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# SOUTHERN JOURNAL OF BUSINESS AND ETHICS

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**From the Editor-in-Chief. . . .**

This is the 3<sup>rd</sup> 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>.

One important update for this year, SJBE has been included in Ebsco Host services, allowing for full text search on most university library systems! This provides a great benefit to our authors and readers!

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 third 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.

Many of the papers herein were presented at the Southern Academy of Legal Studies in Business meeting in San Antonio, Texas, March, 2011. Congratulations to all our authors. I extend a hearty invitation to the 2012 meeting of the SALSb in San Antonio, Texas, March 8-9-10, 2012.

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](http://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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## MANAGING FEDERAL ESTATE TAX LIABILITY WITH TEXAS FAMILY LIMITED PARTNERSHIPS

DAVID RITTER \*  
JOHN F. SHAMPTON \*\*

### INTRODUCTION

*Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.<sup>1</sup>*

The Family Limited Partnership in Texas has, for many years, been known as a useful estate planning tool. With the temporary expiration of the federal estate tax in 2010 (and the adoption of the Texas Business Organizations Code<sup>2</sup>), it might well have been speculated that the era of the FLP was over. Whether this attitude was correct or not, however, the return of the estate tax in the form of a two-year interim imposition leads us to re-examine the use of the FLP and conclude that it does, in fact, have a potentially useful role in reducing the net taxable value of an estate. This outcome is a product of basic valuation concepts applied from the field of financial economics, allowing the use of the FLP to reduce tax burdens as well as facilitate preservation and control of family businesses (the traditional strength of the FLP). In addition, the FLP can even provide a bonus in the form of a modicum of protection against claims unrelated to the FLP's business.

Financial theory calls for increased rates of return on investments that present higher levels of risk. This "risk premium" can be expressed in the form of higher dollar returns or, alternatively, as a lower value for the asset in question. Thus, even the IRS concedes that the valuation of assets placed in an FLP is negatively affected by the difficulty of transfer of such limited partnership interests (sometimes referred to as "liquidity risk") and by the lack of control

\* DBA, Associate Professor of Accounting, Texas A&M University Central Texas, Killeen, Texas.

\*\* PhD, Adjunct Professor of Finance and Economics, Texas A&M University Central Texas, Killeen, Texas.

<sup>1</sup> *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) (Learned Hand, J.), aff'd 293 U.S. 465, 55 S.Ct. 266.

<sup>2</sup> Wassdorf, Lorna and Carmen Flores, LLCs AND PARTNERSHIPS, THE VIEW FROM THE SECRETARY OF STATE'S OFFICE, (2010).

resulting from the nature of that vehicle. Both of these features support discounting the value of the assets in question for estate tax purposes – the only issue for the Service is by how much.<sup>3</sup>

### **LIMITED PARTNERSHIPS IN GENERAL.**

Although well known in Texas (and the several states that have recognized the FLP or its equivalent) under the specific name “Family” Limited Partnership, the word “family” cannot be found in the BOC or its predecessor, the Texas Revised Limited Partnership Act (RLPA).<sup>4</sup> A Family Limited Partnership is, in fact, distinguished from an “ordinary” Limited Partnership only by its use and not by any detail of its formation or other legal characteristic.

Historically, a partnership is a creature of the common law coming into existence upon the mutual agreement of two or more persons to act in concert to do business without any formality or even an express agreement. The overarching characteristic of a partnership is the “joint and several” liability of the partners—an obligation that makes each partner responsible not only for an express share of the partnership’s liabilities (“joint” liability) but also personally responsible for the totality of the debts and obligations of the partnership (“several” liability). The common law of partnerships relies on a concept of mutual agency that, in essence, turns the group of partners into a single “individual” with personal liability for anything done by the whole or any of its parts. While this is not necessarily an unreasonable mode in which to do business, it clearly would not appear entirely safe to an outside investor. Any person not directly involved in the business who would nonetheless be required to assume the joint and several liability of a partner in order to participate as an equity owner, would be justified in balking at the potential for unforeseen loss.

Accordingly, the goal of achieving a combination of corporate-style limitation of liability with partnership pass-through taxation led to the legislative creation of the Limited Partnership, greatly facilitated by the Uniform Limited Partnership Act of 1916, promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL).<sup>5</sup> As the Commissioners observed:

The business reason for the adoption of acts making provisions for limited or special partners is that men in business often desire to secure capital from others... One of the causes forcing business into the corporate form, in spite of the fact that the corporate form is ill suited to many business conditions, is the failure of the existing limited partnership acts to meet the desire of the owners of a business to secure necessary capital under the existing limited partnership form of business association.<sup>6</sup>

Since the BOC became finally effective for all Texas Limited Partnerships as of January 1, 2010, it would be appropriate to examine the provisions under that act rather than the prior law.

<sup>3</sup> See, e.g., *McCord v. Commissioner*, 120 T.C. 358 (2003), *Lappo v. Commissioner*, T.C. Memo. 2003-258, and *Peracchio v. Commissioner*, T.C. Memo. 2003-280, discussed below.

<sup>4</sup> VTCS Art. 6132a-1.

<sup>5</sup> Kleinberger, Daniel S., *A User's Guide to the New Uniform Limited Partnership Act*. Suffolk University Law Review, Vol. 37, p. 647, 2004, at SSRN: <http://ssrn.com/abstract=862824>. Author retains copies.

<sup>6</sup> Comments, Uniform Limited Partnership Act of 1916

Fortunately, there is very little difference. A Limited Partnership under the BOC is a partnership that is comprised of one or more general partners and one or more Limited Partners.<sup>7</sup> The general partners have the same powers duties and obligations—and, most importantly, joint and several liabilities—as any general partner.<sup>8</sup> Limited Partners, however, assuming they fulfill the other requirements of the code, will bear no liability for partnership debts or obligations.<sup>9</sup> This limitation of liability can be claimed only if the Limited Partner refrains from any participation in the conduct of the business of the partnership.<sup>10</sup> The BOC does, however, restrict liability on Limited Partners to claims based on the agency law concept of “apparent authority”, that is, the Limited Partner is liable only to persons transacting with the partnership under the reasonable belief that the Limited Partner is a general partner.<sup>11</sup>

The usefulness of the Limited Partnership as a vehicle for estate planning purposes lies in the ability of the contributor to relinquish ownership of assets, including a functioning business, but at the same time maintain control and assure the integrity of closely-held businesses or investments having value as a going concern. The Family Limited Partnership (FLP) thus provides several attractive estate planning options such as:

- Preservation of a family business as a going concern after the death of the grantor,
- Providing for continued direction and control of the business during the life of the grantor,
- Preservation of the family estate without diminishing the estate corpus with each succeeding generation,
- Providing for the training of successive generations of management during the life of the grantor,
- Avoiding court supervision of the distribution of a business in the event of an intestate succession,
- Protecting the Limited Partner’s share of the assets as a consequence of a divorce or litigation,
- Valuation discounts when transferring the assets by gift or sale to family members.

Not surprisingly, the Internal Revenue Service has been troubled by the potential for abuse and distortion of values that can be presented by such a versatile tool. In particular, the use of the FLP to reduce or avoid estate and gift taxes by unreasonably lowering asset values has been a significant source of concern.

### **RISK, RETURN AND NET TAXABLE ESTATES**

As suggested, one of the more valuable traits of the FLP is its ability to reduce asset valuation. This results from the fundamental relationship between risk and return and the effect of that relationship on asset pricing in portfolio theory. Among other particular financial characteristics

<sup>7</sup> BOC Sec. 1.002(50).

<sup>8</sup> BOC Sec. 153.152.

<sup>9</sup> BOC Sec. 153.102.

<sup>10</sup> Id.

<sup>11</sup> BOC Sec. 152.102b. The provisions of the BOC with regard to the duties and obligations of partners and, in particular, the formation, management and control of the limited partnership are found in Chapter 153 of the BOC. A lengthy discussion of these mechanical requirements is beyond the scope of this paper.

of small businesses (closely held or otherwise subject to control by a relatively small group of persons), equity analysts recognize that in such operations the right of control represents a material determinant of the value of the equity interests, commonly referred to as the “control premium.”<sup>12</sup>

Simply stated, the lack of control presents a possibility of mismanagement of the business (at least in the eyes of the minority owner who does not have control), a situation immediately recognizable as a source of risk. Financial asset valuation theory requires that any source of risk be compensated by an increase in the required rate of return. When all other things are equal, an increase in the required rate of return from an asset requires a decrease in its price.<sup>13</sup> In other words, placing the family business in the Limited Partnership results in a loss of value—at least for estate and gift tax purposes.

Furthermore, limitations placed on the ability of the owners to transfer their interests in the partnership whether resulting from provisions of the law or requirements of the partnership agreement,<sup>14</sup> reduce the ability to resell or market the interests. Again, basic principles of finance demand that the value of these interests be reduced to reflect this illiquidity. Judicious use of these control and liquidity limitations can result in significant reduction in net asset value for estate and gift tax purposes.

### **IRS CHALLENGES TO FLPs**

Prior to the adoption of sections 2703 and 2704 of the Internal Revenue Code,<sup>15</sup> the IRS battled mightily, but generally ineffectively, to prevent the significant reduction of taxes arising from the use of control and marketability discounts for assets in FLPs. The courts apparently were unwilling to distort the established law governing limited partnerships merely because otherwise valid financial principles could be used to avoid or defer estate and gift taxes. The Service seemed especially concerned about the ability to render marketable securities unmarketable by conveying them to a Limited Partnership that provided restrictions on the transferability of its Limited Partnership shares. In addition, IRS challenges were aimed at Limited Partnerships that the Service deemed no more than testamentary schemes.

The first line of attack pursued by the IRS was on the basis of family attribution – claiming that interests held by members of the same family should be combined for the purpose of determining

<sup>12</sup> Damodaran, Aswath, *The Value of Control: Implications for Control Premia, Minority Discounts and Voting Share Differentials*, Stern School of Business (2005), at <http://pages.stern.nyu.edu/~adamodar/pdfiles/papers/controlvalue.pdf>. Author retains copies.

<sup>13</sup> A wealth of material on the issue of capital asset pricing exists in the finance literature. The reader wishing to explore these concepts would do well to begin with any advanced corporate finance text such as Brigham, E.F., & Ehrhardt, M.C. (2011). *FINANCIAL MANAGEMENT: THEORY & PRACTICE*. 13th Edition. Mason, Ohio: Thomson South-Western.

<sup>14</sup> See, e.g., BOC Secs. 153.110 and 153.251.

<sup>15</sup> Pub. L. 101-508, Nov. 5, 1990, 104 Stat. 1388

control given their assumed common interests. This approach was generally not successful<sup>16</sup> and was eventually abandoned by the Service.<sup>17</sup>

This retreat was not the end of the struggle, however, and the Service turned to Congress for statutory plugs for the FLP loopholes. The first of these was IRC Sec. 2036 which included in the gross estate property in which the decedent had retained a life estate – defining the retention of voting rights in transferred property as requiring such inclusion if the transfer was not for adequate consideration<sup>18</sup> and defining control as twenty percent of the combined voting power of all classes of stock.<sup>19</sup> In addition, the relinquishment or cessation of such voting rights was to be considered a transfer of property made by the decedent.<sup>20</sup>

In *Church v. United States*,<sup>21</sup> the service claimed the formation of a Texas FLP was merely a testamentary transaction and should be disregarded for tax purposes. In that case, the formation of an FLP commenced two days before the death of the decedent but had not actually been completed by the time of death (the corporate general partner had not been formed nor had the limited partnership certificate been filed).<sup>22</sup> The District Court, however, ruled in favor of the estate finding that the decedent had owned only equitable title at the time of her death (the securities in question were held by the decedent's brokerage firm in "street name") and that the partnership was not a sham since it had bona fide business purposes and was not formed for the sole purpose of reducing estate taxes. In addition, there was no express or implied agreement on the part of the transferees to allow the decedent to use or possess the property as contemplated in IRC Sec. 2036.

Having given up on attribution rules, and having been struck down in its attempt to attack the formation of FLPs on the grounds of testamentary purpose, the IRS turned to other resources arguing that IRC Sec. 2703 removes any and all restrictions, whether imposed by agreement or by state law, including those inherent in the nature of the limited partnership and state law regarding limited partnerships.<sup>23</sup>

As part of the Omnibus budget reconciliation act of 1990, Congress enacted sections 2703 and 2704 of the Internal Revenue Code. These sections were adopted for the ostensible purpose of eliminating abuses in the use of limited partnerships, as opposed to eliminating the use of these vehicles entirely. Section 2703 provides:

<sup>16</sup> See, e.g., *Propstra v. U.S.*, 680 F.2d 1248 (9<sup>th</sup> Cir. 1982), *Estate of Bright v. U.S.*, 658 F.2d 999 (5<sup>th</sup> Cir. 1981), *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

<sup>17</sup> Rev. Rul. 93-12, 1993-1 C.B. 202.

<sup>18</sup> IRC Sec. 2036(b).

<sup>19</sup> IRC Sec. 2036(b)(2).

<sup>20</sup> IRC Sec. 2036(b)(3), Sec. 2704.

<sup>21</sup> 268 F.3<sup>rd</sup> 1063 (5<sup>th</sup> Cir. 2001), *aff'd per curiam* 85 AFTR2d 2000-804 (W.D. Tex. 2000).

<sup>22</sup> In addition to the incomplete formative process, it may have been significant that the actions in question were taken under powers of attorney by the persons who stood to ultimately inherit the property, *Ibid.*

<sup>23</sup> See, Bray, Christopher, *Does Section 2703 Apply to the Valuation of Family Limited Partnerships?*, 75 TAXES 198 (April 1997).

Sec. 2703. Certain rights and restrictions disregarded

(a) General rule

For purposes of this subtitle, the value of any property shall be determined without regard to -

- (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or
- (2) any restriction on the right to sell or use such property.

(b) Exceptions

Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

- (1) It is a bona fide business arrangement.
- (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
- (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.<sup>24</sup>

Thus, under Sec. 2703(a), the valuation of any property may not include consideration of any purchase or “buy sell” agreement for a price less than the fair market value of the property or any other restriction on the right to sell or use the property. This provision would effectively eliminate the use of limited partnerships as a method of obtaining a discount in net asset value except for the “safe harbor” provided in subsection (b), which exempts from such limitation any option, agreement, right or restriction which represents a bona fide business arrangement, is not a device to transfer property to family members for less than its fair value and which is comparable to similar arrangements entered into in arms length transactions.

Armed with this section, beginning in the late 1990s the Internal Revenue Service commenced its assault on the discounts in a series of Technical Advice Memoranda (TAMs) demonstrating its position that cases involving attempts to use limited partnerships as a means of discounting estates strictly for tax purposes would be disallowed.<sup>25</sup> A number of different theories were proposed by the service to restrict or eliminate the discounts with varying degrees of success.

In *Peracchio v. Commissioner*<sup>26</sup> the IRS attacked the Limited Partnership discounts on the grounds that the partnership lacked economic substance, that the restrictions should be disregarded under IRC Sec. 2703(a)(2), that a limitation on the liquidation of the assets should be disregarded under IRC Sec. 2704(b) and that the claimed control and marketability discounts, totaling 40% of the value of the assets, were unwarranted. At trial the IRS expert offered

<sup>24</sup> Pub. L. 101-508, title XI, Sec. 11602(a), Nov. 5, 1990, 104 Stat. 1388-498

<sup>25</sup> Aghdami, Farhad, *Family Limited Partnership Update*, (2004), William & Mary Annual Tax Conference, at <http://scholarship.law.WM.edu/tax/107>. Author retains copies.

<sup>26</sup> *Supra*, n. 3.

testimony that the control and marketability discounts should be reduced to 18.74%. The Court, however, ordered a discount of 6.02% for the minority interest and 25% for reduced marketability. Similarly, in *Lappo v. Commissioner*<sup>27</sup> after a lengthy technical discussion of the bases for estimating the various discounts and which proxies were correct for use as “comparables” a combined discount of 24% was ordered.

In a Texas case, *McCord v. Commissioner*,<sup>28</sup> the FLP in question comprised 65% marketable securities and 30% in real estate Limited Partnership interests. Petitioner’s expert argued for a combined discount of 57%, while the IRS countered with 15.34%.<sup>29</sup>

Other issues, of course have to be dealt with. In *Bongard v. Commissioner*,<sup>30</sup> for example, the Tax Court ruled in favor of the IRS on the grounds that there was no valid non-tax reason for the Family Limited Partnership. This ruling reinforces the fact that there must be a valid nontax reason for setting up a Family Limited Partnership in order to claim the Sec. 2703 safe harbor. The partnership must be operated as a partnership and a qualified independent appraiser should be hired to value the assets placed in the partnership.<sup>31</sup> Treasury Regulation Sec. 301.6501(c)-1(f)(3) requires that the appraiser be qualified to make appraisals regarding the type of property being appraised.

#### CURRENT STATE OF THE ISSUE.

Since the IRS has effectively conceded that an interest in a Family Limited Partnership is not marketable and a Limited Partner does not control management of the enterprise, the value of interests in an FLP usually can be discounted anywhere from 25% to 50%, with a corresponding reduction in tax liability.<sup>32</sup>

In October of 2006, the IRS provided guidelines for its auditors, set forth in the table below, based on *McCord*, *Lappo* and *Peracchio*. In each of the cases the total valuation discount established by the appraisers was reduced to some extent but each discount amount allowed was much higher than the IRS’s position. It appears that utilizing the facts as presented in the cases below a combined discount of approximately 30% is a very achievable discount total.

<sup>27</sup> *Supra*, n. 3.

<sup>28</sup> 120 T.C. 358 (2003).

<sup>29</sup> The experts engaged in a spirited debate as to the appropriate proxies for the real estate interests, which raises an interesting question as to whether Real Estate Investment Trusts (REITs) may provide a vehicle for FLP-style asset value discounts as well as additional uniquely real estate-related discounts such as a deduction for market absorption (i.e. excess supply), a topic which bears further investigation. See, e.g., Hoffmann, Carsten, *Market Absorption Discount, Two-Level Discounts and Real Estate Limited Partnership Data wins the day . . . Almost*, FMV Valuation Alert (2008), at [http://www.fmv.com/index.php?C=ValuationAlert\\_Archive\\_2008-5-12](http://www.fmv.com/index.php?C=ValuationAlert_Archive_2008-5-12). Author retains copies.

<sup>30</sup> *Bongard v. Commissioner*, 124 T.C. 95, 2005 U.S. Tax Ct. LEXIS 8; 124 T.C. No. 8.

<sup>31</sup> *Id.*

<sup>32</sup> Schmidt, Jim, *Family Limited Partnerships under stronger IRS scrutiny*, at [sw-cpa.com/bottomline/articles/2006-06/flp\\_scrutiny.htm](http://sw-cpa.com/bottomline/articles/2006-06/flp_scrutiny.htm). Author retains copies.

Case Name	Lack-of-Control (Minority Interest) Discount Allowed	Lack-of- Marketability Discount Allowed	Combined Discount
<i>McCord</i>	10%	20%	32%
<i>Lappo</i>	8.5%	24%	27%
<i>Peracchio</i>	6.02%	25%	29%

Depending on the type of assets in the FLP, of course, the discounts may be higher. In one Tax Court case, for example, a 30% lack of marketability discount was ordered<sup>33</sup> and in a Texas case, *Temple v. United States*<sup>34</sup>, the Court, after reviewing each transaction in dispute, allowed discounts of 15% to 60%. It is evident that in a proper case, quite significant discounts may be achieved.

If the taxable estate is \$10,000,000 it would be taxed at 35% under recent (and who knows how permanent), tax laws for an estate tax liability of \$3,500,000. An asset valuation reduction in an FLP of 30% would result in an estate tax savings of \$1,050,000, making creation of an FLP a very attractive option for wealth protection.

### **BUT WAIT, THERE'S MORE!**

A benefit of using limited partnerships that is potentially of great value, but which is frequently overlooked, is the fact that the assets in the limited partnership can be protected against creditors of the limited partners much like the assets held in a spendthrift trust. Specifically, section 153.256 of the Texas Business Organizations Code, provides:

#### **Sec. 153.256. PARTNER'S PARTNERSHIP INTEREST SUBJECT TO CHARGING ORDER.**

- (a) On application by a judgment creditor of a partner or of any other owner of a partnership interest, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment.
- (b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the partnership interest.
- (c) A charging order constitutes a lien on the judgment debtor's partnership interest. The charging order lien may not be foreclosed on under this code or any other law.
- (d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest.

<sup>33</sup> *Astleford v. Commissioner*, 95 T.C. Memo. 1497, Dec. 57,435(M), TC Memo. 2008-128.

<sup>34</sup> 123 F.Supp.2d 605, 622 (2006).

(e) This section does not deprive a partner or other owner of a partnership interest of a right under exemption laws with respect to the judgment debtor's partnership interest.

(f) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership.

Thus, the creditor of a partner or owner of any other partnership interest, as judgment debtor, may obtain no more than a charging order against the partnership to satisfy the claim. This charging order constitutes a lien on the judgment debtor's interest in the partnership but cannot be foreclosed under the BOC ". . . or any other law."<sup>35</sup> Moreover, under subsection (d), "the entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest." In many cases, this protection, alone, would justify giving the creation of an FLP serious consideration.

In the family law arena, the family limited partnership can assure the protection of both the family member and an estranged spouse. Property gifts or bequests to a specific spouse after marriage remain the separate property of the spouse.<sup>36</sup> In today's environment with its high incidence of divorce the FLP can help assure an individual family member's interest in the family property will remain in the family even after a divorce and can be left to succeeding generations of the family. Since the spouse cannot assign his or her FLP interest except in a manner specified in the partnership agreement, an artfully drafted FLP agreement can also protect the family member from being coerced into parting with the property.

There are, of course, problems and pitfalls in the creation of FLPs that must be considered.

### **FORMATION OF THE FLP**

With the increased IRS scrutiny of the Family Limited Partnership great care must be taken in forming the partnership in order to obtain the maximum benefits while limiting the risk of an adverse IRS decision upon audit.

IRS Code Sec. 2001(a) imposes a tax on the estate of every decedent who is a citizen of the United States. In *Bongard v. Commissioner*<sup>37</sup> the Court decided that there were not any non-tax reasons for the FLP. There must be one or more substantial non-tax reasons for a FLP to exist and run the FLP as if it were a business. If transfers to a FLP are simply to avoid taxation of the assets the assets will be brought back into the estate upon death of the transferor.

When setting up a FLP anyone transferring assets to the FLP must retain sufficient assets in their personal estate to satisfy their personal needs with no reliance on FLP assets previously

<sup>35</sup> BOC section 153.256(c). The extent to which this provision obtains over bankruptcy or other debtor/creditor laws is reserved for future consideration.

<sup>36</sup> Texas Family Code Sec. 3.001

<sup>37</sup> *Supra*, n. 30.

transferred. In a Texas case, *Kimbell v. United States*<sup>38</sup>, Mrs. Ruth A. Kimbell transferred approximately eighty five percent of her assets to a FLP. She died two months later and did not need any of the FLP assets to meet her personal needs from the date of transfer to her date of death. The Court decided that she had retained sufficient assets to meet her personal needs and therefore eluded IRS Code Sec. 2036(a)(1) which would bring any assets needed for personal needs back into the gross estate for estate tax purposes. As long as assets transferred to a FLP are not needed for the transferor's personal needs the assets are out of the estate.

Care needs to be taken in forming the FLP. Not only must all state requirements be satisfied for the formation of a valid Limited Partnership (well in advance of the anticipated death of the contributor),<sup>39</sup> but also a carefully prepared partnership agreement must take the IRS positions into account. Some basic rules include:<sup>40</sup>

- Do not retain the economic benefits
- Do not allow the FLP to pay estate expenses or estate taxes
- Clients should have adequate assets to assure there is no need to raid the FLP for living expenses
- Special care should be taken to observe operational formalities for the partnership
- A qualified appraisal of all contributed assets should be obtained.

Clearly this list is not exhaustive.

### CONCLUSION

The return of the Estate Tax has sent tax practitioners and advisors back to the books to resurrect previously much-loved tools for deferral and reduction of death and gift duties. One of those tools, the Family Limited Partnership, deserves consideration for protection of the family business as well as conservation of family assets. While there are a number of hurdles to negotiate in creating a properly unassailable FLP, they appear to be worth the effort. Even the IRS has admitted that creation of an FLP can save the taxes on as much as a fourth or more of the value of its assets outside the partnership while, at the same time, control of the business and benefits similar to those of a spendthrift trust can be secured for future generations. The FLP is a tool well worth sharpening and keeping in the practitioner's toolbox.

<sup>38</sup> *Kimbell v. United States*, 371 F.3d 257, 263 (5th Cir. 2004);

<sup>39</sup> In *Strangi v. Commissioner*, T.C. Memo 2003-45, rem'd by 293 F.3d 279 (5th Cir. 2002), the partnership was formed two months before death of the contributor, in *Harper*, T.C. Memo 2002-121, the span was eight months.

<sup>40</sup> Briskin, Robert, *Practically IRS Proof: Preserving The Tax Benefits of Family Limited Partnerships*, California CPA (2003), at [http://www.rablegal.com/Practically\\_IRS\\_Proof.pdf](http://www.rablegal.com/Practically_IRS_Proof.pdf). Author retains copies.



**SEVERANCE v. PATTERSON: DOES ENFORCEMENT OF THE TEXAS OPEN BEACHES ACT CONSTITUTE A “TAKING”**

Alix Valenti\*

**ABSTRACT**

In *Severance v. Patterson*, the Texas Supreme Court ruled that Texas cannot condemn and take private property that becomes part of the public beach because of erosion. Specifically, the court held that Texas does not recognize a “rolling” easement on Galveston Island’s West Beach. Avulsive events such as storms and hurricanes that drastically alter pre-existing shore-front boundaries do not have the effect of allowing a public use easement to move onto previously unencumbered property. While the decision does not explicitly apply to anywhere but Galveston’s West Beach, it has been argued that the ruling provides a legal basis for widespread challenges to the Texas Open Beaches Act. Under that Act, Texas courts previously held that, once an easement is established, its boundaries shift with movements in the vegetation line and the line of mean low tide, a phenomenon referred to as the “rolling easement doctrine. The Supreme Court’s decision calls into question those rulings when a storm or other event suddenly causes a change in the vegetation line. This paper will review the majority’s holding and rationale as well as the dissenting opinion. It will also cover previous decisions under the Open Beaches Act and legislative efforts to protect private property interests in beach property. Based on an analysis of the Takings Clause under the U.S. Constitution, this paper concludes that the Texas Supreme Court did not deny the public’s right to use Texas beaches, but rather it recognized that property owners who lose their private rights to enjoy their property should be compensated. Thus, the decision raises an ethical question whether the Texas Open Beaches Act can be enforced without restitution.

**I. INTRODUCTION**

Texas has long recognized the unrestricted right of the public to use its beaches along the Gulf of Mexico. In fact Texas is one of the few states that mandate that all beaches be open to the public.<sup>1</sup> The Texas Open Beaches Act (OBA) provides as follows:

It is declared and affirmed to be the public policy of this state that the public, individually and collectively, shall have the free and unrestricted right of ingress and egress to and from the state-owned beaches bordering on the seaward shore of the Gulf of Mexico, or if the public has acquired a right of use or easement to or over an area by prescription, dedication, or has retained a right by virtue of continuous right in the public, the public shall have the free and unrestricted right

\*PhD, JD, LLM, Associate Professor of Legal Studies and Management, University of Houston Clear Lake.

<sup>1</sup> Michael Hofrichter, *Texas’s Open Beaches Act: Proposed Reforms Due to Coastal Erosion*, 4 ENV’T L & ENERGY L. & POL’Y J. 147 (2009).

of ingress and egress to the larger area extending from the line of mean low tide to the line of vegetation bordering on the Gulf of Mexico.<sup>2</sup>

It is illegal for any person “to create, erect, or construct any obstruction, barrier, or restraint that will interfere with the free and unrestricted right of the public.”<sup>3</sup> The Texas Land Commissioner is given the authority to “strictly and vigorously enforce the prohibition against encroachments on and interferences with the public beach easement.”<sup>4</sup> Any county attorney, district attorney, or, at the request of the General Land Office (GLO), the attorney general *must* file suit to obtain an injunction “to remove or prevent any improvement, maintenance, obstruction, barrier, or other encroachment on a public beach.”<sup>5</sup> The public beach is defined as “any beach area, whether publicly or privately owned, extending inland from the line of mean low tide to the line of vegetation,”<sup>6</sup> and the line of vegetation means “means the extreme seaward boundary of natural vegetation which spreads continuously inland.”<sup>7</sup> The Texas General Land Office is charged with determining the boundaries of the easement.<sup>8</sup>

Problems with defining the easement arise when erosion causes part of the easement to become part of the Gulf. To address this issue, the courts have recognized a “rolling easement” as one that moves with the shoreline.<sup>9</sup> In a case of first impression, the Texas Supreme Court recently ruled that a property owner does not automatically lose its right to exclude the public from the new dry beach under the rolling easement theory.<sup>10</sup> This paper will discuss this case and its implications for homeowners along the Texas Gulf Coast. It will also report on legislative developments affecting the rights of homeowners whose property was damaged or destroyed by Hurricane Ike.

## II. BACKGROUND

In *Severance v. Patterson*,<sup>11</sup> the plaintiff had purchased three properties in Galveston along the island’s West Beach. While there is some dispute as to whether two of the three homes were seaward of the vegetation line at the time of the purchase, in 2006, subsequent to Hurricane Rita, the GLO surveyed the properties and determined that two of them were entirely seaward of the vegetation line and the third was partly seaward of the line. It informed Mrs. Severance of its intention to seek removal of the homes that encroached on the beach. Mrs. Severance filed a

<sup>2</sup> TEX. NAT. RES. CODE ANN. § 61.011(a) (Vernon 2011). When originally passed, the Act was codified under Article 5415d of the TEX. REV. CIV. STAT. ANN.

<sup>3</sup> TEX. NAT. RES. CODE ANN. § 61.013(a).

<sup>4</sup> *Id.* § 61.011(c).

<sup>5</sup> *Id.* § 61.018(a) (italics added).

<sup>6</sup> *Id.* § 61.001(8).

<sup>7</sup> *Id.* § 61.001(5).

<sup>8</sup> *Id.* § 61.001(4).

<sup>9</sup> Neal E. Pirkle, *Maintaining Public Access to Texas Coast Beaches: The Past and the Future*, 46 BAYLOR L. REV. 1093 (1994) (hereinafter referred to as Pirkle).

<sup>10</sup> *Severance v. Patterson*, \_\_\_S.W.3d \_\_\_, 2010 WL 4371438 (Tex. 2010).

<sup>11</sup> *Id.*

federal action in July of 2006 seeking declaratory and injunctive relief preventing the enforcement of the public easement against her properties, claiming violation of her rights under the Fourth, Fifth, and Fourteenth Amendments to the federal Constitution.<sup>12</sup>

The district court concluded that under Texas common law, the public's beach easement is superior to the plaintiff's interest in her properties and that the rolling easement concept is not inconsistent with the federal Constitution.<sup>13</sup> Mrs. Severance appealed, and the Court of Appeals for the Fifth Circuit held that her claims were not ripe and certified the unsettled questions under state law to the Texas Supreme Court.<sup>14</sup>

### III. THE SUPREME COURT DECISION

In a six-two decision,<sup>15</sup> the Court ruled that the easement on the beach property seaward of the plaintiff's property did not "roll" onto her property; thus her property was not located on the public beach and was not subject to enforcement action under the Texas Open Beaches Act. The Court began its opinion by examining the history of beach ownership along the Gulf of Mexico. It noted that title to the property on the West Beach of Galveston was first granted by the Republic of Texas to Levi Jones and Edward Hall. Under the Jones-Hall grant, the state relinquished all title and right to use the property. While the grant could have reserved the right to use the beach to the public, it did not, said the Court. This was critical to the Court's decision because under the statute, while there is no dispute that the wet beaches are owned by the state, ownership of the dry beaches is dependent on whether the government can establish an easement "by virtue of a continuous right in the public since time immemorial . . . ."<sup>16</sup>

At this point it is useful to review the types of easements under which the public can acquire access to the beach under the OBA. An easement by prescription is one that arises from the public's use of property for an extended period of time and is equivalent to obtaining a grant from the owner of the property.<sup>17</sup> An easement by prescription is created when public use is adverse to the owner, is continuous, and lasts for at least 10 years.<sup>18</sup> As under a claim for adverse possession, the use of the property must be open, notorious, hostile, adverse, uninterrupted, exclusive, and continuous.<sup>19</sup> In *Seaway Co. v. Attorney General*,<sup>20</sup> the court of appeals held that the mere joint use of the property by both the owner and the public does not defeat the requirement of adverseness. Under such circumstances, the owner's use could be viewed as not

<sup>12</sup> *Severance v. Patterson*, 485 F. Supp. 2d 793 (S.D. Tex. 2007).

<sup>13</sup> *Id.* at 805.

<sup>14</sup> *Severance v. Patterson*, 566 F.3d 490, 500 (5th Cir. 2009).

<sup>15</sup> Chief Justice Jefferson did not participate in the decision.

<sup>16</sup> *Severance*, 2010 WL 4371438, at \*4 (quoting TEX. NAT. RES. CODE ANN. § 61.001(8)).

<sup>17</sup> Mark D. Holmes, *What about My Beach House? A Look at the Takings Issue As Applied to the Texas Open Beaches Act*, 40 HOUS. L. REV. 119 (2003) (hereinafter referred to as Holmes).

<sup>18</sup> *Seaway Co. v. Attorney Gen.*, 375 S.W.2d 923, 937 (Tex. Civ. App.—Houston 1964, writ ref'd n.r.e.).

<sup>19</sup> *Moody v. White*, 593 S.W.2d 372, 377 (Tex. Civ. App.—Corpus Christi 1979, no writ).

<sup>20</sup> 375 S.W.2d 923 (Tex. Civ. App.—Houston 1964, writ ref'd n.r.e.).

in his own right but as a member of the public.<sup>21</sup> As long as the evidence shows that the public used the beach in a manner different than the owner, an easement by prescription can be proven. In *Seaway*, there was an abundance of evidence that “thousands of people” used the beach for driving, camping, swimming, boating, and fishing.<sup>22</sup> Similarly in *Moody v. White*,<sup>23</sup> there were over 200 pages of testimony from fishermen, ferryboat captains, law enforcement personnel, and residents of the public’s use of the beach.<sup>24</sup> Testimony by users of the beach that they had assumed the beach was public and the absence of any restrictions on the use of the beach for over 10 years was sufficient to find an easement by prescription.<sup>25</sup>

Another way that the public may acquire an easement to Texas beaches is by dedication. Dedication may be express or implied but in either case the following requirements must be met: the person making the dedication must be the owner; the dedication must serve a public purpose; there must be an express or implied offer; and there must be an acceptance of the offer.<sup>26</sup> While the concept of easement by prescription is based on adverse possession, an implied easement by dedication is based on the principle of promissory estoppel and arises “when the owner’s conduct reasonably implies that he or she intended to make a dedication.”<sup>27</sup> The fact that an owner watched other people use the beach gives rise to an implied easement of dedication.<sup>28</sup> Implied dedication does not require that the public has used the beach for any length of time.<sup>29</sup> The owner’s erection of a seawall which separated its resort from the beach is sufficient to establish that the owner intended to dedicate the area seaward of the seawall to public use.<sup>30</sup>

A third method of creating an easement is by custom, and it is assumed that the language in the statute, “by virtue of continuous right in the public” refers to this method. To establish an easement by custom, it must be shown that a usage or practice of an undefined group of people has occurred over a long period of time such that it acquires a “force of law” or becomes a “relative necessity.”<sup>31</sup> An easement by custom is not a well-established method<sup>32</sup> and has not been used by Texas courts as their decisions are generally based on easements by prescription or implied dedication.<sup>33</sup> In *Matcha v. Mattox*,<sup>34</sup> the court of appeals recognized that rights to beach

<sup>21</sup> *Id.* at 938.

<sup>22</sup> *Id.*

<sup>23</sup> 593 S.W.2d 372 (Tex. Civ. App.—Corpus Christi 1979, no writ).

<sup>24</sup> *Id.* at 377-78.

<sup>25</sup> *Villa Nova Resort, Inc. v. State*, 711 S.W.2d 120, 127 (Tex. App.—Corpus Christi 1986, no writ).

<sup>26</sup> *Moody*, 593 S.W.2d at 378.

<sup>27</sup> Pirkle, *supra*, note 9, at 1097.

<sup>28</sup> *Moody*, 593 S.W.2d at 379. Many of the facts supporting an easement by prescription will also support an implied easement of dedication.

<sup>29</sup> *Seaway*, 375 S.W.2d at 936.

<sup>30</sup> *Villa Nova*, 711 S.W.2d at 128.

<sup>31</sup> Holmes, *supra*, note 17, at 131.

<sup>32</sup> Pirkle, *supra*, note 9, at 1100.

<sup>33</sup> *E.g.*, *Moody v. White*, 593 S.W.2d 372.

<sup>34</sup> 711 S.W.2d 95 (Tex. App.—Austin 1986, writ ref’d n.r.e.).

use may be acquired by custom, in that case, by the public's use of the beach for travel since 1836 and other uses such that people "just 'figured' everyone had the right to use the beach."<sup>35</sup>

Perhaps the most controversial aspect of the GLO's enforcement of the OBA is its assertion of the rolling easement doctrine, which states that the public easement can shift with the changing shoreline.<sup>36</sup> By way of background, before the OBA was passed, the Texas Supreme Court ruled that the dry beach was not part of the public trust and could be privately owned; moreover, the landward boundary of the public trust was established at the mean high tide line.<sup>37</sup> In response to this decision the Texas legislature passed the OBA to protect the beach area extending from the line of mean low tide to the line of vegetation as long as the public has acquired a right of use or easement to the area by prescription, dedication, or by virtue of continuous right in the public.<sup>38</sup> Although the Act did not specifically provide that the public's easement moved with the vegetation line, the court of appeals in several cases concluded that to protect the public's interest in the beach, such an intent is implicit.<sup>39</sup> Although easements are generally static, the courts have held that once a beach easement is established it can move up or back to each new vegetation line.<sup>40</sup>

Citing the language of the statute, the *Severance* Court noted that the OBA enforces the public's right to use the dry beach only where an easement exists.<sup>41</sup> Texas has no right in privately owned beachfront property without proof of an easement.<sup>42</sup> The Court then observed that in the absence of any historic custom for public use on private West Beach property, the principles of property law apply.<sup>43</sup> While the Court recognized that easements on beach property are dynamic due to natural forces, they do not necessarily attach to private property just because the land originally covered by the easement becomes part of the ocean – they must be proven.<sup>44</sup> Further, although the boundaries of an easement may move with gradual changes in the mean high tide line, if an avulsive event moves the mean high tide line and the vegetation line suddenly, the private property owner is not automatically deprived of her right to exclude the public from the land.<sup>45</sup> The state must prove a new easement on the land, and because of the sudden nature of the change, it would be impossible to prove continuous public use on the new dry beach.<sup>46</sup> Thus, the Court distinguished between movements of the vegetation line by

<sup>35</sup> *Id.* at 99.

<sup>36</sup> Holmes, *supra*, note 17, at 135.

<sup>37</sup> Luttet v. State, 159 Tex. 500, 324 S.W.2d 167 (1958).

<sup>38</sup> TEX. NAT. RES. CODE ANN. § 61.012, .013(a) (2011).

<sup>39</sup> Arrington v. Tex. Gen. Land Office, 38 S.W.3d 764, 766 (Tex. App.—Houston [14th Dist. 2001, no writ]; Matcha, 711 S.W.2d at 99-100; Feinman v. State, 717 S.W.2d 106, 110 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.).

<sup>40</sup> Arrington, 38 S.W.3d at 766.

<sup>41</sup> *Severance*, 2010 WL 4371438, at \*7.

<sup>42</sup> *Id.* at \*8.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at \*9.

<sup>45</sup> *Id.* at \*10.

<sup>46</sup> *Id.* at \*11.

accretion and erosion with movements occurring by sudden events and held that the rolling easement doctrine does not apply in the later situations.<sup>47</sup>

In his dissent, Justice Medina, joined by Justice Lehrmann, wrote that the majority's "vague distinction between gradual and sudden . . . changes to the coastline jeopardizes the public's right to free and open beaches, recognized over the past 200 years, and threatens to embroil the state in beach front litigation for the next 200 years . . ." <sup>48</sup> Further, the notion that beach easements are dynamic but do not roll does not make sense, according to the dissent.<sup>49</sup> Instead the dissent suggests that an implied easement exists from the public's continuous use of the beach,<sup>50</sup> and that these easements roll as a matter of public policy.<sup>51</sup>

After the Supreme Court issued its ruling, several government agencies protested the decision. Harris County attorney Vince Ryan was reported to say that "[t]he court's decision, if left to stand, will destroy an historic right enjoyed by Texans since the founding of the Republic. . . ." <sup>52</sup> Much of the criticism stems from the fact that the suit was filed by the California-based Pacific Legal Foundation, a property rights advocacy group, on behalf of the plaintiff who herself is a California resident, attorney, and real estate broker. Several claim that Mrs. Severance intentionally bought the properties in order to challenge the Texas Open Beaches Act.<sup>53</sup> Harris County joined with the State of Texas, the Texas General Land Office, the Harris County Commissioners Court, the Conference of Urban Counties, Kendall County, the City of Galveston, the Galveston Chamber of Commerce, the Galveston Parks Board, Friends of Surfside, and the Surfriders organization filed a motion for a rehearing. The Court granted the rehearing motion, and arguments were presented on April 19, 2011.

#### IV. LEGISLATIVE DEVELOPMENTS

In an unrelated action, but one that achieves a similar result for Texas owners of beachfront property, the Natural Resource Code was amended in 2009 to address the loss of property caused by Hurricane Ike. Subsections (a-1) and (a-2) were added to Section 61.018(a) of the Code to provide as follows:

(a-1) A county attorney, district attorney, or criminal district attorney or the attorney general may not file a suit under Subsection (a) to obtain a temporary or

<sup>47</sup> By doing so the Court expressly overruled the court of appeals decisions that had previously upheld the rolling easement doctrine. *Arrington v. Tex. Gen. Land Office*, 38 S.W.3d 764, 766 (Tex. App.—Houston [14th Dist. 2001, no writ); *Matcha v. Mattox*, 711 S.W.2d 95 (Tex. App.—Austin 1986, writ ref'd n.r.e.); *Feinman v. State*, 717 S.W.2d 106, 110 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.); *Moody v. White*, 593 S.W.2d 372, 377 (Tex. Civ. App.—Corpus Christi 1979, no writ). In *Feinman* the court expressly refused to distinguish whether the owners' property was lost through erosion or an avulsive process. 717 S.W.2d at 115.

<sup>48</sup> *Severance*, 2010 WL 4371438, at \*15.

<sup>49</sup> *Id.* at \*18.

<sup>50</sup> *Id.* at \*19.

<sup>51</sup> *Id.* at \*24.

<sup>52</sup> John Pape, *Harris County Attorney Weighs in on Fight over Texas Open Beaches*, at <http://instantnewskaty.com/2010/12/22/18156>, last visited on February 19, 2011.

<sup>53</sup> Leigh Jones, *Open Beaches Act Faces Legal Challenge*, *The Galveston County Daily News*, at <http://galvestondailynews.com/story.lasso?ewcd=7dec44e7852f8288>, last visited on February 19, 2011.

permanent court order or injunction, either prohibitory or mandatory, to remove a house from a public beach if:

- (1) the line of vegetation establishing the boundary of the public beach moved as a result of a meteorological event that occurred before January 1, 2009;
- (2) the house was located landward of the natural line of vegetation before the meteorological event;
- (3) a portion of the house continues to be located landward of the line of vegetation; and
- (4) the house is located on a peninsula in a county with a population of more than 250,000 and less than 251,000 that borders the Gulf of Mexico.

(a-2) The owner of a house described by Subsection (a-1) may repair or rebuild the house if the house was damaged or destroyed by the meteorological event.<sup>54</sup>

The narrow wording of the amendment exempts the Bolivar Peninsula from the Texas Open Beaches Act and allows homeowners to rebuild on their property even if most of their new home would be on what is now considered public beach. Ironically, one of the authors of the bill, Representative Wayne Christian, owned a house on Bolivar before it was destroyed by Hurricane Ike. He denies any conflict of interest stating that the amendment would not benefit him directly.<sup>55</sup>

## V. DISCUSSION

Much of the objection to the *Severance* Court's decision is based on the sense that the ruling will seriously deprive the public's access to Texas beaches. This paper submits that the Court did not intend to overrule the mandate of the Open Beaches Act. Rather the decision was based on a literal interpretation of the statute, legislative history, and, most importantly, the view that the Takings Clause under the U.S. Constitution requires compensation to persons who suffer a loss when their property rights are compromised. The remainder of this paper will examine these issues in more depth.

### A. Statutory Interpretation

The basis for the Court's decision was its finding that an easement did not exist for the benefit of the public to use the plaintiff's property. Since the OBA does not create a public beach easement where one does not otherwise exist,<sup>56</sup> the Court noted that the principles of common law governing property rights would apply in determining whether there existed an implied easement.<sup>57</sup> A finding of an implied easement requires "express words, overt, acts, or . . . such inaction on the part of the owner that would justify a conclusion that he intended to dedicate his

<sup>54</sup> TEX. NAT. RES. CODE ANN. § 61.018(a-1), (a-2) (Vernon 2011).

