a paper is twenty pages, all inclusive, single spaced. Articles substantially longer will need to be edited.

All submissions should include a complete copy (with author identification) and a blind copy (with author identification left blank).

All submissions are electronic, in MS-Word format. No paper copies will be reviewed or returned.

Artwork is discouraged. Tables and charts should be kept to a minimum and should be included in an appendix following the paper.

Submissions deadline is 45 days after the SALSBS spring meeting each year. Articles sent after the deadline will be reviewed for the next issue, or may be withdrawn by the author and submitted elsewhere.

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