<sup>55</sup> Sarah Moore, *Exemption to Open Beaches Act Could Allow Bolivar Residents to Rebuild on Beach*, at <http://www.beaumontenterprise.com/default/article/Exemption-to-Open-Beaches-Act-could-allow-Bolivar-742802.php>, last visited on February 19, 2011 (hereinafter referred to as Moore).

<sup>56</sup> Arrington, 767 S.W.2d at 958.

<sup>57</sup> *Severance*, 2010 WL 4371438, at \*8.

land to public use.”<sup>58</sup> Previous cases finding the existence of an implied easement relied on testimony that the beaches in question had been used for years by the public.<sup>59</sup> However, in the case of a sudden, avulsive event, prior use by the public cannot be established and thus no easement exists.

### B. Legislative History

In ruling for the plaintiff, the Court expressly refused to apply the rolling easement principle when avulsive events such as storms and hurricanes drastically change pre-existing boundaries.<sup>60</sup> The Court acknowledged that a previous court of appeals case had reached a contrary conclusion<sup>61</sup> but determined that the decision in that case was flawed in that it did not consider the significance of the land grants nor identify “any basis in Texas law or history for a continuous legal right or custom on which to ground the existence of a migratory easement.”<sup>62</sup> An analysis of this decision first turns on the legislative history of the Open Beaches Act. It is well-settled that the OBA was passed in response to the Supreme Court’s decision in *Luttes v. State*,<sup>63</sup> which held the common law boundary between state land and private property was the mean high tide line, which meant that the dry beach, the land between the mean high tide line to the vegetation line, belonged to private property owners.<sup>64</sup> The *Severance* Court concluded that the OBA did not alter *Luttes*; the OBA continues to enforce the public’s right to use the dry beach only where an easement exists.<sup>65</sup> Thus, the question becomes whether the intent of the OBA was to allow the easement to move regardless whether the movement is gradual or sudden.

The Court of Appeals for the First District in Houston also reviewed this legislative history in *Brannan v. State* and concluded that the Act applies to anything that interferes with the public’s right to use the beach easement.<sup>66</sup> The court found that the OBA gives the state the right to seek removal of structures that block the public’s access to the beach.<sup>67</sup> The Houston court held that this mandate applies to any “encroachment” and ordered the homeowners to remove their homes which had become seaward of the vegetation line due to Tropical Storm Frances. The homeowners had argued that their homes did not block or otherwise interfere with public’s use of the beach, and further, any easement that rolled on to their property must accommodate

<sup>58</sup> *Owens v. Hockett*, 151 Tex. 503, 251 S.W.2d 957, 959 (1952).

<sup>59</sup> *E.g.*, *Villa Nova Resort, Inc. v. State*, 711 S.W.2d 120; *Moody v. White*, 593 S.W.2d 372.

<sup>60</sup> *Severance*, 2010 WL 4371438, at \*11.

<sup>61</sup> *Feinman v. State*, 717 S.W.2d at 115. The court of appeals in Austin also found that the natural movements of the beach could move the public easement and thus alter property lines. *Matcha, v. Mattox*, 711 S.W.2d at 100. The *Feinman* court reasoned that without the rolling easement doctrine, private owners would eventually own the “land under the sea.” 717 S.W.2d at 111. This would not be the case even under *Luttes* which clearly held that the wet beach belonged to the state.

<sup>62</sup> *Severance*, 2010 WL 4371438, at \*14.

<sup>63</sup> 159 Tex. 500, 324 S.W.2d 167 (1958).

<sup>64</sup> *Brannan v. State*, \_\_\_ S.W.3d \_\_\_, 2010 WL 375921, at \*13 (Tex. App.—Houston [1st Dist.] 2010, pet. filed).

<sup>65</sup> *Severance*, 2010 WL 4371438, at \*7. The Court cited Richard J. Elliot, *Open Beaches Act: Public Rights to Beach Access*, 28 BAYLOR L. REV. 383, 392 (1976) (the OBA probably does not create any public right than previously existed under common law).

<sup>66</sup> 2010 WL 375921, at \*17.

<sup>67</sup> *See Gulf Holding Corp. v. Brazoria Cty.*, 497 S.W.2d 614 (Tex. Civ. App.—Houston [14th Dist.] 1973, writ ref’d n.r.e.).

preexisting houses.<sup>68</sup> Whether or not the easement can properly roll when the vegetation line moves was not challenged by the homeowners. The court rejected the homeowners' argument as contrary to the intent of the Act to protect the right of the public to use the beach. The OBA, said the court, was intended "to codify the Legislature's assessment that an unobstructed beach is essential to the public's enjoyment of its use of the beach easement".<sup>69</sup> The court had previously determined the existence of an easement on the homeowners' property by virtue of the public's use of the beach adjacent to their property prior to the storm. Thus, implicit in the court's decision was the recognition of a rolling easement on to the private owners' properties.

### C. *An Analysis of the Takings Clause*

In addition to ruling that an public easement does not roll onto private property due to an avulsive event, the *Severance* Court also noted that even if such an easement could be established, the homeowner is entitled to just compensation.<sup>70</sup>

[P]utting a property owner on notice that the State may attempt to take her property for public use at some undetermined point in the future does not relieve the State from the legal requirement of proving or purchasing an easement nor from the constitutional requirement of compensation if a taking occurs. We do not hold that circumstances do not exist under which the government can require conveyance of property or valuable property rights, such as the right to exclude, but it must pay to validly obtain such right or have a sufficient basis under its police power to do so.<sup>71</sup>

This language calls into question the previously held position that enforcement of the OBA does not amount to a taking by the state. At this point it is useful to review the background of the Takings Clause under the U.S. Constitution. It is well-settled that a state has the power to exercise its police power for the overall benefit of the public. According to some scholars this power draws heavily from the utilitarian principle which recognizes that standards should be applied so that the outcome generates the greatest amount of benefits for the largest amount of people.<sup>72</sup> However, that power is not unlimited as decisions under that theory can be justified even if they require an undue burden or cost to the minority.<sup>73</sup> Thus, the Fifth Amendment to the United States Constitution provides that private property shall not "be taken for public use without just compensation."<sup>74</sup> The purpose of this prohibition is to prevent the "[g]overnment from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."<sup>75</sup>

<sup>68</sup> Brannan, 2010 WL 375921, at \*13.

<sup>69</sup> *Id.* at \*19.

<sup>70</sup> *Severance* 2010 WL 4371438, at \*11.

<sup>71</sup> *Id.* at \*12

<sup>72</sup> Richard A. Epstein, *Takings: Private Property and the Power of Eminent Domain* (1985)

<sup>73</sup> Jon L. Pierce and Donald G. Gardner, *Management and Organizational Behavior* (2002).

<sup>74</sup> U.S. Const. amend. V, cl. 4.

<sup>75</sup> *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 123 (quoting *Armstrong v. United States*, 364 U.S. 40, 49 (1960)).

For purposes of determining whether a party is entitled to just compensation, two broad categories of a “taking” have been established. A physical taking occurs “when the government authorizes an unwarranted physical occupation of an individual’s property”.<sup>76</sup> This type of taking is the “paradigm” of government taking and has long been recognized as requiring just compensation.<sup>77</sup> Further, the amount of compensation depends on the character of the invasion, not the amount of damage resulting from it.<sup>78</sup> Neither the size of the intrusion nor the state’s purpose for the taking is relevant in deciding whether the owner is entitled to compensation.<sup>79</sup>

A regulatory occurs when government regulation denies landowners of the beneficial or productive use of their property.<sup>80</sup> In *Lucas v. South Carolina Coastal Council*, pursuant to the state’s Beachfront Management Act, the Coastal Council established a baseline landward of the property owner’s land which essentially prohibited improvements on his land.<sup>81</sup> The trial court found that this action rendered the land as “valueless.”<sup>82</sup> The Supreme Court held that when an owner of real property must sacrifice all “economically beneficial uses in the name of the common good,” in this case to leave the property unimproved, he has suffered a taking.<sup>83</sup> A regulatory taking is considered a taking per se and a court will award compensation without regard to the specific facts of the case.<sup>84</sup>

When there is no transfer of control or complete extinction of all beneficial uses of the property, the courts apply a balancing approach. In *Penn Central Transportation Co. v. New York City*, the Supreme Court examined three factors central to determine whether a restriction on an owner’s use of property amounted to a taking: (1) the economic impact of the regulation on the owner, (2) the extent of the regulation’s interference with investment expectations, and (3) the character of the governmental action.<sup>85</sup> The Court held that the owners were not entitled to compensation because the city had only restricted the owners’ use of the property which diminished its value but did not rise to the functional equivalent of a taking.

Supporters of the public’s rights to Texas Beaches argue that enforcement under OBA is not a “taking” by the state protected by the Constitution, because it is an act of nature that converts previously private property to property for the public use.<sup>86</sup> In *Brannan v. State*,<sup>87</sup> the court of appeals held that enforcement of the OBA and requiring homeowners to remove their beachfront homes is not a “taking” because the law merely enforces an easement created by

<sup>76</sup> *Mayhew v. Town of Sunnyvale*, 964 S.W.2d 922, 933 (Tex. 1998).

<sup>77</sup> Jason Jordan, *A Pig in the Parlor or Food on the Table: Is Texas’s Right to Farm Act an Unconstitutional Mechanism to Perpetuate Nuisances or Sound Public Policy Ensuring Sustainable Growth*, 42 TEX. TECH L. REV. 943 (2010).

<sup>78</sup> *United States v. Cress*, 243 U.S. 316, 328 (1917).

<sup>79</sup> *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1015 (1994).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* at 1009.

<sup>82</sup> *Id.* at 1020.

<sup>83</sup> *Id.* at 1019.

<sup>84</sup> *Lingle v. Chevron U.S.A., Inc.*, 544 U.S. 528, 538 (2005). In *Lucas*, the Court held that no case-specific inquiry is needed when a regulation “denies [a property owner] all economically beneficial or productive use of [the] land.” 505 U.S. at 1015.

<sup>85</sup> 438 U.S. 104, 124 (1978).

<sup>86</sup> *Severance*, 2010 WL at \*22 (dissenting opinion); Holmes, *supra*, note 17 at 145.

<sup>87</sup> 2010 WL 375921, at \*21.

other means, in this case natural erosion. No governmental taking occurs because an easement historically existed seaward of the vegetation line. The act of moving the line was not caused by the government but by an act of nature.<sup>88</sup> Thus, since no taking took place, no just compensation was required and the owners' claims for damages were property denied.<sup>89</sup> Similarly, in *Match v. Mattox*,<sup>90</sup> the court ruled that enforcement of a common law easement was not a taking under the OBA.

This position belies the legislative intent of passing the OBA, however. The OBA was passed in direct response to the Texas Supreme Court's decision in *Luttes v. State*,<sup>91</sup> which held that the dry beach belonged to the private owner. The type of regulatory taking in this situation is similar to that recognized in *Lingle v. Chevron U.S.A. Inc.*<sup>92</sup> where the government demanded an easement as a condition for granting a development permit. In both *Severance* and *Lingle* a taking occurred as a result of enforcement of a state statute.

A second argument raised to support the view that enforcement of the OBA is not a taking entitling the owner to just compensation is based on an exception noted by the U.S. Supreme Court in *Lucas v. South Carolina Coastal Council*<sup>93</sup> that is recognized when state laws exist. Thus, while the economic benefits test of *Lucas* seems to apply in cases where the OBA operates to convert private property into public beaches,<sup>94</sup> under Texas law, property owners may not interfere with the public's use of the beach. Once a home moves seaward of the vegetation line an argument can be made that it becomes a nuisance in restricting access to the beach, and thus its forced removal is not a taking.<sup>95</sup> Enforcement under the OBA is merely an exercise of the state's legitimate police power to protect the rights of the public and their rights to use Texas beaches.<sup>96</sup>

Whether the existence of a house on the beach threatens the public safety and welfare remains debatable. While concerns for the fragile ecosystem of coastal property may present a unique situation that justify a state's regulation of its development and use,<sup>97</sup> it is suggested that the presence of a house on a beach does not reach the point of becoming a "nuisance" justifying its removal without compensation in all cases especially where it does not present any danger or a health hazard.<sup>98</sup>

A third basis for finding that a taking does not occur applies to property purchased after October 1, 1986. For sales after that date the law requires that a statement be included in a deed

<sup>88</sup> *Id.* at \*22.

<sup>89</sup> *Id.*

<sup>90</sup> 711 S.W.2d at 101.

<sup>91</sup> 159 Tex. 500, 324 S.W.2d 167 (1958).

<sup>92</sup> 544 U.S. 528, 547

<sup>93</sup> 505 U.S. 1003.

<sup>94</sup> Holmes, *supra*, note 17, at 141.

<sup>95</sup> *Severance*, 2010 WL 4371438 at \*25 (dissenting opinion).

<sup>96</sup> Laurencia Fasoyiro, *Does the Texas Open Beaches Act Seek to "Take" Private Property for Public Use without Just Compensation?*, 9 TEX. TECH. ADMIN. L.J. 115, 129 (2007).

<sup>97</sup> *Lucas*, 505 U.S. at 1015.

<sup>98</sup> *Compare Miller v. Schoene*, 276 U.S. 272, 280 (1928), where the Court upheld a state's order to remove cedar trees without compensation to prevent the spread of disease to nearby apple orchards.

specifically warning potential buyers that the property could be lost due to acts of nature.<sup>99</sup> Arguably, purchasers who buy property after October 1, 1986 are on notice that they could be required to remove their homes if they became located on the public beach and waive their rights to any compensation if such an event occurs.<sup>100</sup> In essence, the property owners assume the risks of purchasing beachfront property<sup>101</sup> and never really had the right to own property once it became seaward of the vegetation line.<sup>102</sup>

From a legal standpoint, this may be strongest argument against an owner's claim that a taking occurs when changes in the vegetation line convert private property into a public beach. From a practical standpoint, however, it is unlikely that home buyers read the fine print of their closing documents. Thus, the ethical high ground may be to compensate homeowners for loss of their properties that become public land. This approach is consistent with the intent of the Takings Clause

## VI. IMPLICATIONS AND CONCLUSION

With the Supreme Court's decision in *Severance* and the amendment of the Texas Open Beaches Act affecting property on the Bolivar Peninsula, owners of beach front homes are left in a quandary as to whether they are at risk of losing their property values if a storm damages their houses, and, further, whether they will be allowed to reconstruct their homes in such event. Despite the legislation allowing houses affected by Hurricane Ike to be repaired or rebuilt on Bolivar, GLO Commissioner Patterson said that his office would nevertheless deny any permit if the house would be rebuilt seaward of the newly established vegetation line.<sup>103</sup> One may speculate why, after more than 50 years since the original legislation was passed and a number of court of appeals cases ruling in favor of the preserving the beach for public use, the Supreme Court and the legislature are now taking an opposing position. Certainly, the rising property values on Galveston and Bolivar may be one factor. Twenty or thirty years ago, most of the homes along these beaches were bungalows and cost less than \$50,000. A building boom in the last ten years has increased property values, and new homes are being built costing well in excess of half a million dollars. It does appear to be unfair not to compensate homeowners who lose their homes to natural causes. In fact, Galveston County offered a buy-out to property

<sup>99</sup> TEX. NAT. RES. CODE ANN. § 61.025 (Vernon 2010). The deed must contain the following language:  
 WARNING: THE FOLLOWING NOTICE OF POTENTIAL RISKS OF ECONOMIC LOSS TO YOU AS THE PURCHASER OF COASTAL REAL PROPERTY IS REQUIRED BY STATE LAW.  
 • READ THIS NOTICE CAREFULLY. DO NOT SIGN THIS CONTRACT UNTIL YOU FULLY UNDERSTAND THE RISKS YOU ARE ASSUMING.  
 • BY PURCHASING THIS PROPERTY, YOU MAY BE ASSUMING ECONOMIC RISKS OVER AND ABOVE THE RISKS INVOLVED IN PURCHASING INLAND REAL PROPERTY.  
 • IF YOU OWN A STRUCTURE LOCATED ON COASTAL REAL PROPERTY NEAR A GULF COAST BEACH, IT MAY COME TO BE LOCATED ON THE PUBLIC BEACH BECAUSE OF COASTAL EROSION AND STORM EVENTS.  
 • AS THE OWNER OF A STRUCTURE LOCATED ON THE PUBLIC BEACH, YOU COULD BE SUED BY THE STATE OF TEXAS AND ORDERED TO REMOVE THE STRUCTURE.  
 • THE COSTS OF REMOVING A STRUCTURE FROM THE PUBLIC BEACH AND ANY OTHER ECONOMIC LOSS INCURRED BECAUSE OF A REMOVAL ORDER WOULD BE SOLELY YOUR RESPONSIBILITY.

*Id.*

<sup>100</sup> Holmes, *supra*, note 17, at 142.

<sup>101</sup> *Severance*, 2010 WL 4371438, at \*22 (dissenting opinion).

<sup>102</sup> Holmes, *supra*, note 17, at 142.

<sup>103</sup> More, *supra*, note 55.

owners equal to 75 percent of the value of the land prior to Hurricane Ike. Pursuant to a FEMA buyout program following Hurricane Rita, Severance, the plaintiff, was offered \$335,685.73 and \$611,588.79 for two of her Galveston properties, significantly more than the price she paid for them in 2005.<sup>104</sup> Thus, the Supreme Court's holding may be viewed as a reflection of what is otherwise occurring that owners are being fairly compensated when an easement is created on property that was previously privately owned.

It is also unclear whether the *Severance* Court's ruling would apply to property other than property located on the West Beach of Galveston Island. The Court went to great lengths to trace title to the West Beach property from an 1840 land grant in which the state relinquished all rights and title in the property.<sup>105</sup> From this, the justices concluded that only the existence of a common law easement could support the GLO's order that the property be removed as a nuisance.<sup>106</sup> Absent similar facts, courts could find the existence of an easement on privately owned beach front property.

Finally, while legal scholars will debate the correctness of the Supreme Court's interpretation of the Open Beaches Act, the larger question regarding the rights of property owners to compensation when their property is deemed no longer private should be the starting point for any discussion. It is submitted that the Supreme Court's decision may be considered as a recognition that state-ordered removal of a private home is a rather draconian measure. Generally, easements are enforced in favor of the public only to the extent necessary to protect their right to use and enjoy the property.<sup>107</sup> In fact the GLO seeks to remove property only if it significantly impedes access to the beach or poses a health risk to the public.<sup>108</sup> Nevertheless, at least one court has held that the language of the OBA provides rights to the public beyond those under a common law easement and requires "an unobstructed beach [as] . . . essential to the public's enjoyment of its use of the beach easement."<sup>109</sup> Clearly, the Supreme Court's decision calls into question the sustainability of this position. As a result, the GLO will probably claim that a home interferes with the public's use of the beach only if it blocks an access point or otherwise prohibits passage from one part of the beach to another.

<sup>104</sup> <http://www.supreme.courts.state.tx.us/ebriefs/09/09038708.pdf>, last visited on February 25, 2011.

<sup>105</sup> *Severance*, 2010 WL 4371438, at \*5.

<sup>106</sup> *Id.* at \*8.

<sup>107</sup> *Lakeside Launches, Inc. v. Austin Yacht Club, Inc.*, 750 S.W.2d 868, 871 (Tex. App.—Austin 1988, writ denied).

<sup>108</sup> Holmes, *supra*, note 17, at 145.

<sup>109</sup> *Brannan v. State*, 2010 WL 375921, at \*19.



## WHERE HAVE ALL THE LAWSUITS GONE?

### THE CURIOUS CASE OF SECTION 109 OF THE *OTHER* CIVIL RIGHTS ACT<sup>1</sup>

Margaret Langford\*  
St. Mary's University

#### Abstract

*The extensive Civil Rights Act of 1991 included Section 109, which served to amend both the Civil Rights Act of 1964 and the Americans with Disabilities Act of 1990, by extending employment discrimination protection extraterritorially to U.S. citizens employed by U.S.-controlled businesses operating in foreign lands. Interestingly, although the number of domestic lawsuits involving alleged employment discrimination has risen over the past twenty years, a similar significant increase in extraterritorial cases has not occurred. The purpose of this paper is to discuss the background to the inclusion of Section 109 in the Civil Rights Act of 1991, litigation related to extraterritoriality, and ethical and practical implications for United States employers.*

*Keywords: employment discrimination, extraterritoriality, Civil Rights Act 1964, Civil Rights Act 1991, American with Disabilities Act 1990.*

Since the passage of the Civil Rights Act of 1991, the Equal Employment Opportunity Commission (EEOC) has seen the number of total charges grow from 72,302 in 1992 to 99,922 in 2010, the highest number since the Agency's beginning in 1965 (see "EEOC Charge Statistics") and an increase of over 38%. These charges include the original employment discrimination categories in Title VII of the Civil Rights Act of 1964 (i.e., race, color, national origin, sex, and religion), the Age Discrimination in Employment Act of 1967 (ADEA), the Americans with Disabilities Act of 1990 (ADA), the Equal Pay Act of 1963, and a beginning trickle related to the Genetic Information Nondiscrimination Act of 2008 (GINA). Most of these charges do not rise to the level of the EEOC filing a lawsuit and are instead handled through EEOC mediation, private lawsuits, or charging parties walking away. Nevertheless, the number of charges in each of the categories has increased, with the concomitant increase in time and money to bring or to fight those charges. The increase is likely partly attributable to employees becoming more aware of their rights in the workplace. In addition, the Civil Rights Act of 1991 no doubt contributed to the increase because it allows "compensatory and punitive damages in cases of intentional discrimination, and provides for obtaining attorneys' fees and the possibility of jury trials" (see "EEOC Federal Laws" and "EEOC History"). Yet, an important element of the Act, Section 109, has resulted in very few charges related to it. This lack is curious, given

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<sup>1</sup> A *third* Civil Rights Act, that of 1866, also exists, giving citizenship rights to African-Americans. Also known as Section 1981, it confers several legal rights such as the right to make and enforce contracts, including those regarding employment.

\* Ph.D., Professor of Management, St. Mary's University, San Antonio, Texas, USA

that Section 109 extends Title VII and ADA protection extraterritorially. The purpose of this paper is to discuss the background to the inclusion of Section 109 in the Civil Rights Act of 1991, litigation related to extraterritoriality, and ethical and practical implications for United States employers.

### **Background**

The Civil Rights Act of 1991 (see “EEOC History”) amended the Civil Rights Act of 1964 and in its own way, was just as extensive. It allowed for additional damages and jury trials, it disallowed “race norming” of employee selection devices, and it deliberately reversed a decision by the Supreme Court in *Ward’s Cove Packing v. Atonio* (1989), in which the Court had stunningly overturned disparate impact proof procedures established in the landmark case of *Griggs v. Duke Power* (1971) that “had stood as good law” (Bennett-Alexander & Hartmann, 2009, p. 98). In the *Ward Cove* decision, the Court shifted the burden of proof from the employer having to show that a complained-of policy was job related to the employee having to show it was not. The Civil Rights Act of 1991 shifted the burden back to the employer. But the Civil Rights Act of 1991 also deliberately reversed another Supreme Court decision regarding whether employees who are U.S. citizens can utilize Title VII to claim employment discrimination by a U.S. employer if employment would be outside of the United States.

Previously, on March 26, 1991, the Supreme Court, in a split decision, stated that Title VII was not available as recourse for such employees. In deciding *Equal Employment Opportunity Commission v. Arabian American Oil Company* and *Ali Boureslan v. Arabian American Oil Company* (aka *ARAMCO*, 1991; see also Pinney, 2004), in which Boureslan, a naturalized U.S. citizen, claimed race, religion, and national origin employment discrimination, the Court majority concluded Title VII did not apply extraterritorially. The Court used mostly the argument that had Congress wanted Title VII to do so, Congress would have provided “affirmative intent,” as it did subsequent to the passage of the Age Discrimination in Employment Act. Passed in 1967, the ADEA was amended in 1984 to extend the reach of the Act extraterritorially. That is, the 1991 Court stated Congress in 1984 had made a “clear statement” through the amendment of its intent and had on other many occasions addressed (non-employment) issues of extraterritoriality. At the end of the 1991 decision, the Court essentially threw down the gauntlet and said “Congress, should it wish to do so, may similarly amend Title VII and in doing so will be able to calibrate its provisions in a way that we cannot” (*ARAMCO*, 1991, p. 1236).

Congress did wish to do so. The Court’s decision reportedly occurred on the same day that Congress was originally set to vote on revisions to the Civil Rights Act of 1964. With “almost no debate (thus no later guidance for courts)” (McNier, 2009, p. 14), Section 109 was included, amending both Title VII and the Americans with Disability Act, applying both extraterritorially. President H.W. Bush signed the new far-reaching Civil Rights Act into law on November 7, 1991. Section 109 of the Act was modeled upon the language already established in the 1984 amendment to the ADEA. Namely, Section 109 amended Title VII and the ADA with the following (see “EEOC Enforcement Guidance”):

- expanded the definition of “employee” to include a citizen of the United States, with respect to employment in a foreign country,
- provided for protection of this employee via Title VII and the ADA if the employer is American or a foreign corporation controlled by an American employer,
- identified factors to be considered in determining whether a corporation is American-controlled, and

- provided a defense for employers against a discrimination charge if compliance with either Title VII or the ADA would cause the employer to violate the law of the foreign country (the “foreign compulsion” defense; see Bell, 2009; Brown, 2007; and Paetkau, 2009).

### Subsequent Litigation

As mentioned, subsequent to the passage of the Civil Rights Act of 1991, the number of charges filed with the EEOC has grown in each of the Title VII protected categories, as well as the ADA. Yet, in terms of actual court cases involving employment discrimination and extraterritoriality, few can be found involving United States citizens, i.e., those persons expressly protected in Section 109 of the Civil Rights Act of 1991. Perhaps this lack is due to the diligence of U.S. businesses in their hiring practices for foreign assignments. Yet, many of these businesses are presumably involved domestically in the record number of EEOC charges. Is it likely they are less diligent at home? Another explanation is that, just as foreign workers in the United States enjoy employment discrimination protection, Americans working abroad could pursue complaints through the legal systems of those countries (Lowe, 2006). A third explanation is that U.S. citizens may not be aware of the extraterritorial reach of the Civil Rights Act of 1991. Who *has* pursued employment discrimination charges involving extraterritoriality? The following is a brief review of certain cases in the last 20 years.

U. S. citizen Garland Denty lost his case against SmithKline Beecham in 1995. This was an age discrimination (ADEA) case rather than a Civil Rights Act case. Denty lost because the circuit court found that although management overlapped between its American and English operations, SmithKline was ultimately British-owned and the ADEA could not apply (*Denty v. SmithKline Beecham*, 1995; McNeir, 2009, p. 17). In another ADEA extraterritoriality case, William Mahoney lost because his U.S. employer, RFE/RI, Inc. was able to show that termination at age 65 was required by a collective bargaining agreement in Germany where Mahoney worked for the company (*Mahoney v. RFE/RI, Inc.*, 1995; Berkowitz, 2009, p. 4; Collins, 2006, p. 11). In still another ADEA extraterritoriality case, Luis Reyes-Gaona alleged employment discrimination against his potential U.S. employer, N.C. Growers Association, but lost because Reyes-Gaona was not a U.S. citizen and the ADEA again could not apply (*Reyes-Gaona v. N.C. Growers Association*, 2001; McNeir, 2009, p. 17). In each of the cases, the respective courts held strictly to the extraterritoriality factors established in the 1984 ADEA amendment, the same factors later adopted in Section 109 of the Civil Rights Act of 1991.

Therefore, out of the ADEA litigation, court interpretation and guidance exist regarding the application of Section 109. However, *cases* that exist are relatively few. It is a central irony that through the Civil Rights Act of 1964, U.S. employers on U.S. soil must not discriminate against U.S. citizens and non-U.S. citizens who are legally authorized to work in the United States, yet this protection does not extend to the latter if overseas employment is involved, as affirmed in the case *Shekoyan v. Sibley International* (2005; also, see Roberts 2007, p. 310). Vladimir Shekoyan, a lawful permanent resident of the U.S. working for his U.S. employer in the Republic of Georgia, nevertheless lost his national-origin discrimination lawsuit against the employer because he was not protected under the Civil Rights Act of 1964 as amended through Section 109 of the Civil Rights Act of 1991. His argument regarding retaliation for whistleblowing also failed along similar lines.

The few other cases that are found involve perhaps the most complex aspect of extraterritoriality cases: the definition of a U.S. employer. The EEOC offers guidance in assessing an entity’s nationality. Relevant factors include but are not limited to the entity’s principal place of business, nationality of dominant shareholders, nationality of management

officers, and in the case of subsidiaries or even joint ventures, how much financial or other control is exerted by the U.S. entity. The more interrelated the various entities' programs, processes, and policies are, the more likely U.S. control is established (see "EEOC Enforcement Guidance"). Thus, in employment discrimination cases, centralization of labor relations, institution of corporate-wide personnel policies, central coordination of compensation and benefit plans, and so on loom large in determining whether the entity is U.S.-controlled and therefore subject to abiding by the Civil Rights Acts.

For example, Shayna Duncan lost her race, sex, and disability discrimination lawsuit against her employer because it was established that the employing entity was a Bermudan corporation located in Bermuda (*Duncan v. American International Group*, 2002). The defendant corporation AIG owned 20 percent of the Bermudan corporation, but the Bermudan corporation had its own human resources department, maintained and administered its employees' records, and made its own hiring and firing decisions. Therefore, no U.S.-centralized control was established and AIG was not considered the employer for purposes of Title VII and the ADA.

However, in a lawsuit brought forward to test whether the court had jurisdiction to hear a race-discrimination case, the U.S. district court decided it did, contending that the plaintiff had established his claim that his direct employer was controlled by a joint venture of U.S.-based companies (*Watson v. CSA, Ltd. et al.*, 2005). John Watson, a U.S. citizen employed by an apparently foreign entity providing support services at the U.S. military base in Kuwait, established that its operations were interrelated with the U.S.-based entities as part of a joint venture. The district court stated that in reaching its decision it paid close attention to the degree to which labor relations were centralized. The district court found sufficient evidence regarding the centralized nature of human resource management for the joint-venture entities, in essence suggesting that separation maneuvering for taxation purposes does not protect an entity against a Title VII employment discrimination claim.

Similarly, another defendant corporation failed to establish its lack of management control involving overseas operations (*Rajoppe v. GMAC Corporation Holding Corp.*, 2007). The defendant corporation moved to dismiss the race discrimination case, claiming that the U.S. citizen plaintiff was employed by GMACCM Japan, a foreign corporation therefore out of the reach of Title VII. Although the plaintiff had accepted a settlement upon dismissal from the Japanese entity (rather than be fired), the district court accepted the case (earlier, the EEOC had refused the case because of the settlement). The court looked closely at the notion of "integrated enterprise" and acknowledged the holistic nature in determining entity nationality, i.e., "the presence or absence of any single factor is not dispositive" (*Rajoppe v. GMAC*, p. 10). The plaintiff was able to show the substantial role GMACCH played in GMACCM Japan, including having directors common to both entities. Rajoppe was also able to establish that GMACCH played a role in routine employment decisions at GMACCM Japan, including performance bonuses and the hiring and firing of the plaintiff.

### **Implications**

With so few cases involving alleged extraterritorial employment discrimination, do U.S. employers have anything to worry about? The answer is, arguably, yes, because both ethical and practical considerations exist.

In recent years, attorneys and legal scholars have noted the inconsistency in employment protection for legally authorized non-U.S. citizens working in the U.S. versus working elsewhere in the world for U.S.-owned businesses. For example, Roberts (2007) stated that while U.S.

courts are understandably reluctant to offend the sovereignty of other nations and their own employment laws, the U.S. courts are “failing to intervene where they should” (p. 296) in extending protection to all employees of U.S. employers in other countries, not just to U.S. citizen employees. Roberts contended that currently, a U.S. employer might deliberately transfer a non-U.S. citizen employee abroad for the sole purpose of discharging the worker, knowing he or she had no legal recourse under Title VII. In addition, U.S. employers have the ability to discriminate against “local” employees in countries where employment discrimination laws are lax. That is, it is possible that a U.S. operation abroad might have working in it a mix of U.S. citizens, host-country nationals and third-country nationals, all of whom might have the legal protection, such as it exists, of that country, but only the U.S. citizens would have an additional avenue through which to pursue their employment rights.

Roberts (2007) also discussed how international law does not preclude extending anti-discrimination law to non-U.S. citizens working abroad for U.S. companies, as long as a U.S. court would not have to evaluate and rule on an act of a foreign country (i.e., the international principle of “comity” acknowledges the sovereignty of each country). After exploring philosophies that could be used as ethical support for the application of U.S. anti-discrimination law in other countries (in essence, reinforcing U.S. norms of equality in someone else’s home), Roberts concluded that current U.S. law creates uneven employment rights and that Congress could extend anti-discrimination law to include all U.S.[organizations’] employees, representing “a step in the direction of responsible participation in an increasingly interdependent global community” (p. 331). McNeir (2009), citing Roberts, framed the ethical dimensions by questioning the proper scope and definition of “covered employee” and the extent to which the law can truly be applied to firms not operating under a U.S. banner. The author ended by questioning whether the American Bar Association should now adopt new ethical standards regarding advising U.S.-owned foreign operations through an international thicket of employment law.

However, amendments to current laws and standards await their promotion and passage. Meanwhile, as businesses become more global (and more globally complex), their employees will look to avail themselves as they can of laws that protect them. With certain avenues unavailable, others can be sought. For example, non-U.S. citizens have attempted, albeit with unsuccessful results thus far, to pursue employment discrimination claims by looking to state law where it provides protection to *all* employees of firms with headquarters in that state but also with foreign operations (Berkowitz & Rosenberg, 2009; Darch, Field, & Geraghty, 2010; Domagalski, 2008). In addition, non-U.S. citizen employees could possibly challenge the nature of the overseas assignment in order to gain U.S. employment discrimination protection. That is, it is possible these employees might successfully argue that they were domiciled in the U.S. and on a temporary assignment overseas, therefore protected under U.S. laws (Berkowitz & Rosenberg, 2009). In addition, the existence of an employment contract with non-U.S. citizen employees working outside of the U.S. might establish employment discrimination protection for them. In a recent case (*Rabé v. United Airlines* 7<sup>th</sup> Cir., WL 677946, Feb. 28, 2011); Achille, 2011; “7<sup>th</sup> Circuit Rules”), flight attendant and French citizen Rabé alleged United Airlines had discriminated against her on the basis of her national origin, age, and sexual orientation. Rabé had an employment contract stating she would be working throughout the airline’s worldwide system. United argued that neither federal nor Illinois (location of United’s headquarters) state employment discrimination law applied to Rabé as a non-U.S. citizen. The court did not comment on the respective merits of the case, but stated that by entering into a contract with

Rabé, United Airlines extended statutory legal protection even if the employee would not normally be covered by that statute. This decision may well encourage all non-U.S. citizens to seek written contracts with U.S. employers in order to afford themselves of this protection.

Employment protections provided by the Civil Rights Acts, the ADA, and the ADEA also might be extended through class action lawsuits. Recently, the Supreme Court ruled that a sex discrimination lawsuit against Wal-Mart could not go forward as a class action lawsuit. Had it done so, it could have involved 1.5 million past and present employees seeking redress for an alleged pattern of sex discrimination, regardless of the type of job held or where they worked. While legal experts are divided regarding the impact of the decision on future lawsuits (see “Supreme Court Sides”), it could affect the willingness of non-U.S. citizens to work for Wal-Mart, the world’s largest retailer, or for smaller U.S. organizations with foreign operations, especially as civil rights and women’s groups continue to press these issues.

Most of the discussion of this paper has centered on non-U.S. citizens and their lack of employment discrimination protection when working elsewhere for a U.S.-controlled organization. However, U.S. citizens *are* protected extraterritorially, but this protection is not absolute when the employment of the U.S. citizen would cause the organization to violate the law of the foreign country. To prevail in the “foreign compulsion” defense, the organization would likely have to argue successfully that the foreign law is fundamental and that it had no other choice but to violate U.S. law in order to comply with the foreign law. Bell (2009), Brown (2007), Paetkau (2009), and Roberts (2007) all point to problems inherent with the notion of what constitutes a law. Roberts summarized EEOC enforcement guidance by stating the foreign law must be “generally applicable, mandated by government, and probably explicitly codified” (2007, p. 307). Bell (2009) calls for a more informal foreign compulsion defense that would allow a defendant organization to be able to establish the significant repercussions it would face in violating strongly held customs or traditions in order to comply with U.S. law. Both Brown (2007) and Paetkau (2009) go a step further, calling for Congress to amend the language of the foreign compulsion defense as found in Title VII, the ADA, and the ADEA. Paetkau (2009) also suggests that the amendment allow the U.S. Department of State to intervene in cases where employment laws are in conflict. Regardless, U.S.-controlled entities must be prepared to make very careful decisions in terms of what would otherwise be discriminatory employment, especially as more U.S. citizens seek employment opportunities abroad.

### **Conclusion**

When teaching employment law concepts to business students over the years, the author of the current paper noticed that cases in textbooks regarding different kinds of workplace discrimination were abundant, yet none appeared to illustrate the application of the Civil Rights Act of 1991 regarding extraterritoriality. The paper was therefore originally intended to be a review and categorization of these “Section 109” cases, which were assumed to have grown significantly in number as did their domestic counterparts the past twenty years. Upon the unexpected discovery that such cases were relatively few, the purpose of the paper had to shift somewhat. However, issues raised in these cases remain pertinent and, considering the recency of some court decisions, are perhaps just beginning to gather momentum as U.S. and foreign businesses become increasingly globally intertwined. Lawsuits have not disappeared (as the paper’s title might imply), but they have certainly “gone” in interesting directions since 1991. Considering that worldwide employment by U.S. companies is estimated to involve over 33 million workers (see “Summary Estimates,” 2010), the U.S. organization that is known to hold an ethical, equitable view toward *all* of its workers -- whoever and wherever they are in the

world -- while also comprehending and honoring the intricacies of foreign laws and traditions positions itself well for increasing global success.

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## FIGHTING FUTILITY II: MORE TOOLS FOR MEDIATION SUCCESS

CHARLES BULTENA\*  
CHARLES RAMSER\*\*  
KRISTOPHER TILKER\*\*\*

### I. INTRODUCTION

Mediation has become a successful conflict resolution tool that is used often as an alternative to the formal process of litigation. “Mediation offers individuals the opportunity to resolve whatever issue they have in a cost effective and timely manner,” notes Gene Valentini, director of the Texas Dispute Resolution System.<sup>1</sup> “Also, in mediation, you talk freely about anything you feel will get you to a point of resolution because nobody’s recording or saying it’s out of order, whereas in the courtroom you may not be able to address those things.”<sup>2</sup> Businesses of all sizes need to be more aware of the dynamics of mediation in order to understand how this process either can be successful or an exercise in futility. Only when business leaders have some understanding about those dynamics can they both prepare for and manage a successful mediation.

A previous paper on this subject offered insights into how to prepare for mediation so that the time and energy expended would not be wasted.<sup>3</sup> This paper builds on that earlier work, focusing on three new models from the field of group dynamics as they are applied to improve communication throughout the mediation process. The models are the Johari Window, Emotional Intelligence, and the Communication Intimacy Matrix. The extent to which business leaders apply these models to open the communication process can determine whether mediation succeeds or fails. Before considering how these skills can be developed using the models, it is important to examine the meaning of mediation, its use, and its success in resolving conflict.

### II. THE MEANING OF MEDIATION

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

- (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.<sup>4</sup>

\* Ph.D., Associate Professor of Management, Dillard College of Business Administration, Midwestern State University.

\*\* Ph.D., Professor of Management, Dillard College of Business Administration, Midwestern State University.

\*\*\* J.D., Professor of Legal Studies, Dillard College of Business Administration, Midwestern State University.

<sup>1</sup> Office of Dispute Resolution, *The Texas Resolution Connection*, Vol. 24, Issue 4, (Fourth Quarter, 2010), p. 2.

<sup>2</sup> Ibid.

<sup>3</sup> C.D. Bultena; C.D. Ramser; & K.R. Tilker, “Fighting Futility: Tools for Mediation Success,” *Southern Journal of Business and Ethics*, Vol. 2, 2010, pp. 64-73.

<sup>4</sup> TEX. CIVIL PRACTICE AND REMEDIES CODE ANN. §154.023 (2008).

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 binding ruling.<sup>5</sup> 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.

### III. 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. Cases received by Texas alternative dispute resolution centers in the most recent three-year period for which records were kept total an average of almost 20,000 cases annually, with a total of more than 58,000 cases from 2003 to 2005.<sup>6</sup> The same type of growth holds true in Oklahoma. As shown in Table 2, on average, more than 6,000 cases have been referred annually in that state to the alternative dispute resolution system, with 44,000 cases referred through the most recent seven-year period available.<sup>7</sup> Equally impressive is Oklahoma's settlement rate, which averages 65 percent over the most recent seven-year period available.<sup>8</sup> Settlement rate data are not available for Texas, but as Table 2 shows, in 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.

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

<sup>6</sup> Annual Report of the Texas Judiciary, Office of Court Administration, 2005 (last year reported).

<sup>7</sup> Annual Report of Alternative Dispute Resolution System, Supreme Court of Oklahoma Administrative Office of the Courts, 2003 - 2009.

<sup>8</sup> *Ibid.*

**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
<b>Total</b>	<b>58,481</b>	

**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%
2009	6,275	71%
<b>Total</b>	<b>44,629</b>	<b>65%</b>

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

#### IV. PURPOSE

Businesses of all sizes need to be aware of mediation's dynamics, because if they are not, 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, which is collaborative communication that both cultivates and then depends upon a high degree of mutual trust among participants. In mediation, participants must come to believe that each has integrity, character, and capability. Without that, the option of persuasion upon which mediation is founded cannot operate. In mediation dynamics, perceptions are as important as reality. If people perceive a situation as being closed, then that becomes their "truth," and the motivation to communicate with the opposing party will not exist. One of the common complaints of clients entering mediation is that they cannot communicate, which indicates that they perceive a closed situation. Frustration then builds from feelings of being misunderstood.<sup>9</sup> The ultimate result is a barrier to any communicative activity and even a loss of desire to communicate with others who share a common stake in a resolution.

<sup>9</sup> Nancy J. Foster, *Barriers to Everyday Communications*, (Aug. 2000), available at <http://mediate.com/articles/foster.cfm>.

A previous paper on this subject offered insights into how to prepare for mediation so that the time and energy expended would not be wasted.<sup>10</sup> This paper builds on that earlier work, focusing on three important models from the field of group dynamics as they are applied to improve communication throughout the mediation process. Three models from the field of group dynamics—the Johari Window, Emotional Intelligence, and the Communication Intimacy Matrix—are revisited and combined in a fresh way to enhance communication in the mediation process. The Johari Window is presented as a graphic tool for assessing the communicative status of the mediation. Then, Emotional Intelligence is explored as a means to “Open the Window” of communication by unlocking the power of emotions in communication. Finally, the Intimacy Matrix is presented as a roadmap to open communication.

## V. THREE TOOLS FOR “OPENING THE WINDOW” OF COMMUNICATION IN MEDIATION

### A. *THE JOHARI WINDOW – VISUALIZING COMMUNICATION IN MEDIATION*

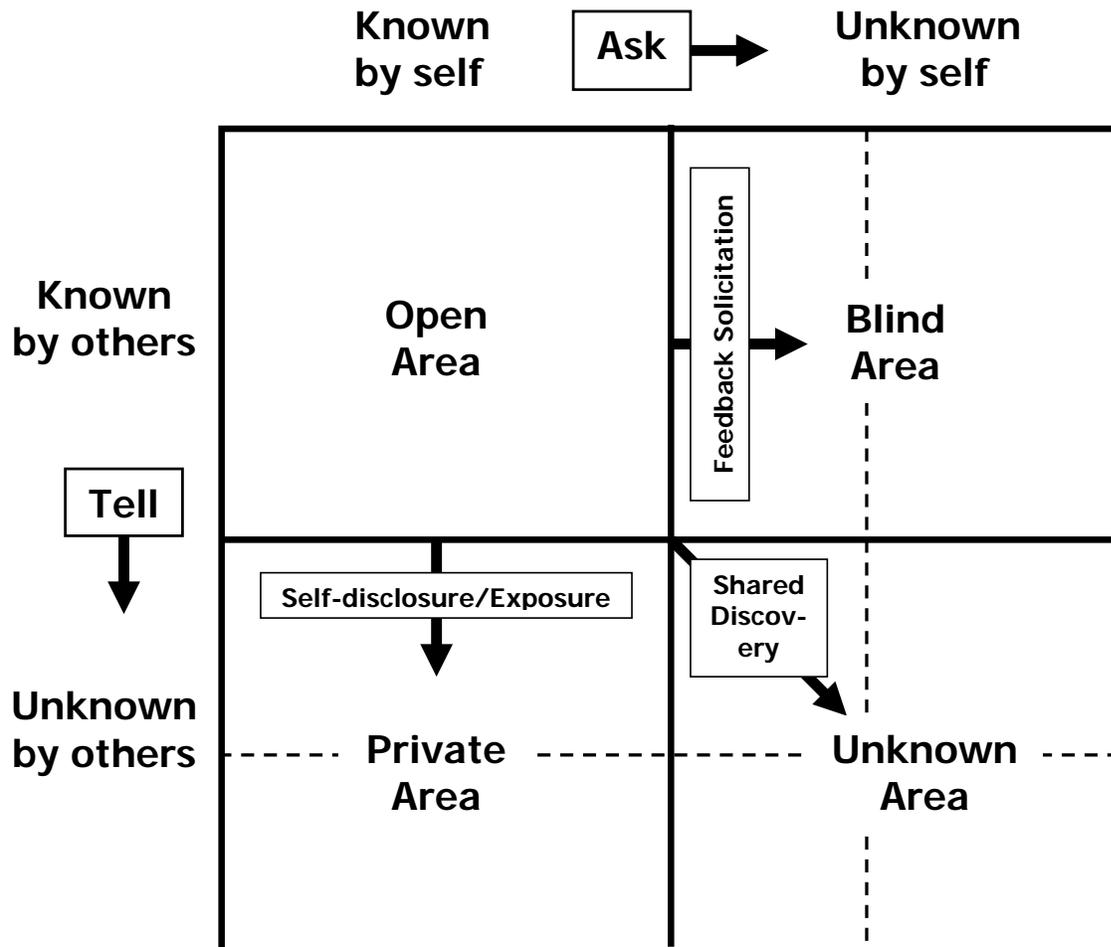
In 1955, Joseph Luft and Harry Ingham proposed the Johari Window as a graphic model of interpersonal awareness<sup>11</sup> (See Figure 1). Since then, scholars, executives, and consultants have used the model as a tool for developing high levels of trust and openness in different situations. Basically, the model describes mechanisms for developing effective working relationships through self-disclosure, feedback, and shared discovery. The model is depicted as a window with four panes that visually represent four areas of effectiveness in the relationship between two people or entities (Open, Blind, Public, and Unknown). That relationship can be looked at as two-dimensional: information known and unknown to oneself, and information known and unknown to another person. What each person knows about the other is “open,” and what is not known is “hidden.” The **Open Area** (“the window of exchange”) is the area in which successful mediation occurs. It consists of perceptions, understanding, and knowledge of relevant information held in common by both mediation parties, a sharing that can reduce the potential for conflict. This pane must be open for effective mediation to occur. The Open Area is small when communications are closed, blocked, or not forthcoming. Research by industry and universities, as well as among counselors, has shown that communications are richer, more authentic, and complete when the Open Area is larger than the hidden areas (Blind, Public, and Unknown).<sup>12</sup>

<sup>10</sup> C.D. Bultena; C.D. Ramser; & K.R. Tilker, “Fighting Futility: Tools for Mediation Success,” *Southern Journal of Business and Ethics*, Vol. 2, 2010, pp. 64-73.

<sup>11</sup> Joseph Luft and Harry Ingham, “The Johari Window, A Graphic Model of Interpersonal Awareness,” *Proceedings of the Western Training Laboratory in Group Development*, Los Angeles, UCLA Extension Office, 1955.

<sup>12</sup> *Ibid.*

**Figure 1: The Johari Window**



**Source:** Based on Joseph Luft and Harry Ingham, “The Johari Window, A Graphic Model of Interpersonal Awareness,” *Proceedings of the Western Training Laboratory in Group Development*, Los Angeles, UCLA Extension Office, 1955. Figure adapted from Alan Chapman (2003).<sup>13</sup>

The hidden areas are comprised of the Blind, Private, and Unknown Areas. Attitudes and behaviors in these areas are not known to one or both parties. The **Blind Area** is comprised of attitudes and behavior not known to oneself but known to the other party. To illustrate, one party may perceive the other as arrogant, something that person may not be aware of or seek to discover via feedback about perceptions. The **Private Area** consists of attitudes and behaviors known to one but not to the other party. One person may feel that the other has a false premise underlying part of his position. The person feeling that may not disclose it, and the other party

<sup>13</sup> Alan Chapman, *Johari Window Model*, (2003), available at <http://businessballs.com/johariwindowmodeldiagram.pdf>.

may not pick up on it from the other's verbal and nonverbal messages.<sup>14</sup> These blockages directly hamper open communication in mediation. Finally, the **Unknown Area**, the last pane of the Johari Window, represents attitudes, behavior, and relevant information unknown to either party. Unfortunately, the hidden areas of the Johari Window would be large in early stages of mediation. There would be many possible observations, reflections, and concepts never arrived at because one or both parties in mediation lack the will to communicate.<sup>15</sup>

Three processes shaping the configuration of the four Johari panes are *feedback*, *disclosure*, and *shared discovery*. Feedback is the extent to which people are willing to share with others how they are perceived. It is the willingness to be open with an adversary and is also one's ability to understand verbal and nonverbal communication from others. As shown in Figure 1, feedback should be sought because it has the potential to open communication (expand the Open Area) by shrinking the Blind Area.<sup>16</sup> Disclosure, on the other hand, is the extent to which people are willing to share with others appropriate information, feelings, and perceptions about themselves.<sup>17</sup> This is important in mediation because it is difficult to resolve issues effectively with only partial information. Disclosure, as shown in Figure 1, can open communication (expand the Open Area) by shrinking the Private Area. Finally, shared discovery refers to the process by which both parties jointly discern new information and potential resolutions to mediation issues. Shared discovery, as shown in Figure 1, opens communication (expands the Open Area) by shrinking the Unknown Area. Thus, the Johari Window graphically illustrates how to open "The Window of Communication" with feedback, disclosure, and shared discovery.

The disclosure and feedback processes should be in balance. With all disclosure and little feedback, the process becomes one way, involving conceited domination. A person operating this way could be termed a **Blabbermouth** because he talks a lot but does not listen well. In mediation settings, other people tend to get annoyed with such a person and eventually either will actively or passively learn to shut him up.<sup>18</sup> If the balance is too far in the opposite direction (all feedback and little or no disclosure), the mode of communication is exploitive, with a large façade or private area. A person operating this way could be termed the **Pumper** because he keeps large amounts of information private. In mediation, this person tends to make parties feel defensive and resentful through relentless questioning.<sup>19</sup> Finally, when there is little disclosure and also little feedback sought, a large unknown area exists. A person in this mode could be labeled the **Hermit**, a person difficult to read because he is unpredictable. In mediation, this would cause the other parties to feel insecure and confused about expectations.<sup>20</sup> As can be seen,

<sup>14</sup> Joseph Luft and Harry Ingham, "The Johari Window, A Graphic Model of Interpersonal Awareness," *Proceedings of the Western Training Laboratory in Group Development*, Los Angeles, UCLA Extension Office, 1955, p. 237

<sup>15</sup> *Ibid.*

<sup>16</sup> *Ibid.* at 238.

<sup>17</sup> *Ibid.* at 239

<sup>18</sup> University of San Francisco Faculty, *Johari Window*, (2005), <http://www.cps.usfca.edu/324sh/johari.htm> (last visited 18 March 2005).

<sup>19</sup> *Ibid.*

<sup>20</sup> *Ibid.*

then, without effective communication, the mediation process can break down, leaving participating parties feeling offended, disliked, and distrustful of each other. Smoothing out interpersonal communication would facilitate the mediation process and make it more effective for all.

The ideal state for keeping communication at an optimum level is one in which a large open area exists (plenty of feedback, disclosure, and shared discovery, or an open window). This is the realm of the *Open-Receptive Person*, one in which agreement occurs.<sup>21</sup> Generally the Blind, Private, and Unknown areas of the Johari Window would be smaller. It would not be appropriate or possible for Blind and Private areas to be non-existent because in mediation, people rarely share everything with their adversary. Also, because all parties are by nature limited in their knowledge, the Unknown Area would always exist.

Opening the window of communication requires an effective mechanism for offering disclosure, obtaining feedback, and promoting shared discovery, processes that are often hampered in mediation by negative emotions, hidden motives, and secret agendas. Next, we offer a tool to enhance awareness and management of emotions to unlock the hidden areas of the Johari Window.

#### B. EMOTIONAL INTELLIGENCE – OPENING THE WINDOW OF COMMUNICATION

Mediation arises out of conflict or disagreement among parties. Conflict, by its very nature, is an emotional interaction that impacts the way in which parties communicate with and respond to each other.<sup>22</sup> Research indicates that when emotions rather than rational, objective thought begin to drive negotiators, an impasse is much more likely to be reached.<sup>23</sup> Lack of awareness of and failure to manage emotions in mediation lead to miscommunication and conflict, which lessens the likelihood of resolution. To succeed in mediation, one must go beyond traditional intelligence (IQ) and technical skill; one must possess Emotional Intelligence (EI), which is the ability to perceive emotions and recognize their meaning; to understand emotion-related feelings; and to manage emotions and solve problems on the basis of them.<sup>24</sup> Awareness of and the ability to manage one's own and other's feelings and emotions are key elements in effective communication. Daniel Goleman claims EI is twice as important to success in the workplace as is raw intelligence or technical knowhow.<sup>25</sup> Emotional Intelligence has important implications for communication, conflict management, and mediation success. People with high EI can engage in promoting information-sharing, trust, healthy risk-taking, and learning, while those

<sup>21</sup> *Ibid.*

<sup>22</sup> A.M. Bodtker & R.L. Oliver, Emotion in Conflict Formation and Its Transformation: Application to Organizational Conflict Management, *International Journal of Conflict Management*, 12, 2001, p. 259-275.

<sup>23</sup> J. Schopler, C.A. Insko, J. Wieselquist, et al., When Groups Are More Competitive Than Individuals: The Domain of the Discontinuity Effect, *Journal of Personality and Social Psychology*, 80, 2001, p. 632-644.

<sup>24</sup> J.D. Mayer, P. Salovey, & D. Caruso, Selecting a measure of emotional intelligence: The case for ability scales, *The Handbook of Emotional Intelligence*, San Francisco: Josey-Bass, 2000.

<sup>25</sup> D. Goleman, *Working with Emotional Intelligence*, New York: Bantam Books, 1998.

with low levels of emotional intelligence may tend to endorse fear, anxiety, and pessimism.<sup>26</sup> Overall, EI allows people to connect with others and solve problems.

Goleman and Boyatzis (2001) identified four distinct EI competencies that impact communication and mediation success: self-awareness, self-management, social awareness, and relationship management (see Figure 2).<sup>27</sup> These competencies can be developed and can be used to enhance self-disclosure, feedback, and shared discovery in the Johari Window, thus opening the window of communication and enhancing the mediation process.

**Figure 2: Components of Emotional Intelligence**

	<b>SELF</b>	<b>OTHERS</b>
<b>AWARENESS</b>	<p style="text-align: center;"><b><u>Self-Awareness</u></b></p> <ul style="list-style-type: none"> <li>• Emotional self-awareness</li> <li>• Accurate self-assessment</li> <li>• Confidence</li> </ul>	<p style="text-align: center;"><b><u>Social-Awareness</u></b></p> <ul style="list-style-type: none"> <li>• Empathy</li> <li>• Organizational awareness</li> <li>• Service orientation</li> </ul>
<b>BEHAVIOR</b>	<p style="text-align: center;"><b><u>Self-Management</u></b></p> <ul style="list-style-type: none"> <li>• Emotional self-control</li> <li>• Trustworthiness</li> <li>• Conscientiousness</li> <li>• Adaptability</li> <li>• Optimism</li> <li>• Achievement-orientation</li> <li>• Initiative</li> </ul>	<p style="text-align: center;"><b><u>Relationship Management</u></b></p> <ul style="list-style-type: none"> <li>• Development of others</li> <li>• Inspirational leadership</li> <li>• Influence</li> <li>• Communication</li> <li>• Change catalyst</li> <li>• Conflict management</li> <li>• Bond Building</li> <li>• Teamwork and collaboration</li> </ul>

**Source:** Adapted from Richard E. Boyatzis & Daniel Goleman, *The Emotional Competence Inventory—University Edition* (Boston, Mass: The Hay Group, 2001).

**Self-awareness:** This involves a person reading his own emotions and recognizing their impact; knowing his strengths and limitations, and feeling good about them; and appreciating his personal qualities.<sup>28</sup> People who have a high degree of self-awareness recognize how their feelings affect themselves, other people, and their job performance.

<sup>26</sup> M. Bagshaw, Emotional Intelligence – training people to be affective so they can be effective, *Industrial & Commercial Training*, 32, (2), 2000, p. 61-66.

<sup>27</sup> Richard E. Boyatzis & Daniel Goleman, *The Emotional Competence Inventory—University Edition*, Boston, Mass: The Hay Group, 2001.

<sup>28</sup> M. Bagshaw, Emotional Intelligence – training people to be affective so they can be effective, *Industrial & Commercial Training*, 32, (2), 2000, p. 61-66.

**Self-management:** This second dimension of emotional intelligence involves keeping disturbing emotions under control; acting on opportunities; displaying honesty and integrity; recognizing the needs of others; and adapting to changing situations.<sup>29</sup>

**Impact on the Johari Window and Mediation Communication:** Self-awareness and self-management have the potential to expand the Open Area of the Johari Window (see Figure 1), thus enhancing communication in mediation. Becoming aware of one's emotions and limitations and then learning how to manage them provide a form of self-discovery that can shrink the Blind Area (what is known to one party and not to the other). For example, in a mediation, Party A may be aware that Party B is impulsive and quick-tempered and can use this to his advantage. If Party B acknowledges these characteristics in himself and learns to manage them, the other party's advantage is eliminated. The Open Area is expanded and the Blind Area shrunk. Additionally, gaining control over emotions may alleviate unfounded fear, anxiety, and inhibition while boosting trust, honesty, flexibility, and initiative among parties in mediation. This leads to greater confidence, cooperation, and the ability to interact more effectively with the other party. As a result, one party may be less guarded and protective of information that should be disclosed to the other party in mediation, thus shrinking the Private Area (what one knows and the other party does not) and further expanding the Open Area. Thus, self-awareness and self-management have the potential to open the window of communication and contribute to mediation success.

**Social Awareness:** This involves having empathy for others and intuition about organizational problems. Empathy means thoughtfully considering other's feelings in the process of making intelligent decisions.<sup>30</sup> Emotionally intelligent individuals are aware of the nonverbal cues that exist in social settings and are more capable of understanding, communicating, and establishing relationships of trust and credibility.

**Relationship Management:** This last dimension of emotional intelligence involves the ability to persuade others; to guide and inspire with a convincing vision; to develop abilities in others; to act as a catalyst for change; and to manage conflict and build bonds with others.<sup>31</sup> Effective leaders use these relationship management skills to spread their enthusiasm and solve disagreements, often with consideration and wit.

**Impact on the Johari Window and Mediation Communication:** Social awareness enhances one's ability to read and interpret feedback, even nonverbal responses, from the other party in mediation. This enhanced ability to read and interpret feedback from the other party shrinks the Blind Area and further expands the Open Area in the Johari Window. Finally, relationship management builds trust and a bond between the parties that should lead to greater exchange of relevant information, greater cooperation, and mutual discovery in mediation that will shrink the Unknown Area (what was formerly unknown to both parties) and expand the

<sup>29</sup> T. Estep, The Emotional Intelligence of Genghis Khan, President and CEO Mongolia Inc., *Training & Development*, 58, (12), 2004, p. 71-73.

<sup>30</sup> D. Goleman, *Working with Emotional Intelligence*, New York: Bantam Books, 1998.

<sup>31</sup> *Ibid.*

Open Area. Thus, self-awareness and self-management also have the potential to open the window of communication and contribute to mediation success.

Overall, EI offers an effective mechanism to enhance self-disclosure, feedback, and shared discovery in mediation. Enhanced awareness and management of emotions unlock the hidden areas of the Johari Window (Blind, Private, and Unknown) and open communication (expand the Open Area) in the mediation process. The good news for mediation is that EI can be improved with appropriate assessment and training.<sup>32</sup> If EI provides a *formula* for opening communication, a final model, the Intimacy Matrix, provides a *roadmap* for opening the window of communication.

### C. THE INTIMACY MATRIX – A ROADMAP FOR OPEN COMMUNICATION

Whetten and Cameron (1987) offered considerable insight into the process of building communication intimacy between groups and individuals.<sup>33</sup> They represented the process as a progression, or roadmap for the journey, from closed to open communication, complete with specific indicators or milestones one would observe along the way in terms of the focus of communication and the type or form of communication. Their work can be summarized in the form of a matrix, depicted in Figure 3. One dimension refers to communication focus (subject). It can include external issues; internal or common group experiences; personal disclosure; and even the specific relationship between the two or more mediation parties themselves. The other dimension of the matrix is the type of communication. Such types can range from clichés, which are superficial expressions requiring little communication investment (e.g., “The ball is in your court” or “Let’s not reinvent the wheel”), to facts, which require more investment, to one’s opinion, an even larger investment of self. This dimension culminates, finally, in feelings, which are the strongest involvement of self because they are emotional and require trust.<sup>34</sup>

This matrix works with the Johari Window model to facilitate a balanced Open Area in that rather than simply calling for simultaneous disclosure, feedback, and shared discovery — a big jump for those who have not been communicating effectively — it suggests a more incremental, gradual process (a roadmap) for traveling from the closed to the open space on the matrix. This journey involves moving from external to group to personal to relationship foci in mediation communication. At the same time, it involves branching from clichés to facts to opinions to feelings, as intimacy increases. The lower right portion of the matrix, the **OPEN** space, is the territory for mediation success. Here the parties have developed an effective working relationship characterized by mutual trust and free exchange of meaningful information, ideas, and feelings. The upper left portion, the **CLOSED** space, is unlikely territory for success because it focuses on external issues, with information flow limited to impersonal facts and superficial expressions or clichés. Progression toward the lower right is vital to mediation

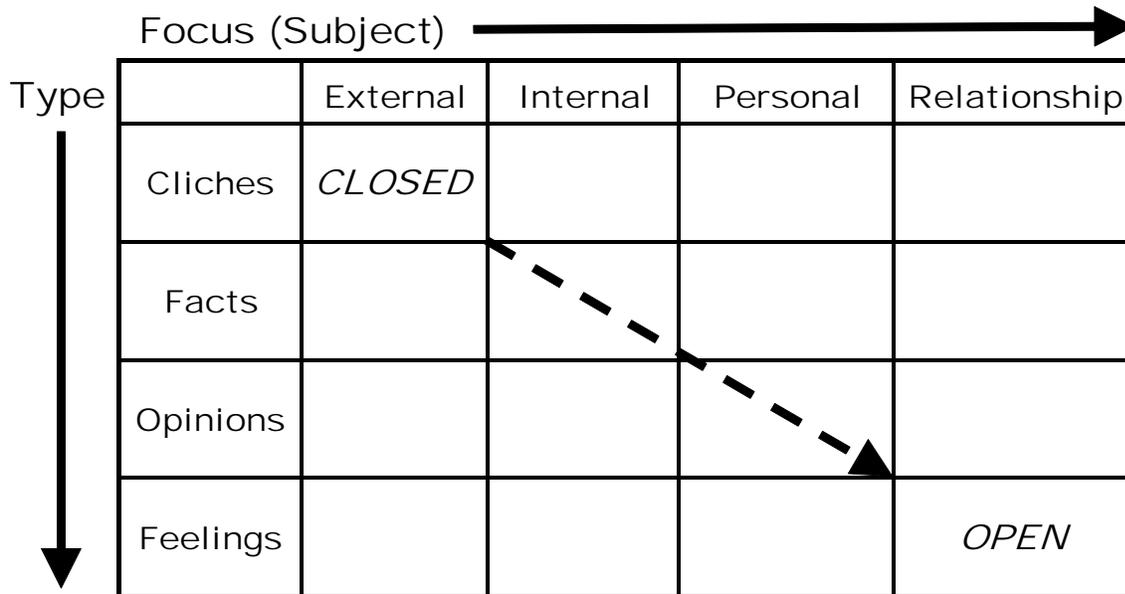
<sup>32</sup> Daniel Goleman, *Emotional Intelligence: Why It Can Matter More Than IQ*, New York, Bantam, 1995.

<sup>33</sup> D. A. Whetten & K. S. Cameron, *The Performance Management Sourcebook*, 109 (Craig Schneur, et al. eds., 1987).

<sup>34</sup> *Ibid.*

success and may occur before the actual process begins or during it as issues are tackled. The Intimacy Matrix highlights specific steps, or milestones, on the road to open communication. Thus, it is useful in assessing the current state of communication in mediation and in specifying specific steps to improve or open communication.

**Figure 3: The Intimacy Matrix**



**Source:** C.D. Ramser based upon D. A. Whetten & K. S. Cameron, *The Performance Management Sourcebook*, 109 (Craig Schneir, et al. eds., 1987).

## VI. SUMMARY

In summary, open communication is essential to mediation success. This paper offers three vital tools from the field of group dynamics to visualize and open the “Window of Communication” in mediation. The Johari Window is a useful analytical tool to visualize and improve communication in mediation. It provides a graphic representation of the communicative status of mediation, focusing on the relative size of the Open and Hidden (Blind, Private, and Unknown) areas of the communication window. Mediators may use the Johari Window to help parties honestly evaluate and visualize the status of communication in the mediation, revealing shortcomings and suggesting strategies to open the respective hidden areas with disclosure, feedback, and shared discovery.

Once the “Window of Communication” is assessed using the Johari approach, Emotional Intelligence and the Intimacy Matrix can be used to further increase the size of the communication opening. Emotional Intelligence offers a formula for opening the communication process. Each of the four components of EI has specific implications for

entering the various hidden areas of the Johari Window. These components impact the three processes of the Johari Window (disclosure, feedback, and shared discovery) in definite ways, and each can be assessed and developed with appropriate training.<sup>35</sup>

If Emotional Intelligence offers a *formula* for opening the window of communication, the Intimacy Matrix provides a *roadmap* for the journey from closed to open communication. The matrix reveals a gradual process in which communication moves from being in a closed state focused on external issues and limited information flow to an open state focused on a relationship between the parties, with rich information exchange. It maps specific milestones, or checkpoints, along the way that can be used to assess and improve open communication in mediation.

Collectively, these models offer a useful tool kit for assessing, understanding, and improving communication in mediation. The Johari Window helps parties visualize the communication status of the mediation, while Emotional Intelligence and the Intimacy Matrix offer specific steps to address hidden areas and open the window of communication. Mediation is a more dynamic process than can be wholly reflected through two-dimensional grids such as the Johari Window and the Intimacy Matrix and through the four components of Emotional Intelligence. However, these tools used together can help mediation participants understand the process of building trust and openness between parties to help facilitate the process. Mediation is a collaborative tool for resolving conflicts in the business world, and the use of mechanisms such as the Johari Window, Emotional Intelligence, and the Intimacy Matrix will help parties who are considering mediation instead of litigation make a more informed decision about which process could be used most effectively in the current situation.

## VII. SUCCESSFUL MEDIATION IN BUSINESS

Although there is room to improve mediation through application of the tools presented in this paper, there is no doubt that mediation has become a highly effective mechanism 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, not to mention the many cases that do not reach full settlement yet leave fewer extreme differences to be resolved through arbitration or litigation.<sup>36</sup> 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.

<sup>35</sup> Daniel Goleman, *Emotional Intelligence: Why It Can Matter More Than IQ*, New York, Bantam, 1995. D. Goleman, *Working with Emotional Intelligence*, New York: Bantam Books, 1998.

<sup>36</sup>Financial Industry Regulatory Authority, *What is Mediation and How Does Mediation Differ from Arbitration?* <http://www.finra.org/ArbitrationMediation/Parties/Overview/MediationAnAlternatePath/P007961> (last visited Feb. 24, 2011).

## VIII. CONCLUSION

The success of mediation and its application across a wide spectrum of conflict situations have been noted, and three tools for opening the communication process for success in mediation, have been supported. Business leaders can use these three 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 communication is open, hidden areas are addressed, and the gradual progression from closed to open communication is engaged.

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 communication process and how to assess and open the window of communication.

**Table 3: Examples of Successful Mediation in Business**

**Cases Mediated by Bruce Meyerson**<sup>37</sup>

- An FLSA collective action involving 80,000 employee claims.
- A whistle-blower claim against a public entity.
- A claim of retaliation and sexual harassment.
- A franchise dispute over claimed failure of franchisee to fulfill agreement.
- A construction dispute involving claims of poor workmanship.
- A securities dispute involving claims of breach of fiduciary duty.

**Cases Mediated by World Intellectual Property Organization**<sup>38</sup>

- A copyright license mediation between a Dutch and a French company.
- A contract dispute between a publisher and a software company over web presence.
- A dispute between an airline and a software company over ticket sales platform.

**EUCON Case Examples**<sup>39</sup>

- A dispute involving damage compensation in the construction industry.
- A dispute between two entities involving trademark licensing.
- A dispute involving obligations under a master contract in engine manufacturing.

**RESOLVE Case Examples**

- A dispute involving scarce water allocation from the Truckee River and Carson River Basin in Nevada.<sup>40</sup>
- A dispute involving preservation of a forest ecosystem and forest mining in New Brunswick, Canada.<sup>41</sup>
- A dispute involving a large chemical company proposal to mine for titanium in Georgia.<sup>42</sup>

<sup>37</sup> Bruce Meyerson, *Examples of Cases Mediated*, [http://www.brucemeyerson.com/ec\\_mediation.html](http://www.brucemeyerson.com/ec_mediation.html) (last visited Feb. 24, 2011).

<sup>38</sup> World Intellectual Property Services, *WIPO Mediation Case Examples*, <http://www.wipo.int/amc/en/mediation/case-example.html> (last visited Feb. 24, 2011).

<sup>39</sup> Europäisches Institut für Conflict Management e.V., *Concrete Examples In Detail*, [http://www.eucon-institute.com/mediation\\_beispiele.html](http://www.eucon-institute.com/mediation_beispiele.html) (last visited Feb. 24, 2011).

<sup>40</sup> Resolve, *Resilient Ecosystems*, <http://www.resolve.org/our-work/issues/resilient-ecosystems/>. (last visited Feb. 24, 2011).

<sup>41</sup> Id.

<sup>42</sup> Resolve, *Natural Resource Conflict*, <http://www.resolve.org/our-work/issues/natural-resource-conflict/>. (last visited Feb. 24, 2011).



## IMPLICATIONS OF THE MELENDEZ-DIAZ SUPREME COURT DECISION

DAPHYNE SAUNDERS THOMAS\*

DAVID L. PARKER\*\*

TERRY S. KELLY\*\*\*

### Introduction

Business law as well as numerous other law classes regularly require the students to study the United States Constitution including the sixth amendment. Frequently, little time or attention has been devoted to the confrontation clause in these classes. With the recent cases in Virginia and the cases before the United States Supreme court, this clause has taken on greater significance.

The Confrontation Clause of the Sixth Amendment to the United States Constitution provides that "in all criminal prosecutions, the accused shall enjoy the right ... to be confronted with the witnesses against him". The Supreme Court and Congress have looked to this amendment to determine what impact this has on the rights of the defendant. It is crucial to understand from a legal standpoint what the difference between testimonial and hearsay is and what cross examination entails. This paper proposes to provide an overview of the Confrontation clause and a discussion of the legal implications from those cases that have recently come before the United States Supreme court.

### Melendez-Diaz Case Summary

Luis E. Melendez-Diaz was arrested for distributing and trafficking cocaine in 2001. He was tried by the Commonwealth of Massachusetts and found guilty by a jury. His appeal was based on the fact that the admission of certificates to the trial that verified the identity and quantity of the substance in his possession at the time of arrest violated his right under the Sixth Amendment to confront the witness against him. In this case that witness was the lab analyst that performed the tests on the confiscated material and swore to the validity of the certificates confirming the substance and amount (who did not appear in court).<sup>1</sup>

The *Melendez-Diaz* appeal of the guilty verdict was rejected by the Appeals Court of Massachusetts. The case was escalated to the U.S. Supreme Court where that court found that per an earlier ruling in *Crawford v. Washington*<sup>2</sup>, lab analysts were "witnesses" for purposes of applying the Sixth Amendment and the accused were entitled to confront the forensic analysts at their trial unless the analysts were unavailable to testify. The resulting Supreme Court decision ruled in favor of Melendez-Diaz and upheld the requirement that the right to confrontation does apply to an analyst performing lab tests when the results are used as evidence in a trial. The decision was not an overwhelming majority but was a 5-4 decision issued in June 2009.<sup>3</sup>

In order to completely understand the *Melendez-Diaz* case and the resulting Supreme Court decision, it is crucial to understand the intention and description from a legal standpoint of the Sixth Amendment and more importantly the Confrontation Clause of that amendment, what the difference between testimonial and hearsay is and what cross examination entails.

### The Sixth Amendment and the Confrontation Clause

The United States Constitution includes language safeguarding the rights of individuals who have been accused of committing a crime. The Sixth Amendment provides that "in all prosecutions, the accused shall enjoy

\*B.A., Virginia Polytechnic Institute and State University; J.D., Washington and Lee University, School of Law; M.B.A., James Madison University; Adolph Coors Business Professor, James Madison University.

\*\*B.A., Virginia Military Institute; J.D., University of Richmond, T.C. Williams School of Law; L.L.M., The U.S. Army Judge Advocate General's School; Associate Professor of Business Law, James Madison University.

\*\*\*B.S. and M.B.A., Virginia Polytechnic Institute and State University; Lecturer of Finance, James Madison University.

<sup>1</sup> *Melendez-Diaz v. Massachusetts*, 129 S.Ct. 2527 (2009).

<sup>2</sup> *Id.* at 5, citing *Crawford v. Washington*, 541 U.S. 36, 54 (2004).

<sup>3</sup> Ben Conery, *States Scramble to Keep Techs in Labs, Out of Courts*, Washington Times, Aug. 31, 2009, at A1.

the right to a speedy and public trial, by an impartial jury of the State and district wherein the crime shall have been committed, which district shall have been previously ascertained by law, and to be informed of the nature and cause of the accusation; to be confronted with the witnesses against him, to have compulsory process for obtaining witnesses in his favor, and to have the Assistance of Counsel for his defense."<sup>4</sup> One fundamental right guaranteed that is at the heart of this decision is the right to confrontation which guarantees the accused the opportunity to test the witness's memory of events surrounding the alleged crime and to require testimony that determines whether or not a judge or jury believes the witness.<sup>5</sup>

The Supreme Court and Congress have studied this amendment trying to interpret what impact this has on the rights of the defendant. The *Melendez-Diaz* case is one of the most recent decisions by the court clarifying those rights. The Supreme Court held in *Melendez-Diaz* that the Sixth Amendment prohibits the prosecution in a criminal case from placing crime laboratory reports into evidence in lieu of live testimony by the crime lab analyst. U.S. Supreme Court Justice Scalia predicted that the "sky will not fall" with the decision mandating that lab analysts testify in person to the validity of drug tests and alcohol screenings.<sup>6</sup>

The Confrontation Clause has its roots in both English common law, protecting the right of cross-examination, and Roman law, which guaranteed persons accused of a crime the right to look their accusers in the eye.<sup>7</sup>

The most notorious instances of cross examination occurred in the great political trials of the 16th and 17th centuries. One such was the 1603 trial of Sir Walter Raleigh for treason. Lord Cobham, Raleigh's alleged accomplice, had implicated him in an examination before the Privy Council and in a letter. At Raleigh's trial, these were read to the jury. Raleigh argued that Cobham had lied to save himself: "Cobham is absolutely in the King's mercy; to excuse me cannot avail him; by accusing me he may hope for favour."<sup>8</sup> Suspecting that Cobham would recant, Raleigh demanded that the judges call him to appear, arguing that "[t]he Proof of the Common Law is by witness and jury: let Cobham be here, let him speak it. Call my accuser before my face . . ."<sup>9</sup> The judges refused, and, despite Raleigh's protestations that he was being tried "by the Spanish Inquisition," the jury convicted, and Raleigh was sentenced to death.<sup>10</sup>

One of Raleigh's trial judges later lamented that "the justice of England has never been so degraded and injured as by the condemnation of Sir Walter Raleigh."<sup>11</sup> Through a series of statutory and judicial reforms, English law developed a right of confrontation that limited these abuses. For example, treason statutes required witnesses to confront the accused "face to face" at his arraignment.<sup>12</sup> Courts, meanwhile, developed relatively strict rules of unavailability, admitting examinations only if the witness was demonstrably unable to testify in person.<sup>13</sup> Several authorities also stated that a suspect's confession could be admitted only against himself, and not against others he implicated.<sup>14</sup>

In *Crawford v. Washington*,<sup>15</sup> the Supreme Court made any "testimonial" out-of-court statements inadmissible if the accused did not have the opportunity to cross-examine that accuser and that accuser is unavailable at trial. "Testimonial" statements include statements that an objectively reasonable person in the declarant's situation would have deemed likely to be used in court. In *Melendez-Diaz v. Massachusetts*, the Court

<sup>4</sup> 58 Catholic University Law Review 703, Spring 2009.

<sup>5</sup> <http://caselaw.lpfindlaw.com/data/constituion/amendment06/>

<sup>6</sup> *Melendez-Diaz*, at 22, 129 S.Ct. 2527 (2009).

<sup>7</sup> *Crawford v. Washington*, 541 U.S. 36, 45 (2004).

<sup>8</sup> 1 D. Jardine, *Criminal Trials*, 435 (1832).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 520.

<sup>12</sup> . E. g., 13 Car. 2, c. 1, § 5 (1661).

<sup>13</sup> See Lord Morley's Case, 6 How. St. Tr. 769, 770-771 (H. L. 1666).

<sup>14</sup> See 2 W. Hawkins, *Pleas of the Crown*, ch. 46, § 3, pp. 603-604 (T. Leach 6th ed. 1787); 1 Hale, *supra*, at 585, n. (k); 1 G. Gilbert, *Evidence* 216 (C. Lofft ed. 1791); cf. Tong's Case, Kel. J. 17, 18, 84 Eng. Rep. 1061, 1062 (1662) (treason). *But see* King v. Westbeer, 1 Leach 12, 168 Eng. Rep. 108, 109 (1739).

<sup>15</sup> 541 U.S. 36 (2004).

ruled that admitting a lab chemist's analysis into evidence, without having him testify, violated the Confrontation Clause.<sup>16</sup>

Such a rule is based on the right to prevent hearsay testimony to be presented in a court of law. The rationale was that the defendant had no opportunity to challenge the credibility of and cross-examine the person making the statements. Certain exceptions to the hearsay rule have been permitted; for instance, admissions by the defendant are admissible, as are dying declarations. Nevertheless, the Supreme Court has held that the hearsay rule is not exactly the same as the confrontation clause. Hearsay may, in some circumstances, be admitted though it is not covered by one of the long-recognized exceptions; for example, prior testimony may sometimes be admitted if the witness is unavailable.<sup>17</sup>

### **Nontestimonial and Hearsay Statements**

Hearsay testimony is defined as testimony by one witness to the out of court statements and observations of another person to prove that the statement or observation was accurate. Two years after the Supreme Court's *Crawford* decision, the Court had the opportunity to clarify the difference between testimonial and nontestimonial hearsay in *Davis v. Washington*.<sup>18</sup> Statements are nontestimonial when made in the course of police interrogation under circumstances objectively indicating that the primary purpose of the interrogation is to enable police to deal with "present or imminent risk of harm to an individual or the public".<sup>19</sup> They are testimonial when the circumstances objectively indicate that there is no such ongoing emergency, and that the primary purpose of the interrogation is to establish or prove past events potentially relevant to later criminal prosecution.<sup>20</sup>

Justice Scalia concluded that the history of the Confrontation Clause was directed at keeping "ex parte" examinations out of the evidentiary record. Specifically, the Confrontation Clause applies to "witnesses" against the accused, "those who 'bear testimony.'" Relying on this and the historical record, Scalia stated, "the Framers would not have allowed admission of testimonial statements of a witness who did not appear at trial unless he was unavailable to testify, and the defendant had had a prior opportunity for cross-examination." Scalia determined that a prior opportunity for cross-examination was mandatory, and dispositive of whether or not testimonial statements of an unavailable witness are admissible.<sup>21</sup>

The *Crawford* Court determined that where non-testimonial statements are involved, the Confrontation Clause allows a court to use its discretion to determine the reliability of the statements.<sup>22</sup> The *Crawford* Court held that when testimonial evidence is at issue, the Confrontation Clause prohibits out-of-court testimonial statements by a witness, regardless of whether the statements are deemed reliable by the trial court, unless (1) the witness is unavailable, and (2) the defendant had a prior opportunity to cross-examine the witness. The only indicium of reliability sufficient to satisfy constitutional demands is the one the Constitution actually prescribes: confrontation.<sup>23</sup>

### **Cross Examination**

Cross-examination is the interrogation of a witness called by one's opponent. It is preceded by direct examination. The cross-examining attorney is typically not permitted to ask questions which do not pertain to the facts revealed in direct examination. This is called going beyond the scope of the direct examination. Since a witness called by the opposing party is presumed to be hostile, cross examination does permit leading questions. A witness called by the direct examiner, on the other hand, may only be treated as hostile by that examiner after being permitted to do so by the judge, at the request of that examiner and as a result of the witness being openly antagonistic and/or prejudiced against the opposing party. Cross-examination frequently produces critical evidence in trials, especially if a witness contradicts previous testimony.<sup>24</sup>

Citing *Crawford v. Washington*, the Melendez court ruled that a witness's testimony is inadmissible unless he or she appears at trial, or if unavailable, the court afforded the defendant the opportunity to cross examine the witness. The court reiterated the non-exclusive class of statements which are testimonial in nature including *ex parte* in-court testimony or its functional equivalent that is, material such as *affidavits*, custodial examinations, prior

<sup>16</sup> *Melendez-Diaz*, at 7 129 S. Ct. 2527 (2009).

<sup>17</sup> 33 Creighton Law Review 763, 799 – 800 (2000).

<sup>18</sup> 547 U.S. 813, 822 (2006)

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Crawford*, 158 L. Ed. 2<sup>nd</sup> 177, 184

<sup>22</sup> *Melendez-Diaz*, at 2, citing *Crawford*, 541 U.S. 36, 54 (2004).

<sup>23</sup> *Id.* at 5, citing *Crawford v. Washington*, 541 U.S. 36, 54 (2004).

<sup>24</sup> *Melendez-Diaz*, 129 S. Ct. 2527 (2009).

testimony that the defendant was unable to cross-examine, or similar pretrial statements that declarants would reasonably expect to be used prosecutorially.<sup>25</sup>

The Court held that the *Melendez-Diaz* lab analysis certificates constituted testimonial evidence because they were prepared for the purpose of a later criminal trial. The U. S. Supreme Court found that the forensic analyst in the *Melendez-Diaz* case who tested the contraband substance and reported that it was cocaine was a witness for purposes of the Confrontation clause. Because the trial court did not give Melendez-Diaz the opportunity to cross examine the analyst, his right of Confrontation was violated.<sup>26</sup>

Under the Confrontation clause, defendants must also be permitted to call witnesses in their favor. If such witnesses refuse to attend, they may be compelled to do so by the court at the request of the defendant. In some cases, however, the court may refuse to permit a defense witness to testify. If, for example, a defense lawyer fails to notify the prosecution of the identity of its witnesses to gain a tactical advantage, the witnesses whose identities were undisclosed may be precluded from testifying.<sup>27</sup>

The right to confront and cross-examine witnesses also applies to physical evidence. The prosecution must present physical evidence to the jury, providing the defense ample opportunity to cross-examine its validity and meaning. The prosecution generally may not refer to evidence without first presenting it.<sup>28</sup>

Many decisions of the Supreme Court of the United States have affirmed the right of the accused under the Confrontation Clause to have a face-to-face confrontation with the accuser, and an opportunity to cross-examine the accuser. In the 2004 decision *Crawford v. Washington*, the Supreme Court emphasized that the right to confront one's accusers could not be taken away in cases where judges believe that testimonial hearsay evidence is reliable, because such hearsay evidence had not had its reliability tested through the procedural crucible of cross-examination.<sup>29</sup>

The fact that the Confrontation Clause does not apply, however, does not mean that the statement is automatically admissible. The statement still has to be admissible under the particular jurisdiction's rules of evidence which usually means that the statement must meet the requirements of an exception to the hearsay rule.

#### **Melendez-Diaz Decision**

The primary Melendez-Diaz argument was that the affidavits from a forensic analysis are considered "testimonial" in nature therefore the analyst that prepared and verified them is subject to the defendant's Sixth Amendment right to confrontation.<sup>30</sup> The counter argument is that these affidavits should be treated as "business documents" which are not "testimonial" in nature and since the forensic results are not documents kept in the regular course of business, this argument was not valid.<sup>31</sup> A business record is a document that records a business dealing and must be retrievable at a later date. Certain types of business records may be admissible in court at a later date.<sup>32</sup>

The argument against analyst's results being testimonial in nature, hinges upon three propositions: (1) a conventional witness recalls incidents from the past while a forensic analyst reports observations from a test that does not occur at the same time as the alleged crime, (2) analysts did not observe the alleged criminal event or actions of the accused, and (3) analyst statements are not provided in response to interrogation.<sup>33</sup>

It is Justice Scalia's response that the lab analyst should not have any reason to alter his/her professional evaluation of the test results when being confronted in the courtroom by the accused. He continues that omitting confrontation because testimony is obviously reliable and accurate would be similar to eliminating the jury trial because the defendant is obviously guilty.<sup>34</sup>

The confrontation issue in regards to forensic lab evidence was raised in response to a phenomenon called "drylabbing" where the analysts did not actually perform the tests but just reported fictional results, perhaps as a result of pressure from law enforcement officials, due to a backlog of tests to be run or as a result of personal feelings about the guilt of the accused. One study confirmed that these invalid test results were used in 60% of all

<sup>25</sup> *Id* at 8, citing *Crawford*, 541 U.S. 36, 54 (2004).

<sup>26</sup> *Melendez-Diaz*, 129 S. Ct. 2527, 174 L. Ed. 2<sup>nd</sup> 314.

<sup>27</sup> *Id* at 324.

<sup>28</sup> *Id.*

<sup>29</sup> *Melendez-Diaz*, at 2, citing *Crawford*, 541 U.S. 36, 54.

<sup>30</sup> *Melendez-Diaz*, at 1, 129 S.Ct. 2527.

<sup>31</sup> *Id.* at 15.

<sup>32</sup> Federal Rule of Evidence 803 (6).

<sup>33</sup> *Melendez-Diaz v. Massachusetts*, at 9 - 10, 129 S.Ct. 2527.

<sup>34</sup> *Id.*

convictions. This type of fraudulent activity has harmed the credibility of forensic lab results and escalated occurrences of defense attorneys requesting the “right to confrontation”.<sup>35</sup>

Honesty, proficiency and methods may all be questioned in the courtroom.<sup>36</sup> Analysts may be well-trained to perform the lab tests and report them but they are not trained to communicate confidently in a courtroom setting under cross-examination. The risk of test error will likely be raised under the cross examination and effective communication is critical to the analyst’s credibility.

As a result of the *Melendez-Diaz* Supreme Court decision, there have been sweeping changes in the way drug/alcohol cases supported by lab tests have been pursued and defended. Many defendants are electing to go to trial rather than plea in hope that the lab analyst will not be able to testify and the case may be dismissed. While prior to the *Melendez-Diaz* ruling, only about 5% of the drug and other criminal cases went to trial, according to prosecutors, there has been an increase due to the decision. Prosecutors are accepting deals in less serious cases that they would not have accepted before, given the evidence.<sup>37</sup>

#### **State Reactions to the Melendez-Diaz Decision**

Massachusetts faces daunting volumes of cases to manage in the wake of *Melendez-Diaz*. In 2009, more than 20,000 drug cases were prosecuted in Massachusetts trial courts, and many thousands more await trial. Since *Melendez-Diaz*, Massachusetts state prosecutors have asked defendants to stipulate to the results of the drug analysis. Defendants, however, have routinely declined to do so, instead insisting on their right to demand an analyst’s presence at trial. Securing an analyst’s presence at trial has resulted in numerous continuances and trial delays. It also has imposed substantial burdens on the 35 chemists currently employed by the state’s drug laboratories. In fact, following *Melendez Diaz*, the average turnaround for drug analysis performed by the State Department of Public Health has more than doubled, from 83 days in July 2008 to 169 days in July 2009.

In Indiana, two labs handle forensic testing for the entire state. In 2008, these two labs received tens of thousands of items in 27,568 cases, but were able to complete the analysis in only 26,349 cases.<sup>38</sup> Specifically related to drugs, these labs received 13,903 cases, but had a backlog of 1,013 cases.<sup>39</sup> Between them, these two labs have only 24 drug chemists.<sup>40</sup>

Other states experience similar problems. In Michigan, for example, State Police scientists have been logging, in the wake of *Melendez-Diaz*, 15 hours of overtime per week trying to reduce a backlog of forensic evidence.<sup>41</sup> In North Carolina, “with regard to blood or urine tests, the State is in a particularly egregious situation as there are only 8 to 12 analysts handling blood and urine tests for all 100 counties in the State.”<sup>42</sup> In New York, the Manhattan medical examiner’s office experiences such high personnel turnover that in many cases the pathologist who performs an autopsy is no longer employed at the office when the case goes to trial.<sup>43</sup> As a consequence, prior to *Melendez-Diaz*, the accepted practice for Manhattan criminal courts was to admit autopsy reports without testimony from the analyst.<sup>44</sup> Further, it is New York’s practice to use an assembly-line-like rotation system for DNA analysis, sometimes involving up to 40 analysts per case. Following *Melendez-Diaz*, this practice raises difficult questions regarding who must testify as to the results of any given DNA test.

<sup>35</sup> *Melendez-Diaz v. Massachusetts*, at 11 -12, 129 S.Ct. 2527.

<sup>36</sup> *Id.* at 13

<sup>37</sup> Ben Conery, *States Scramble to Keep Techs in Labs, Out of Courts*, Washington Times, Aug. 31, 2009, at A1

<sup>38</sup> Indiana State Police, 2008 Annual Report 51; Indianapolis-Marion County Forensic Services Agency, 2008 Annual Report 4-9

<sup>39</sup> Indianapolis - Marion County Forensic Services Agency, 2008 Annual Report 7; ISP Laboratory Division, 2008 Annual Report 2

<sup>40</sup> Indianapolis-Marion County Forensic Services Agency, 2008 Annual Report 7; Indiana State Police Laboratory, 2008 Annual Report 6

<sup>41</sup> Rebecca Waters, *Supreme Court Requires Lab Analysts to Testify: Now What?*, Forensic Magazine, July 24, 2009.

<sup>42</sup> *Supreme Court Ruling in Melendez-Diaz Requires the State to Produce the Chemical Analyst in All DWI Prosecutions*, Carolina Newswire, Aug. 7, 2009.

<sup>43</sup> Tom Jackman, *Prosecutors Worried By High Court Ruling on Lab Evidence*, Washington Post, July 15, 2009.

<sup>44</sup> *Id.*

In some states, the main problem is not the volume of cases so much as the distance from the lab to the courtroom. Because of this, Oregon district attorneys sometimes do not even bother to bring lower-level drug charges because they know it will be too difficult to produce a lab-technician.<sup>45</sup> Similarly, in some South Dakota counties, a “round trip (for the lab analyst) is going to be 10 to 12 hours to testify.”<sup>46</sup>

### Virginia Legislative Reaction

In Virginia, the number of subpoenas for analyst testimony from the Virginia Department of Forensic Science for drug cases jumped from 43 in July 2008 to 925 in July 2009, which is a twenty-fold increase.<sup>47</sup> In 2008, before the ruling, those requests came in by the dozen per month, not by the hundreds. And in most cases, the analysts would not be called to testify. This increase in subpoenas leads to increased time that lab technicians spend in court and thus the lab’s backlog in testing of drug cases. In the last six months of 2009, Virginia state lab analysts were subpoenaed to testify in courts across the state in 5,651 drug cases.<sup>48</sup> Since the *Melendez-Diaz* decision was issued, the backlog of drug tests has risen 40 percent and the backlog of alcohol or toxicology test has risen 15 percent.<sup>49</sup>

This has caused massive scheduling conflicts with the analysts who spent 369 hours traveling to courtrooms across the state to testify in July 2009. In the previous 11 months, the total amount of time traveling to court was 230 hours.<sup>50</sup> These scheduling conflicts result in cases being dropped or suspended.<sup>51</sup>

In addition to the travel burden on the lab analysts, another real concern is the backlog of cases to be analyzed. At the end of July 2009, this backlog was 6,100 and it will only increase as the lab analysts are out of the office an increasing amount of time to travel to and testify at trials.<sup>52</sup>

The huge impact of the *Melendez-Diaz* Supreme Court ruling on Virginia’s forensic lab and court systems prompted a special session of the General Assembly called by Governor Kaine in August 2009 to help the state respond to the ruling. The legislature considered several proposals including:

1. Lab equipment inspection records would be deemed “business records” not subject to cross-examination.
2. Defense attorneys would be required to formally object to lab records in advance of the trial.
3. Dismiss the “right to a speedy trial” when lab analysts are not available to testify until they can be scheduled.<sup>53</sup>

The state’s primary issue is the need for more analyst positions as evidence testing is being challenged more frequently requiring analysts to be out of the office often. The major concerns include disruption of forensic investigations and risk of dismissal due to inability of lab analyst to appear in court, an ever increasing backlog of forensic cases as analysts are out of the office appearing in court and unable to complete the lab tests, and the requirement of analysts to appear for a large number of cases where the actual lab results are not disputed all of which will cause great increases in the cost of administering justice.<sup>54</sup>

The state currently has 160 forensic scientists and cannot meet the needs for live testimony with that number of employees while still processing and certifying evidence in the other cases.<sup>55</sup> One defense attorney argues that without requiring the live testimony of the lab analyst, the state would be shifting the burden of disproving scientific evidence to the defendant instead of requiring the state to prove the validation of the scientific evidence.<sup>56</sup>

<sup>45</sup> Conery, *States Scramble to Keep Techs in Labs, Out of Courts*.

<sup>46</sup> Jackman, *Prosecutors Worried By High Court Ruling on Lab Evidence*.

<sup>47</sup> Tom Jackman, (2009, August 18). *Va. Rushes to Address Ruling on Analysts; Drug-Case Demands Have Strained State Lab*. The Washington Post, Pg. B01.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> Conery, *States Scramble to Keep Techs in Labs, Out of Courts*

<sup>52</sup> *Id.*

<sup>53</sup> Tom Jackman

<sup>54</sup> See Senate Joint Resolution No. 5001 offered August 19, 2009, Prefiled August 19, 2009

<sup>55</sup> Jackman, (2009, August 18). *Va. Rushes to Address Ruling on Analysts; Drug-Case Demands Have Strained State Lab*.

<sup>56</sup> *Id.*

To reduce the load on the Department of Forensic Science's analysts and to make it easier for prosecutors to schedule cases, the Virginia legislature enacted House Bill 5007 in August 2009. This legislation has three major components. First, it sets up a "notice and demand" procedure where a prosecutor notifies the defendant that he intends to use a sworn statement by the analyst rather than require the analyst to testify in court. The defendant may then demand that the analyst appear at trial and be subject to cross examination. Second, the state's speedy trial requirements are extended by 90 days if a defendant is incarcerated and by 180 days if he is on bond.<sup>57</sup> Third, the legislation eliminates the admission of the certification of the reliability of the breath analysis machine as an element of proof in Driving Under the Influence cases.<sup>58</sup>

#### **Grant vs. the Commonwealth of Virginia**

In September 2009, the Court of Appeals of Virginia overturned the conviction of Phillip Lawton Grant for driving while intoxicated citing the *Melendez-Diaz* ruling that Grant was not allowed the right to confront the witnesses against him.<sup>59</sup> This was the first appellate case in Virginia since the U.S. Supreme Court's decision in *Melendez-Diaz*.

On June 30, 2007, Phillip Grant was involved in a traffic accident and the officer responding, Officer Wolfe, asked Grant to take a preliminary breath test due to the odor of alcohol and bloodshot eyes. Grant refused to take the test. Grant was taken to the Fairfax County Adult Detention Center and then agreed to take an alcohol breath test. The attestation clause which was completed and signed by the forensic lab analyst performing the blood alcohol concentration (BAC) test affirmed that Grant's BAC at the time of the test was ".11 grams per 210 liters of breath". This attestation clause was used by the Commonwealth as evidence in Grant's conviction but the analyst that signed the clause was not called to appear in court.<sup>60</sup>

Mr. Grant notified the Commonwealth of Virginia that he was requesting the person that prepared the certificate of BAC to appear at the trial. This person was not called and Officer Wolfe testified instead. The court concluded that the defense must subpoena the lab analyst to testify. Grant was found guilty.<sup>61</sup>

Grant's appeal was filed after the *Melendez-Diaz* Supreme Court Decision and the Virginia Appeals court ruled that Grant was entitled to be confronted with the analyst at the trial. Grant's disagreement was not with the results from the Intoxilyzer 5000 machine but with the fact that he wanted to confront the person who signed the certification clause that verified the test. That certification, called the attestation clause, was determined by the court to be testimonial in nature. Therefore, analysts who are verifying conclusions in these certificates are considered "witnesses" in the application of the Sixth Amendment. This application of the Sixth Amendment is supported by *Crawford* and *Wimbish*.<sup>62</sup>

The Virginia General Assembly's intent was for these attestation clauses to be "self-proving". The attestation clause was intended to provide proof of the reliability and admissibility of the facts replacing the need for live, in-court testimony. The Supreme Court *Melendez-Diaz* decision determined that this method of introducing evidence is not legally valid. The reliability and admissibility must be supported by live testimony in court.<sup>63</sup>

Grant did not waive the right to confront his accuser, which in this case was the person that prepared and signed the attestation clause. The Commonwealth's objection is that there was sufficient evidence to convict without the admission of the attestation clause. Grant's objection was that this attestation clause is testimonial and the *Melendez-Diaz* ruling supports this objection. He did notify the Commonwealth that he wished the lab analyst to appear at the trial so that the Commonwealth could summon that individual.<sup>64</sup>

<sup>57</sup> Virginia law generally requires trial within five months of a probable cause hearing if the defendant is incarcerated and nine months if he is on bond.

<sup>58</sup> The reliability of the machine is now a matter of maintenance for the Department of Forensic Science.

<sup>59</sup> *Phillip Lawton Grant v. Commonwealth of Virginia*, at 1, (Record No. 0877-08-4) September 1, 2009 Circuit Court of Fairfax County – Bruce D. White, Judge.

<sup>60</sup> *Id* at 2 – 3.

<sup>61</sup> *Id* at 3.

<sup>62</sup> *Id* at 4, citing *Crawford v. Washington*, 541 U.S. at 36, 54 (2004) *Id.* at 2532 and *Wimbish* 51, Va. App. 474, 658 S. E. 2d 715; *Wimbish v. Commonwealth*, 51 Va. App. 474, 482 – 84, 658 S. E. 2<sup>nd</sup> 715, 719-20 (2008).

<sup>63</sup> *See Grant* at 7.

<sup>64</sup> *Id.* at 3, 9.

In *Grant*, the admission of this attestation clause might have contributed to the conviction and thus it was overturned. “When a federal constitution error is found it must be determined to be harmless beyond a reasonable doubt.”<sup>65</sup> According to the trial documents, Officer Wolfe’s testimony was that “...the machine determined that [Grant’s] blood alcohol concentration ... was .11.” This testimony was not descriptive enough and precise enough concerning the results of the BAC test to convict Grant in the absence of the certificate of results. The law requires proof that the accused’s BAC is “0.08 grams or more per 210 liters of breath.”<sup>66</sup> The attestation clause which was ruled inadmissible would have provided the context for Officer Wolfe’s testimony.<sup>67</sup>

The Commonwealth contended that Officer Wolfe’s description of the field sobriety tests affirm the condition of Grant, but the Virginia Court of Appeals disagreed and determined that there was not sufficient evidence to convict without the attestation clause. “Constitutional harmless errors” have to be proven that they were harmless beyond a reasonable doubt in regards to the trial outcome and this is not the case in the *Grant* decision.<sup>68</sup>

### ***Briscoe v. Commonwealth of Virginia***

Many thought that *Briscoe*<sup>69</sup> may turn out to be the U.S. Supreme Court’s vehicle to reverse their decision in *Melendez-Diaz*. The Court quickly took up this case only two days after the *Melendez-Diaz* decision. This was surprising since Virginia’s statutory scheme was similar enough to that of Massachusetts to make one think that *Briscoe* would have been immediately remanded. The Court reviewed the briefs in the case and after hearing full oral arguments, surprisingly vacated and, in a *per curiam* opinion, remanded the case for further proceedings not inconsistent with *Melendez-Diaz*.<sup>70</sup> The Court’s opinion in *Briscoe*, reaffirms it’s holding in *Melendez-Diaz* that a prosecution witness must testify in person, face to face with the defendant, and not through affidavits. Therefore, it is important to review the facts and arguments in *Briscoe*.<sup>71</sup>

Sheldon A. Cypress was a passenger in a car stopped by police in the City of Chesapeake, Virginia, for having improperly tinted windows. The driver, Cypress’s cousin, consented to a search of the car. The police found two bags containing a chunky white substance. One of the baggies was under the passenger seat and the other was under the driver’s seat. A test by the Virginia Department of Forensic Science concluded that the substance was cocaine. These test results were reflected in a certificate of analysis, signed and attested to by the analyst who performed the test. Subsequently, Cypress was charged with possession of cocaine with the intent to distribute, having previously committed the offense of distribution or possession with the intent to distribute. At trial, he objected to the admission of the certificate of analysis, contending that it was testimonial evidence that could not be admitted without the testimony from the forensic analyst who conducted the test. The trial court overruled the objections, ruling that the evidence was not testimonial. Cypress did not present any evidence and did not request or subpoena the analyst. Cypress was convicted of possession of cocaine with the intent to distribute, second or subsequent offense, and he was sentenced to serve 15 years, with 10 years suspended, and a fine was imposed.<sup>72</sup>

In *Briscoe*, while executing a search warrant of *Briscoe*’s apartment, police found two scales, a razor blade, a 100-gram weight, and a box of plastic sandwich bags. When they searched *Briscoe*’s person, police retrieved from the front pocket of his shorts a white, rock-like substance wrapped in plastic. Police recovered additional suspected cocaine from the kitchen area of the apartment. Police submitted this item for testing to the Virginia Department of Criminal Justice Services, Division of Forensic Science. A forensic analyst prepared two certificates of analysis, which stated that the substances were cocaine in an amount totaling 36.578 grams. The analyst signed the certificates and stated that she had performed the analyses and that the certificates accurately reflected the results of

<sup>65</sup> *Id.*

<sup>66</sup> Virginia Code § 18.2-266(i).

<sup>67</sup> *Grant* at 10 – 11.

<sup>68</sup> *Id.* at 13

<sup>69</sup> *Briscoe v. Virginia*, 559 U.S. \_\_\_\_ (2010).

<sup>70</sup> *Id.*

<sup>71</sup> *Briscoe* involves two separate criminal defendants who committed separate crimes. The Supreme Court of Virginia consolidated their appeals because of the commonality of the central issue. The original appellate case before the Supreme Court of Virginia involved three defendants. The third defendant, Michael Ricardo Magruder, whose case was consolidated with *Briscoe*’s and *Cypress*’s, did not seek the U.S. Supreme Court’s review of the judgment by the Supreme Court of Virginia.

<sup>72</sup> *Cypress v. Virginia*, Record No. 1547-06-1 (Jan. 3, 2007).

the analyses. Briscoe was charged with possession of cocaine with the intent to distribute, conspiracy to distribute cocaine, and unlawful transportation of cocaine into the Commonwealth.<sup>73</sup>

At Briscoe's trial, the prosecution admitted into evidence the two certificates of analysis. Briscoe argued that the certificates were testimonial evidence under the holding in *Crawford*, and therefore, admitting the certificates of analysis without the testimony of the forensic analyst constituted a violation of his right to confront witnesses. The trial court overruled this objection, concluding that the statutory procedure available under *Virginia Code Ann.* § 19.2-187.1 adequately protected his right to confront the analyst.<sup>74</sup> Briscoe did not call the analyst to testify and did not present any evidence. The trial court convicted him, and he was sentenced to serve a total of 20 years in prison, with all but five years and eight months suspended.<sup>75</sup>

On appeal, both convictions for Cypress and Briscoe were affirmed by the Court of Appeals of Virginia.<sup>76</sup> The Court denied Cypress's appeal in an unpublished order.<sup>77</sup> The Court assumed that a certificate of analysis was testimonial evidence, but reasoned that a defendant's confrontation rights were nonetheless protected by the procedures provided by Virginia Code §§ 19.2-187 and 19.2-187.1. Because the defendant had not invoked these procedures, the court held, he had waived his right to confront the analyst.<sup>78</sup>

The Court of Appeals of Virginia also affirmed Briscoe's convictions by an unpublished *per curiam* order.<sup>79</sup> The Court assumed, without deciding, that the certificate of analysis was testimonial. The Court concluded, however, that the defendant's right to ensure the presence of the forensic analyst was protected by *Virginia Code* § 19.2-187.1. The Court further held that by failing to avail himself of the procedure provided by this statute, Briscoe had waived his right to confront the analyst.<sup>80</sup> Briscoe's attempt to obtain further review in that court was unsuccessful and he petitioned for appeal in the Supreme Court of Virginia. That Court granted his petition, and consolidated his case with Cypress and Magruder.

After consolidating Briscoe, Cypress and Magruder, the Supreme Court of Virginia, by a vote of 4-3, affirmed the decisions of the Court of Appeals of Virginia.<sup>81</sup> The Court first reasoned that it was not necessary to reach the issue of whether a certificate of analysis is testimonial evidence. Instead, the Court upheld the admission of the certificates of analysis under Virginia's statutory scheme found in Virginia Code § 19.2-187 and § 19.2-187.1.<sup>82</sup>

Under Virginia Code § 19.2-187, "a duly attested certificate of analysis by the person performing analysis or examination in certain laboratories may be admitted into evidence [i]n any hearing or trial of any criminal offense . . . as evidence of the facts therein stated and the results of the analysis or examination referred to therein."<sup>83</sup> A prerequisite to admitting such a certificate of analysis is that the certificate must be filed with the clerk of the court hearing the case at least seven days prior to the hearing or trial. Failure to follow the seven-day filing requirement precludes the admission of the certificate of analysis at trial.<sup>84</sup>

Virginia Code § 19.2-187.1, sets forth a procedure for the accused to question the person performing the analysis or examination. That statute provides that "[t]he accused in any hearing or trial in which a certificate of analysis is admitted into evidence pursuant to § 19.2-187 or § 19.2-187.1 shall have the right to call the person performing such analysis or examination or involved in the chain of custody as a witness therein, and examine him in the same manner as if he had been called as an adverse witness. Such witness shall be summoned and appear at the cost of the Commonwealth." Under this procedure, the Court observed, the defendants could have insured the physical presence of the forensic analysts at trial by issuing a summons for their appearance at the Commonwealth's cost, or asking the trial court or Commonwealth to do so. At trial, the defendants could have called the forensic analysts as witnesses, placed them under oath, and questioned them as adverse witnesses.<sup>85</sup>

<sup>73</sup> *Id.*

<sup>74</sup> This procedure has now been changed by the Virginia legislature in reaction to *Melendez-Diaz* to a "notice and demand" statute as discussed earlier.

<sup>75</sup> *Cypress.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Briscoe v. Virginia*, Record No. 1478-06-4 (January 18, 2007).

<sup>80</sup> *Id.*

<sup>81</sup> *Magruder v. Virginia*, 657 S.E.2d 113 (Va. 2008).

<sup>82</sup> *Id.*

<sup>83</sup> Virginia Code § 19.2-187.

<sup>84</sup> *Bell v. Virginia*, 622 S.E.2d 751, 754 (Va. Ct. App. 2005).

<sup>85</sup> *Magruder, at 115.*

The Court held that if the defendants had utilized the procedure provided in Code § 19.2-187.1, they would have had the opportunity to cross-examine the forensic analysts. The Court rejected the defendants' arguments that they could not be required to take affirmative steps to assert a right to confront witnesses. The Court reasoned that States can and, with some frequency do, regulate the exercise of constitutional rights such as requiring defendants to provide notice when they intend to raise an alibi defense and imposing restrictions concerning when a defendant must file a motion to suppress.<sup>86</sup>

The Court found unpersuasive the defendants' contention that Virginia's statutory scheme forces a defendant to produce evidence. The Court observed that none of the defendants had taken any steps to ensure the presence of the analyst at trial. Therefore, none of them were forced to call the witness to the stand. If they had, the Court noted, the trial court could have addressed the proper order of proof. Finally, the Court held that the defendants could, and did, waive their confrontation rights by failing to seek the presence of the analyst at trial.<sup>87</sup> The US Supreme Court granted both Briscoe and Cypress's Writ for Certiorari and combined the cases for review.

#### **Petitioner's Argument**

Briscoe and Cypress argue that the decision of the Supreme Court of Virginia poses a fundamental threat to the confrontation right. The Sixth Amendment gives the accused "the right . . . to *be confronted with* the witnesses against him."<sup>88</sup> The use of the passive voice in the Confrontation Clause is not adventitious.<sup>89</sup> The Confrontation Clause, governing the process for witnesses *against* the accused, stands in sharp contrast to the Compulsory Process Clause, which allows the accused to bring to trial witnesses "in his favor." The right accorded by the latter Clause "is dependent entirely on the defendant's initiative." The confrontation right, however, like most of the others granted by the Sixth Amendment, "arise[s] automatically on the initiation of the adversary process and no action by the defendant is necessary to make them active in his or her case."<sup>90</sup> The difference has immense practical significance, going to the essence of the criminal trial process. Even given the advantage of cross examination under the Virginia Statute, it remains true that "[o]nly a lawyer without trial experience would suggest that the limited right to impeach one's own witness is the equivalent of that right to immediate cross-examination which has always been regarded as the greatest safeguard of American trial procedure."<sup>91</sup>

Further, petitioners did not waive their right to confrontation. They demanded that they be accorded the right, and at most they waived the inferior opportunity Virginia offered them in lieu of the right to confrontation.<sup>92</sup> To fully understand the difference, compare the tactical decisions facing defense counsel in two scenarios. The first scenario, petitioners contend, is called for by the Confrontation Clause, and is termed "Confrontation Scenario." In the "Confrontation Scenario" the prosecution presents the live testimony of the lab technician, and defense counsel may then cross examine. The second scenario is the one provided by the Virginia statutory scheme, and is termed the "Subpoena Scenario" In the "Subpoena Scenario" the prosecution presents a certificate of the lab results and the accused may subpoena the technician to be a live witness as part of his case.

1. In the "Confrontation Scenario," when counsel decides whether, and how, to examine the witness, the witness has just testified on direct examination for the prosecution. Further, there is no possible confusion to the trier of fact as to as to which side the witness is testifying. In the "Subpoena Scenario," by contrast, substantial time may have passed since the witness's (written) testimonial statement has been presented to the trier of fact, and a much greater time has passed since the witness made that statement. This gap in time is critical as explained in *State*

<sup>86</sup> *Id.*t

<sup>87</sup> *Id.*

<sup>88</sup> US Constitution, Sixth Amendment.

<sup>89</sup> See *Thomas*, supra, 914 A.2d at 16 ("This language, employing the passive voice, imposes a burden of production on the prosecution, not on the defense. *State v. Snowden*, 385 Md. 64, 867 A.2d 314, 332 n. 22 (2005) (rejecting the theory that the defendant could call his accusers to the stand because 'the burden of production . . . is placed on the State [by the Confrontation Clause] to produce affirmatively the witnesses needed for its prima facie showing of the defendant's guilt'."); *Magruder*, at 118 (Keenan, J., dissenting).

<sup>90</sup> *Taylor v. Illinois*, 484 U.S. 400, 410 (1988).

<sup>91</sup> *New York Life Ins. Co. v. Taylor*, 147 F.2d 297, 305 (D.C. Cir. 1944); *accord, e.g., Magruder*, at 118 (Keenan, J., dissenting) ("The opportunity for effective cross-examination of prosecution witnesses, however, presupposes that a defendant has an opportunity to cross-examine those witnesses during the prosecution's case.").

<sup>92</sup> See *Magruder*, at 118 (Keenan, J., dissenting) ("While a defendant's failure to act under Code § 19.2-187.1 may constitute a waiver of his statutory right under that Code section to call the forensic scientist in the defendant's case, the fact that he chooses not to exercise this statutory right is insufficient to establish a waiver of his separate constitutional confrontation right that is guaranteed to him throughout his criminal trial.").

v. *Saporen*, “the chief merit of cross examination is not that at some future time it gives the party opponent the right to dissect adverse testimony. Its principal virtue is in its immediate application of the testing process.”<sup>93</sup>

2. In the “Confrontation Scenario,” immediately before cross-examination begins, the attention of the trier of fact is presumably already focused on the testimony of the witness. In the “Subpoena Scenario,” by contrast, to conduct the direct examination of the technician, the defense must first remind the trier of fact of the adverse statement made by the witness.<sup>94</sup>

3. In the “Confrontation Scenario,” the witness is already on the stand and the trier of fact will expect the defense to conduct a cross examination at the conclusion of the prosecution’s direct examination. In the “Subpoena Scenario,” by contrast, calling to the stand a witness whose statement has already been admitted may be annoying to the trier of fact and may appear to be harassment of the witness and wasting the trier of fact’s time.<sup>95</sup>

4. In the “Confrontation Scenario,” defense examination of the technician will come in the middle of the prosecution’s case. This cross-examination may work to the defense’s advantage by disrupting the smooth presentation of evidence by the prosecutor. In the “Subpoena Scenario,” by contrast, the defense must disrupt its own case to examine the technician. This also gives the prosecution an opportunity to examine a witness friendly to it in the middle of the defense case.<sup>96</sup> To avoid giving too prominent a position to an adverse witness, the defense will probably find it best to adhere to the advice that, if one must present such a witness, it is best to do so in the middle of one’s case, rather than at the beginning or end.<sup>97</sup> And if the defense does not present any other evidence, then the adverse witness will be both at the beginning and at the end of the defense case.

5. In the “Confrontation Scenario,” if the direct testimony has been harmful to the defense, as it will be in the case of a lab technician, the defense will find it advantageous to ask at least a few questions on cross-examination to chip away where possible at the testimony and to introduce some element of doubt.<sup>98</sup> By taking small, careful steps, the defense can ensure that even disappointing answers do not create significant damage.<sup>99</sup> In the “Subpoena Scenario,” by contrast, by calling to the stand an adverse witness whose written testimonial statement has already been admitted against the defendant, the defense raises the expectations of the trier of fact that this witness’s testimony will be of major importance. If the defense fails to have a “Perry Mason Moment” then the trier of fact will feel like their time has been wasted by this foolish defense counsel. Further, the defense has done nothing more than reaffirm the prosecutor’s case. Therefore, defense counsel will probably elect not to call the technician as a witness at all.<sup>100</sup>

<sup>93</sup> 285 N.W. 898, 901 (Minn.1939); *accord*, Peter Westen, *Confrontation and Compulsory Process: A Unified Theory of Evidence for Criminal Cases*, 91 HARV. L. REV. 567, 578-79 (1978) (“Were the hearsay introduced as part of the prosecution’s presentation, the jury might form an initial impression which the defense could not later counteract by examining the declarant in person once the state rested. . . . If such witnesses are to be examined at all about the truth of their statements, it should be the prosecution’s duty to examine them in the first instance.”).

<sup>94</sup> *Note, Right of Confrontation: Admission of Declaration by Co-Conspirator*, 85 HARV. L. REV. 188, 195 (1971) (“even a direct examination successful from the defendant’s perspective is less effective than cross-examination because . . . the damaging hearsay will have to be repeated during the examination, thereby increasing its impact”).

<sup>95</sup> *E.g., Lowery v. Collins*, 988 F.2d 1364, 1369 (5th Cir. 1993) (“The State would . . . impermissibly impose on the defendant the Catch-22 . . . of either calling the child-complainant to the stand at the ‘risk [of] inflaming the jury against [himself]’ or avoiding the risk of thus inflaming the jury at the cost of waiving his constitutional right to confront and cross-examine the key witness against him.”) (alteration in original) (footnote omitted) (quoting *Lowrey v. State*, 757 S.W.2d 358, 359 (Tex.Crim.App. 1988)).

<sup>96</sup> . Janeen Kerper, *The Art and Ethics of Direct Examination*, 22 AM. J. TRIAL ADVOC. 377, 411 (1998).

<sup>97</sup> *Id.*

<sup>98</sup> See Irving Younger, *The Art of Cross-Examination*, AMERICAN BAR ASSOCIATION, SECTION OF LITIGATION, MONOGRAPH SERIES, No. 1 (1975), at 1 (before discussing “destructive cross-examination,” noting that even “if here is nothing to be done,” counsel “may ask a couple of questions, just for show, and sit down”).

<sup>99</sup> See EDGAR LUSTGARTEN, VERDICT IN DISPUTE (1950), at 251 (describing a careful cross-examination, in which counsel “cannot foresee the terms of [the witness’s] reply: “he needs to approach the question circumspectly, advancing only one step at a time, and at every stage leaving channels of escape which he can use without grave loss of face”).

<sup>100</sup> See *Reardon v. Manson*, 806 F.2d 39, 43 (2d Cir. 1986) (“We think it entirely plain that petitioners chose not to subpoena the chemists who assisted Dr. Reading because they perceived, as we do, that the possibility of benefit from such testimony was remote and the more likely result would have been the corroboration of Dr. Reading’s

6. In the “Confrontation Scenario,” defense counsel may cross-examine the technician and decide not to present an affirmative case, relying instead on a clean, uncluttered argument that the prosecution has failed to satisfy its burden of proof. In the “Subpoena Scenario,” by contrast, the defense is forced to elect to either decline to examine the technician, or abandon the clean burden-of-proof argument.<sup>101</sup> Defense lawyers will always cross-examine a witness who has given damaging testimony. If the witness’s testimony has been admitted without the witness appearing at trial, however, the defense will almost never call the witness on their behalf. Further, in the “Confrontation Scenario,” the accused is guaranteed the ability to cross examine. If the witness should suddenly become unavailable before the accused had an adequate opportunity for cross, the testimony would have to be stricken.<sup>102</sup> In the “Subpoena Scenario,” by contrast, if the witness becomes unavailable after preparing the certificate and before trial, the certificate is still admitted and the accused has no opportunity to examine the witness.

For the reasons stated above, statutory schemes like Virginia’s work a fundamental transformation in traditional criminal procedure. The effect is to turn the heart of the trial into a presentation of affidavits.<sup>103</sup> This principle, that the ability of the accused to call a witness as his own may substitute for the opportunity of cross examination, will spread to other aspects outside of the context of laboratory reports.<sup>104</sup> Trials could be held much more expeditiously without any live witnesses, or without juries or lawyers. This system, of course, would certainly violate the Constitution.

testimony.”). Further, *Cypress’s* case provides a vivid illustration of the difference. The critical evidence against him was the certificate purporting to report a significant quantity of cocaine in form suitable for use by a dealer in the substances seized from the car. Given the statutory scheme, the Commonwealth had no need to present the live testimony of the author of the report, and the Petitioner did not call the author to the stand. But the prosecution also presented another certificate, one indicating that no fingerprints had been found on the seized materials. Despite the Commonwealth’s resistance on grounds of practicality to bringing in lab technicians, it did just that in that instance, so that the technician could explain that failure to recover fingerprints was not surprising. Peripheral though this witness was to the case, defense counsel cross-examined him rather extensively, largely with respect to chain-of-custody issues that applied as well to the certificate reporting the presence of cocaine.

<sup>101</sup> See *Gray v. Commonwealth*, 265 S.E.2d 705 (1980) (preparer 5 of certificate unavailable as a witness at trial, the failure of the Commonwealth to comply with the filing provisions of § 19.2-187 held fatal to admissibility – the apparent implication being that had the Commonwealth filed in a timely manner the certificate would have been admissible notwithstanding the preparer’s unavailability). See, e.g., *Thomas, supra*, 914 A.2d at 16 (“the ‘available to the accused’ theory of the Confrontation Clause is flawed because it ‘unfairly requires the defendant to choose between his right to cross-examine a complaining [or other prosecution] witness and his right to rely on the State’s burden of proof in a criminal case.’ *Snowden*, 867 A.2d at 332-33 (quoting *Lowery v. Collins*, 988 F.2d 1364, 1369-70 (5th Cir. 1993)).

<sup>102</sup> See *Crawford*, 541 U.S. at 68 (opportunity for cross essential for admissibility of testimonial statement, even given unavailability of witness).

<sup>103</sup> Virginia Code Section 19.2-187.01 also applies not just to the proof of the laboratory results but also to proof of the chain of custody of the tested materials. Further, statutory authorization is not essential for a court to implement a scheme like Virginia’s. If Virginia’s scheme is valid, a prosecutor and a court could replicate it even absent a burden-shifting statute. The hearsay rule would not pose a serious obstacle; if the jurisdiction does not have a special-purpose hearsay exception to cover the certificate, then its exceptions for business and public records could easily do so, and if necessary the residual exception could be invoked. The Compulsory Process Clause would in itself give the accused the right to subpoena the author of the certificate. The prosecutor could offer to pay for the cost of producing the witness if the accused decides to subpoena him, or the court could make such payment a condition of admissibility. Finally, given that the author would be a hostile witness, the court would presumably allow the accused to ask leading questions. Thus, the resolution achieved by Va. Code § 19.2-187.1 could be reached without need for a comparable statute – which means that the problem posed by the decision in this case can arise in *any* state, not just those that have provided by legislation for burden-shifting.

<sup>104</sup> Lab reports, however, should not be deemed so inherently trustworthy that cross examination is seen as of minuscule value. Pamela R. Metzger, *Cheating the Constitution*, 59 VAND. L. REV. 475, 494 (2006) (“laboratory error and operator error exist even with the most well-established or unassailable scientific method”). See also *California v. Trombetta*, 467 U.S. 479, 490 (1984) (emphasizing defendant’s “right to cross-examine the law enforcement officer who administered [a breath] test, and to attempt to raise doubts in the mind of the fact finder whether the test was properly administered”).

Petitioner contends that if the Court is concerned with efficiency then it could certainly adopt a scheme where a certificate of lab results is admissible unless the defense makes a timely demand for the author of the report to appear as a witness, and that if he does so then the prosecution must call the author as a witness or forgo use of the certificate. Many states have adopted such a system.<sup>105</sup> Petitioners believe such a “notice and demand” statute, if properly drafted, is constitutionally unobjectionable.<sup>106</sup> It would ensure that the lab technician will be required to testify subject to confrontation only when the accused has a strong enough interest in cross-examining him to be worth the cost to him of making the technician’s testimony, presented live, far more vivid than a certificate. Such a statute would also satisfy the state’s legitimate interest in preventing gratuitous expense.

### Respondent’s Argument

Respondent first argues that Virginia’s Notice-Waiver statute represents a permissible and long validated regulation of a defendant’s exercise of his constitutional rights. States may enact reasonable rules to regulate the exercise of constitutional rights and have long imposed rules governing all aspects of a criminal trial, including the exercise of constitutional rights. For example, a requirement that a defendant file a notice that he intends to pursue an alibi defense does not violate the Sixth Amendment.<sup>107</sup> States can also require defendants who wish to impeach the victim of a sexual crime with her past sexual conduct to file a notice of their intent to do so without infringing on a defendant’s constitutional rights.<sup>108</sup> Similarly, the States can impose reasonable rules of procedure to govern the exercise of rights under the Confrontation Clause.<sup>109</sup>

First, the identity of the drug analyzed is usually never an issue at trial. The drug is identified pursuant to routine, simple and well-established scientific testing. The test is performed by an analyst with no connection to the investigation and who has no reason to falsify the result. In the overwhelming majority of cases, defendants have nothing to gain by cross-examining the analyst. It is hardly surprising that nearly every State has a statutory framework in place that authorizes as a default the introduction of certain certificates of analysis and asks a criminal defendant to take some step to ensure the presence of a forensic analyst.<sup>110</sup>

<sup>105</sup> The District of Columbia Court of Appeals construed the District’s statute as operating in this manner, because it recognized that the statute would be unconstitutional if construed as operating like the Virginia scheme. *Thomas, supra*, 914 A.2d at 16, 18. *See also, Hinojos-Mendoza v. People*, 169 P.3d 662, 668 (Col. 2007) (upholding Col. Rev. Stat. §16-3-309(5), which provides that laboratory report is admissible unless a party makes a timely request that witness “testify in person at a criminal trial on behalf of the state”: “The statute provides the opportunity for confrontation-only the timing of the defendant’s decision is changed.”); *State v. Cunningham*, 903 So.2d 110 (La. 2005) (citing cases endorsing such statutes); Vt. R. Evid. 804a(b) (“Upon motion of either party in a criminal or delinquency proceeding, the court shall require the child or mentally retarded or mentally ill person to testify for the state.”); *State v. Laturner*, 163 P.3d 367 (Kans. App. 2007) (review granted Dec. 18, 2007).

<sup>106</sup> *Cf. State v. Caulfield*, 722 N.W.2d 304 (Minn. 2006) (“although there may be legitimate public policy reasons to advance the time to assert confrontation rights to a reasonable time before trial, such a shift cannot be constitutionally accomplished without adequate notice to the defendant that his failure to request the testimony of the analyst will result in the waiver of his confrontation rights, especially when the report is offered to prove an element of the offense with which the defendant is charged”); Metzger, *supra*, 59 VAND. L. REV. at 516-518 (criticizing “demand-waiver” statutes).

<sup>107</sup> *Williams v. Florida*, 399 U.S. 78, 82-83 (1970).

<sup>108</sup> *Michigan v. Lucas*, 500 U.S. 145, 152-53 (1991). In *Lucas*, the Court noted that [t]he notice-and-hearing requirement serves legitimate state interests in protecting against surprise, harassment, and undue delay. *Id. See also Poulos v. New Hampshire*, 345 U.S. 395, 405 (1953) (State may establish reasonable procedures that must be followed to exercise First Amendment rights).

<sup>109</sup> *Pointer v. Texas*, 380 U.S. 400, 406 (1965) (In all criminal prosecutions, the accused shall enjoy the right . . . to be confronted with the witnesses against him. U.S. CONST. Amendment VI. This guarantee applies to the States as well as to the United States government.).

<sup>110</sup> . Alabama: ALABAMA CODE § 12-21-300 (2006); Alaska: ALASKA STAT. § 12.45.084 (2006); Arizona: ARIZONA REV. STAT. ANN. § 36-254 (2006); Arkansas: ARKANSAS CODE ANN. §§ 5-64-707, 12-12-313 (2006); Colorado: COLORADO REV. STAT. § 16-3-309(5) (2006); Connecticut: CONNECTICUT GEN. STAT. § 21a-283(b) (2006); Delaware: DELAWARE CODE ANN. tit. § 10, 4330-32 (2006); District of Columbia: DISTRICT OF COLUMBIA CODE ANN. § 48-905.06 (LexisNexis 2006); Florida: FLORIDA STAT. ANN. §§ 316.1934, 327.354 (West 2006); Idaho: IDAHO CODE ANN. § 37-2745 (2006); Illinois: 725 ILLINOIS COMP. STAT. ANN. 5/115-15 (West 2000); *but see Illinois v. McClanahan*, 729 N.E.2d 470, 478 (Ill. 2000), (holding the statute unconstitutional); Iowa: IOWA CODE § 691.2 (2006); Kansas: KANSAS STAT. ANN. §§ 22-2902a, 22-3437 (2006); Kentucky: KENTUCKY REV. STAT. ANN. § 189A.010 (West 2006); Louisiana: LOUISIANA REV.

Requiring a defendant to provide notice that he wishes to have the analyst present for cross-examination, like the statutes requiring notice of an alibi or notice of the intent to explore the sexual history of the victim, is a constitutionally permissible measure. The right of an accused to confront and cross-examine is not absolute and may give way to other legitimate interests.<sup>111</sup> The requirement that the defendant provide notice to ensure the presence of the analyst is a constitutionally permissible regulation of the exercise of the right to confront witnesses.

Second, a defendant who fails to ensure the presence of the analyst has waived his right to confront the analyst. The right to confront witnesses, like other constitutional rights, can be waived.<sup>112</sup> Petitioners contend that they vigorously demanded their right to confront the analyst. They, however, failed to avail themselves of the mechanism to ensure that confrontation took place, either by notifying the prosecution or the court that they wished to have the analyst present, or by issuing a subpoena for the analyst. The Supreme Court of Virginia correctly concluded that this failure constituted a waiver.

Third, Respondent argues that states need to balance laboratory analysts confrontation demands with the efficient allocation of scarce resources. The sheer volume of drug cases requires special attention to the pitfalls of requiring strict confrontation rights. Since 2000, state and federal law enforcement officials have arrested more than 11 million persons for possessing or trafficking illegal narcotics.<sup>113</sup> As the number of arrests escalates, so does the burden on the state and local laboratories charged with analyzing the substances recovered.

Year	Persons Arrested	Substances Analyzed
2000	1,579,566	1,532,412
2001	1,586,902	1,894,610
2002	1,538,813	1,798,045
2003	1,678,192	1,715,598

STAT. ANN. §§ 15:499-15:501, 32:662-32:663 (2006); Maine: MAINE REV. STAT. ANN. tit. 5, § 9057; tit. 6, § 205; tit. 17-A, § 1112; tit. 29-A, § 2431 (2006); Maryland: MARYLAND CODE ANN., CTS. & JUD. PROC. §§ 10-914, -1001 to -1003 (West 2006); Massachusetts: MASSACHUSETTS GEN. LAWS ch. 22C, §§ 39, 41; ch. 90, § 24; ch. 90B, § 8; ch. 94C; ch. 111, § 13 (2006); Michigan: MICHIGAN COMP. LAWS §§ 257.625a, 600.2167 (2006); Minnesota: MINNESOTA STAT. §§ 634.15-16 (2006); Missouri: MISSOURI REV. STAT. §§ 577.020, 577.037 (2006); Nebraska: NEBRASKA REV. STAT. § 28-1439 (2006); Nevada: NEVADA REV. STAT. §§ 50.315, 50.320, 50.325 (2006); New Hampshire: NEW HAMPSHIRE REV. STAT. ANN. §§ 215-A:11-i, 265:92-a, 270:57 (2006); New Jersey: NEW JERSEY STAT. ANN. § 2C:35-19 (West 2006); New Mexico: NEW MEXICO STAT. ANN. §§ 66-8-110, 66-13-11 (LexisNexis 2006); New York: NEW YORK VEH. & TRAF. LAW § 1195 (McKinney 2006), NEW YORK C.P.L.R. 4518, 4520 (McKinney 2006), NEW YORK CRIM. PROC. LAW § 190.30 (McKinney 2006); North Carolina: NORTH CAROLINA GEN. STAT. §§ 20-139.1, 90-95(g) (2006); North Dakota: NORTH DAKOTA CENT. CODE §§ 19-03.1-37, 39-20-07 (2006); Ohio: OHIO REV. CODE ANN. § 2925.51 (West 2006); Oklahoma: OKLAHOMA STAT. ANN. tit. 22 §§ 751, 751.1; tit. 47, § 754 (West 2006); Oregon: OREGON REV. STAT. §§ 40.460, 40.510, 475.235 (2006); Pennsylvania: 75 PENNSYLVANIA CONS. STAT. ANN. § 1547 (West 2006); Rhode Island: RHODE ISLAND GEN. LAWS § 9-19-43 (2006); South Dakota: SOUTH DAKOTA CODIFIED LAWS § 1-49-6 (2006); Tennessee: TENNESSEE CODE ANN. §§ 40-28-122, 40-35-311, 55-10-407 (2006); Texas: TEXAS CODE CRIM. PROC. ANN. art. 38.41 (Vernon 2006); Utah: UTAH CODE ANN. §§ 41-6a-515, 72-10-503 (2006); VERMONT STAT. ANN. tit. 13, § 4816; tit. 23, §§ 1202, 1203, (2006); Virginia: VIRGINIA CODE ANN. §§ 18.2-268.7, 18.2-268.9, 19.2-187, 19.2-187.01, 19.2-187.02, 19.2-187.2 (2006); Washington: WASHINGTON REV. CODE § 46.20.308 (2006); West Virginia: WEST VIRGINIA CODE § 17C-5A-1 (2006); Wisconsin: WISCONSIN STAT. § 970.03 (2006); Montana: MONTANA R. EVID. 803(8) (2006); South Carolina: SOUTH CAROLINA R. CRIM. PRO. 6 (2006); Washington: WASHINGTON ST. SUPER. CT. CRIM. R. 6.13 (2006).

<sup>111</sup> *Chambers v. Mississippi*, 410 U.S. 284, 295 17 (1973). See also *Mattox v. United States*, 156 U.S. 237, 243 (1895) (noting that confrontation of witnesses must occasionally give way to considerations of public policy and the necessities of the case.).

<sup>112</sup> *Brookhart v. Janis*, 384 U.S. 1, 4 (1966); *Singer v. United States*, 380 U.S. 24, 35 (1965); *Chambers v. Mississippi*, 410 U.S. 284, 295 17 (1973). See also *Mattox v. United States*, 156 U.S. 237, 243 (1895) (noting that confrontation of witnesses must occasionally give way to considerations of public policy and the necessities of the case.).

<sup>113</sup> See Uniform Crime Report, Crime in the United States 2000-2008, Table 29.

2004	1,745,712	1,734,658
2005	1,846,351	1,749,275
2006	1,889,810	1,935,788
2007	1,841,182	1,808,810
2008	1,702,537	1,768,886

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Further, in 2005 alone, the States spent \$135.8 billion, 15.7% of their annual budgets, fighting “substance abuse and addiction.”<sup>115</sup> Of this amount, \$8.1 billion was spent in the state courts, \$4.5 billion of which funded drug-related criminal cases.<sup>116</sup> The above illustrates the fact that Supreme Court’s decision in *Melendez-Diaz* impacts a high-volume, high-cost subset of criminal prosecutions.

### Conclusion

The United States Supreme Court held that it was a violation of the Sixth Amendment right of confrontation for a prosecutor to submit a chemical drug test report without the testimony of the scientist. The *Melendez-Diaz* decision expands the rights of defendants in criminal cases to confront witnesses against them. Prosecutors must now have available the lab analysts to testify at trial, rather than simply admitting a report certified by a lab analyst into evidence. These analysts will likely be expected to testify about their own personal credentials and to address the accuracy of the result and the processes used to produce the result.

By requiring testimony from forensic analysts about the processes and techniques used in labs across the country, the *Melendez-Diaz* Supreme Court decision will afford an opportunity for greater scrutiny of the lab analysis and process. This increased scrutiny by defense attorneys and the public will require greater accountability of the laboratories to produce accurate results and to ensure the use of best practices in laboratory analyses involving criminal matters. Under *Melendez-Diaz*, the relevancy of the Confrontation Clause in the twenty-first century has expanded broadly.

<sup>114</sup> *Id.*; National Forensic Laboratory Information System, Years 2000-2008 Annual Report, Table 1.1.

<sup>115</sup> The National Association on Addiction and Substance Abuse, *Shoveling Up II: The Impact of Substance Abuse on Federal, State and Local Budgets 2* (2009).

<sup>116</sup> *Id.* at 31.



## GLASS CEILING AND MATERNITY LEAVE AS IMPORTANT CONTRIBUTORS TO THE GENDER WAGE GAP

MARIA FLORENCIA CABEZA<sup>\*</sup>, JENNIFER BARGER JOHNSON<sup>\*\*</sup>, AND LEE J. TYNER<sup>\*\*\*</sup>

Over the last decades, several studies have been conducted to explain the reasons why women are paid less than men, even when performing similar or the same jobs. Despite the global spotlight that this issue has raised over the last decades, the gender wage gap is still a reality and women continue to suffer several economic consequences for this unfair treatment in the workplace. The objective of this paper is to investigate whether the glass ceiling and maternity leave are important contributors to the wage gap. To address this question, each concept is first examined individually, and then contrasted with other potential factors for gender pay gap. The glass ceiling section presents the definition of the concept, its causes, a comparative analysis of its effects in different countries in the world, and finally its influence on the gender pay gap. The next section focuses on maternity leave, by describing the laws and policies that provide the regulatory framework, making a comparative analysis of these policies across the world, and finally assessing the influence of maternity leave and motherhood in general in the gender wage gap. The last section compares the glass ceiling and maternity leave with other potential contributors to the gender wage gap.

### I. DEFINITION AND EVOLUTION OF THE GLASS CEILING

Glass ceiling is defined by "...the U.S. Department of Labor as 'those artificial barriers based on attitudinal or organizational bias that prevent qualified individuals from advancing upward in their organization into management level positions.'"<sup>1</sup> Jackson and O'Callaghan explain that since it was mentioned in a Wall Street Journal's article in 1986, the term glass ceiling has been widely used, especially for women in the workplace.<sup>2</sup> The Federal Glass Ceiling Commission (FGCC) was constituted by the Civil Rights Act of 1991 to "...focus attention on, and complete a study relating to the existence of artificial barriers to the advancement of women and minorities in the workplace, and to make recommendations for overcoming such barriers."<sup>3</sup> Although the number of women in management positions has improved since the creation of the FGCC, the rate of change of this improvement is still slow. To illustrate that despite being 46.7 percent of the workforce, women held only 14.4 percent of executive officer positions in Fortune 500 companies, and 15.7 percent of those corporate board seats in 2010.<sup>4</sup>

### II. CAUSES OF THE GLASS CEILING

The Federal Glass Ceiling Commission defines three clearly differentiated barriers to the advancement of women into high level management positions, and these are: societal, internal and governmental barriers.<sup>5</sup> The

<sup>\*</sup> MBA Candidate, University of Central Oklahoma, Edmond, OK.

<sup>\*\*</sup> J.D., Assistant Professor of Legal Studies and Copyright Compliance Officer, University of Central Oklahoma, Edmond, OK.

<sup>\*\*\*</sup> Ed.D., Assistant Chairperson and Assistant Professor of Management, University of Central Oklahoma, Edmond, OK.

<sup>1</sup> Tina C. Elacqua, Terry A. Beehr, Curtiss P. Hansen, & Jennica Webster, *Managers' beliefs about the glass ceiling: Interpersonal and organizational factors*, 33(3) PSYCHOLOGY OF WOMEN QUARTERLY 285-294, 289 (2009).

<sup>2</sup> Jerlando F. L. Jackson, & Elizabeth M. O'Callaghan, *What do we know about glass ceiling effects? A taxonomy and critical review to inform higher education research*. 50(5) RESEARCH IN HIGHER EDUCATION 460-482 (2009).

<sup>3</sup> THE CIVIL RIGHTS ACT OF 1991, 42 U.S.C. 1981 *et. seq.* (2009). Also available at <http://archive.eeoc.gov/policy/cra91.html>.

<sup>4</sup> Catalyst, *Statistical Overview of Women in the Workplace* (2011), available at <http://www.catalyst.org/publication/219/statistical-overview-of-women-in-the-workplace>.

<sup>5</sup> Federal Glass Ceiling Commission, *Good for Business: Making Full Use of the Nation's Human Capital* (1995), available at <http://www.dol.gov/oasam/programs/history/reich/reports/ceiling.pdf>.

*societal barriers* are conformed by the *supply barrier*, which represents the low availability of women candidates since they mostly occupy traditional female dead-end positions; and the *difference barrier*, which is based on stereotypes due to gender difference.<sup>6</sup> Some of the gender stereotypes state that female executives are less able to do the job, unable to work longer hours, too emotional, unwilling to relocate, not tough enough, and unable to make decisions. The *internal barriers* are classified into corporate climate and pipeline issues.<sup>7</sup> Since the corporate management positions are mostly filled by white males, they impose rules and an organizational culture that make it difficult for women to fit in and become part of the formal and informal networks that are crucial for promotions. Likely due to white male upper level management anxiety and fear of losing power, women are not placed in the pipeline to senior management positions. This blocks females' access to mentoring, training, job rotation and career development. The *governmental barriers* are related to the lack of auditing and law enforcement, the poor detailing and quality of data collected by government agencies to effectively track the progress of women in the workplace, and the limited educational use of the reports generated from the collected data.<sup>8</sup>

After the release of the Federal Glass Ceiling Commission reports, many other institutions have continued the research of the glass ceiling causes, effects and solutions by collecting and updating statistical information about these issues. A recent research conducted by Carter and Silva states that the "pipeline for women is in peril," meaning that despite the higher achievement of women in education during the last fifteen years, they still lag behind men in advancement and compensation.<sup>9</sup> By studying men and women who graduated from full-time MBA programs and worked full-time in companies at the time of the survey, these authors discovered that men have far more chances to start their first post-MBA job in higher positions than do women, even after considering childless women with higher aspirations. "After starting from behind, women don't catch up," neither in the rank of the position nor in compensation.<sup>10</sup> Nowadays, women in the United States are acquiring equal or higher educational levels than men, but they are still paid less than men while performing the same jobs.<sup>11</sup> Therefore, education is not an excuse to impede women's advancement any longer.

### III. INDUSTRY COMPARATIVE

Although the presence of women in managerial positions has steadily increased from 29.3 percent in 1990 to 36.4 percent in 2002, based on the data provided by the U.S. Equal Employment Opportunity Commission (EEOC)<sup>12</sup>, and to 42.7 percent in 2010, according to Bureau of Labor Statistics<sup>13</sup>, the percentage of women is not evenly distributed across different industries and occupations. To acquire a deep understanding of the glass ceiling for women, it is important to identify the industries in which they are more concentrated and whether this distribution has other consequences in their path to acquiring top management positions.

Absent of discriminatory practices, to determine whether women are fairly represented in a certain job, the percentage of women working in different kinds of jobs should match the percentage of women available in the labor market.<sup>14</sup> Since women are 48 percent of the labor force, the U.S. Equal Employment Opportunity Commission states that they are overrepresented in certain occupations while underrepresented in others.<sup>15</sup> As shown in Table 1, women are concentrated in clerical, services, and sales jobs. Along with these results, this Commission also reports the industries in which women as managers and officials are the most and least represented. These industry comparatives are shown in Table 2 and Table 3 respectively, demonstrating that women have an equivalent or higher number of management positions in only seven out the 50 largest industries in the U.S. The health care and other service industries are the ones in which women have shattered the glass ceiling barriers;

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> Nancy M. Carter, & Christine Silva, *Pipeline's Broken Promise*, 2 (2010), [http://www.catalyst.org/file/340/pipeline's\\_broken\\_promise\\_final\\_021710.pdf](http://www.catalyst.org/file/340/pipeline's_broken_promise_final_021710.pdf).

<sup>10</sup> *Id.* at 4.

<sup>11</sup> *Id.*

<sup>12</sup> U.S. Equal Employment Opportunity Commission, *Glass Ceilings: The Status of Women as Officials and Managers in the Private Sector* (2004), available at <http://www.eeoc.gov/eeoc/statistics/reports/glassceiling/index.html>.

<sup>13</sup> Bureau of Labor Statistics, *Current Population Survey: Employed Persons by Detailed Occupation, Sex, Race, and Hispanic or Latino Ethnicity* (2010), <ftp://ftp.bls.gov/pub/special.requests/lf/aat11.txt>.

<sup>14</sup> David J. Walsh, *EMPLOYMENT LAW FOR HUMAN RESOURCE PRACTICE*, (South-Western/Cengage Learning, 2010).

<sup>15</sup> U.S. Equal Employment Opportunity Commission, *supra* note 12 at 6.

whereas in manufacturing industries women are barely represented in managerial jobs. Similar results emerge from the evaluation of current data obtained from the Bureau of Labor Statistics<sup>16</sup>, which reaffirms that the trends have not changed since the EEOC's report in 2004, as shown in Table 4.

Table 1: *Distribution of Women Across 2002 EEO-1<sup>17</sup> Job Groups<sup>18</sup>*

Job group	Percentage of women
Clerical workers	80.3
Service workers	57.7
Sales workers	56.4
Professionals	51.7
Technicians	45.9
Official and managers	36.4
Laborers	33.7
Operatives	26.3
Craft workers	12.8
<b>Total employment</b>	<b>48.0</b>

Table 2: *Industries with Highest Percentage of Women as Officials and Managers, From the Top 50 Industries<sup>19</sup>*

Industry	Percentage of women
Nursing care facilities	77.20
Offices of physicians	67.65
Community care facilities for the elderly	67.60
General medical & surgical hospitals	67.53
Other ambulatory health care services	58.66
Department stores	56.16
Legal services	50.57
Depository credit information	49.24
Insurance carriers	48.49
Non-depository credit intermediation	46.99

<sup>16</sup> U.S. Equal Employment Opportunity Commission, *supra* note 3.

<sup>17</sup> U.S. Equal Employment Opportunity Commission, *supra* note 12 at 6.

<sup>18</sup> The Employer Information EEO-1 survey is conducted annually under the authority of Title VII of the Civil Rights Act of 1964, 42 U.S.C. 2000e, *et. seq.*, as amended. All employers with 15 or more employees are covered by Title VII and are required to keep employment records as specified by Commission regulations. Based on the number of employees and federal contract activities, certain large employers are required to file an EEO-1 report on an annual basis.

<sup>19</sup> U.S. Equal Employment Opportunity Commission, *supra* note 12 at 8.

Table 3: *Industries With Lowest Percentage of Women as Officials and Managers, From the Top 50 Industries*<sup>20</sup>

Industry	Percentage of women
Motor vehicle body and trailer manufacturing	13.84
Aerospace product and parts manufacturing	14.73
Motor vehicle parts manufacturing	15.14
Electric power generation, transmission and distribution	15.16
Other fabricated metal product manufacturing	15.71
Architectural, engineering and related services	16.08
Motor vehicle manufacturing	17.28
Plastics product manufacturing	18.11
Covert paper product manufacturing	18.24
General freight trucking	18.45

Table 4: *Participation of Women in Management Positions Among Industries in 2010*<sup>21</sup>

Managers by industry or specific position	Percentage of women
Medical and health services	69.5
Social and community services	69.4
Human resources	66.8
Education administrators	62.6
Advertising and promotions	56.5
Financial	54.7
Public relations	53.1
Purchasing	50.3
Lodging	48.2
Property, real estate, and community association	46.7
Food service	45.7
Marketing and sales	42.8
Administrative services	40.9
Computer and information systems	29.0
Chief executives	25.0
Farm, ranch, and other agricultural	17.5
Industrial production	16.4
Transportation, storage, and distribution	16.4
Engineering	8.1
Construction	5.9

As demonstrated, women have more difficulties in advancing mainly in industries that have been traditionally male-dominated. Demaiter and Adams state that “male-dominated jobs have a masculine structure and

<sup>20</sup> U.S. Equal Employment Opportunity Commission, *supra* note 12 at 8.

<sup>21</sup> Bureau of Labor Statistics, *supra* note 13.

a masculine organizational and occupational culture.”<sup>22</sup> Therefore, the glass ceiling barriers for women, especially at societal and internal levels, are more accentuated in those kinds of jobs traditionally occupied by men.

#### IV. THE GLASS CEILING IN THE UNITED STATES VERSUS OTHER COUNTRIES

As in the U.S., women in other countries also encounter barriers in advancing to management positions. The glass ceiling is a global issue, but the barriers vary considerably depending on the culture, size, welfare, and the political and religious history of the different countries. There are also differences in the way each country’s inhabitants perceive the glass ceiling. For instance, women in the U.S. and the U.K. acknowledge that the greatest glass ceiling barriers come from the society. In contrast, in Canada, Philippines, and Austria, women believe that internal corporate barriers prevent them from advancing upward in their organizations.<sup>23</sup> In Mexico, Braine explains that while she was giving a seminar to female executives, 80 percent of the attending women did not know what the term glass ceiling meant.<sup>24</sup> Despite the different perceptions about the concept, the reality is that there is no country in the world where the glass ceiling does not exist.

The higher the management positions, the lower the percentage of women who occupy those positions. When looking at the percentage of women on the board of directors of the top companies across different regions of the world, the numbers are dramatically low, as shown in Table 5.

Table 5: *Percentage of Women on Board Seats*<sup>25</sup>

Region or country	Percentage of women
United States	15.1
European Union	9.7
Latin America <sup>26</sup>	5.1
China and India	5.0
Japan	1.4

Barriaux explains that according to a PricewaterhouseCoopers’s global study, women in eastern developing countries encounter less glass ceiling barriers than in countries in the west, where cultural stereotypes and perceptions place women in a weaker position.<sup>27</sup> Since in the developing world there is a high demand of talent due to the rapidly increasing growth of these economies, companies in those countries fill positions without much objection to the gender of the candidate. In the case of China, Barriaux states that the government birth-rate control has improved the participation of women in the labor force and their level of education.<sup>28</sup> Moreover, women have become more self-confident since they do not have to compete at home with male siblings for parental attention. Despite these positive comments about China and the developing world, the statistics of the World Economic Forum show that women as legislators, senior officials and managers are still underrepresented in those countries, as shown in Table 6.<sup>29</sup>

<sup>22</sup> Erin I. Demaiter & Tracey L. Adams, “*I really didn’t have any problems with the male-female thing until ...*”: *Successful women’s experiences in IT organizations*, 34(1) CANADIAN JOURNAL OF SOCIOLOGY 31, 34 (2009); and Bureau of Labor Statistics, *supra* note 13.

<sup>23</sup> Nic Paton, *Glass Ceiling Stretches Around the World* (2006), available at <http://www.management-issues.com/2006/8/24/research/glass-ceiling-stretches-around-the-world.asp>.

<sup>24</sup> Theresa Braine, *Latin America Business put Few Women on Board* (2005), available at <http://www.womensenews.org/story/business/050829/latin-american-business-puts-few-women-board>.

<sup>25</sup> Nicola Clark, *Getting Women into Boardrooms, by Law*, N.Y. TIMES, January 27, 2010, available at <http://www.nytimes.com/2010/01/28/world/europe/28iht-quota.html>.

<sup>26</sup> Braine, *supra* note 24.

<sup>27</sup> Marianne Barriaux, *Developing World Cracks Glass Ceiling*, THE GUARDIAN, October 15, 2007, available at <http://www.guardian.co.uk/business/2007/oct/15/genderissues>.

<sup>28</sup> Barriaux, *supra* note 27.

<sup>29</sup> Ricardo Hausmann, Laura D. Tyson, & Saadia Zahidi, *The Global Gender Gap Report 2010*, THE WORLD ECONOMIC FORUM, available at <https://members.weforum.org/pdf/gendergap/report2010.pdf>.

Table 6: *Distribution of the Labor Force Across the World*<sup>30</sup>

Country	Percentage of people in labor from total gender population			% of women as managers
	% Female	% Male	Difference of % between genders	
Europe				
Malta	39	78	39	18
Italy	52	74	22	33
Greece	55	79	24	28
Spain	63	82	19	32
Cyprus	64	80	16	16
France	65	75	10	49
Austria	68	81	13	28
United Kingdom	69	82	13	35
Germany	71	82	11	38
Norway	76	81	5	31
Denmark	76	83	7	24
Sweden	77	82	5	32
North America				
United States	68	80	12	43
Canada	75	83	8	36
Mexico	46	84	38	31
Asia and other regions				
Japan	62	84	22	9
India	35	85	50	3
China	74	85	11	17
Iran	33	76	43	13
Saudi Arabia	22	82	60	8
South Africa	51	67	16	30
Latin America				
Argentina	58	82	24	23
Brazil	64	85	21	36
Chile	47	78	31	24
Colombia	43	80	37	46

In Europe, there are several differences among the twenty-five countries that form the European Union (EU). Firstly, not all countries have similar female employment rates. QeC-ERAN Report states that, with 80 percent of working women, Nordic countries have almost equal participation between men and women in the workforce.<sup>31</sup> One would expect to find more women as legislators, managers and officials in these countries;

<sup>30</sup> *Id.*

<sup>31</sup> QeC-European Regeneration Areas Network, *Women in the Workplace: Factors Affecting the European Situation and Envisaged Policy Options* (2007), available at <http://www.qeceran.org/qec/publications/women%20in%20the%20workplace%20recycled%20report/Women%20in%20the%20workplace.doc>.

however, the statistics show that most European countries have less than 40 percent of women in management positions.

Regarding Latin American countries, Braine emphasizes that this region lags behind other countries in placing women in senior management jobs.<sup>32</sup> Among other factors, Braine explains that women are at a big disadvantage by not being part of the right networks since the most accepted way to do business in this region is through powerful connections.<sup>33</sup> In Latin America, an average of 55 percent of women participates in the workforce, but only an average of 34 percent of them occupies management positions.<sup>34</sup>

There is a common factor among the majority of the countries. Women have matched and, in some cases, even surpassed men in tertiary education enrollment.<sup>35</sup> However, this global trend is not accompanied with improvements in the incomes they receive, since men are still leading the management and top executive positions around the globe.

## V. THE GLASS CEILING AS A FACTOR OF THE GENDER WAGE GAP

Up to this point, it is clear that the glass ceiling barriers prevent women from not only getting to top level positions, but also earning the same compensations and benefits as men. As it was shown in Table 1 from the industry comparative, the proportion of women in management positions is lower than the percentage of women in the general workforce. This factor by itself is an important contributor to the gender wage gap, since managerial occupations are better compensated than others, such as clerical or service jobs. On the other hand, as shown in Tables 2 and 3, when occupying management positions, women tend to be overrepresented in medium and medium-low wage industries, such as nursing and education, and underrepresented in high wage industries such as manufacturing. To illustrate the wage differences across different industries, Table 7 shows the results from the United States Government Accountability Office report, which studied the gender wage gap by analyzing information from 13 industry sectors and comparing the compensation of men and women working full-time in management positions in each industry.<sup>36</sup> The results of this study also show that overall, considering all industry sectors combined, in 2007, women were paid 81 cents for each dollar earned by men while in the same positions.

Table 7: *Estimated Pay Differences for Full-Time Managers by Industry, 2007*<sup>37</sup>

Industry	Median salary for full-time managers (in dollars)		Adjusted female wage per dollar paid to males (in cents)
	Male	Female	
Professional and business services	90,000	63,000	81
Manufacturing	86,000	67,000	84
Financial activities	85,000	50,000	78
Information and communication	84,000	62,000	84
Wholesale trade	76,000	55,000	83
Public administration	74,000	60,000	87
Construction	70,000	52,000	78
Educational services	70,000	59,000	86
Health care and social assistance	70,000	52,000	81
Transportation and utilities	70,000	52,000	81
Retail trade	67,000	48,000	81

<sup>32</sup> Braine, *supra* note 24.

<sup>33</sup> *Id.*

<sup>34</sup> Hausmann, *supra* note 29.

<sup>35</sup> *Id.*

<sup>36</sup> United States Government Accountability Office (GAO), *Women in Management: Analysis of Female Managers' Representation, Characteristics, and Pay* (2010), 9, available at <http://www.gao.gov/new.items/d10892r.pdf>.

<sup>37</sup> *Id.* at 9-21. (Values adjusted for age, hours worked beyond full time, race and ethnic, state, veteran status, education, industry sector, citizenship, marital status, and presence of children in the household.)

Other Services	55,000	49,000	87
Leisure and hospitality	45,000	35,000	80

Why do women earn less than men while doing the same jobs? Wirth explains that men are more likely to be in charge and perform the more skilled and valued tasks, which are better compensated by bonuses, commissions, and profit sharing.<sup>38</sup> Therefore, in these cases, wage decisions are most likely to be influenced by gender stereotypes, such as women being less able to do the job or having personality traits that are not appropriate for such responsibilities. Moreover, the lack of training, mentoring and support during their careers hinder women from being paid equally.

## VI. MATERNITY LEAVE

The workforce in the U.S has drastically changed over the last few decades primarily due to the increase in percentage of women in the workforce, especially women with children.<sup>39</sup> To illustrate, "...the Bureau of Labor Statistics reported that couples in which only the husband worked represented 18 percent of married couple families in 2007, compared with 36 percent in 1967."<sup>40</sup> In this section of the paper, the effects of maternity leave policies and also the consequences of motherhood by itself will be studied closely to discover whether these issues are important factors in explaining the gender wage gap. To answer this question, three main topics will be discussed: the laws and policies regarding parental leave, a comparison between these policies in the U.S and those of other countries and its different consequences on women's careers, and finally maternity leave as a factor of the gender wage gap.

### A. Laws and Policies

After being constantly fired for getting pregnant, in 1978, women were protected for the first time in this regard by the Pregnancy Discrimination Act (PDA), which was incorporated in Title VII of the Civil Rights Act of 1964.<sup>41</sup> Covering government and private employers with 15 or more employees, the PDA prevents women from being discriminated against on the basis of pregnancy, childbirth, or related medical conditions. Under this law, employers must not refuse to hire, deny promotions or fire pregnant women. "The law also states that an employer must treat a pregnant woman in the same way it would treat any other employee who becomes sick or temporarily disabled."<sup>42</sup> As a result, employers must hold jobs open for women who take pregnancy-related leave if they do so for other employees taking other kinds of leave.<sup>43</sup> However, this law "does not provide job protection" if women need to stay home to take care of their new child.<sup>44</sup> Therefore, the PDA has been very important in helping protect women from discrimination during their pregnancy, but still many women lose their jobs after having a baby and find themselves without resources to feed and maintain their new family.

Since 1993, covering private employers with more than 50 employees and all government employers, the Family and Medical Leave Act has become the most important federal law for parents, allowing them to ask for 12 weeks of leave to take care of newborns as well as adopted babies.<sup>45</sup> Under FMLA, employers are obligated to restore parents to their original or equivalent job position with the same pay, benefits, and other conditions of employment. One important condition to be eligible for FMLA benefits is to have worked for the company for at least one year and a minimum of 1250 hours during that year.<sup>46</sup> Despite the benefits brought under this law, many issues regarding new parents are still unresolved. Since the law only covers employees working for private

<sup>38</sup> Linda Wirth, *Breaking Through Glass Ceiling: Women in Management*, INTERNATIONAL LABOUR OFFICE (2004), available at <http://www.ilo.org/dyn/gender/docs/RES/292/f267981337>.

<sup>39</sup> GAO, *supra* note 36 at 6-12.

<sup>40</sup> GAO, *supra* note 36 at 6-12.

<sup>41</sup> Jodi Grant, Taylor Hatcher, & Nirali Patel, *Expecting Better: A State-by-State Analysis of Parental Leave Programs*, NATIONAL PARTNERSHIP FOR WOMEN AND FAMILIES (2005), available at <http://www.nationalpartnership.org/site/DocServer/ParentalLeaveReportMay05.pdf?docID=1052>

<sup>42</sup> *Id.* at 7.

<sup>43</sup> Walsh, *supra* note 14 at 345.

<sup>44</sup> Grant, *supra* note 41 at 7.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

companies with more than 50 employees, almost 40 percent of the labor force is not qualified for exercising the FMLA.<sup>47</sup> On the other hand, employees who are eligible for this coverage cannot afford to take the unpaid leave and thus they return to work after the birth, leaving the newborns during the most critical months in which the parental caregiving improves many developmental aspects of the baby. Vahratian states that “in its current form, the Leave Act may present more barriers than benefits in its application.”<sup>48</sup> Many women combine vacation time, sick days, and other paid days available to guarantee some income during their maternity leave, leaving women in a precarious economic situation for the period they have ahead.

Some efforts have been made at the state level to overcome the economic problems that new parents have to affront during this important stage of their lives. Vahratian reports that six states and some U.S. territories provide paid family and medical leave to their residents: California, Hawaii, New Jersey, New York, Rhode Island, and Puerto Rico.<sup>49</sup> California is the state with more extensive benefits, providing “...4 weeks antenatally and 6 to 8 weeks postnatally for women working for public or private employers with five or more employees.”<sup>50</sup> Lovell, O’Neil, and Olsen from the Institute for Women’s Policy Research showed that even among the best employers for working mothers, the paid leave is not standard.<sup>51</sup> They demonstrated that by using data provided by the *Working Mother* magazine’s ranking of the best 100 family-friendliest companies in the U.S. Table 8 shows detailed information about this issue, highlighting the fact that 52 percent of these companies provide six weeks or less of paid maternity leave and 24 percent provide four or fewer paid weeks. None of these companies provide more than six weeks of paid paternity leave.

Table 8: *Working Mother 100 Best Companies, 2006: Percent Offering Paid Maternity Leave*<sup>52</sup>

Number of weeks of paid maternity leave	Cumulative Percent of companies offering some paid maternity leave
More than 12	8
11 to 12	19
9 to 10	28
7 to 8	48
5 to 6	76
3 to 4	86
1 to 2	93

Lovell, O’Neil, and Olsen also included in their research the percentage of paid leave among the different occupations in the U.S. Managers and professionals are the most benefited from the paid leave, as shown in Table 9.<sup>53</sup> Overall, despite the efforts of the different states and some important companies, only 8 percent of all private sector workers are eligible for some kind of economic help during their parental leaves.

Table 9: *Percent of U.S. Private Sector Workers with Access to Paid or Unpaid Family Leave, 2007*<sup>54</sup>

Characteristics	Percentage of family
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<sup>47</sup> *Id.*

<sup>48</sup> Anjel Vahratian & Timothy R. B. Johnson, *Maternity Leave Benefits in the United States: Today’s Economic Climate Underlines Deficiencies*, 36 BIRTH 177, 178 (2009), available at <http://onlinelibrary.wiley.com/doi/10.1111/j.1523-536X.2009.00330.x/pdf>.

<sup>49</sup> *Id.* at 178.

<sup>50</sup> *Id.*

<sup>51</sup> Vicky Lovell, Elizabeth O’Neil, & Skylar Olsen, *Maternity leave in the United States: Paid Parental Leave is Still Not Standard, Even Among the Best U.S. Employers*, INSTITUTE FOR WOMEN’S POLICY RESEARCH (August 2007), available at <http://iwpr.org/pdf/parentalleaveA131.pdf>.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> Lovell, *supra* note 51. (Because employers report that some workers have access to both paid and unpaid family leave, percents given may add to more than 100 percent. For the same reason, it is not possible to determine how many workers lack access to any form of leave, paid or unpaid.)

	leave	
	Paid	Unpaid
All workers	8	83
Worker Characteristics		
Management, professional and related	14	90
Service	5	79
Sales and office	9	84
Natural Resources, construction, and maintenance	6	75
Production, transportation, and material moving	4	84

#### B. *Maternity Leave in the United States Versus Other Countries*

The United States parental leave policies are among the worst in the world.<sup>55</sup> Through FMLA, American parents are provided with 12 weeks, and just a few receive some form of payment during the leave. Only four countries in the world do not have any national policy for paid maternity leave: Lesotho, Swaziland, Papua New Guinea, and the United States of America.<sup>56</sup> As a result, the U.S has become the only industrialized nation without a paid leave policy, after Australia passed its own law to be in effect by January 2011.<sup>57</sup>

The paid leave policies around the world vary considerably in both the length of the leave and the percentage of the salary that mothers, and in some cases fathers as well, receive during that period. In the European Union, most of the countries pay between 80 percent and 100 percent of the leave.<sup>58</sup> Sweden is the country with the most leave benefits, providing for both mothers and fathers with 69 weeks and 80 percent of the salary for the first 12 months. Despite this broad coverage, the average fertility rate in EU countries is approximately 1.5, thus the use of this practice has not produced a large impact on the increase of the population. Women in most developing countries also have important coverage, which ranges from 12 to 14 weeks and provides between 80 percent and 100 percent of their salary during that time.<sup>59</sup> To illustrate this, Table 10 shows the different policies in the most important countries in each region of the world.

Table 10: *Characteristics of the Parental Leave Policies Around the World*<sup>60</sup>

Country	Leave length in weeks	Percentage of paid leave	Age of marriage	Fertility rate
Europe				
Italy	20	80	30	1.4
Greece	17	50	27	1.4
Spain	16	100	29	1.4
France	16	100	32	1.9
United Kingdom	52	90	26	1.8
Germany	14	100	31	1.3

<sup>55</sup> *Id.*

<sup>56</sup> Elizabeth Vargas, *Can Working Mothers Have It All?*, ABCNEWS.GO.COM (Nov. 9, 2006), available at <http://abcnews.go.com/2020/LifeStages/story?id=2641588&page=1>.

<sup>57</sup> Debbie Richards, *Paid Parental Leave - A Long and Winding Road*, 17 AUSTRALIAN NURSING JOURNAL 23 (Aug. 2009).

<sup>58</sup> Hausmann, *supra* note 29.

<sup>59</sup> *Id.*

<sup>60</sup> Hausmann, *supra* note 29.

Norway	46-56	80-100	32	1.9
Demark	52	100	31	1.8
Sweden	69	80	32	1.9
North America				
United States	12	0	26	2.1
Canada	17	55	27	1.6
Mexico	12	100	23	2.2
Asia and other regions				
Japan	14	67	29	1.3
India	12	100	20	2.7
China	13	100	23	1.8
Iran	52	100	24	1.8
South Africa	16	60	28	2.5
Latin America				
Argentina	13	100	25	2.2
Brazil	17	100	23	1.9
Colombia	12	100	23	2.4

Aisenbrey, Evertsson, and Grunow provide an interesting comparison among Germany, Sweden and the United States, regarding the effects of mothers' time out on their careers.<sup>61</sup> Even though the three countries present distinct policies and cultures, the long time off periods negatively affect women in all three countries, increasing the risks of downward movement in their careers and reducing the possibilities of upward advancement in the organization. The United States is the country where the punishment of time off is the most noticeable, even when women take very short periods of leave compared to the other two countries. American women are less protected from the labor market forces and therefore their careers can be seriously affected.

Supporting the above results regarding the length of time off, Clark suggests that in Sweden, the long paid parental leave negatively affects career advancement.<sup>62</sup> To sustain this statement, Clark shows that in countries where the maternity leave is shorter, such as Australia, Great Britain, Canada and the U.S., women have more participation in management positions, from 34 to 43 percent, compared to those countries where the leave is longer, as in the case of Sweden with only 32 percent of women in those positions.

The U.S Department of Commerce states that as "...the mean age of first-time mothers has increased from 21.4 years in 1970 to 24.9 years in 2000", so has the educational attainment they are able to gain before the first child.<sup>63</sup> This fact has improved the possibilities of women for advancement in their careers during the last 40 years. Aisenbrey, Evertsson, and Grunow explain that women who wait longer to have their first child "...have lower upward or downward mobility rates" after returning from the leaves.<sup>64</sup> These authors also report that, when comparing the U.S, Germany and Sweden, the higher the educational level of the women, the shorter the leave. In the U.S. and Germany highly educated women are more likely to return to the same jobs faster than less educated women; and in Sweden, highly educated women tend to come back to their jobs with an upward movement if they have not accumulated too much time outside the labor force.

In conclusion, when comparing the family leave policies around the world, the U.S resists following the global trend of paying parents for their leaves. Vahratian states that American women, unlike their non-U.S. counterparts, feel discouraged to take advantage of their maternity leave for three main reasons: first, it may

<sup>61</sup> Silke Aisenbrey, Marie Evertsson, & Daniela Grunow, *Is There a Career Penalty for Mothers' Time Out? A Comparison of Germany, Sweden, and the United States*, 88 SOCIAL FORCES 573 (2009).

<sup>62</sup> Clark, *supra* note 25.

<sup>63</sup> Tallesse D. Johnson, *Maternity Leave and Employment Patterns of first-Time Mothers: 1961-2000*, U.S. DEPARTMENT OF COMMERCE, U.S. CENSUS BUREAU, 1, 2 (Oct. 2005).

<sup>64</sup> Aisenbrey, *supra* note 61 at 594.

obstruct the advancement in their careers; second, negative effects on their wages may occur over the long term; and third, it may indirectly hamper the progress in their fight for gender equality in the workplace.<sup>65</sup> Although there is a consensus among the different researchers that long periods of leave do not benefit mothers, women in the U.S. pay larger penalties for taking off the 12 unpaid weeks.

### C. Maternity Leave as a Factor of the Gender Wage Gap

After studying the parental leave policies across the U.S and other countries, it is clear that motherhood is an issue to consider for women who are trying to advance in their careers and improve their income to obtain higher standards of living. This section will focus on the consequences that come with maternity leave and motherhood, and how they contribute to the existence of the wage gap between men and women in the workplace.

For most women, becoming mothers is one of the happiest stages in their lives. However, today more than ever, working mothers are struggling to achieve success in both their personal and professional lives. Why do men have the privilege of enjoying parenthood while being successful in their careers without obstacles? And why do women need to sometimes skip motherhood to be successful and earn as much as men do?

One of the reasons for the gender wage gap, as shown in the first section of this paper, is the underrepresentation of women in management and leadership positions. When studying the composition of women who reach these positions, the situation is even worse for working mothers. The United States Government Accountability Office reports that women managers are less likely to be mothers, to get married, and more likely to have smaller family size than their men counterparts.<sup>66</sup> Only 14 percent of women managers are mothers with children under 18, being "...less than proportionally represented in management than in the rest of the workforce in most industry sectors in 2007."<sup>67</sup> The same study shows that the wage gap between men and women managers is larger when women have children. For instance, in 2007, "...female managers with children in the household earned on average 79 cents for each dollar earned by male managers with children in the household", and childless women "...earned an average of 82 cents for each dollar earned" by childless male managers.<sup>68</sup> Budig states that women suffer from a wage penalty due to motherhood.<sup>69</sup> Despite having the same qualifications, experience, work hours, and education as men, women with children earn less than men, and the size of this difference is directly proportional to the number of children women have. Part of this penalty is explained by the fact that women may accept lower wages in exchange for family-friendly jobs and may also lose experience due to the maternity leave that keeps them out of the job for long periods of time.

The above studies affirm that women with children are not only paid less, but also face more obstacles in reaching leadership positions than their childless women and male counterparts. Is that stereotype discrimination? One of the main barriers women need to overcome is the stereotypes that come with being a woman and also with being a mother. Walsh states that "stereotypes about women's domestic roles are reinforced by parallel stereotypes presuming a lack of domestic responsibilities for men;"<sup>70</sup> therefore, since employers assume women are in charge of family care, they usually refuse or discourage men from taking parental leaves. Moreover, men face social pressure of being the breadwinners and other stereotypes that influence them to dedicate less time to the family.<sup>71</sup> Furthermore, although the FMLA intends to provide gender equality, the lack of economic help during the periods of leave generates few incentives for mothers and fathers to share child care and household responsibilities.<sup>72</sup>

In summary, maternity leave in the U.S., along with motherhood responsibilities, is an important contributor to the gender wage gap for three main reasons. First, the fact that women are not paid during the weeks of the leave directly affect their wages, while men do not suffer any salary decrement. Second, women pay a wage penalty for taking the leave since the time out of their jobs prevents them from gaining experience and taking more

<sup>65</sup> Vahratian, *supra* note 48 at 178.

<sup>66</sup> United States Government Accountability Office (GAO), *Women's Pay: Converging Characteristics of Men and Women in the Federal Workforce Help Explain the Narrowing Pay Gap* (2009), available at <http://www.gao.gov/new.items/d09621t.pdf>.

<sup>67</sup> *Id.* at 6.

<sup>68</sup> *Id.* at 8.

<sup>69</sup> Michelle J. Budig, *The Motherhood Wage and Management Gap: The Policies that Work* (Sept. 29, 2010), available at <http://womenmakenews.com/content/story/motherhood-wage-and-management-gap-policies-work>.

<sup>70</sup> Walsh, *supra* note 14 at 206.

<sup>71</sup> The Lattice Group, *Work-Life Balance: How Do We Get Some?* (2010), available at [http://www.nifi.org/stream\\_document.aspx?rID=10816&catID=15&itemID=10813&TypeID=8](http://www.nifi.org/stream_document.aspx?rID=10816&catID=15&itemID=10813&TypeID=8).

<sup>72</sup> Vahratian, *supra* note 48 at 178.

responsibilities, which are important for them to advance in their careers. Finally, this lack of advancement, plus the female's stereotypes regarding the inability to balance work and family, leaves mothers in a weak position when asking for higher salaries and promotions.

#### D. *The Glass Ceiling and Maternity Leave Versus Other Factors for the Gender Wage Gap*

Through this research, it was demonstrated that the glass ceiling and maternity leave are two very important contributors to the gender wage gap. Are there any other factors that contribute to this global wage gap issue? As it was mentioned before "... female managers in 2007 had less education, were younger on average, were more likely to work part-time, and were less likely to be married or have children, than male managers."<sup>73</sup> These different characteristics between men and women can also be contributors to the gender wage gap. Wirth explains that since women may have several periods of part-time work, due to motherhood issues, during the first years of their careers, when they return at a later stage, they tend to have shorter careers than men.<sup>74</sup> However, "the gender pay gap persists even after taking into account hours worked, skill levels [or education level] and occupations," leading to the conclusion that there is an unexplained portion of the gap, which is related to discrimination practices.<sup>75</sup>

The Government Accountability Office reports that there are three reasons why women are paid less than men: gender discrimination, occupational distribution, and family responsibilities.<sup>76</sup> Women still suffer from discrimination in hiring and advancing in the workplace, male dominated jobs are better paid than traditional female jobs. Finally, women's family responsibilities prevent them from choosing or maintaining jobs that do not have accommodations for these responsibilities, consequently, they give up higher paying jobs for family friendly ones.

Therefore, after looking into the results of several researches and statistical analysis related to the gender wage gap, most of them attempt to conclude that gender discrimination is an important factor to explain the gap. Since both the glass ceiling and caregiving are forms of discrimination, the conclusion of this paper is that these two factors are relevant to the gender wage gap.

## VI. CONCLUSION

Through the closer study of the glass ceiling effects in the U.S and around the world, it can be concluded that women across the world have to fight against different levels of barriers to get ahead in their careers. Even in countries where women participate in the workforce at almost the same rate as men, women often get trapped in low or middle level management positions, and they are just a handful, since the majority never reaches any leadership business position. Since women not only occupy fewer management positions than men, but also are underrepresented in industries with high wages, the glass ceiling becomes an important factor when looking for reasons to explain the gender pay gap. More prevalent in some countries relative to others, the glass ceiling barriers, led by gender stereotypes and prejudice, and followed by the lack of mentoring, training and access to leveraging networks prevent women from earning salaries equivalent to those that men receive; even when working the same amount of hours and with the same educational credentials.

When studying the consequences of maternity leave and its contribution to the gender wage gap, important differences are found among the countries analyzed. Since the parental policies in the U.S have not followed the global trend of providing a paid maternity leave, working mothers in this country are doubly affected by this factor. On the one hand, when the moment of motherhood approaches, women know that the pleasant experience of becoming a mother will be accompanied by a reduction in income due to the inexistence of a salary during the weeks on leave. On the other hand, they have to take almost full responsibility for their newborn by deciding whether to work less hours, pay expensive childcare or completely resign from their professional careers. Another common factor that comes from becoming a mother is the stereotype that they are supposed to take more responsibility for their babies and children than their male counterparts, and that they are not able to efficiently manage both work and family at the same time. These societal barriers limit women from achieving success in their careers and receiving equal compensation when doing the same or similar jobs that men do. Finally, this paper concludes that the glass ceiling and maternity leave, as well as motherhood by itself, have discriminatory effects that prevent women from obtaining equal treatment and remuneration in the workplace.

<sup>73</sup> GAO, *supra* note 66 at 2.

<sup>74</sup> Wirth, *supra* note 38.

<sup>75</sup> GAO, *supra* note 66 at 48.

<sup>76</sup> *Id.*



## **I'M IN THE BAND, NOW WHAT DO I DO? AN ANALYSIS AND APPLICATION OF BUSINESS LAW PRINCIPLES TO THE FORMATION AND OPERATION OF A BAND**

RAYMOND H. C. TESKE III\*

RODOLPHO SANDOVAL\*\*

LARRY A. BRUNER\*\*\*

### **I. ABSTRACT**

Being in a band or pursuing a musical endeavor is often a dream of many on which few will capitalize. For those that are able to pursue their dream they may fail to properly plan and assess the legal risks associated with forming a band and entering the music industry, and often encounter issues similar to those associated with a new business start-up. This paper presents a case study of forming a band and applying principles of business law, including but not limited to, business entities, intellectual property, contracts, agency and formation, personal property law, and torts.

### **II. INTRODUCTION**

One could imagine that being a solo artist or a member of a band is the dream of every kid growing up. The desire for stardom that comes with being on stage in front of fans doing what they love for a living – playing music and singing. It's all about the music. And, staying up late, traveling, recording, merchandising, signing contracts, dealing with financial issues, litigation, and all of the other issues that can arise from operating a band, or a business. The glamour of being in the public domain is only one piece of the bigger picture when it comes down to the business of music. And, similar to a scenario encountered with a new business start-up, legal issues are either not known or neglected until they arise at a later date, and then the law becomes a reactive response to solve a problem. Then the focus is no longer the music, but becomes the business of music.

This paper is intended to be a teaching tool that provides a salient and entertaining application of teaching business law principles in a classroom to a real world setting; one that may be easier for the students to identify with. In today's academic legal environment there is a demand for not only learning the legal principles, but being able to apply the principles to a real-world scenario through critical thinking. This paper can also be used as a road map or guide for a solo artist or individuals forming a new band, and is drawn from the experiences and personal observations of the authors in representing clients in new business ventures and interviews with the members of three bands.

### **III. SCENARIO<sup>1</sup>**

Started by Cody Crane (lead vocals/guitar), the unique sound of the Americana-country-rock band The Cody Crane Band originated in a Midland, Texas garage and includes best friend and drummer Sam Jones, Sam's cousin Willie Robert Jennings on bass guitar, and Roger "Jack" Green on the rhythm guitar and violin. The band relocated to Austin, Texas in the summer of 2010 to further pursue their musical careers after the members graduated from Midland College with various degrees in communication, philosophy, criminal justice and English.

The band members have been playing a long time, but it wasn't until they started college that they began to take their playing to the next level when, without really meaning to, developed an unexpected following amongst their friends. Based on the recommendations of few friends and music artists they met at local music venues, the

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<sup>1</sup> The name of the band and the scenario are fictitious and developed only for the purposes of this paper. The scenario is made up based on a collection of experiences from interviews with Cooper Wade, Jonathan Garcia and Jay Elizalde.

\* J.D., M.B.A., Lecturer and Assistant Director of the Real Estate Finance and Development Program, University of Texas at San Antonio.

\*\* J.D., LL.M., Associate Professor, University of Texas at San Antonio.

\*\*\* J.D., Lecturer, University of Texas at San Antonio.

band began playing gigs at local establishments for fun and a little extra spending money. The fun soon turned into a passion for wanting to make music their career. After graduating from college and to their parents' mixed objections, they moved to Austin and began expanding their fan base by playing state-wide. Now that they were making decent money, the members orally outlined their commitment to the band and how proceeds from the shows would be distributed (all proceeds are distributed equally between the members after each show, after deducting expenses). Cody acts as the manager for the band, handles the scheduling and booking, and signs all contracts on behalf of the band.

The band primarily plays locally in Austin in the evenings during the week, and then travels on weekends throughout the state. They have been invited to play at music fests in New Mexico, Colorado and Oklahoma. During the week, each member has a part-time job to cover living expenses. Their music venues include playing in dives, at fraternity parties, rural county rodeos and fairs, and in music venues that are known to promote up and coming artists and bands.

Although the band plays a few cover songs, Cody is the primary songwriter for the band. A few of his songs have been recorded by well-known Texas artists, and he has been labeled as a rising star in the industry. The band recorded and mixed a music CD on Cody's home computer, and they make their own copies each week for sale at the shows. The band also sells merchandise with the band's name and logo, including t-shirts, hats, koozies, key-chain bottle openers, and bumper stickers, for additional revenue.

The members of the band consider music their real full-time job, with their part-time jobs being something to do until they make it big. The band has a web site developed by Sam, and they are looking at expanding their operations by seeking endorsements, selling their music on iTunes, recording a studio album, and increasing the number of shows they play on a monthly basis.

What they never realized were the issues they would soon encounter with their growing pains; issues that were not expected and that they did not know how to resolve.

There are a number of legal issues a new business start-up, or in the present case, a band, may encounter in formation and its subsequent operations. Examples include contractual disputes, civil and criminal liability, agency issues with third-parties, ownership of personal property and intellectual property, and dissolution.

## VI. CONTRACTS WITH MUSIC VENUES

Get it in writing, get it in writing, get it in writing! This is a basic common law contract principle that anyone entering into a transaction should have ingrained as part of their thinking, and understand and apply it as an absolute requirement. Yet, it is often neglected because the importance of having a contract may not be readily apparent until an issue arises. Individuals do not understand the importance of having an agreement in writing, may think that it is not necessary, or do not know where to begin in preparing a written agreement. The perception that an attorney will charge a lot of money can and does act as a prohibition in seeking legal advice, even for a basic contract. The Internet may be used as a resource, but the contracts are often deficient or not applicable to a given situation. How do you explain the difficulty to a client in enforcing an oral agreement? Many attorneys have at least one story where a client has had an issue relating to a contract, but there is no written contract. The mantra of "something in writing is better than nothing" is applicable, but then there are the stories where the contract was written on a napkin and the substance of the agreement or intent of the parties was not appropriately encapsulated, thus leaving many issues open to costly litigation. The lack of a written contract can create an uphill battle for an attorney attempting to litigate a contract dispute.

### **The Situation**

Cody talks to Billy Bob, manger of The Red Barn in Lubbock, Texas over the phone. They enter into an oral agreement for the band to play in three weeks on a Friday night. As part of the terms of their agreement, Cody outlines the amount the band will charge and Billy Bob agrees to that amount. The band rents a van and trailer to transport the band and their equipment and reserves a room at the Vacation Inn for a one-night stay after the show. As part of Cody's fee structure, he includes the cost of the van and trailer, fuel, the hotel room, meals, and each member of the band's fee for playing at the music venue.

### **The Issue**

The band arrives as scheduled for load-in and asks to speak with Billy Bob. They are told he has been fired and that they are not on the schedule to play that night. The interim manager, John Smith, states he has never heard of them and wishes them good luck on their way back to Austin as he shows them to the door.

Contractual agreements are one of the primary issues a band will encounter, and it should be prepared to require a written agreement before committing to play a music venue. Assume that a band plays an average of two nights per week for one year; this is equivalent to 104 shows per year. If a band plays an average of three shows per week for one year, they will play 156 shows per year. With this many commitments and nothing in writing, a disagreement or breach of an oral agreement is inevitable.

The members of The Cody Crane Band have not used a written contract with the music venues where they play, and they have never had a major issue up to this point. There have been disagreements about how they would be paid, but they have always been resolved with the band usually being paid less than what was originally agreed to. They do not know where to begin in asking for a contract, or what the terms of a contract should state.

From the interviews with three different band members, there are three different perspectives on the use of contracts with music venues or promoters. One band member interviewed stated that no contracts are ever utilized and the culture of the industry would question the use of a contract.<sup>2</sup> Another band stated that general contracts are the norm, but these fall under what are termed detail sheets.<sup>3</sup> See Exhibits “A” and “B” for examples of simple contracts, one with a promoter and the other with a venue. The third band uses an agreement that can be classified as a more complex contract.<sup>4</sup> It is easy from a legal perspective to operate within a silo and state that a contract should be a mandatory requirement at all times. From a business perspective, requiring a contract may kill the deal. A band needs to play to establish a following and its credibility. So, there needs to be a balance between the legal and business perspectives that compliments the relationship between the band and a third-party. Within the music culture there is another angle to be taken into consideration as well: One where the use of contracts are *perceived* as acceptable and the other where they are not. This is really an issue of reality versus perception relating to the negotiating leverage a band thinks it has in being able to negotiate a contract. A band that is just starting out may not be able to suggest the use of a contract with a music venue as the response from the venue may be, “We’ll pay you \$250, take it or leave it”. A band that has the ability to draw a larger crowd will have more leverage in negotiating specific contract terms. The key to the use of contracts comes down to leverage and understanding how to approach the subject of using a contract. How popular is the band, where are they ranked on the music charts, and what kind of crowd can they draw?<sup>5</sup> A few examples of these specific terms by famous bands are referenced below:

#### **Faith Hill and Tim McGraw Soul to Soul Tour**

“Camera policy: No cameras with interchangeable lenses. Basically no professional type equipment. Instamatics, the small pocket cameras and the like are acceptable. No video cameras or cam corders (sic) at any time.”<sup>6</sup>

#### **Willie Nelson Contract Rider**

“PURCHASER to provide at PURCHASER’S own expense, catering for the entire band and crew as per the following requirements:

1. Breakfast, lunch or both (determined by load-in times) 30 MINUTES PRIOR to Willie’s equipment load-in for twelve people.
  - a. Breakfast – 8 am to 11 am: Eggs to order, bacon, ham, sausage, toast, dry cereal, fresh fruit, whole milk, 2% milk, orange and cranberry juice, coffee, tea, USA Today and local newspapers.

<sup>2</sup> Telephone Interview with Jay Elizalde, bass guitarist for Altus, (February 22, 2011).

<sup>3</sup> Telephone Interview with Jonathan Garcia, acoustic guitar/ lead vocals and General Manager of the Jonathan Garcia Band, (February 23, 2011).

<sup>4</sup> Telephone Interview with Cooper Wade, Artist, Musician, Producer (February 28, 2011).

<sup>5</sup> See Garcia, *supra* note 3; See Wade, *supra* note 4.

<sup>6</sup> See Faith Hill Rider, *Tim and Faith, Soul 2 Soul* (July 7, 2000) <http://www.thesmokinggun.com/file/faith-hill-rider> (last visited August 27, 2011).

- b. Lunch – 11 am to 1 pm: Hamburgers (high grade beef only), hot dogs, chicken breast, french fries or chips, hot soup, tossed salad, tuna salad, iced tea, 1 gal. whole milk and 1 gal. of 2% milk, cranberry and orange juice, Coke, Diet Coke, tea, coffee, Dr. Pepper, USA Today and local newspapers.
- c. Supper – 6 pm or 2 hours before show (32 people sit down): “Home Style” cooking local or regional dishes requested. Few to no fried foods. One meat, and chicken or fish. Fresh vegetables, tossed salad and desert, Iced tea, coffee, Coke, Diet Coke, Dr. Pepper, bottled water – Evian or Mountain Valley, 1 gal or whole milk and 1 gal of 2% milk served in food warmers and refreshed as needed, laminates permitted without meal tickets to eat.”<sup>7</sup>

### **Van Halen '82 Tour**

#### “Munchies

Potato chips with assorted dips  
Nuts  
Pretzels  
M & M’s (WARNING: ABSOLUTELY NO BROWN ONES)  
Twelve (12) Reese’s peanut butter cups  
Twelve (12) assorted Dannon yogurt (on ice)”<sup>8</sup>

### **Jack Ingram Hospitality Rider**

“\*\*\*Please note: We are from Texas and if attempting Bar-BQ it better ROCK-sometimes it’s best not to attempt\*\*\*”<sup>9</sup>

A band will not be able to include specific (or humorous) terms such as these until it has the leverage, or the ability to draw a large crowd. But a written agreement with general terms is sufficient to prove that a contract exists in the event of a default. But, what are the requirements and general terms for a valid enforceable contract?

Although a written agreement is not required, the terms of an oral agreement can be difficult to prove. The statute of frauds requires certain contracts to be in writing to be enforceable, but most of the provisions under the Texas statute are likely not applicable. The only provision that may require a written agreement to be enforceable would be Section 26.01(6) of the Texas Business and Commerce Code, which states that an agreement must be in writing if it is “not to be performed within one year from the date of making the agreement.”<sup>10</sup> It is unlikely many smaller bands like The Cody Crane Band would enter into a contract to play at a music venue that is more than a year away from signing the contract. A band may be referred to a music venue by another band, and there is an understanding or an expectation as to the terms of the agreement that will be entered into with the music venue; this is passed down orally from one band to the next.<sup>11</sup>

Another potential issue concerning contracts between the band and others has to do with representative capacity. Who has the authority to enter into a contract between the band and the music venue? Cody typically signs the contracts on behalf of the band, and it is apparent that he has the authority to do so as the leader of the band. However, an issue may arise if Cody enters into an oral or written agreement with someone at the music venue who does not have the authority to contract for the venue. In the given case the band arrived to play the gig and the person who contracted on behalf of the venue was no longer employed there.

One must have an understanding of agency law to understand the rights of the parties to such a contract. The law recognizes that a principal (in this case the band or the venue) can authorize an agent to enter into contracts

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<sup>7</sup> The Smoking Gun, *Willie Nelson & Family Valentine Road Corporation Contract Rider* (2011), <http://www.thesmokinggun.com/file/willie-nelson-rider?page=3> (last visited August 27, 2011).

<sup>8</sup> The Smoking Gun, *Van Halen* (1982), <http://www.thesmokinggun.com/file/van-halen-1982-backstage-rider?page=8> (last visited August 27, 2011).

<sup>9</sup> Triple8Management, *Jack Ingram Hospitality Rider – Full Band*, <http://triple8mgmt.com/T8/jack-ingram/band-images/JI%20Hospitality%20-%20Jan%2009.pdf> (last visited August 27, 2011).

<sup>10</sup> Statutes of Fraud, Tex. Bus. & Com. Code § 26.1(6) (2010).

<sup>11</sup> See Elizalde, *supra* note 2.

for the principal.<sup>12</sup> Agency law focuses on the relationship between a principal and an agent and the relationship is fused when the principal has legal authority over the agent. Simultaneously, the agent has authority to act for the principal and as a consequence, bind the principal in contract with third parties. The basis of the relationship is fiduciary<sup>13</sup> in nature where the principal entrusts the agent with limited or extended power to act in the principals behalf. The presumption is that the agent will perform her duty and communicate to her principal the facts that the agent acquires while acting in the scope of the agency relationship. Thus, under the rule of imputation the principal is chargeable with the knowledge the agent has acquired, whether the agent communicates it or not. Therefore, the knowledge imputed to the band is considered actual knowledge, not constructive.<sup>14</sup>

The agent may have express, implied, or apparent authority. With respect to express or actual authority, where a principal intentionally confers upon the agent express authority, either orally or in writing, the principal is bound by the acts of the agent within the scope of authority expressly conferred upon the agent,<sup>15</sup> and in this case would involve the band or the venue (whether it be a sole proprietorship, partnership, or corporation) providing express authority to an individual to contract for the band or the music venue. Implied authority, on the other hand, is actual authority that is implied by facts and circumstances and it may be proved by circumstantial evidence. An agent has implied authority for the performance or transaction of anything reasonably necessary to effective execution of his express authority.<sup>16</sup> Therefore, if the person entering into a contract on behalf of the band or venue has express authority to act as a manager, then Texas law recognizes that this person may also have the implied authority to enter into a binding oral or written contract to book the band or music venue.<sup>17</sup> Texas law also recognizes that an individual may be placed in a situation where he does not have any express or implied authority, but is perceived to have apparent authority to enter into such a contract due to the words or conduct of the principal. For apparent authority to exist, the principal must do something which leads the other contracting party to believe the agent has authority to act for the principal.<sup>18</sup> Apparent authority exists if a party knowingly permits another to hold himself out as having authority or, through lack of ordinary care, bestows on another such indications of authority that lead a reasonably prudent person to rely on the apparent existence of authority to his detriment.<sup>19</sup> Only the acts of the party sought to be charged with responsibility for the conduct of another may be considered in determining whether apparent authority exists.<sup>20</sup> Furthermore, “an agent acting within the scope of his apparent authority binds the principal as if the principal itself had taken the action.”<sup>21</sup> The principle for the agent must make statements or take actions that lead the third party to believe the agent has the apparent authority.<sup>22</sup> This could be done verbally where the owner of the venue tells the band to deal with the manager of the music venue concerning the details of the contract. Likewise, the owner of the band may tell the representative of the venue that a certain person in the band is the “contact” for booking the gig, thereby creating apparent authority. Therefore, if a person purporting to act on behalf of the band or the venue does not have express, implied, or apparent authority, then the principal they claimed to be acting for would not be liable under the contract.

When Cody contracted with Billy Bob, and later learned that Billy Bob no longer worked at The Red Barn, Cody would need to show that Billy Bob had express, implied or apparent authority in order to enforce the contract and sue for breach. If Billy Bob was not authorized to enter into a contract on behalf of The Red Barn, then the band would have to look solely to Billy Bob for damages. In the event the music venue refused to honor the authorized contract entered into with Billy Bob on behalf of The Red Barn, the band could seek to recover for breach of contract. The band could pursue a remedy at law and seek money damages for the amount required to be

<sup>12</sup> See *Railroad Co. v. Howard*, 74 U.S. (7 Wall.) 392 (1869), stating that companies are responsible in their corporate capacity for acts done by their agents, either *ex contractu* or *ex delicto*, in the course of their business and within the scope of the agent's authority.

<sup>13</sup> See *Green v. H & R Block, Inc.*, 355 Md. 488 (1999).

<sup>14</sup> See *Martin Marietta Corp. v. Gould*, 70 F.3d 768 (1995).

<sup>15</sup> See *Harris v. City of Chattanooga* 137 Fed. Appx., 788, 2005 U.S. App. LEXIS 11588 (*affm.* June 15, 2005).

<sup>16</sup> See *Opp v. Wheaton Van Lines*, 231 F.3d 1069 (*affm.* May 9, 2000).

<sup>17</sup> See *Gleason v. Seaboard Air Line RRY Co.*, 278 U.S. 349 (1929).

<sup>18</sup> See *Highland Capital Management, LP v. Leonard Schneider*, 607 F.3d 322 (*rev.*, June 22, 2010), stating that apparent authority exists when a principal, either intentionally or by lack of ordinary care, induces a third party to believe that an individual has been authorized to act on its behalf.

<sup>19</sup> See *Batton v. City of Jasper, Alabama*, 354 Fed. Appx. 400 (*J. vacated, remanded*, Nov. 25, 2009), stating that an agent's apparent authority must be founded upon the conduct of the principal and not upon the conduct of the agent.

<sup>20</sup> See *Regal Fin. Co. v. Tex Star Moto*, 53 Tex. Sup. Ct. J. 1034 (2010), 2010 LEXIS 611 (2010).

<sup>21</sup> See *Reliant Entergy Svs, Inc. v. Cotton Valley Compression, L.L.C.*, 2011 Tex. App. LEXIS 959 (Aug. 20, 2011).

<sup>22</sup> *Id.*

paid under the contract. In the alternative, the band could seek an equitable remedy in the form of restitution, and recover their out of pocket expenses and other damages to put them back in the position they were in before they entered into the contract. If a lawsuit was filed, the ability to collect attorney’s fees is another expense that the band would need to consider. Section 38.001(8) of the Texas Civil Practices & Remedies Code provides that “[A] person may recover reasonable attorney’s fees from an individual or corporation, in addition to the amount of a valid claim and costs, if the claim is for... an oral or written contract.”<sup>23</sup> And, a final consideration to be included is accrued interest on the amount the band is claiming it is owed. The Texas Finance Code provides that if a contract does not provide for a specific interest rate for past due amounts, the interest rate is “six percent per year beginning on the 30th day after the date on which the amount is due.”<sup>24</sup> In this scenario, the band would need to send a statement to The Red Barn for the amount they are claiming the band is owed by certified mail, return receipt requested as a demand for payment, and interest would begin to accrue on the 30th day after The Red Barn receives notice, which will be reflected in the return receipt.

The primary basic common law contract principle in this scenario between the band and The Red Barn is agreement.<sup>25</sup> Is there an offer and acceptance, and if so, what are the terms? How are contract disputes or a breach of contract handled? What can the band do to ensure no contractual issues arise, or if issues have been encountered what can the band do to minimize them in the future? One option is to get something in writing, even if it is in the form of emails between the band and the music venue to ensure a basic understanding of the agreement between the parties. This is similar to the proverbial napkin, yet likely to provide a foundation that an agreement exists should a dispute arise. A second option is to use a detail sheet that is customarily used in the industry that outlines the essential terms of the agreement between a band and a music venue or promoter: The date of the music venue, the purpose of the event, load-in time, playing time, and pay. Although these agreements are still missing a few basic provisions (jurisdiction and venue, defining a default, and remedies), they establish the basic intent between the band and the music venue.<sup>26</sup> The third option is to have a promulgated form contract prepared by an attorney that contains general provisions that are standard and will not change, and includes specific terms that are variable and agreed upon between the band and each music venue.

It is important to note that once a contract is breached it will be difficult to present evidence to the court of previous negotiation that occurred prior to the consummation of the contract. Here the parol evidence rule becomes applicable and the court will restrict the kind of evidence that can be admitted to prove or disprove the content or lack of content in the contract.<sup>27</sup>

The following are examples of general terms that can be included as standard terms to a contract to minimize potential issues in the future in the event of a default:

Clause:	Consideration
<b>Example:</b>	In consideration of \$10 and other good and valuable consideration, and the mutual terms, conditions, covenants and agreements contained in this Agreement, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged by each of the Parties hereto, the Parties agree as follows:

<sup>23</sup> Tex. Civ. Prac. & Rem. Code § 38.001(8) (2010). In *Preload Technology, Inc. v. A.B. & J. C. Constr. Co.*, 696 F.2d 1080 (5<sup>th</sup> Cir. 1983), where the Fifth Circuit Court defined a §38.001(8) contract as an agreement.

<sup>24</sup> See *Accrual of Interest When No Rate Specified*, Tex. Fin. Code § 302.002 (2010).

<sup>25</sup> See *U. S. v. Muzika*, 986 F.2d 1050 (rev. Feb. 4, 1993), stating that agreements are governed by an objective standard, and a reviewing court must inquire about the parties' reasonable expectations.

<sup>26</sup> See *Lindahl v. Office of Personnel Management*, 470 U.S. 768 (1985), stating that **venue** provisions come into play only after jurisdiction has been established and concern the place where judicial authority may be exercised; rather than relating to the power of a court, venue relates to the convenience of litigants and as such is subject to their disposition.

<sup>27</sup> See *Blackledge, Warden v. Allison*, 431 U.S. 63 (1977), stating that the parol evidence rule has as its very purpose the exclusion of evidence designed to repudiate provisions in a written integration of contractual terms. Yet even a written contractual provision declaring that the contract contains the complete agreement of the parties, and that no antecedent or extrinsic representations exist, does not conclusively bar subsequent proof that such additional agreements exist and should be given force. The provision denying the existence of such agreements, of course, carries great weight, but it can be set aside by a court on the grounds of fraud, mistake, duress, or on some ground that is sufficient for setting aside other contracts.

<b>Texas Law:</b>	Consideration is “a present exchange bargained for in return for a promise.” <sup>28</sup> Texas courts have held that where “a written instrument reciting consideration imports one, and with such a recitation we presume the consideration to be sufficient,” <sup>29</sup> and that the Texas Supreme Court has held that “the nonpayment of the recited nominal consideration does not preclude enforcement of the parties' written [option] agreement.” <sup>30</sup>
<b>Purpose:</b>	Although a contract will not fail for lack of a statement relating to consideration in the contract, it is customary and evidences the parties bargained for the exchange of the agreements outlined in the contract.

<b>Clause:</b>	<b>Choice of law or forum selection clause</b>
<b>Example:</b>	This Agreement shall be construed under the laws of the state of Texas, without regard to choice-of-law rules of any jurisdiction. The parties agree at the time of signing this agreement that venue shall solely be Travis County, Texas, where the principle office of the band is located, for any and all claims directly or indirectly relating to this agreement.
<b>Texas Law:</b>	This is especially important for bands playing throughout Texas and across state lines. The Texas Supreme Court has held a forum selection clause in a contract valid, <sup>31</sup> and that “enforcement of a forum-selection clause was mandatory unless a party opposing enforcement “clearly shows that enforcement would be unreasonable and unjust, or that the clause was invalid for such reason as fraud and overreaching.” <sup>32</sup>
<b>Texas Statute:</b>	Section 15.002 of the Texas Civil Practices & Remedies Code provides venue as follows: “(a) Except as otherwise provided by this subchapter or Subchapter B or C, all lawsuits shall be brought: (1) in the county in which all or a substantial part of the events or omissions giving rise to the claim occurred; (2) in the county of defendant's residence at the time the cause of action accrued if defendant is a natural person; (3) in the county of the defendant's principal office in this state, if the defendant is not a natural person; or (4) if Subdivisions (1), (2), and (3) do not apply, in the county in which the plaintiff resided at the time of the accrual of the cause of action. (b) For the convenience of the parties and witnesses and in the interest of justice, a court may transfer an action from a county of proper venue under this subchapter or Subchapter C to any other county of proper venue on motion of a defendant filed and served concurrently with or before the filing of the answer, where the court finds: (1) maintenance of the action in the county of suit would work an injustice to the movant considering the movant's economic and personal hardship; (2) the balance of interests of all the parties predominates in favor of the action being brought in the other county; and (3) the transfer of the action would not work an injustice to any other party. (c) A court's ruling or decision to grant or deny a transfer under Subsection (b) is not grounds for appeal or mandamus and is not reversible error.” <sup>33</sup>
<b>Purpose:</b>	If the members of a band reside in one town (e.g., Austin) and the only music venues they play in are local establishments in Austin, then the venue and choice of law provisions in the contract are not a strict necessity as the Texas Civil Practices and Remedies Code will apply and venue <i>should</i> be Travis County. If a band resides in Austin, plays in Amarillo, and a dispute arises relating to the contract with no choice of law or venue provision stated in the contract, then venue may be Travis County or Potter County. This is a difference of approximately 500 miles and nine hours of drive time for the band if a court decides venue is in Potter County. The result may be that a band decides to not pursue a contract dispute because of the time and expense. With a choice of law and venue provision in the contract stating Travis County, Texas is the venue for any disputes, the court is likely to enforce the provision in a contractual agreement between the parties. This can save the band time, money,

<sup>28</sup> See *Westfield Dev., Inc. v. Rubashkin*, 2007 Tex. App. LEXIS 1154 (Tex. App. Feb. 15, 2007).

<sup>29</sup> *Id.* See also *Hoagland v. Finholt*, 773 S.W.2d 740, 743 (Tex. App. 1989, no writ).

<sup>30</sup> See *1464-Eight v. Joppich*, 154 S.W.3d 101 (Tex. 2004).

<sup>31</sup> See *In re Tyco Elecs. Power Sys*, 2005 Tex. App. LEXIS 819 (Tex. App. Dallas Feb. 2, 2005).

<sup>32</sup> See *In re Automated Collection Techs*, 156 S.W.3d 557 (Tex. 2004).

<sup>33</sup> Tex. Civ. Prac. & Rem. Code § 15.002 (2010).

	and they can litigate the case in their own backyard. This might even expedite a settlement in their favor as the other party may not want to spend the time and expense on traveling to Austin and hiring local counsel.
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<b>Clause:</b>	<b>Indemnification</b>
<b>Example:</b>	INDEMNIFICATIONS. NOT WITHSTANDING ANYTHING HEREIN TO THE CONTRARY, AND TO THE EXTENT AUTHORIZED BY THE CONSTITUTION AND LAWS OF THE STATE OF TEXAS, MUSIC VENUE HEREBY AGREES TO DEFEND, INDEMNIFY, AND HOLD THE CODY CRANE BAND AND ITS MEMBERS, OWNERS, MANAGERS, OFFICERS, DIRECTORS, SHAREHOLDERS, AGENTS, AFFILIATES, EMPLOYEES AND INDEPENDENT CONTRACTORS (“INDEMNITEES”), HARMLESS AGAINST ANY AND ALL CLAIMS, DEMANDS, PROCEEDINGS, SUITS, LIABILITIES, ACTIONS, OR CAUSES OF ACTION, OF ANY KIND WHATSOEVER, WHETHER IN CONTRACT, TORT OR CRIMINAL, AND INCLUDING BUT NOT LIMITED TO LIABILITIES, DAMAGES, JUDGMENTS, REMEDIES, COSTS, EXPENSES, OR ATTORNEYS FEES, INCURRED BY INDEMNITEES WHICH DIRECTLY OR INDIRECTLY RESULTS FROM, OR ARISES OUT OF OR IN CONNECTION WITH, ANY ACT, NEGLIGENT ACT OR OMISSION BY MUSIC VENUE, ITS OWNERS, MANAGERS, OFFICERS, DIRECTORS, SHAREHOLDERS, AGENTS, AFFILIATES, EMPLOYEES AND/OR INDEPENDENT CONTRACTORS.
<b>Texas Law:</b>	To be enforceable, an indemnification/indemnity provision must be in writing on the face of the contract to impose negligence on another party under the fair notice requirement of the negligence doctrine, and the agreement. <sup>34</sup> “Indemnity provisions that do not state the intent of the parties within the four corners of the instrument are unenforceable as a matter of law.” <sup>35</sup> The agreement must also be conspicuous, and the courts have held that “the capitalized heading, followed by language in all capitals, attracts the attention of a reasonable person, and thus, the indemnity provision is conspicuous.” <sup>36</sup> Language is also conspicuous “if it appears in larger type, contrasting colors, or otherwise causes attention to itself.” <sup>37</sup>
<b>Purpose:</b>	The band needs to limit its liability by including a clause in the contract that the venue or promoter is liable to any third parties who are injured while attending the music venue to see the show. Due to the large numbers of individuals attending shows on a yearly basis, there is a likelihood of injury by or to a third party. See the Criminal Law and Tort Liability sections <i>infra</i> for examples of why an indemnification clause is necessary in a contract.

<b>Clause:</b>	<b>Default Provision</b>
<b>Example:</b>	It is imperative that music venue perform all conditions of this contract on or before the load-in time without delay. Time is of the essence. In the event music venue fails to comply with the terms and conditions of this contract on time, this shall constitute a material breach, music venue will be in default, and The Cody Crane Band may declare a default and seek liquidated damages, seek such other relief as may be provided by law, or both. Any party who prevails in any legal proceeding related to this contract is entitled to recover reasonable attorney’s fees and all reasonable costs and expenses. In the event The Cody Crane Band fails to comply with the terms and conditions of this contract on time, this shall constitute a material breach, and the music venue shall be entitled to liquidated damages of \$100 as its sole and exclusive remedy.
<b>Texas Law:</b>	The agreement should contain specific conditions, such as payment, due dates, time, etc. Texas courts have held that “[f]or timely performance to be a material term of the contract, the contract must expressly make time of the essence or there must be something

<sup>34</sup> See *Amtech Elevator Servs. Co. v. CSFB*, 248 S.W. 3d 373 (Tex. App. Houston 1st Dist. 2007).

<sup>35</sup> *Fisk Elec. Co. v. Constructors & Assoc*, 888 S.W.2d 813 (Tex. 1994).

<sup>36</sup> See *Amtech*, *supra* note 34.

<sup>37</sup> *Id.*

	in the nature or purpose of the contract and the circumstances surrounding it making it apparent that the parties intended that time be of the essence.” <sup>38</sup>
<b>Purpose:</b>	Absent a default provision in a contract, it may be difficult to determine if a breach of contract has occurred. The purpose of having a default provision in a contract provides a foundation for when a breach has occurred. A standard default clause states that the failure to comply with any provision of the contract constitutes a default. A default clause is also important if there are specific terms that the music venue is required to adhere to and the remedies available to the parties. By including the clause “the music venue shall be entitled to liquidated damages of \$100 as its sole and exclusive remedy,” the band has limited the remedies available to the music venue, thus minimizing any significant damages.

<b>Clause:</b>	<b>Integration or Merger Clause</b>
<b>Example:</b>	This Agreement represents the complete understanding between the Parties hereto with respect to the subject matter hereof and supersedes all prior negotiations, representations or agreements, either written or oral, as to the matters described herein. This Agreement may be amended only by written instrument signed by both Parties hereto. There are no oral representations, warranties, agreements, or promises pertaining to the agreements contained herein.
<b>Texas Law:</b>	“When a contract contains a merger or integration clause, the contract's execution presumes that all prior negotiations and agreements relating to the transaction have been merged into the contract, and it will be enforced as written and cannot be added to, varied, or contradicted by parol evidence,” <sup>39</sup> and that “when the parties utilize a merger provision, the substance of any pre-execution negotiations, including the text of any prior drafts, is not a permissible consideration absent pleading and proof of an ambiguity, fraud, or accident.” <sup>40</sup>
<b>Purpose:</b>	An integration clause (or merger clause) states that all of the agreements between the parties have been reduced to writing, and there are no open-ended negotiations or issues to be resolved at a later date. The courts will then generally rely on the contract as the parties’ intent, absent fraud, misrepresentation, or ambiguities. Parol evidence may be used to interpret provisions of the contract, but it generally is not allowed to add additional provisions to the contract after the contract was signed. One exception to this is when there has been partial performance after the contract has been signed that varies from the written agreement. This is why it is important to ensure that the terms of the contract are followed, and if after a contract is signed and subsequent performance deviates from the written agreement, it is extremely important to reduce the amendment to a writing that is signed by all parties to the contract.

<b>Clause:</b>	<b>Liquidated Damages</b>
<b>Example:</b>	Cancellations shall not be permitted within 14 days of the event. Music venue shall be liable for \$50 for each day of non-payment under the terms of this agreement.
<b>Texas Law:</b>	A liquidated damages clause is intended to be a reasonable estimate of the parties’ damages in the event of non-payment or breach. <sup>41</sup>
<b>Purpose:</b>	A liquidated damages clause is intended to arrive at a set dollar amount a defaulting party owes to a non-defaulting party in the event of a breach of contract. This is generally used in contracts where time is of the essence, and there are damages that will result from the breach that are difficult to estimate, so the parties agree to a reasonable estimate at the time of signing the contract. If a band books an event six months out and a default occurs on or around the date of the event, the band may have difficulty booking another event with such short notice. If the music venue decides to not pay, then the liquidated damages clause in the contract would provide an agreed upon amount of damages at the time of signing the contract.

<sup>38</sup> See *Deep Nines Inc. v. McAfee, Inc.* 246 S.W.3d 842, 846 (Tex. App. 2008).

<sup>39</sup> See *Bandera Drilling Co. v. Sledge Drilling*, 293 S.W.3d 867 (Tex. App. 2009).

<sup>40</sup> *Id.*

<sup>41</sup> See *BMG Direct Mktg. v. Peake*, 178 S.W.3d 763 (Tex. 2005).

<b>Clause:</b>	<b>Force Majeure</b>
<b>Example:</b>	“Any delays in or failure of performance by either party, except in respect of the obligation to make payments under this Agreement, shall not constitute default hereunder if and to the extent such delays or failure of performance are caused by occurrence(s) beyond the reasonable control of the party affected, and which by the exercise of due diligence such party is unable to prevent (herein called "Force Majeure"), including but not limited to: acts of God or the public enemy, sabotage, war, mobilization, revolution, civil commotion, riots, strikes, lockouts, fires, accidents or breakdowns, floods, hurricanes or other actions of the elements, restrictions or restraints imposed by law, rule or regulations or other actions of governmental authorities... In any such event, the party claiming Force Majeure shall notify the other party in writing and, if possible, of the extent and duration thereof and shall exercise due diligence to prevent, eliminate or overcome such cause where it is possible to do so and resume performance at the earliest possible date.” <sup>42</sup>
<b>Texas Law:</b>	Texas courts have held that when the parties to a contract include a force majeure clause in the contract, then they are bound by the effect of that clause. <sup>43</sup>
<b>Purpose:</b>	With The Cody Crane Band being based out of Austin there are likely few issues to incur in and around the Austin area that would provide significant concerns. But, the band does play around the state, and even out of state. Hurricanes are known to affect parts of Texas, and roads will ice over on occasion which may prevent travel (especially in the Panhandle area). There may be difficulty accessing a venue in Colorado due to snow. These natural events open the door on possibilities that could occur, and it is best to be prepared for them by stating in the contract the parties’ understanding if the band is unable to play due to an intervening event.

Other terms that can be modified to a specific venue or event and resemble those found in the detail sheet include:

- Terms for payment
- Date of music venue
- Load in time
- Playing time

The important thing the band needs to note is the necessity in using a contract with the music venues. The court held in the Deep Nines case that “We discern intent from the agreement itself and the agreement must be enforced as written.”<sup>44</sup> One thing Cody will need to be comfortable with is in how the subject of using a written contract is approached, and this will come with experience.

#### V. AGREEMENTS BETWEEN BAND MEMBERS: FORMATION, OPERATION AND DISSOLUTION

**Hypothetical**

The members of the band do not have a written agreement between themselves, and they are hesitant to require anything in writing.

**Issues**

What are the agreements among the members, how are they structured from a management and tax perspective, and who owns what?

A major issue between any group of individuals who are forming a business or have already started one is managing agreement – committing any oral agreements or understandings among the members to writing. In interviews with bands, the agreements between the members are oral conditions that have been discussed and agreed

<sup>42</sup> See *Tex. City Ref., Inc. v. Conoco, Inc.*, 767 S.W.2d 183 (Tex. App. 1989).

<sup>43</sup> See *Moore v. Jet Stream Invs.*, 261 S.W.3d 412 (Tex. App. 2008).

<sup>44</sup> See *Deep Nines*, *supra* note 33.

to.<sup>45</sup> One band member stated that they are playing more as a hobby than a career, so they have a very loose structure and it is not foreseeable that they would ever have anything in writing between the members.<sup>46</sup> The money the band earns goes into the “Band Fund”, and one trustworthy member of the band keeps the Band Fund (consisting of mostly cash as there is no bank account for the band). In an interview with the band member that is focusing on making music his career, the agreements are still oral, but with the crossing of the proverbial line from a hobby to a career it was noted that some form of structure was needed; that the band would need to operate more like a business. The unwritten agreements between band members tend to operate under an implied code that exists in the industry as to how agreements are interpreted and enforced. The problem with an implied code is that it is subject to change based on the needs of those involved. The agreements between band members should be outlined in writing, and this can be accomplished with a one page agreement (at the very least).

Another issue is the structure of the band. Of the band members interviewed, most viewed their structure as a collective of sole proprietorships (one band member stated his band operates more like a collective of independent contractors).<sup>47</sup> While there are benefits to a sole proprietorship, the disadvantages far outweigh the advantages with unlimited liability being the biggest issue. There are also issues with the use of independent contractors, and it is important to consult with legal counsel to ensure the individuals are in fact independent contractors to prevent a state taxing authority or the Internal Revenue Service from classifying the “independent contractors” as employees, and thus incurring withholding and unemployment tax arrearages, penalties, and interest at a future date.

Advantages of a Sole Proprietorship	Disadvantages of a Sole Proprietorship
<ul style="list-style-type: none"> <li>▪ Simple to form and operate</li> <li>▪ Flexibility in decision-making and operations</li> <li>▪ Pass-through taxation to the owners IRS Form 1040 Schedule C</li> <li>▪ No franchise tax or business organizations tax</li> </ul>	<ul style="list-style-type: none"> <li>▪ Unlimited Liability</li> <li>▪ Limited Duration</li> <li>▪ Limitations on Transferability</li> <li>▪ Difficulty in Raising Investment Capital</li> </ul>

What is the legal structure of the band and band members? Is there a band leader that acts as a sole proprietor, who owns all the instruments and hires band members on a temporary basis to play in the band? Or, is the band a partnership where each member is a partner and has a fiduciary relationship with the partnership and with the other partner band members?

If the legal structure of the band is a sole proprietorship and the band leader is the sole owner of the band, he or she can dictate the guidelines for employing other band members. He could own all of the instruments<sup>48</sup> or the individual band members could own their own instruments. He would also make all the arrangements for contracting with performance venues, and be responsible for obtaining the proper insurance.

In interviewing the bands, there was a common theme of it is my band, or it’s so-and-so’s band and I’m just part of his band.<sup>49</sup> There should be a written outline as to the organizational structure of the band so there are no questions as to whether the members are sole proprietors, employees or independent contractors. Again, this could be a major issue from a federal income tax perspective at a later date.

If on the other hand, if the band is a partnership then each member of the band, as a partner, would have equal responsibility for any liabilities that would arise. Alternatively, they could agree that the partnership would obtain the insurance for all the partners. As partners, they could also reach an agreement as to the distribution of profits and losses and ownership of the instruments and equipment. The purchase of band instruments could be accomplished on an individual basis, with each member of a band owning his or her own instrument. If a member decides to leave the band or their involvement is terminated, it is understood that they will take their instrument(s) with them. There are instances of the band buying equipment from the proceeds of their work (the Band Fund), such as microphones, cords, stands, etc., and it was implied that this equipment would remain with the band or with the individual who started the band.<sup>50</sup>

## VI. TORT LIABILITY

<sup>45</sup> See Elizalde, *supra* note 2; See Garcia, *supra* note 3; See Wade, *supra* note 4.

<sup>46</sup> See Elizalde, *supra* note 2.

<sup>47</sup> See Elizalde, *supra* note 2; See Garcia, *supra* note 3; See Wade, *supra* note 4.

<sup>48</sup> See Wade, *supra* note 4.

<sup>49</sup> See Elizalde, *supra* note 2; See Garcia, *supra* note 3; See Wade, *supra* note 4.

<sup>50</sup> See Elizalde, *supra* note 2.

A tort is a civil wrong for which the law provides a remedy.<sup>51</sup> The civil liability of a band is another element that is often not considered until it occurs. The following provides an example of a basic tort that a band is most likely to encounter.

#### **Hypothetical**

A member of the band signs a rental agreement to rent a van and trailer so that the band can drive the members and the equipment to the gig. The band is late for the performance and the member that is driving negligently causes a collision with another vehicle.

One member of the band rents the vehicle for transportation, and that individual is responsible for signing the contract with the transportation rental company. Each band member takes a turn in renting the transportation and signs the contract – this time it is Sam’s turn. There is significant liability here that rests on one member of the band. The band is on their way to Lubbock and running a little late, so Sam is driving well over the speed limit to make up the time. He causes a collision with another vehicle when he crosses the center line and bumps an oncoming vehicle. Fortunately the damage to the vehicles is not severe, and the occupants of the other vehicle and the members of the band (who are not wearing seatbelts) incur only minor injuries. Everyone is more shaken up than anything. A Texas Department of Public Safety trooper arrives and cites Sam for driver inattention. The band continues on and makes it to The Red Barn before the agreed load-in time.

#### **Issues**

- What is the liability of the member to the rental company who signed the rental agreement for the transportation?
- What is the liability of the driver if the band is involved in an accident?
- What is the liability of the band if they are involved in an accident on the way to a music venue?

If one member of the band rents the vehicle for transportation, that individual is responsible for signing the contract with the transportation company. Each band member rotates turns in renting the vehicle. There is significant liability here that rests on one or all members of the band depending on whether the band is set up as a sole proprietorship, a general partnership, a corporation, or limited liability company.

If the band is set up as a sole proprietor with one member owning the band acting as employer and the other members acting as employees or independent contractors, then the negligent band member that caused the collision would be liable for all property damage and bodily injuries caused to the occupants of the other vehicle. If the negligent band member is not the owner of the band, the owner of the band may be liable for damages caused by the employee member or independent contractor under the doctrine of respondeat superior.<sup>52</sup> In order to impose liability under the doctrine of respondeat superior, the occupants of the other vehicle will need to show a master servant relationship between the driver and the employer, and that the negligent act occurred in the course and scope of employment.<sup>53</sup> It is important to note that, the negligent driver and/or employer may be liable to the band members riding with him in the vehicle as well. Typically, these damages will be covered by the auto insurance, as long as the injuries do not exceed the policy liability limits. But, this raises an issue as to the driver’s or band owner’s amount of liability coverage. Another issue to be reviewed is whether the band itself has insurance, which is unlikely, but something that should be taken into consideration.

If the band is set up as a general partnership, then all band members have unlimited personal liability for the negligent conduct of any one band member acting on behalf of the band, and will be jointly and severally liable for all damages caused. If the band is not set up as a general partnership, but has the “appearance” of being a partnership, then all band members could have unlimited joint and several personal liability for the negligent conduct of any one band member acting on behalf of the band under the doctrine of partnership by estoppel. Partnership by estoppel occurs when one band member represents to a third party that another band member is his

<sup>51</sup> See KENNETH W. CLARKSON, ET. AL., WEST’S BUSINESS LAW (11<sup>TH</sup> ED. 2009).

<sup>52</sup> See *Goodyear Tire & Rubber Co. v. Mayes*, 236 S.W.3d 754 (Tex. 2007).

<sup>53</sup> *Id.*

partner when in fact, he is not. “[E]lements of partnership by estoppel include representation of partnership and reliance by one to whom representation made.”<sup>54</sup> Any third party that contracts with the non-partner is considered an agent whose acts can bind the partnership and its purported members.

If the band is set up as a corporation or limited liability company, then the negligent band member (the driver) will be liable, and the corporation or limited liability company may be vicariously liable under respondent superior, however the other band members riding as passengers will have limited liability, limited to the extent of their investment in the corporation or limited liability company.

One of the things a band can do to protect itself is to form an entity – a corporation or limited liability company – and avoid the sole proprietor or general partnership structure, or the appearance of a general partnership. A corporation or limited liability company has the advantages of limited liability, perpetual duration, transferability of ownership interest, ability to raise investment capital, centralized management, management of resources, and various options for tax election and benefits. The disadvantages are legal formalities and the possibility the entity may be subject to franchise tax.

A final means of legal protection, as stated supra, is ensuring the band has sufficient insurance coverage purchased by the band for the protection of the band and the individual members.

## VII. CRIMINAL LIABILITY

When the interviewed band members were asked about potential criminal liability, they could not think of an instance where criminal liability would be an issue. The following scenarios were presented to the individuals for consideration:

On February 23, 2003 the 1980s band Great White had just started playing a show at The Station music venue in West Warwick, Rhode Island when the pyrotechnics ignited the soundproofing material in the roof and a fire quickly spread throughout the building.<sup>55</sup> The fire killed “100 [people] and injured 200 more.”<sup>56</sup> The lead guitarist for Great White lost his life in the fire.<sup>57</sup> Although the band members escaped criminal indictment and prosecution, their manager and the owners of The Station were indicted. Dan Biechele, the band’s manager, pled guilty to involuntary manslaughter in 2006.<sup>58</sup> The two club owners received prison time and probation respectively.<sup>59</sup>

On October 12, 2010, the members of Imperial Stars stopped traffic on a Los Angeles freeway when they blocked the road with their vehicle and proceeded to play a free concert.<sup>60</sup> The band members were arrested for “malicious and willful disturbance by loud noise, willful obstruction of public officers or emergency medical personnel, committing an act injuring the public health, and the old standby, unlawful assembly.”<sup>61</sup>

On December 1969, the Rolling Stones played a free concert at the Altamont Speedway in California where an attendee was stabbed to death by a member of the security team. Although this act did not result in any criminal charges against the Rolling Stones, it potentially led to a settlement between the band and the deceased’s heirs on the civil side.<sup>62</sup>

## VIII. INTELLECTUAL PROPERTY

<sup>54</sup> See *Kondos Ent. v. Quinney Elec.*, 1999 Tex. App. LEXIS 9535 (Tex. App. San Antonio Dec. 29, 1999).

<sup>55</sup> Scott Mervis, Pittsburgh Post-Gazette, *After the Fire: Great White, survivors live with the horror of Rhode Island tragedy*, (March 25, 2005), <http://www.post-gazette.com/pg/05084/477106-42.stm> (last visited August 27, 2011).

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> Alex Mar, *Great White Manager to Plead Guilty* (Feb. 1, 2006), <http://www.rollingstone.com/music/news/great-white-manager-to-plead-guilty-20060201> (last visited August 27, 2011).

<sup>59</sup> R.I. Cranston, *Great White Manager Released from Jail* (Mar. 19, 2008), [http://www.cbsnews.com/stories/2008/03/19/national/main3951445.shtml?source=RSSattr=U.S.\\_3951445](http://www.cbsnews.com/stories/2008/03/19/national/main3951445.shtml?source=RSSattr=U.S._3951445) (last visited August 27, 2011).

<sup>60</sup> Carla Hall and Andrew Blankstein, Los Angeles Times, *Musical stunt shuts southbound lanes of 101 Freeway south of Sunset Blvd* (Oct. 13, 2010), <http://articles.latimes.com/2010/oct/13/local/la-me-1013-traffic-band-20101013/2> (last visited August 27, 2011).

<sup>61</sup> *Id.*

<sup>62</sup> Wikipedia, *Altamont Free Concert* (Dec. 6, 1969), [http://en.wikipedia.org/wiki/Altamont\\_Free\\_Concert](http://en.wikipedia.org/wiki/Altamont_Free_Concert) (last visited August 27, 2011).

Copyrights and trademarks are two forms of intellectual property that a band should consider in protecting its interests and determining ownership.

**Hypothetical**  
The name of the band is “The Cody Crane Band” and Cody writes all of the songs for the band.

**Issues**

- Who owns the name of the band?
- Who owns the songs?
- What can the band do to protect its name and songs?

Cody is the songwriter for the band, and absent a written agreement with the band as to how the ownership of the songs are determined, Cody will be the owner of the songs. To protect his interests, it is recommended that Cody join ASCAP, SESAC or BMI as a songwriter.<sup>63</sup> These organizations provide an avenue for Cody to submit his songs and prove his ownership, and also allow for remuneration when one of his songs is played where a license is required (e.g., radio station, music venue by a disc jockey, restaurant, etc.).<sup>64</sup> Another thing Cody can do is register his songs with the United States Copyright Office to provide conclusive evidence of his ownership of the songs.<sup>65</sup> One songwriter stated that he mails a copy of each song he writes to himself by certified mail, return receipt requested and leaves the envelope unopened, a process he calls the “poor man’s copyright”, so as to provide evidence in the event of a copyright dispute.<sup>66</sup>

Most bands (and businesses) will wait to file for trademark protection until they cross the proverbial line of being a start-up to a going concern, when the best time to file is from the very beginning of a new business venture. Cost is another reason for the delay, as the federal trademark application is \$325 for the electronic filing and the state trademark application with the Texas Secretary of State is \$50, not including attorney’s fees.<sup>67</sup> A third reason is that the name of the band can change and members of a band come and go, so there is no real perceived purpose in spending the money on a trademark when its usefulness may be short-term.

There are four types of trademark protection: International, federal, state and common law. For the purposes of this paper, only the latter three will be discussed as they would apply to a start-up band. Federal trademark protection involves filing an application with the United States Patent and Trademark Office (USPTO). When a federal trademark application is accepted, it provides protection against the use of the mark throughout the geographic boundaries of the United States.<sup>68</sup> For examples of trademarks filed with the USPTO by individuals related to the music industry, see Exhibit “C”. This exhibit also provides a brief overview that can be used as an exercise for students to conduct an online federal trademark search. A state trademark application is filed with the Texas Secretary of State and will provide trademark protection against the use of the mark in the state of Texas by another.<sup>69</sup> A common law trademark does not cost anything and exists when a mark is being used and no trademark application has been filed on the federal or state level. The protection for the use of the mark is limited in geographical scope (e.g., a business using a mark in San Antonio has a common law trademark protection within the geographical limitations of San Antonio).<sup>70</sup>

There can be a question as to the ownership of the name of the band. One could assume that it belongs to the band, but when the band is a collective of sole proprietors the ownership issue can become a problem. In

<sup>63</sup> See Garcia, *supra* note 3; See Wade, *supra* note 4.

<sup>64</sup> See <http://www.ascap.com/join/>; <http://www.sesac.com/About/About.aspx>; and <http://www.bmi.com/join/> (last visited August 27, 2011).

<sup>65</sup> See [www.copyright.gov/eco/](http://www.copyright.gov/eco/) (last visited August 27, 2011).

<sup>66</sup> See Wade, *supra* note 4.

<sup>67</sup> See <http://www.uspto.gov/web/offices/ac/qs/ope/fee2009september15.htm#tm> and <https://direct.sos.state.tx.us/help/help-corp.asp?pg=fee> (last visited August 27, 2011). For more information on the Federal Trademark application process, see [http://www.uspto.gov/trademarks/basics/BasicFacts\\_with\\_correct\\_links.pdf](http://www.uspto.gov/trademarks/basics/BasicFacts_with_correct_links.pdf) (last visited August 27, 2011).

<sup>68</sup> See [http://www.uspto.gov/faq/trademarks.jsp#\\_Toc275426681](http://www.uspto.gov/faq/trademarks.jsp#_Toc275426681) (last visited August 27, 2011).

<sup>69</sup> See <http://www.sos.state.tx.us/corp/forms/901.pdf> (last visited August 27, 2011).

<sup>70</sup> *San Antonio: A legacy Steeped in History, A Culture Rich in Diversity*, [http://www.fss.gsa.gov/pub/mtips/Jan\\_Feb03/SanAntonio.pdf](http://www.fss.gsa.gov/pub/mtips/Jan_Feb03/SanAntonio.pdf)

interviews with the bands, the consensus was the person starting the band owns the rights to the band's name.<sup>71</sup> The band Sublime was denied the continued use of its name, which had been trademarked by the lead singer, after the lead singer died and his heirs objected to the use of the trademark by the remaining members of the band.<sup>72</sup> The registered trademark owner can be an individual or a legal entity.

### IX. CONCLUSION

Forming a band, or a new business, can be a fun and exciting adventure. It is important that the individuals recognize that as a band starts to look more like a business, more structure and legal protection is necessary to prepare for or minimize legal issues, and to implement proactive measure to minimize potential liability, costs, and expended energy on these issues. These are only suggestions, and should not be taken as an absolute guide without the proper legal consultation with an attorney, as each situation and scenario is different. It is goal, though, that students will be able to identify, understand and apply legal principles learned in business law based on the use of a band and the scenario, hypotheticals and issues outlined herein.

### EXHIBIT "A"

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<sup>71</sup> See Elizalde, *supra* note 2; See Garcia, *supra* note 3; See Wade, *supra* note 4.

<sup>72</sup> Chang, Vickie, *Breaking: Sublime Lawsuit Settled; Showdates Planned* (Jan. 18, 2010), [http://blogs.ocweekly.com/heardmentality/2010/01/breaking\\_sublime\\_lawuit\\_settle.php](http://blogs.ocweekly.com/heardmentality/2010/01/breaking_sublime_lawuit_settle.php) (last visited August 27, 2011).

# PERFORMANCE AGREEMENT

The Venue 123 Main Street San Antonio, Texas 78205  
Booking (210) 555-5555 Venue (210) 555-5555

Artist: The Band  
Show Date: August 27, 2011  
Load In: 8  
Set Time: 11 till 11:40  
Exclusivity: No performance in Bexar County 14 days before or 14 days after performance.  
Compensation: Bands will split **80% of the door over \$400**. (i.e. sound, security, and ads) We mark down whom each guest comes to see and divide that number into the 80% to determine the payout for each band.

This breaks down as:	10 – 50 = \$4 per paid for your band
	51 – 100 = \$5 per paid for your band
	100 – 150 = \$6 per paid for your band

Payment will be made no sooner than 1:00 a.m. so that we have a full door count of the night. We prefer that you receive your money the night of your performance. If you can't wait you will need to pick it up the next business day. We will not hold payment for longer than three business days. Any money left after three business days will be forfeited to The Aardvark.

Band Specials: \$2 draft is the band special  
Over 50 paid for your band 3 free pitchers  
Over 100 paid for your band 5 free pitchers

Please forward a contact name and number for our records.

Press kits or promotional materials may be sent to: The Venue  
123 Main Street  
San Antonio, Texas 78205

John Doe  
Booking @ The Venue  
music@thevenue.nett

**EXHIBIT “B”**

**OFFER**

**ARTIST:** The Band

**DATE OFFERED:** August 27, 2011

**SHOW DATE:** November 11, 2011

**AGENT:** The Band

**ARTIST FEE:** \$

**Notes:** This is to be the opening band at The Venue

**Comments:** BBQ, Meals, and PA provided  
This offer is to open for XYZ Band

		<b>Promoter:</b>	
<b>VENUE:</b>		Contract Signatory:	Jane Doe
Venue Address:	123 Main Street	Company:	Music Promoter LLC
Venue City:	San Antonio	Address:	123 Broadway
Venue State:	Texas	City:	San Antonio
Venue Manager:	James Smith	State:	Texas
Venue Phone:	(210) 555-5555		
Venue mgr. email	j\$mith@th#v#nu#.com	Phone:	(210) 555-5555
		Fax:	(210) 555-5556
		Contact:	John Smith
		Email	john\$mith@mu\$cipr#m#ter.com

Showtime:	7 to 7:45 p.m.		Promoter to provide Sound and Lights: Yes
Show Length:	45 min		Production Contact:John Smith
Doors:	5:30 p.m.		Prod Phone #:(210) 555-5557
Load-in:	4:30 p.m.		Prod Email: production@mu\$cipr#m#ter.com
Merchandise:	100 % artist sells	<b>Presenting Station:XYZFM</b>	

<sup>1</sup>Offer only valid within thirty (30) days of the date offered.

**EXHIBIT "C"**

The following exhibit provides a variety of word marks, types of marks, mark drawing codes, and types of goods and services protected. The information was obtained directly from the United States Patent and Trademark Office USPTO) by conducting a Basic Word Mark Search (<http://www.uspto.gov/>). The information referenced

herein below is cited with a link to the USPTO's office, and the narrative under goods and services is taken directly and collectively from the Trademark Electronic Search System (<http://www.uspto.gov/trademarks/index.jsp>). For the purposes of this exhibit, not every example, work mark, type of mark, mark drawing code or goods and services has been cited individually.

The examples of trademarks and service marks were also obtained directly from the USPTO web site. The following process was used to search for the trademarks as of August 27, 2011 (note that the menu and web page design may change in the future so this process may not be exactly the same at a later date):

1. Go to <http://www.uspto.gov/trademarks/index.jsp>
2. Under tools in the left-hand menu select Trademark Electronic Search System (TESS).
3. Next select Basic Word Mark Search (New User) under the Select a Search Option.
4. Under Search Term, enter the trade mark.
5. The trademarks referenced below can be matched directly to the registration number.

<b>Example</b>	WILLIE NELSON
Word Mark	Willie Nelson
Type of Mark	Service Mark
Mark Drawing Code	Standard Character Mark (letters and/or numbers)
Goods and Services	"Entertainment services, namely, live musical and vocal performances by a solo recording artist; providing a web site featuring pre-recorded musical audio and audio-visual clips, photographs, news, review and other multimedia articles in connection with a solo recording artist; and fan club services."
Registrant	WN Music Company LLC
Registration Number	3639034

<b>Example</b>	WILLIE NELSON
Word Mark	Willie Nelson
Type of Mark	Trademark
Mark Drawing Code	Standard Character Mark (letters and/or numbers)
Goods and Services	"Shirts, tank tops and hats."
Registrant	WN Music Company LLC
Registration Number	3759888

<b>Example</b>	<b>George Strait</b>
Word Mark	George Strait
Type of Mark	Service Mark
Mark Drawing Code	Typed Drawing (letters and/or numbers)
Goods and Services	"Entertainment services, namely, musical performances by a vocalist."
Registrant	George Strait Productions, Inc.
Registration Number	2039665

<b>Example</b>	<b>Garth Brooks</b>
Word Mark	Garth Brooks
Type of Mark	Trademark
Mark Drawing Code	Typed Drawing (letters and/or numbers)
Goods and Services	"Pre recorded phonorecords, compact discs, audio cassette tapes and video cassette tapes feature music and spoken words; baseball style caps, t-shirts and sweatshirts."
Registrant	Garth Troyal Brooks
Registration Number	2443657

<b>Example:</b>	<b>Garth Brooks</b>
Word Mark	Garth Brooks
Type of Mark	Service Mark
Mark Drawing Code	Typed Drawing (letters and/or numbers)
Goods and Services	“Entertainment services, namely, live entertainment comprising musical performances, dramatic performances and comedic performances by Garth Brooks.”
Registrant	Garth Troyal Brooks
Registration Number	2226176

<b>Example</b>	<b>TAYLOR SWIFT</b>
Word Mark	Taylor Swift
Type of Mark	Trademark
Mark Drawing Code	Standard Character Mark (letters and/or numbers)
Goods and Services	“Clothing, namely, shirts, T-shirts, sweatshirts, jerseys, hats and caps.”
Registrant	Taylor Swift
Registration Number	3439210

<b>Example</b>	
Word Mark	Taylor Swift
Type of Mark	Trademark
Mark Drawing Code	Words, letters, and/or numbers in stylized form (design or logo)
Goods and Services	“Clothing, namely, bandanas, caps, hats, hooded pullovers, hooded sweat shirts, sweat shirts, pants, and t-shirts.”
Registrant	Taylor Swift
Registration Number	3809274

<b>Example</b>	<b>BON JOVI</b>
Word Mark	Bon Jovi
Type of Mark	Trademark
Mark Drawing Code	Standard Character Mark (letters and/or numbers)
Goods and Services	“Entertainment services, namely, live performances by a musical group.”
Registrant	Bon Jovi Productions, Inc
Registration Number	1484670

<b>Example</b>	<b>Reckless Kelly</b>
Word Mark	Reckless Kelly
Type of Mark	Service Mark
Mark Drawing Code	Typed Drawing
Goods and Services	“Entertainment services; namely live performances by a musical band.”
Registrant	Reckless Kelly Partnership
Registration Number	2371263



## **LIBEL TOURISM AND INTERNATIONAL FORUM SHOPPING: THE UNITED STATES SAYS “NO SALE” (THE SPEECH ACT OF 2010).**

Mary Rau-Foster\*  
Brad Reid\*\*

### **I. Introduction**

Libel tourism is a specialized category of international forum shopping, a deliberate selection of a court that is known to rule in the plaintiff’s favor. Threats of defamation lawsuits and judgments made by public figures against authors, publishing companies, doctors, editors have a chilling effect on free speech. As this growing problem continued to impact others, it became apparent that a federal law was necessary to protect the U.S. citizens against defamation judgments in other countries that afforded less protection than the U.S. Constitution.

On August 10, 2010, President Barak Obama signed into law the “Securing the Protection of our Enduring and Established Constitutional Heritage” (SPEECH) Act of 2010<sup>1</sup>, amending title 28 of the United States Code. The purpose of the SPEECH Act is to prohibit recognition and enforcement of foreign defamation judgments and certain foreign judgments against the providers of interactive computer services.<sup>2</sup>

The law was created in response to meritless libel cases filed by foreign plaintiffs, in foreign courts against United States residents. Often, the publication at issue is not directed to that foreign country, and in many cases, the plaintiff has no connection to the foreign forum. An aggrieved party seeking to silence the critical voices of authors and publishers by successfully shopping for the most accommodating legal forum, poses a threat to free speech in this and other countries.

The impact of one such United Kingdom international forum shopping libel tourism case (Mahfouz v. Ehrenfeld)<sup>3</sup> prompted the United States legislature to work together to create the SPEECH Act of 2010, in attempt to shield the victims of libel tourism. But will it offer enough protection? Should there also be a sword which would allow libel victims to fight back? The purpose of this article is to examine the problem of internet libel tourism, the conflict of libel laws between the United States and the United Kingdom and the sufficiency of protection under the SPEECH Act of 2010.

<sup>1</sup> PUBLIC LAW 111–223—AUG. 10, 2010 (SPEECH Act Of 2010)

<sup>2</sup> Id

\*Assistant Professor, Jack C. Massey Graduate School of Business, Belmont University, Nashville, TN

\*\* Professor, Managing Director of the Dean Institute for Corporate Governance and Integrity  
Lipscomb University, Nashville, TN

<sup>3</sup> Mahfouz v. Ehrenfeld [2005] EWHC 1156 (QB)

### A. *Freedom of Speech: Our Established and Enduring Constitutional Heritage*

Freedom of speech is of such great import that the framers of the U.S. States Constitution amended the Constitution to reflect that right,<sup>4</sup> the U.S Supreme Court protects it and in the Universal Declaration of Human Rights (1948), the United Nations lauded it. “Everyone has the right to freedom of opinion and expression; this right includes freedom to hold opinions without interference and to seek, receive and impart information and ideas through any media and regardless of frontiers”.<sup>5</sup> However, it is unlikely that in 1948, the United Nations could have imagined that a frontier might include the World Wide Web.

Freedom of speech is a cornerstone of democracy and has been protected by U.S. Supreme Court has protected even when the protected speech may be offensive. Our freedom of speech and freedom of the press affords more protection of utterances, opinions, criticisms and of our political leaders and public figures than may be found in other countries. But for the press, that was not always the case. Defamation law began in common law and was changed by *New York Times Co. v. Sullivan* in 1965. This case established the actual malice burden of proof required for public figures to recover their libel damages.

### B. *The Internet: The Cyber-Highway to Potential Libel Claims*

The Internet has become very popular because of its use for information and social exchanges, communications, entertainment, purchases, and news acquisition. The most common methods of internet communications (and therefore those with potential libel exposure for communications) include: email, listserv, distributed message databases, (USENET) newsgroups, real time communication (Internet Relay Chat), real time remote computer utilization (“telnet”) remote information retrieval (the World Wide Web) and blogging.

One of the greatest advantages of the Internet is the ability to broadcast material from all over the world, to all over the world. In *Reno v. ACLU* (1997), the U.S. Supreme Court said “by using the Internet, any person with a phone line can become a town crier with a voice that resonates farther than it could from any soapbox”.<sup>6</sup> However, this advantage is offset by the potential for being sued or prosecuted on the basis of an online publication. (Kurt Wimmer)<sup>7</sup>

The advent of the internet brought with it tremendous communications and e-commerce opportunities. It also opened a Pandora’s Box of legal conundrums raising numerous questions and concerns: Where is material determined to be defamatory; where it is created, stored or downloaded? When is online content considered published? What if the content is meant for a targeted or restricted audience but is accessed someone other than that audience? What is the effect when content, housed on a computer server in the United States, uploaded to the World

<sup>4</sup> First Amendment to the U.S. Constitution

<sup>5</sup> The Universal Declaration of Human Rights Article 19  
<http://www.un.org/en/documents/udhr/index.shtml>

<sup>6</sup> *Reno v. ACLU* (1997),

<sup>7</sup> US Senate Judiciary Committee Hearing Feb 2010 hearing on Libel Tourism

Wide Web crosses transnational borders and is made viewable and downloadable to a computer in a country which determines that content to be defamatory? Is the material considered defamatory where it is created, stored or downloaded? When is online content considered “published” and therefore defamatory?

Since 2000 U.S. publishers have faced defamation actions in Australia, Canada, England, France, Germany, Italy and Zimbabwe.<sup>8</sup> These vexing legal questions are at the root of the concerns shared by authors, publishers, scholars, citizen journalists, bloggers and internet users in general.

An unfavorable online book review leading to a criminal libel complaint has chilled the world of writing, publishing and website hosting. A recent chilling example of how the Internet can connect multinationals is a criminal libel action that resulted from a critical (and unretracted) book review. An Israeli resident (Dr. Karen Calvo-Goller) made the complaint, against an American professor (Dr. Joseph Weiler), because his website (globallawbooks.com) hosted a critical (solicited) review by a German reviewer (Dr. Thomas Weigend) of a Netherlands published book which resulted in a summons to Dr. Weiler by a French court, to answer criminal libel charges.<sup>9</sup> This case concerns a review of Dr Calvo-Goller's book, *The Trial Proceedings of the International Criminal Court* by Thomas Weigend, director of the Cologne Institute of Foreign and International Criminal Law, and dean of the faculty of law at the University of Cologne. The review was published on a website in 2007.<sup>10</sup> Dr. Calvo-Goller challenged Dr. Weigend 's assertions claiming that they were defamatory and demanded that Weiler remove the review from the website. When Dr. Weiler refused, she took her case to a Paris court. In 2011, the Paris court returned a verdict in favor of Dr. Weiler.

## II. Defamation, Libel Tourism and International Forum Shopping

Defamation is any “action or other proceeding for defamation, libel, slander, or similar claim alleging that forms of speech are false, have caused damage to reputation or emotional distress, have presented any person in a false light, or have resulted in criticism, dishonor, or condemnation of any person”.<sup>11</sup> Libel is the written form of defamation.

The Restatement (Second) of Torts describes the elements of a U.S. defamation action to be as follows: To create liability for defamation there must be:

- (a) a false and defamatory statement concerning another;
- (b) an unprivileged publication to a third party;
- (c) fault amounting to at least negligence on the part of the publisher;
- (d) either actionability of the statement irrespective of special harm or the existence of special harm caused by the publication.<sup>12</sup>

<sup>8</sup> <http://www.firstamendmentcenter.org/analysis.aspx?id=15940>

<sup>9</sup> *The European Journal of International Law* Vol. 20 no. 4 973

<http://www.ejil.org/pdfs/20/4/1952.pdf>

<sup>10</sup> Book Review: <http://www.globallawbooks.org/reviews/detail.asp?id=298>

<sup>11</sup> §4101 (1) of PUBLIC LAW 111–223—AUG. 10, 2010

<sup>12</sup> RESTATEMENT (SECOND) of TORTS § 558 (1977)

Libel tourism, a form of international forum shopping in which an aggrieved party shops for a forum that will be most plaintiff-friendly, is a “pernicious and growing phenomenon whereby wealthy individuals, including corrupt terror financiers exploit plaintiff-friendly foreign libel laws to silence American scholars, authors, producers and publishers”.<sup>13</sup> The ease with which the libel plaintiff can select the most favorable court forum and the expense in defending a foreign defamation claim, causes publishers, writers, scholars and members of the press to rethink, and in some cases withdraw, content from publication under the threat of a defamation suit. Perhaps this is, after all, what some libel tourists might be seeking. As the U.S. House of Representative member, Pete King (NY) said in a hearing on the SPEECH Act of 2010, under this act, “the litigants would never see a dime of the judgments they are awarded, but it's not money they are after in the first place. They want the publicity, an apology, and they want these books to disappear. Most of all they want to intimidate authors and publishers. And it's working!”<sup>14</sup>

### III. Comparison of the United States and United Kingdom Defamation Laws

Unlike in the United States, where private and public persons are regarded differently, the UK does not distinguish between private and public persons. In addition, there is a disconcerting conflict between defamation legal standards in the United States and those of the United Kingdom. In a 1992 case *Bachchan v. India Abroad Publications, Inc*<sup>15</sup>, the New York Supreme Court, commented on the UK and NY conflicting standards. “England and the United States share many common law principles of law. Nevertheless, a significant difference between the two jurisdictions lies in England’s lack of an equivalent to the First Amendment to the United States Constitution. The protection to free speech and the press embodied in that amendment would be seriously jeopardized by the entry of foreign libel judgments granted pursuant to standards deemed appropriate in England but considered antithetical to the protections afforded the press by the U.S. Constitution”.<sup>16</sup>

In the 1995 *Matusevitch v. Telnikoff* case, the U.S. District Court in the District of Columbia, relying on the Uniform Foreign Money Judgments Recognition Act, dismissed a British libel judgment against a Maryland radio broadcaster because it was “based on libel standards that are repugnant to the public policies of the State of Maryland and the United States.”

In this case, Telnikoff had published an opinion piece the London Daily Telegraph about the BBC’s hiring of Russian correspondents and Matusevitch wrote a letter to the editor charging Telnikoff with anti-Semitism. Telnikoff sued Matusevitch, a Maryland resident, and won. Matusevitch countersued and argued that the state’s public policy barred Telnikoff from enforcing the judgment against him. The court of appeals agreed.<sup>17</sup>

Unlike the United States, where the defamation burden of proof rests with the plaintiff, in the United Kingdom, the burden of the proof is upon the defendant to prove the truthfulness of

<sup>13</sup> Senate Judiciary Committee Hearing on foreign libel lawsuits. Feb 23, 2010

<sup>14</sup> *Id*

<sup>15</sup> 154 Misc. 2d 228, 585 N.Y.S.2d 661 (Sup. Ct. N.Y. Co.1992)

<sup>16</sup> 154 Misc. 2d 228, 585 N.Y.S.2d 661 (Sup. Ct. N.Y. Co.1992) \*235

<sup>17</sup> *See Telnikoff v. Matusevitch*, 702 A.2d.230,237(Md.1997)

the alleged libelous statements. Another difference between the United States, which has the single publication rule, the Duke of Brunswick rule (1849)<sup>18</sup> is still in effect in the UK. Under this rule each individual publication of libel gives rise to a separate cause of action. Therefore, each time a newspaper is read or online content is downloaded, a separate cause of action may accrue. As a Member state of the European Union, any judgment entered in the U.K. can be enforced in any other the twenty-six Member states<sup>19</sup> without any special procedure requirement.<sup>20</sup>

#### IV. The Back Story of the Speech Act: The Rachel Ehrenfeld Libel Tourism Case

To date, Rachel Ehrenfeld may be the most famous U.S. victim of U.K. libel tourism.

In 2003, Chicago based Bonus Books published *Funding Evil: How Terrorism Is Financed—and How to Stop it*,<sup>21</sup> a book written by New York author Rachel Ehrenfeld following the 9/11 terrorist attacks on the United States. The book, which identified networks of criminals, billionaires, and state leaders who underwrite terrorism and political violence, was marketed in the United States. Twenty-three copies of the book were purchased in the United Kingdom via the Internet and a chapter of the book, accessible from the ABCNews.com Web site, was also available in the UK. This was considered sufficient contact for a London court to claim jurisdiction over Ehrenfeld and Bonus Books. Such globally available online content and book purchase options may give the English courts the “thinnest of jurisdictional hooks for libel cases, but is one which they have seized”.<sup>22</sup>

The plaintiff, Kahlid Bin Mahfouz, a resident of Saudi Arabia and a frequent libel tourist and forum shopper, chose London (referred to as a “city named Sue”)<sup>23</sup> as the forum of choice for his 2005 defamation suit against Rachel Ehrenfeld and Bonus Books<sup>24</sup>. Bin Mahfouz exploited the difference between English and American libel law in an effort to threaten those who maligned his reputation. Since the September 11, 2001 attacks, Mahfouz, who has been accused of funding Al Qaeda the alleged source of the attacks, has successfully used or threatened to use, the English courts on twenty-nine occasions against similar allegations.<sup>25</sup>

Ehrenfeld alleges in her book about the funding of terrorism that Kahlid Bin Mahfouz funded terroristic acts through his National Commercial Bank. Mahfouz insisted that he abhorred terrorism and had never knowingly provided money to Al-Qaeda. Since the September 1, 2001

<sup>18</sup> The Duke Of Brunswick and Luneberg -v- Harmer [1849] EngR 915; (1849) 14 QB 185; (1849) 117 ER 75

<sup>19</sup> [http://europa.eu/abc/european\\_countries/eu\\_members/index\\_en.htm](http://europa.eu/abc/european_countries/eu_members/index_en.htm)

<sup>20</sup> CHAPTER III, Section 1, Article 33 (1) Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32001R0044:EN:NOT>

<sup>21</sup> RACHEL EHRENFELD, *FUNDING EVIL: HOW TERRORISM IS FINANCED-AND HOW TO STOP IT*. (Chicago, Bonus Books, 2003).

<sup>22</sup> Bruce Brown’s Testimony Senate Judiciary Committee Hearing on foreign libel lawsuits. Feb 23, 2010  
23 Id

24 (2005) EWHC 1156 (QB)

<http://www.bailii.org/ew/cases/EWHC/QB/2005/1156.html>

<sup>25</sup> David Pallister US Author Mounts 'Libel Tourism' Challenge

<http://www.guardian.co.uk/world/2007/nov/15/books.usa> Last viewed Oct. 16, 2010

terror attacks on the U.S., believed to have been conducted by members of Al-Qaeda, Mahfouz, with a fortune estimated by Forbes at \$3bn (£1.45bn), has successfully used or threatened to use the English courts on 29 occasions against similar allegations.<sup>26</sup>

Mahfouz denied Ehrenfeld's allegations, which she states were based on testimonies in Congress, official statements by American officials, other foreign intelligence services statements and documentation.<sup>27</sup> Mahfouz claimed that he suffered personal and professional injury to his reputation in the U.K. He sought to force Ehrenfeld to withdraw her statements, apologize to him and make a donation to a charity of his choice. Ehrenfeld ignored his demands and Mahfouz sought assistance from the High Court in the United Kingdom.

When Ehrenfeld refused to subject herself to the jurisdiction of the court, the High Court of England entered a default judgment against her. The court ordered her to pay \$250,000 in damages and attorney's fees, to destroy all remaining copies of the book and to publish retractions drafted by his solicitors. Ehrenfeld continued to ignore the foreign court's order. Mahfouz did not attempt to enforce his judgment in the U.S. Instead he harassed Ehrenfeld through email and other forms of contact in an attempt to get her to disaffirm her allegations. She refused to respond to his demands, but instead petitioned the New York court to declare the judgment unenforceable. The New York courts refused to grant her petition because of the lack of personal jurisdiction over Mahfouz who did not own property or conduct business in New York and who had not subjected himself to the court's jurisdiction<sup>28</sup>.

At the suggestion of the New York court, Ehrenfeld lobbied the New York legislature to create a protective state law addressing the libel tourism issue and specifically the ability to prohibit the enforcement of foreign defamation judgments. The passage in 2008 of the New York "Libel Terrorism Protection Act"<sup>29</sup> (sometimes referred to as Rachel's law) provides protection for NY residents against any libel foreign judgment that is repugnant to the US Constitution and the NY State Constitution. What it could not do was to protect its citizens who had assets in other states or who moved out of the state New York.

The New York law became a model for other state laws that followed suit either by passing legislation that directly addressed libel tourism, or by amending their state "Enforcement of Foreign Judgments"<sup>30</sup> laws thereby preventing the enforcement of certain foreign defamation judgments.

Even though Mahfouz, who died in August 2009, never attempted to enforce the judgment against her, Ehrenfeld stated that until the passage of the NY Libel Terrorism Act, the UK judgment hung over her "head like the sword of Damocles".<sup>31</sup> In a 2010 Senate Judiciary

26 David Pallister US Author Mounts 'Libel Tourism' Challenge  
<http://www.guardian.co.uk/world/2007/nov/15/books.usa> Last viewed Oct. 16, 2010

27 Transcript of Ehrenfeld interview with Katy Clark; Protection against libel actions overseas  
<http://www.theworld.org/2010/08/16/protection-against-libel-actions-overseas/> Last viewed Sept. 25, 2010

28 Ehrenfeld v. Mahfouz 518 F.3d 102 (2008)

29 Libel Terrorism Protection Act of 2008

<sup>30</sup> Enforcement of foreign judgments usually refers to enforcement of judgments from other states

<sup>31</sup> US Senate Judiciary Committee Hearing Feb 2010 hearing on Libel Tourism

Hearings held on the effects of libel tourism, Ehrenfeld testified that her ability to research and write freely about international terrorism has been impeded by libel tourism.

## V. Traditional Enforcement of Foreign Judgments by U.S. Courts

Comity is an old common law doctrine that allows courts to enforce the official acts of foreign nations even in the absence of a treaty. The concept of “comity” has a long legal history in the enforcement of foreign judgments in U.S. courts. In an 1895 U.S. Supreme Court decision, Justice Gray wrote: “Comity,” in the legal sense, is neither a matter of absolute obligation, on the one hand, nor of mere courtesy and good will, upon the other. But it is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.”<sup>32</sup>

However, this 1895 same decision indicated by implication situations in which a foreign judgment should not be recognized. The Court wrote: “...Where there has been opportunity for a full and fair trial abroad before a court of competent jurisdiction, conducting the trial upon regular proceedings, after due citation or voluntary appearance of the defendant, and under a system of jurisprudence likely to secure an impartial administration of justice between the citizens of its own country and those of other countries, and there is nothing to show either prejudice in the court, or in the system of laws under which it was sitting, or fraud in procuring the judgment, or any other special reason why the comity of this nation should not allow it full effect, the merits of the case should not, in an action brought in this country upon the judgment, be tried afresh, as on a new trial or on appeal, upon the mere assertion of a party that the judgment was erroneous in law or in fact.”<sup>33</sup> The “special reason” for non-enforcement could be a denial to the defendant of fundamentally recognized U.S. Constitutional rights.

Regarding comity, a 1994 Third Circuit decision stated: “In general, “under the principle of international comity, a domestic court normally will give effect to executive, legislative, and judicial acts of a foreign nation.” *Remington Rand v. Business Sys. Inc.*, 830 F.2d 1260, 1266 (3d Cir. 1987). More specifically, we have stated that “comity should be withheld only when its acceptance would be contrary or prejudicial to the interest of the nation called upon to give it effect.” *Somportex Ltd. V. Philadelphia Chewing Gum Corp.*, 453 F.2d 435, 440 (3d Cir. 1971), cert. denied, 405 U.S. 1017. 92 S. Ct. 1294, 31 L. Ed. 2d 479 (1972). Thus, a court may, within its discretion, deny comity to a foreign judicial act if it finds that the extension of comity “would be contrary or prejudicial to the interest of the” United States. Accordingly, we review “the extension or denial of comity...by the abuse of discretion standard.” *Remington*, 830 F.2d at 1266. Consequently, when reviewing a denial of comity, we must determine whether a district court acted within its discretion if it concluded that “acceptance (of comity) would be prejudicial to the interest of the United States.”<sup>34</sup> This analysis is representative of how comity is applied.

<sup>32</sup> *Hilton v. Guyot*, 159 U.S. 113 at 126 (1895).

<sup>33</sup> *Hilton v. Guyot*, 159 U.S. 113 at 135 (1895).

<sup>34</sup> *Philadelphia Gear Corp. v. Philadelphia Gear De Mexico, S.A.*, 44 F.3d 187, at 195 (3d. Cir. 1994).

With regard to the enforcement of foreign libel judgments, the Second Circuit wrote in 2007: “Foreign judgments that impinge on First Amendment rights will be found to be “repugnant” to public policy.”<sup>35</sup> In this case, the Court applied New York’s Recognition of Foreign Money Judgments Act that allows non-recognition if “the cause of action on which the judgment is based is repugnant to the public policy of this state.”<sup>36</sup> In fact the Court cited with approval the statement “If...the public policy to which the foreign judgment is repugnant is embodied in the First Amendment to the United States Constitution or the free speech guaranty of the Constitution of this State, the refusal to recognize the judgment should be, and it is deemed to be, ‘constitutionally mandatory.’”; *Yahoo!, Inc. v. La Ligue Contre Le Racisme et L’Antisemitisme*, 169 F. Supp. 2d 1181, 1189-90 (N.D. Cal. 2001) (holding unenforceable French judgment rendered under law prohibiting Nazi propaganda because such law would violate the First Amendment), rev’d on other grounds, 433 F. 3d 1199 (9<sup>th</sup> Cir. 2006) (en banc).<sup>37</sup>

The Second Circuit’s First Amendment analysis had increasingly become the rule by the time the SPEECH Act was enacted. However, the now classic “actual malice” standard for public officials demonstrates that even a First Amendment argument for non enforcement of a foreign libel judgment has limitations.<sup>38</sup> In other words, defamation with actual malice is not allowed, and a foreign judgment for defamation could not consistently be blindly rejected on First Amendment grounds.

In *Desai v. Hersh*<sup>39</sup> the plaintiff, a former Prime Minister of India, sued in a U.S. Court and wanted Indian law applied, that does not have the actual malice standard.<sup>40</sup> In denying this, the Court noted that the publisher had not “abandoned” his First Amendment protections by “an intentional and direct publication” in India.<sup>41</sup> To rule otherwise, “...publishers would be required to conform to the most restrictive law of defamation, wherever in the world that may be.”<sup>42</sup> “Publications may be disseminated worldwide in a matter of hours, with or without the permission of the author or publisher.”<sup>43</sup> This 1992 decision is one of the first to acknowledge the increasing problem of involuntary publication abroad due to modern mass media.

While one might suppose that the enforcement of foreign judgments would be a matter of federal law, it has typically been controlled by state law. The Uniform Foreign Money-Judgments Recognition Act was promulgated by the National Conference on Uniform State Laws in 1962 and stated “...rules that have long been applied by the majority of courts in this country.”<sup>44</sup> This model legislation contained the “repugnant” exception previously mentioned.

<sup>35</sup> *Sarl Lovis Feraud International v. Viewfinder, Inc.*, 489 F. 3d 474, 484 (2d Cir. 2007).

<sup>36</sup> N.Y. C.P.L.R. 5304 \*(b)(4).

<sup>37</sup> *Sarl Lovis Feraud International v. Viewfinder, Inc.*, 489 F. 3d 474, 484 (2d Cir. 2007).

<sup>38</sup> *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964).

<sup>39</sup> 719 F. Supp. 670 (N.D. Ill. 1989), aff’d on other grounds, 954 F.2d 1408 (7<sup>th</sup> Cir.), cert. denied, 113 S. Ct. 190 (1992).

<sup>40</sup> 719 F. Supp. 670 at 674.

<sup>41</sup> 719 F. Supp. 670 at 681.

<sup>42</sup> 719 F. Supp. 670 at 677.

<sup>43</sup> 719 F. Supp. 670 at 677.

<sup>44</sup> Uniform Foreign Money-Judgments Recognition Act available at [www.lawupenn.edu/b11/archives/u/c/fnact99/120](http://www.lawupenn.edu/b11/archives/u/c/fnact99/120). Last visited January 19, 2011.

“The 1962...Act has been enacted in [virtually all] states.”<sup>45</sup> In 2005, the National Conference of Commissioners on Uniform State Laws promulgated a revision to the 1962 Act. Among other changes, it establishes the burden of proof on a party who argues for the non-recognition of a foreign judgment.

There are few treaties that address the enforcement of foreign judgments. The 1971 Hague Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters never did obtain any significant status for a variety of reasons rooted in the international political environment..<sup>46</sup> Only Cyprus, Netherlands and Portugal have ratified it. This mixed background of enforcement and nonenforcement made the enactment of the SPEECH Act especially significant.

## VI. The Language of the Speech Act of 2010

“Some persons are obstructing the free expression rights of United States authors and publishers, and in turn chilling the first amendment to the Constitution of the United States interest of the citizenry in receiving information on matters of importance, by seeking out foreign jurisdictions that do not provide the full extent of free-speech protections to authors and publishers that are available in the United States, and suing a United States author or publisher in that foreign jurisdiction. These foreign defamation lawsuits not only suppress the free speech rights of the defendants to the suit, but inhibit other written speech that might otherwise have been written or published but for the fear of a foreign lawsuit”<sup>47</sup>

### A. The Shield

Notwithstanding any other provision of Federal or State law, a domestic court shall not recognize or enforce a foreign judgment for defamation unless the domestic court determines that—

“(A) the defamation law applied in the foreign court’s adjudication provided at least as much protection for freedom of speech and press in that case as would be provided by the first amendment to the Constitution of the United States and by the constitution and law of the State in which the domestic court is located; or

“(B) even if the defamation law applied in the foreign court’s adjudication did not provide as much protection for freedom of speech and press as the first amendment to the Constitution of the United States and the constitution and law of the State, the party opposing recognition or enforcement of that foreign judgment would have been found liable for defamation by a domestic court applying the first amendment to the Constitution of the United States and the constitution and law of the State in which the domestic court is located.”<sup>48</sup>

<sup>45</sup> Uniform Law Commissioners, [www.ncusl.org/update](http://www.ncusl.org/update). Last visited January 19, 2011.

<sup>46</sup> Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters, Feb. 1, 1971, 1144 U.N.T.S. 249, available at [http://hcch.e-vision.nl/indexd\\_en.php?act=conventions..text&cid=78](http://hcch.e-vision.nl/indexd_en.php?act=conventions..text&cid=78). Last visited January 19, 2011.

<sup>47</sup> Public Law 111-223- Aug. 10, 2010 Sec. 2 (2)

<sup>48</sup> Id § 4102 (1)

The party seeking recognition or enforcement of the foreign judgment bears the burden of making the showings required under subparagraph (A) or (B) as noted above.

Jurisdictional Considerations: Notwithstanding any other provision of Federal or State law, a domestic court shall not recognize or enforce a foreign judgment for defamation unless the domestic court determines that the exercise of personal jurisdiction by the foreign court comported with the due process requirements that are imposed on domestic courts by the Constitution of the United States.<sup>49</sup>

Internet Service Providers are also protected: Notwithstanding any other provision of Federal or State law, a domestic court shall not recognize or enforce a foreign judgment for defamation against the provider of an interactive computer service, as defined in section 230 of the Communications Act of 1934 (47 U.S.C. 230) unless the domestic court determines that the judgment would be consistent with section 230 if the information that is the subject of such judgment had been provided in the United States.<sup>50</sup>

“(a) CAUSE OF ACTION.—

“(1) IN GENERAL.—Any United States person against whom a foreign judgment is entered on the basis of the content of any writing, utterance, or other speech by that person that has been published, may bring an action in district court, under section 2201(a), for a declaration that the foreign judgment is repugnant to the Constitution or laws of the United States. For the purposes of this paragraph, a judgment is repugnant to the Constitution or laws of the United States if it would not be enforceable under section 4102 (a), (b), or (c).<sup>51</sup>

“(2) BURDEN OF ESTABLISHING UNENFORCEABILITY OF JUDGMENT.—The party bringing an action under paragraph (1) shall bear the burden of establishing that the foreign judgment would not be enforceable under section 4102 (a), (b), or (c).

## B. The Sword

The SPEECH Act did not include the cutting language from an earlier Senate bill 449 (referred to as the Free Speech Protection Act of 2009)<sup>52</sup>. That Senate committee recognized that refusing to enforce a foreign defamation judgment did not address the collateral and sustaining damage to one’s reputation, career, image and lost opportunities. In addition to the shielding language that was ultimately included in the SPEECH Act, this bill offered a sharp sword that could be used to strike back at plaintiffs who “intentionally engaged in a scheme to suppress first amendment rights by discouraging publishers or other media from publishing, or discouraging employers, contractors, donors, sponsors, or similar financial supporters from employing, retaining, or supporting research, writing or other speech of a journalist, academic, commentator, expert or other individual”.<sup>53</sup>

The Senate committee wanted to create a recourse that would allow the use of a sword by the libel tourist victim. The Senate bill would have allowed for a cause of action for damages

<sup>49</sup> Id §4102 (2)(b) (1)

<sup>50</sup> Id § 4102 (c) (1)

<sup>51</sup> §4104 (a) (1)

<sup>52</sup> S 449 111<sup>th</sup> CONGRESS 1<sup>st</sup> Session, Feb. 13, 2009

<sup>53</sup> Id\*8

based on (A) the amount of any foreign judgment in the underlying foreign lawsuit (B) the costs and legal expenses attributable to the foreign lawsuit and (C) the harm caused due to decreased opportunities to publish, conduct research or generate funding.<sup>54</sup> In addition, treble damages<sup>55</sup> would also be available if it could be proven that the plaintiffs intentionally engaged in a first amendment rights suppression scheme.

### **VII Analysis: Does The Speech Act Of 2010 Go Far Enough Or Too Far?**

The SPEECH Act prohibits the recognition of foreign defamation judgments in the United States. However, it does not provide protection to Americans who have foreign assets that may be attached by a foreign court to satisfy a foreign defamation judgment. Nor does this law provide a “sword” with which to fight back in the case of a meritless foreign suit brought by the plaintiff to deter or eliminate criticism and exposure of his illegal or unethical acts. Therefore, meritless suits can continue to be filed in foreign forums, requiring defendants defend themselves, at great expense, under the laws of a country with less free speech protection or to refuse to submit to the foreign court jurisdiction and risk receiving a default judgment.

Will it become necessary for Congress consider additional legislation that (1) eliminates the possible significant differences in how different countries approach freedom of expression as it impacts libel defendants or (2) creates a very long arm statute that would allow for a retaliatory (and reputation saving) cause of action against the foreign shopping libel tourist who brought a meritless suit simply to force a monetary settlement (3) requires mediation or arbitration of libel cases. The United States respects the sovereign right of other countries to enact their own laws regarding speech, and seeks only to protect the First Amendment rights of Americans in connection with speech that occurs, in whole or part, in the United States.

In addition to legislative solutions to threats of libel tourism claims to any author of online content, other non-legislative solutions may include (1) self assessment and self-regulation of written content which could be considered defamatory in this or other countries, (2) geographical filtering to prevent access to published or posted online content by libel plaintiff-friendly countries and (3) a better understanding of and compliance with defamation laws.

### **V. Conclusion**

Though the SPEECH Act may prevent the enforcement foreign libel judgments in the U.S., it is powerless to protect the citizens outside of its borders. Freedom of speech, though valuable, can also be costly when our laws collide with those of a foreign country where there is less appreciation for and protection of, opinions and free speech and free press. The global availability and accessibility to information intended for a targeted audience may not be as restricted as intended. In addition, unsatisfied judgments can be held over libel defendants head until the statute of limitations for enforcement in that particular country expires. Unfortunately, the “impact of the sword of Damocles is not that it falls, but that it hangs”.

<sup>54</sup> Id\* 7

<sup>55</sup> Id 8



***NEW PROCESS STEEL, LP V. NLRB: QUORUM ISSUES AND THEIR IMPACT ON  
FEDERAL LABOR CODE ENFORCEMENT***

Robert K. Robinson, The University of Mississippi  
brobinson@bus.olemiss.edu

Dave L. Nichols, The University of Mississippi  
acdln@olemiss.edu

Sam Cousley, The University of Mississippi  
scousley@bus.olemiss.edu

Frank B. Markham, Mesa State College  
fmarkham@mesastate.edu

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**I. INTRODUCTION**

The June 17, 2010, *New Process Steel, LP v. NLRB*,<sup>1</sup> sent ripples through the industrial relations community as this Supreme Court ruling immediately declared 596 National Labor Relations Board (NLRB) decisions null and void. The justification for this action was predicated on the Court's interpretation of the National Labor Relations Act (NLRA) that the Board failed to have sufficient members to constitute a quorum during a period from January 1, 2008 to March 27, 2010. The central issue confronting the Court hinged on its reading of the ambiguous delegation clause of the NLRA,<sup>2</sup> and whether the quorum necessary for the NLRB to conduct its business is two commissioners or three. Previously, five federal courts of appeal for (the First,<sup>3</sup> Second,<sup>4</sup> Fourth,<sup>5</sup> Seventh<sup>6</sup> and Tenth Circuits<sup>7</sup>) had upheld the NLRB's own interpretation that decisions from a two-member Board were in conformance with the delegation clause. However, when the matter was reviewed by the Supreme Court, five justices concluded that when the NLRA was amended by the Labor Management Relations Act (LMRA) the quorum requirement of the Board increased from two to three commissioners, thus invalidating all two-member decisions.<sup>8</sup>

<sup>1</sup> 130 S.Ct. 2635 (2010).

<sup>2</sup> 29 U.S.C. § 153(b) (2009).

<sup>3</sup> *Northeastern Land Servs., Ltd. v. NLRB*, 560 F.3d 36, 41 (1<sup>st</sup> Cir. 2009).

<sup>4</sup> *Snell Island SNF LLC v. NLRB*, 568 F.3d 410 (2<sup>nd</sup> Cir. 2009).

<sup>5</sup> *Narricot Indus., L.P. v. NLRB*, 587 F.3d 654 (4<sup>th</sup> Cir. 2009).

<sup>6</sup> *New Process Steel, LP v. NLRB* 564 F.3d 840 (7<sup>th</sup> Cir. 2009).

<sup>7</sup> *Teamsters Local Union No. 523 v. NLRB*, 590 F.3d 849, 852 (10<sup>th</sup> Cir. 2009).

<sup>8</sup> *Supra*, note 1.

This article provides a full discussion of the Supreme Court's rationale in vacating all NLRB decisions made by a two-member Board. Additionally, both arguments, those for a three-member quorum and those for a two-member quorum, are presented. Finally, the immediate consequences of the ruling are discussed, as well as prognostications of its future impact on the vacated decisions, the NLRB's workload, and the future of labor relations.

## II. Background

District Lodge 34 of the International Association of Machinists and Aerospace Workers (IAM) was the exclusive bargaining representative of the employees at a New Process Steel plant in Butler, Indiana. In August 2007, during collective bargaining negotiations, the two parties reached an impasse. When the IAM sent the employer's initial offer to the bargaining unit, the employees voted down the contract, however they did not have sufficient support to muster a strike vote (this required a two-thirds majority vote).<sup>9</sup>

Because a majority of union members rejected a new CBA, but an insufficient number voted for a strike, the union was required to accept the contract. A number of union members were unhappy with having to accept the contract began petitioning to decertify the union.<sup>10</sup> At this juncture, the plant owner withdrew its recognition from the union.<sup>11</sup> The union subsequently filed an unfair labor practice (ULP) complaints with the NLRB, arguing that the employer failed to honor its collective bargaining agreement to deal with the union as the exclusive representative of employees of the plant. An administrative law judge (ALJ) held that the employer was in violation of § 8(a)(5) of the NLRA by failing to bargain in good faith.<sup>12</sup> A two-member panel of the NLRB found for the union.<sup>13</sup> The employer then challenged the NLRB's order because it lacked authority to issue it by failing to have sufficient members for a quorum.<sup>14</sup>

### A. *The National Labor Relations Board*

The NLRB was created in 1935 under § 3 of the National Labor Relations Act (NLRA)<sup>15</sup> to enforce what was later to become known as the National Labor Code (the National Labor Relations Act, the Labor Management Relations Act, and the Labor Management Reporting and Disclosure Act).<sup>16</sup> At the time of its inception, the Board consisted of three members.<sup>17</sup> The primary functions of the NLRB are to oversee the union representation process, investigate violations of the Act (unfair labor practices), conduct secret ballot representation elections, and determine the appropriateness of bargaining units.<sup>18</sup> Under the NLRA, the original three-member Board had a quorum of two members in order to conduct business.

<sup>9</sup> New Process Steel, LP, 353 NLRB 111 (2008).

<sup>10</sup> *Supra*, note 6 at 842.

<sup>11</sup> New Process Steel, LP, 353 NLRB 254, 255 (2008).

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Supra*, note 6 at 845.

<sup>15</sup> 29 U.S.C. § 153.

<sup>16</sup> The term National Labor Code is a term used to encompass the National labor Relations Act and its two subsequent amendments: The Labor Management Relations Act and the Labor Management Reporting and Disclosure Act.

<sup>17</sup> 60TH ANNIVERSARY COMMITTEE, NATIONAL LABOR RELATIONS BOARD, *THE FIRST SIXTY YEARS: THE STORY OF THE NATIONAL LABOR RELATIONS BOARD 1935-1995*, 10 (1995).

<sup>18</sup> 29 U.S.C. § 153(b).

In 1947, the NLRA was amended by the enactment of the Labor Management Relations Act (LMRA). In addition to implementing major changes to the NLRA, such as imposing unfair labor practices on unions<sup>19</sup> and creating right-to-work provisions,<sup>20</sup> the LMRA also increased the size of the NLRB from three to five members.<sup>21</sup> Though provisions were made to increase the quorum from two to three, the wording of part of this portion of the statute (later know as the delegation clause) was ambiguous. This delegation clause specifically states,

A vacancy in the Board shall not impair the right of the remaining members to exercise all of the powers of the Board, and three members of the Board shall, at all times, constitute a quorum of the Board, except that two members shall constitute a quorum of any group designated pursuant to the first sentence hereof.<sup>22</sup>

It is the arcane “. . . *except* [emphasis added by the authors] that two members shall constitute a quorum of any group designated pursuant to the first sentence hereof,” that gives rise to confusion as whether a two-member NLRB is still empowered to perform its statutory duties.

Because the NLRB is an independent federal agency, its enforcement orders and final orders are reviewable by, and thus appealed directly to, the appropriate United States Circuit Court of Appeals.<sup>23</sup>

### III. ARGUMENTS FOR A TWO-MEMBER BOARD

As a historical artifact, there have not been five members on the NLRB since 2003, though never fewer than three.<sup>24</sup> Because no new commissioners were confirmed in 2007, the four sitting members realized that the Board would be left with only two members on January 1, 2008. On that date, the terms of two recess appointees, Dennis Walsh and Peter Kirsanov, were due to expire. In an effort to preserve the Board's authority to function, the Board decided on December 28, 2007 to invoke their interpretation of the delegation clause<sup>25</sup> and delegate all of the NLRB's authority to a three-member panel.

This three-member board (consisting of Kirsanov, Wilma Liebman and, then chairman, Peter Schaumber) then proceeded to delegate all of the panel's powers to the remaining two members. Thus Liebman and Schaumber would now be entrusted to exercise the Board's powers. In essence, the power of four had been transferred into three, which was then vested into two.

It was a result of this two-member Board arrangement that New Process Steel challenged the numerically reduced NLRB's affirmation of an administrative law judge's injunction to cease and desist from refusing to adhere to the collective-bargaining

<sup>19</sup> *Id.*

<sup>20</sup> 29 U.S.C. § 164.

<sup>21</sup> 29 U.S.C. § 153(a).

<sup>22</sup> *Supra* at note 7.

<sup>23</sup> 29 U.S.C. §§ 160(e) & (f).

<sup>24</sup> ADAM WIT LABOR MANAGEMENT RELATIONS: U.S. SUPREME COURT POTENTIALLY INVALIDATES HUNDREDS OF NLRB DECISIONS (JUNE 2010).

<http://www.littler.com/PressPublications/Lists/ASAPs/DispASAPs.aspx?List=edb4a871-9e73-4eae-bf81-3d045b6ede6d&ID=1509> (last accessed March 21, 2011)).

<sup>25</sup> New Process Steel, LP, 353 N.L.R.B. 254, n. 2 (2008).

agreement.<sup>26</sup> Based on New Process Steel's interpretation of the delegation clause, the language seemed to plainly indicate that the National Labor Relations Act requires that three members of the five member NLRB "at all times" are necessary to constitute a quorum. "A vacancy in the Board shall not impair the right of the remaining members to exercise all of the powers of the Board, and three members of the Board shall, at all times, constitute a quorum of the Board . . ." seemed to indicate that a two-member Board was operating without a quorum.<sup>27</sup>

#### A. *The Two-Member Quorum*

This is where the confusion naturally arises out of the delegation clause. Though the delegation clause does state plainly that "[a] vacancy in the Board shall not impair the right of the remaining members to exercise all of the powers of the Board, and three members of the Board shall, at all times, constitute a quorum of the Board. . ." There is still that ambiguous "except [emphasis added by the authors] that two members shall constitute a quorum of any group designated pursuant to the first sentence hereof." To the Board, this apparently contradicts the previous clause and makes the argument that a five-member Board can delegate its authority to a three-member panel, which can then delegate its authority to a two-member panel. This is what prompted the NLRB to engage in the previous mentioned metamorphosis from a four-member board to two.

The attorneys for New Process Steel argued that there is a difference between the full NLRB and smaller panels, and it is a mistake to equate them.<sup>28</sup> As a consequence, New Process Steel claimed that the vacancy on a panel may impair the right of panel members to exercise the powers of the NLRB and disqualify the decisions it makes.<sup>29</sup>

The NLRB rejected this argument and asserted that since the members of the smaller groups are still duly appointed members of the NLRB, it stood to reason that the vacancy language must also apply to them.<sup>30</sup> Accordingly, neither the power of panel nor Board members is ever diminished by a vacancy,<sup>31</sup> apparently, even one which would leave the Board without 60 percent of its authorized members.

The NLRB argues that, when the LMRA expanded the board to five members, the added possibility of having smaller panels with a two-member quorum served to make the NLRB more efficient but did not change the original concept of two members being able to render decisions.<sup>32</sup> By dividing the Board into smaller panels the NLRB could handle a greater case load than a body required to hear all cases *en banc*.

It was this argument that the Seventh Circuit found plausible when it affirmed the two-member Board's decision in *New Process Steel*<sup>33</sup> and entered a judgment enforcing the NLRB's

<sup>26</sup> New Process Steel, LP, 2008 NLRB LEXIS 316 (Sept. 25, 2008)

<sup>27</sup> 29 U.S.C. § 153(b).

<sup>28</sup> Brief for Petitioner at 13, 19–20.

<sup>29</sup> *Id.* at 27.

<sup>30</sup> Brief for Respondent at 22–23

<sup>31</sup> *Id.*

<sup>32</sup> FREDERICK WU AND OLIVER REIMERS, LEGAL INFORMATION INSTITUTE BULLETIN: NEW PROCESS STEEL V. NLRB (2010). <http://topics.law.cornell.edu/supct/cert/08-1457> (last accessed February 2, 2011).

<sup>33</sup> *Supra*, note 9.

order.<sup>34</sup> This line of reasoning was supported by subsequent decisions in four other circuits, the First,<sup>35</sup> Second,<sup>36</sup> Fourth,<sup>37</sup> and Tenth.<sup>38</sup>

One circuit reviewing the two-member decisions, the U.S. Circuit Court for the District of Columbia, drew a different conclusion. In its line of reasoning, a two-member NLRB did not have the authority to render decisions.<sup>39</sup>

### B. *The Three-Member Quorum*

On June 17, 2010, The Supreme Court weighed in on this issue, eventually reversing and remanding *New Process Steel*.<sup>40</sup> Ultimately the Court would conclude that the NLRA requires the Board, when it delegates its authority, can only do so if the delegated group is of at least three commissioners. Any group must maintain a membership of three if it intends to exercise the delegated authority of the Board. The majority reasoned that the plain language of the statute – the Board may delegate its powers to a "group of three or more members" – required that the delegated group must have at least three members to exercise the full enforcement authority granted the NLRB under the statute. A contrary reading of the NLRA, according to the majority, would allow two members (a mere 40% of its authorized strength) to act as the Board *ad infinitum*, thus drastically weakening the statutory significance of the quorum requirement and permitting its permanent circumvention.<sup>41</sup>

The majority opinion even declared that the action of the NLRB's the delegation of power to a three-member group with the expectation that within days it would become a two-member group possessed a "somewhat fictional nature."<sup>42</sup> Though it may be argued that the language of the delegation clause is anything but straightforward, the Supreme Court felt that it had an uncomplicated understanding of the text.<sup>43</sup> As a consequence, it concluded that the NLRA requires "that no fewer than three members be vested with the Board's full authority, coupled with the Board's longstanding practice, points us toward an interpretation of the delegation clause that requires a delegee group to maintain a membership of three."<sup>44</sup> At the present, all two-member NLRB decisions lack legitimately delegated authority. Unless, as the Supreme Court declared, Congress wishes to amend the Act, the Board's full power cannot be vested in fewer than three members.

Further, "[i]f Congress wishes to allow the Board to decide cases with only two members, it can easily do so. But until it does, Congress' decision to require that the Board's full power be delegated to no fewer than three members, and to provide for a Board quorum of three, must be given practical effect rather than swept aside in the face of admittedly difficult circumstances. § 3(b), as it currently

<sup>34</sup> *Supra*, note 6 at 851.

<sup>35</sup> *Supra*, note 3.

<sup>36</sup> *Supra*, note 4.

<sup>37</sup> *Supra*, note 5.

<sup>38</sup> *Supra*, note 7.

<sup>39</sup> *Atrium at Princeton. LLC v. NLRB*, 2010 U.S. App. LEXIS 19653 (DC Cir., 2010).

<sup>40</sup> *Supra*, note 1 at 2645.

<sup>41</sup> *Id.* at 2640.

<sup>42</sup> *Id.* at 2642.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

exists, does not authorize the Board to create a tail that would not only wag the dog, but would continue to wag after the dog died.”<sup>45</sup>

To permit two members to act as the Board *ad infinitum* would dramatically undercut “the significance of the Board quorum requirement by allowing its permanent circumvention.”<sup>46</sup> To do otherwise would, in essence, permit a rump board with only two member to operate unrestrained in making and enforcing private-sector labor policy.

#### IV. CONSEQUENCES OF *NEW PROCESS STEEL*

Following the *New Process Steel* decision, all eleven geographic circuits and the D.C. Circuit began overturning two-member Board decisions (see Appendix A). Though these cases will most likely be reheard by a board meeting the statutory quorum (now defined by the Court as three or more commissioners), this is unlikely to drastically alter the outcome of the two-member decision themselves. The pro-labor NLRB constructed by the Obama Administration is unlikely to overturn the previously rendered two-member decisions. The 596 NLRB decisions which *New Process Steel* has declared null and void are only going to be delayed and their outcome is little in doubt. The most significant outcome will be the burdensome case load which is imposed on the NLRB until the old cases are reheard and resolved.

Not all two-member decisions are necessarily voided by this decision, there may be a few rare instances in which two members would be permissible under *New Process Steel*. In the rare event that a matter comes before a three-member board, and circumstances arise, germane to this case which cause one of the three commissioners to recuse himself or herself. Under such an exceptional situation, the two-remaining members would be able to decide the matter.<sup>47</sup> It is only when the number of sitting commissioners on the NLRB is reduced to two-members (a permanent vacancy) that the Board’s ability to render decisions will be curtailed.

Perhaps the greatest lesson learned from *New Process Steel* is that standing Presidents must ensure that at least three-fifths of its seats must be filled, or the NLRB will grind to a halt.

On a Draconian note, now that the Supreme Court has clearly voided the actions of an understaffed Board, the Achilles heel of the delegation clause is exposed for potential abuse.<sup>48</sup> The turnover of NLRB commissioners is likely to make the subsequent appointment process hostage to the political “whims” of an increasingly partisan Senate. If the opposition party desired to do so, NLRB appointments could be used as bargaining chips to gain political concessions in other legislative areas. The threat would be the ability to bring the enforcement of the labor code to a complete halt. By maintaining a full five-member NLRB, the President would greatly reduce this risk, while allowing the Board to attrit to the three-commissioner minimum would exacerbate it.

<sup>45</sup> *Id.* at 2645.

<sup>46</sup> *Id.* at 2640.

<sup>47</sup> *Id.* at 2639-40.

<sup>48</sup> John E. Higgins, Jr. *Taft-Hartley Symposium: The First fifty Years: Labor Czars—Commissars—Keeping Women in the Kitchen—the Purpose and Effects of the Administrative Changes made by Taft-Hartley*, 47 CATH. U. L. REV. 941, 953 (1998).

## Appendix A

<b>Circuit Decisions overturning Two-Member Board Decisions</b>	
<b>Circuit</b>	<b>Citation</b>
1 <sup>st</sup>	<i>NLRB v. Metro Mayaguez, Inc.</i> 2010 U.S. App. LEXIS 15782 (1 <sup>st</sup> Cir. 2010)
2 <sup>nd</sup>	<i>County Waste of Ulster, LLC v. NLRB</i> , 2010 U.S. App. LEXIS 13471(2 <sup>nd</sup> Cir. 2010)
3 <sup>rd</sup>	<i>St. George Warehouse Inc. v. NLRB</i> , 2010 U.S. App. LEXIS 13886 (3 <sup>rd</sup> Cir. 2010)
4 <sup>th</sup>	<i>McElroy Coal Co. v. NLRB</i> , 2010 U.S. App. LEXIS 17571 (4 <sup>th</sup> Cir., 2010)
5 <sup>th</sup>	<i>NLRB v. Coastal Cargo Co., Inc.</i> 2010 U.S. App. LEXIS 14232 (5 <sup>th</sup> Cir., 2010)
6 <sup>th</sup>	<i>SPE Util. Contrs., LLC v. NLRB</i> , 2010 U.S. App. LEXIS 18132 (6 <sup>th</sup> Cir., 2010)
7 <sup>th</sup>	<i>Sheehy Enterprizes, Inc. v. NLRB</i> , 2010 U.S. App. LEXIS 18125 (7 <sup>th</sup> Cir., 2010 )
8 <sup>th</sup>	<i>NLRB v. Whitesell Corp.</i> , 2010 U.S. App. LEXIS 13045 (8 <sup>th</sup> Cir., 2010)
9 <sup>th</sup>	<i>UFUFCW Local No. 770 v. NLRB</i> , 2010 U.S. App. LEXIS 27018 (Aug. 23, 2010)
10 <sup>th</sup>	<i>Teamsters Local Union No. 523 v. NLRB</i> , 2010 U.S. LEXIS 6557 (Oct. 4, 2010)
11 <sup>th</sup>	<i>CSS Healthcare Servs. v. NLRB</i> , 2010 U.S. App. LEXIS 19236 (July 16, 2010)
D.C.	<i>Trump Marina Assocs., LLC v. NLRB</i> , 2010 U.S. App. LEXIS 19651 (Sept. 20, 2010)



## TOWARDS A BETTER UNDERSTANDING OF THE SURGE OF INTEREST IN BUSINESS ETHICS INSTRUCTION

John L. Keifer,<sup>++</sup> Mary Carter Keifer<sup>+++</sup>

### *Abstract*

*Our innovativeness and creativity are what make the American economy so dynamic and vibrant. However, the recent financial meltdown has called into question the very values by which our Nation has prospered for the past two centuries plus of our existence. It has also elevated interest in the role that ethics and sustainability should play in managerial decision making. The authors seek to address the underpinnings of the recent meltdown from a decisional standpoint; i.e., they seek to prescribe how public policy can be tailored to control the impact of such risks without doing harm to the ability of the private sector to remain competitive. The authors opine that there are at least two such sources contributing to this elevated interest. The first has to do with the “democratization” of abstract economic theory that has resulted in what the authors label “the tyranny of the singular metric.” The second has to do with the impact that technology has had on the rapidity with which businesses are able to create, modify or extend themselves both domestically and internationally into new or existing market space. The coupling of the two, the singular metric and the enablement of technology, it is contended, has exposed the global economy to very new and very dangerous systemic kinds of risks, such as the world recently experienced as a result of innovation in the area of financial instruments. While the US Government has sought to address the financial instrument risk belatedly in the case of the recent financial meltdown, it merits study to determine which other areas of our economy might be subject to such systemic risk. The authors conclude that further legislation may be required to avoid these sorts of risk and recommend in such cases that the most effective kind of regulation would be some form of market balkanization designed to offset the hazards inherent in entrepreneurship when it comes to market innovations. The goal would be the enactment of public policy that protects against such risk without undermining free market innovation and creativity needlessly.*

### **I. Introduction**

Market creation and exploitation is not a new phenomenon.<sup>1</sup> In fact, the notion of “creative destruction” has been with us since as early as the 1940s with the writings of Joseph

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<sup>++</sup> J.D., MBA, Lecturer, College of Business, Ohio University

<sup>+++</sup> J.D, Associate Professor of Business Law, College of Business, Ohio University

<sup>1</sup> Michael J. Sandel, in his book “Justice: What’s The Right Thing To Do?,” talks about how insurance companies saw an opportunity for making money when Congress, during the Civil

Schumpeter.<sup>2</sup> What then can explain this sudden, clarion call for instruction in business ethics<sup>3</sup> which has emerged in recent years?<sup>4</sup> What explains why the need for such instruction was not as heartily felt since the inception of business education? The authors argue that a revolution began in academic thinking in the 1970s that impacted dramatically the “game of business,” through the introduction of economic theory into the main stream of management thought and instruction. The effect of this was amplified by advances in information technology that have enabled firms to achieve immediate scalability by replacing organic growth with digital growth without the gestation period typical of firm and product growth over time. This was complemented by the removal of regulatory barriers that now permitted instant scalability to be

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War, gave commoners the ability to buy out their duty to serve, if conscripted, for \$300. By pooling premiums from multiple likely conscription candidates, they were able to meet the requirement on the behalf of their policy holders given the level of conscriptions. The legislation passed in an attempt to equalize matters between the rich and the working poor since the rich were able to pay the going rate of service substitutes for the sum of \$1000.

<sup>2</sup> The following quote of Schumpeter (*Capitalism, Socialism and Democracy*, New York: Harper, 1975 [orig. pub. 1942]), unlike convention economic theory, which largely hypothesizes on the basis of the immutable nature of industry structure, defines the elements along which change can and does occur. He states at page 84:

“It is still competition within the rigid pattern of invariant conditions, methods of production and forms of industrial organization in particular, that particularly monopolizes attention. But in capitalistic reality as distinct from its textbook pictures, it is not that kind of capitalism which counts *but the competition from the new commodity, the new technology, the new organization* (emphasis added)...competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives. This kind of competition is much more effective than the other as a bombardment is in comparison with forcing a door.

<sup>3</sup> Khurana, R. *From Higher Aims To Hired Hands: The Social Transformation of American Business Schools And The Unfulfilled Promise of Management As A Profession*. Princeton, 2007; and, Ghoshal, S. & Moran, P. “Towards A Good Theory of Management.” Birkinshaw, J. & Piramal, G. *Sumantra Ghoshal on Management: A Force for Good*. Prentice Hall, 2005, 21.

<sup>4</sup> In an earlier paper, the authors argued that the unit of analysis taught in business schools was largely the problem because it moved to the periphery issue of rightness and responsibility. See: Keifer, JL & Keifer, MC. “A Method for Embedding Business Ethics into Traditional Business Analysis,” 144-150, *Southern Journal of Business and Ethics*, Volume 1, 2009. In particular, it was the contention that focusing attention of firm profitability and not on firm sustainability largely served to distract decision makers from both spatial and temporal factors in arriving at their analysis. A focus on sustainability, it was argued, would broaden the focus of decision making to issues of social and environmental sustainability and not just to profits. Additionally, it would require firm decision makers to consider both the near term and long term effects of their strategy as well when it comes to profitability.

achieved without regard to geographic, sector, or industrial boundaries. The net effect of these developments was a heightened regard for firm performance coincidental with the ability to move into new market space overnight. When viewed in this light, it was probably inevitable that excesses in firm and individual behavior would likely be the outcome of such events.

The paper is divided into the following sections. The authors begin by explaining what they mean by the “tyranny of the singular metric” and how it came to govern management decision making. It is then argued that such effect from a risk standpoint was greatly exacerbated by changes in technology that allowed firms to expand, extend and/or modify their footprint dramatically with little more than a single keystroke. Our recent experience shows the importance of effective instruction in ethics and firm sustainability in the absence of public policies designed to corral potentially risky behaviors. The challenge for policy makers going forward, in the absence of such effective instruction, to outlaw risky behaviors that in a manner designed not to unduly undermine our national economic vibrancy.

## **II. The Genesis of the Tyranny of the Singular Metric—Economic Profit**

The genesis of the singular metric actually originated within the mathematics laden academic literature (particularly, the academic writings of Professor J. George Stigler of the Chicago School of Economics for which he was awarded the Nobel prize in 1982 for his seminal studies of industrial structures, functioning of markets and causes and effects of public regulation) but was popularized only beginning in 1979 through the publications of Michael Porter, Bishop William Lawrence University Professor at Harvard Business School. Porter’s contribution to management thought was his ability to “dumb down” elegant economic theory into manageable frameworks and dichotomies understandable to both the individual manager and the management academy; a feat that had a profound impact of business schools globally. It is contended that his opening of management thought to the practical applicability of economic theory had a cascade effect on the managerial class as managers soon were being judged based not on the growth of profits per se but instead economic profits<sup>5</sup>, a much higher hurdle.

In order to understand the impact of Porter’s work on management education<sup>6</sup>, it is necessary first to understand the limited role that the study of economics had on business decision making prior to Porter. The notable economists prior to Porter who wrote about firms and their management were John Commons (1934) who wrote about strategic or limiting factors

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<sup>5</sup> Porter, M.E. 1987. From competitive advantage to competitive strategy. HBR, May-June, pgs. 225-55. Porter discusses how managerial incentives were based on the size of the firm and its accounting profits; it then came to pass following Porter’s introduction of economic theory into the mainstream of management thinking that managers came to be judged on the degree of economic profits (i.e., the extent to which firms actually earned income above their cost of capital).

<sup>6</sup> Porter, M. E. (1980). *Competitive strategy*. Free Press.  
 \_\_\_\_\_ (1985). *Competitive advantage*. Free Press.

on firm choices,<sup>7</sup> Ronald Coase (1937) who wrote a short paper on why firms even exist given the efficiencies of the price mechanism in allocating resources for which he later received the Nobel Prize in Economics in 1991,<sup>8</sup> Joseph Schumpeter (1942) who addressed the role competition plays in societal innovations,<sup>9</sup> and Edith Penrose (1959) who originated the notion of firm dependent growth (suggesting heterogeneity among firms even within the same industries).<sup>10</sup> Business policy itself focused on the interdependencies across the disparate functions of the firm and the policies and procedures necessary to assure their coordination and integration.<sup>11</sup> Courses focused at the firm level addressed issues of fit with a firm's environment and it was during this period prior to Porter that SWOT (a firm's strengths, weaknesses, opportunities and threats) was originated as a firm level analytical tool.<sup>12</sup> Business strategy was taught on a case-by-case basis although Bruce Henderson, an economist and founder of the Boston Consulting Group, felt that economic theory would ultimately lead to a set of universals for decision making replacing intuition (i.e., traditional patterns of behavior which have been successful in the past).<sup>13</sup> Henderson also expressed some derision when it came to the mentality of managers and their affinity for quick and simple heuristics. He described his firm's development of a strategy group as "the business of selling powerful oversimplifications."<sup>14</sup>

It is important to note that nearly every development within the Academy prior to Porter treated firms as heterogeneous and embedded in their own unique situation. While Henderson's firm looked to develop oversimplified forms of analysis, such as the "experience curve", it basically was substituting a quantitative approach to measuring firm differences for a qualitative approach. It was left to Porter to put firms on notice that all firms share common features to the point that they could be considered homogeneous for purposes of analysis and decision making and that the driver to their success was thoroughly rooted in the income equation that had been around for decades if not centuries. What Porter unearthed for the erstwhile profession of managers and management academics was the simple truth that profit is a function of both revenues and costs and that any firm's success lies in the tradeoffs they make between those two functional units. Thus, profit was a function of either extraordinary revenues for a given cost structure or having a lower cost structure than your competition.

Given that businesses are essentially economic organizations, it is ironic that the full impact of the discipline of economics on firm decision making came relatively recently to the forefront. Not until Porter do we find in the strategy literature references to the notions of "value addition," "value creation," the value chain itself, competitive strategy couched in terms of a firm's choice of activities or the explicit mention of scale or scope effects (although you do see earlier references to functional area "synergies"). It was after Porter that we see for the first time

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<sup>7</sup> Commons, JR. *Industrial economics: its place in political economy*. (New York: MacMillian Co., 1934).

<sup>8</sup> Coase, RH. *The nature of the firm*. *Economica* 4, no. 16 (1937: 386-405).

<sup>9</sup> Schumpeter, J. *Capitalism, socialism, and democracy*. (New York: Harper, 1942).

<sup>10</sup> Penrose, E. *The theory of the growth of the firm*. (Oxford: Basil Blackwell, 1959).

<sup>11</sup> Ghemawat, P. *Strategy and the business landscape*. (Prentice Hall, 2010)

<sup>12</sup> Arrow, KR. *The concept of corporate strategy*. (Irwin, 1980: 69).

<sup>13</sup> Henderson, B. *The logic of business strategy*. (Ballinger, 1984: 10).

<sup>14</sup> Supra at ftn 28. *Interview with Seymour Tilles*, October 24, 1996 (ftn 35: 15). It is interesting to consider whether business school faculty have likewise fallen prey to the power of such oversimplifications.

references to concepts such as economic value added<sup>15</sup> or EVA<sup>TM</sup> in which analysts looked for economics returns in excess of the firm's cost of capital, the effect of which was to put much added pressure on top managers to exceed market expectations and simply not just have their firms be profitable.<sup>16</sup> Introduction of economic profits into the management lexicon brought with it the concepts of free cash flow, enterprise value, opportunity cost and the weighted cost of capital. Prior to Porter, profitability was measured in absolute terms and corporate executives were paid based on increases in absolute or nominal profitability without regard to the actual creation or destruction of corporate value in terms of economic profits.

Microeconomics was taught as part of the basic business school curriculum prior to Porter's time, but its importance was of interest primarily to accountants concerned with the cost-volume-profit relationship and to questions of market structure in general. It took Porter's works to expose the rich insights present in economic principles when it came to the sources of competitive advantage (i.e., firm profitability) through his suggested analysis both at the industry level and the firm level.<sup>17</sup>

The impact of Porter's work was palpable. At least one journal article details management thinking when it comes to firm diversification and links the prevalent thought to the decades in which they predominated.<sup>18</sup> In the 1950s and 1960s, with the rise of conglomerates, it was believed that general management capability was applicable across all industrial contexts regardless of the industrial experience of senior managers. This was followed in the 1970s with a focus on strategy as opposed to long-range planning as foreign competition increased. In addition, the work of Boston Consulting Group and its growth matrix analysis induced firms to see their businesses as a portfolio to be managed for optimum profitability, growth and cash flow. It was only in the 1980s that *value-based planning concepts* and their use to restructure firms become the dominant basis for creating corporate value.<sup>19</sup> This too was the time that markets for corporate control became ascendant with hostile corporate takeovers driven by rent seeking investors seeing firms whose market value was less than its liquidation value.<sup>20</sup> Among the leaders who became proficient in the takeover market was Kohlberg, Kravis & Roberts

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<sup>15</sup> Rapport, A. 1984. *Creating shareholder value*. Free Press.

<sup>16</sup> This trend has gone so far now that the Academy has developed the concept of Expectations-Based Management.<sup>TM</sup> See: Copeland, T. and Dolgoff, A. 2005. *Outperform with Expectations-Based Management: TM A State of the Art Approach to Creating and Enhancing Shareholder Value*. John Wiley & Sons, Inc.

<sup>17</sup> Porter's initial work in 1980 on competitive strategy came largely from industry organization (IO) economics and basically translated IO concepts into terms understandable to managers (and business school academician's for that matter).

<sup>18</sup> Goold, M & Luchs, K (1993). *Why diversify? Four decades of management thinking*. Academy of Management Executive, Vol. 7 No. 3.

<sup>19</sup> Rappaport, A. (1986). *Creating shareholder value: the new standard for business performance*. Free Press.

<sup>20</sup> This idea was first recognized in the 1960s. See: Manne, HG, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110. However, it received virtually no attention until the 1980s. See: Scharfstein, D, 'The Disciplinary Role of Takeovers' (1988) 55 *Rev Econ Stud* 85.

(KKR), deemed “the new financial capitalist.”<sup>21</sup> Further evidence of Porter’s impact is the fact that McKinsey & Company, founded in 1926, as an accounting and financial engineering firm, did not publish until 1990 its famed book entitled, “Valuation: Measuring and Managing the Value of Companies,” which is in its fourth edition.<sup>22</sup> This publication has led to others entering the fray when it comes to value-based management.<sup>23</sup> Prior to Porter, people did not think in such a singular way about using a simple metric applicable to all enterprises regardless of their industry or character. Since Porter, it has all been about value creation with a focus on the marginal benefits and costs associated with the tradeoffs firms must make to be successful strategically. This has served largely to leave questions of business ethics an anathema to questions of firm value creation.

### III. The Impact of Technology Enablement

Successful companies in any industry are market makers: they create and operate “institutions of exchange.” The smart ones seek to innovate transactions that successfully connect suppliers and buyers in new and interesting ways.<sup>24</sup> According to Spulber, industrial exchange mechanics can take on one or more of four different forms: creators of markets where none existed before; monitors of markets that look to arbitrage across them; providers of intermediation services between suppliers and buyers; and, creators of networks between suppliers and buyers which facilitate their interactions.<sup>25</sup> Among these, the ones that can create the greatest business risk to the firm are the creators (and exploiters) of new markets or new product or service offerings where none existed before.<sup>26</sup> Unlike existing markets which at least have the benefits of established industrial practices and standards to help guide decision making, new markets are typically without the advantages of any such legacies. Recent examples include the online trading in commodities and broadband by Enron,<sup>27</sup> and the marketing of credit default swaps (a form of creditor insurance developed by JP Morgan<sup>28</sup>), which sunk Lehman Brothers<sup>29</sup>

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<sup>21</sup> Baker, G. & Smith, GD (1998). *The new financial capitalists: Kohlberg Kravis Roberts and the creation of corporate value*. Cambridge Press.

<sup>22</sup> Koller, T, Goedhart, M & Wessels, D (2005).

<sup>23</sup> Martin, JD & Petty, JW (2000). *Value based management: the corporate response to shareholder revolution*. HBSP.

<sup>24</sup> Daniel F. Spulber, 1998, The Market Makers: How Leading Companies Create and Win Markets, New York, NY: McGraw Hill/Business Week Books.

<sup>25</sup> Id.

<sup>26</sup> Eichenwald, K. *Conspiracy of fools: a true story*. (Broadway 2005); McLean, B & Elkind, P. *The smartest guys in the room: the amazing rise and scandalous fall of enron*. (Portfolio 2004)

<sup>27</sup> Hamel, G. *Leading the revolution*. (HBSP 2000).

<sup>28</sup> Tett, G. “Fool’s Gold: The Inside Story of J.P. Morgan and How Wall St. Greed Corrupted Its Bold Dream and Created a Financial Catastrophe.” (Free Press 2009). It should be noted that Jamie Diamond upon arriving at JP Morgan and seeing the monies earned by other financial institutions pressured his risk analysts to allow JP Morgan to begin dealing in mortgage-backed securities but they resisted his entreaty. They simply could not see how these other institutions were able to hedge their downside risk of such investments.

and the acquisition of Bear Stearns. Just recently, the SEC announced its launch of an investigation into fast growing, largely unregulated markets for buying and selling shares of private companies like Facebook, Inc., and Twitter, Inc. Companies named in that investigation include SharesPost, Inc., an online marketplace for private investments.<sup>30</sup> One analyst stated,

“[t]his marketplace is like the early days of the ‘junk’-bond market, where companies are finding creative ways to raise capital.”<sup>31</sup>

Another relatively recent invention are cash-settled equity derivatives which allowed hedge firms to acquire options on common shares above the five percent threshold without triggering the Williams Act mandatory disclosure requirement due to the non-voting nature of the stock rights short of their exercise.<sup>32</sup>

Scholars have long recognized the importance of organic growth when it comes to the heterogeneity among existing firms even within the same industries.<sup>33</sup> This concept has largely become known as path-dependency. Among its characteristics are the firm’s culture, values and beliefs which serve to guide and even constrain decision making enabled by the long period of gestation of the firm historically.<sup>34</sup> What experience has shown through the financial meltdown and the examples above is that technology enables firms to enter new market space rapidly without the need for any physical infrastructure. This is true both in terms of expansion and in the development of increasingly sophisticated kinds of transactions as a result of increased computational power.

#### IV. Implications for Instruction in Business Ethics

Business schools are struggling with teaching business ethics in an effective way. A review of curricula of different schools generally shows it taught either as a general education course by the philosophy department or tucked safely into an existing course or courses in the

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<sup>29</sup> Tibman, J. “The Murder of Lehman Brothers: An Insider’s Look at the Global Meltdown.” (Brick Tower Press, 2009).

<sup>30</sup> Private-Share Trades Probed: SEC Searches for Conflicts in Market for Pieces of Firms Like Facebook, (2011, February 23). The Wall Street Journal (Eastern ed.), p. C1.

<sup>31</sup> Id., statement by Lou Kerner, a social-media analyst at Wedbush Securities, Inc.

<sup>32</sup> Davidoff, S. M. (2009). *Gods at War: Shotgun Takeovers, Government by Deal, and the Private Equity Implosion*. Wiley Publishing. For a thorough critique of the disclosure requirements in the Williams Act, see: Colombo, R. J. (2010). *Effective Disclosure Under the Williams Act*. Selected Works from the Selected Works of Ronald J. Colombo, retrieved March 28, 2011 from <

[http://works.bepress.com/cgi/viewcontent.cgi?article=1007&context=ronald\\_colombo&seidir=1#search=%22disclosure%20five%20percent%20under%20Williams%20Act%22](http://works.bepress.com/cgi/viewcontent.cgi?article=1007&context=ronald_colombo&seidir=1#search=%22disclosure%20five%20percent%20under%20Williams%20Act%22)>.

<sup>33</sup> Penrose, E. 1959, revised 1995. *The theory of the growth of the firm*. Oxford Press.

<sup>34</sup> Simons, R. 1995. *Levers of Control: How Managers Use Innovative Control Systems to Drive Strategic Renewal*. Boston: Harvard Business School Press.

curriculum. What impact such an approach has is uncertain especially when the overwhelming majority of instructional courses involve decision making not vetted for any ethical parameters.

A possible solution to this conundrum may lie in the work of Dan Ariely, a behavioral economist and author of the book, “Irrational Predictability: The Hidden Forces That Shape Our Decisions.”<sup>35</sup> He became intrigued during the last decade with the corporate scandals and the underlying assumption that the people involved were motivated by greed. However, he noted that these same individuals had given considerable amounts of their own money in addition to corporate money to charitable causes. He therefore looked to create an experiment in which he tested people’s honesty. He asked participants to complete 20 math problems and gave them only five minutes in which to do it. The first group were monitored and had to turn in their papers. On average the participants were able to complete just four of the problems for which they were compensated. The subsequent groups were offered various opportunities to cheat including self-reporting their score after destroying their paper and merely taking cash from a glass jar outside the experiment room based on the number they claimed to have gotten right without any reporting. Regardless of the circumstances or amounts of the compensation, the average claimed number of problems solved was seven. In other words, the participants did cheat but only by a small amount.

Ariely then altered the experiment slightly. He had groups of participants recall before participating in the math experiment the Ten Commandments. What he found was that the number of math problems claimed under the various testing scenarios returned to four, the number achieved by the control group. In other words, it was simply enough that the participants were asked to contemplate something moral that influenced their behavior.

What this may suggest is that students might actually benefit from an exposure to real life persons whose errant, immoral or unethical decisions have had a profound effect on their lives.<sup>36</sup> In this way, they can be mindful of the dangers lurking behind some of the decisions and alternatives with which decision makers might be confronted as they apply with singularity the norms of profits and returns. By revealing the ugly edges of past transgressions on the part of the business community, it might inspire students to avoid such pitfalls in their own careers.

A second possible solution is suggested by the recently published book entitled, “Reality is Broken: Why Games Make Us Better and How They Can Change the World.”<sup>37</sup> Its author, Jane McGonigal, is a Berkley Phd and director of game R&D at the Institute for the Future, “a nonprofit forecasting firm where she developed *Superstruct*, a massively multiplayer game in which players organize society to solve for issues that will confront the world in 2019.” “She masterminded *World Without Oil*, which simulated the beginning of a global oil crisis and inspired players to change their daily energy habits...[and] McGonigal also works with global companies to develop **games that build on our collective-intelligence infrastructure** -- like

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<sup>35</sup> Harper (2008). An equally delightful and insightful book is his “The Upside of Irrationality: The Unexpected Benefits of Defying Logic At Work and At Home (Harper 2010).”

<sup>36</sup> Krogh, E. 2007. *Integrity: good people, bad choices and life lessons from the white house*. Public Affairs.

<sup>37</sup> McGonigal, J (2011). *Reality is Broken: Why Games Make Us Better and How They Can Change the World*. Penguin Press.

*The Lost Ring*, a mystery game for McDonald's that became the world's biggest alternate reality game, played by more than 5 million people."<sup>38</sup>

What is conceivable is that online games could be engineered to challenge students to make business decisions in a competitive environment in which tradeoffs would need to be made in situations where moral or ethical issues could be embedded. It could measure success using societal norms including business success but would hold some danger for participants in terms of fines and possible imprisonment or damage to their individual, professional or business reputation over the long term. The goal would be the development of an online game of epic proportions.

## V. Conclusion

The goal of public policy needs to be the preservation of market innovation without attendant systemic risk like what happened to our financial markets. Prior to this past few years, business risk was largely seen as a firm level problem and not the subject of regulation. However, the confluence of technological innovation, globalization and deregulation has changed the competitive dynamics to the point that re-regulation may be necessary to re-balkanize some markets to avoid the possible catastrophic effect of firm level decisions on industries prone to systemic risk. Interestingly, what we have learned about the *wisdom of crowds*<sup>39</sup> coupled with McGonigal's work, could offer an alternative to blindly shooting in the dark when it comes to finding the right balance between freedom to innovate on one hand and legislative change on the other.

The authors have attempted to explain the sudden interest in business ethics given the long history of business education. An answer was found in a confluence of events beginning with the development of management metrics that have largely served to denude or decontextualize firm matters in favor of a one-size fits all approach to firm decisions. An additional argument is made that this approach and its impact on good decisions has been further exacerbated by development in technology which has changed the rapidity of firm growth dramatically as it has become less of an organic process in favor of a digital one. As a result of such events, it is believed that the delivery of business ethics, to be effective, must be reconsidered if it is to be impactful. It is also believed that future regulatory decisions that run the risk of a systemic meltdown like we just experienced may require the re-balkanization of markets to avoid such problems going forward. It is also suggested that the work being done at the Institute for the Future when it comes to online games could provide a pedagogical intervention as well as a way to design legislation in the future which takes into account how economic actors may react to a plethora of incentives and constraints.

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<sup>38</sup> Retrieved on February 28, 2011 from < [http://www.ted.com/speakers/jane\\_mcgonigal.html](http://www.ted.com/speakers/jane_mcgonigal.html)>.

<sup>39</sup> Surowiecki, J (2004) *The wisdom of the crowds*. Anchor



## **ETHICAL BEHAVIOR OF GRADUATE BUSINESS STUDENTS: AN EXAMINATION OF THE EFFECT OF AGE, GENDER, GPA, AND WORK EXPERIENCE**

**Sanjay Gupta, Department of Accounting & Finance, Valdosta State University**  
[sgupta@valdosta.edu](mailto:sgupta@valdosta.edu)

**Edward D. Walker II, Department of Management & International Studies, Valdosta State University**  
[eddwalker@valdosta.edu](mailto:eddwalker@valdosta.edu)

**Nancy J. Swanson, Department of Accounting & Finance, Valdosta State University**  
[njswanson@valdosta.edu](mailto:njswanson@valdosta.edu)

### Background

Lack of business ethics has been fairly well documented in both the academic and professional community. While earlier studies have shown that there is a positive influence of college education on a student's ethical decision making ability, this effect is weaker for business students and mostly absent for graduate business students. Ever since details emerged about the corporate scandals at Enron, Tyco, MCI WorldCom, and Arthur Anderson, among others, the Association to Advance Collegiate Schools of Business (AACSB) has struggled with steps higher education can take to prevent future ethical embarrassments (Verschoor, 2007). Adding fuel to fire is a recent occurrence at Duke University's Fuqua School of Business where nearly 10% of a first-year class was found guilty of cheating on a take-home final exam. This occurred in spite of the school's emphasis on ethical behavior. While some business schools are struggling to incorporate an increased ethics component to their curricula others believe that ethics cannot be taught.

There are several objectives of this research (1) examine the ethical choices graduate business students make when faced with an ethical dilemma in a controlled environment, (2) examine whether graduate business students actually make the choices they stated they would when placed in a similar ethical dilemma, and (3) determine whether age, gender, GPA, and work experience are factors that influence ethical choices made by graduate business students. To date, there has been no prior research that has examined the above and therefore provides a fertile area for research.

### Literature Review

In response to the plethora of business scandals which seem to emerge daily in media outlets, business educators and others have researched the issue of why and to what degree a business student cheats, with the goal of improving the ethics of business students and,

ultimately, the ethical climate of business. Studies have compared business students to non-business students, male to female students, older to younger students, traditional to non-traditional students, and graduate to undergraduate students. Others have examined cultural demographics, personality variables, and religious variables. All of these studies seem to have been conducted in the belief that if we were to know more about the students' ethical decision-making processes, then we might somehow be better equipped to instill in them a moral compass of sorts.

Jones (2010), who traced the history of ethical thought, contrasted two schools of thought regarding ethical decision-making. Citing Adam Smith, he posits that ethics is the conscious desire to work towards the good of all. In contrast, Marcus Aurelius spoke to the dangers of man pursuing his own interests. In their research Crittenden, Hanna, & Peterson (2009) suggest that business students are living in an age of the "cheating culture" where students cheat because everyone cheats. Further, they propose that students may be learning to incorporate this "cheating culture" with best business practices. Simkin & McLeod (2010) found only one statistically significant motivator for cheating: a student's "desire to get ahead". They also found only one significant deterrent: "a student's "moral beliefs." Interestingly, neither "culture" (the acceptability of cheating) nor "risk" (the penalty of getting caught) – two assumed deterrents – were found to be significant. Similarly, Bloodgood, Turnley, & Mudrack (2010) found that Machiavellianism (self-interest) was positively related to students' attitudes towards the acceptability of cheating. Also of interest is one the findings of Bateman & Valentine (2010). Their research suggested that a rules-based morals philosophy lead to more ethical behavior than a consequences-based moral philosophy.

Two factors that do seem to predict behavior that is more ethical are gender and age (Comer & Vega, 2008; Rucinski & Bauch, 2006; Peterson, Rhoades, & Vaught, 2001; Ruegger & King, 1992; Trevino, 1986). Borowski & Ugras (1998) conducted a meta-analysis of 35 studies on age and 48 studies on gender between 1985 and 1994. They found consistent links between ethical behavior and both female gender and older age. Women formed ethical attitudes at a younger age, and generally, people became more ethical as they aged. Later studies (Bateman & Valentine, 2010; Lau, 2010; McInerney, Mader, & Mader, 2010) again found that women score somewhat higher to much higher on ethicality.

The issue of age is somewhat contentious. Forte (2004) conclude that age played almost no role in the moral reasoning of business managers, while others (e.g. Eweje & Brunton, 2010) suggest that age does play a role. It is possible that age is a factor in students still developing moral maturity, but not for adults who have already matured. Morgan & Neal (2010) found that while age in some instances does not predict ethical behavior, work experience is positively related to ethical judgement. Boyd (2010) found generational differences suggesting that age, experience, or possibly cultural differences are at play. He suggests that the older generation subscribes to such ideals that rewards are commensurate with experience and that the younger generation tends towards self-gratification. Whether this difference is due to age or experience was not determined in this study.

Whether ethical decision-making can be taught to students has also been addressed. Several researchers (e.g. Comegys, 2010; Lau, 2010; and Shurden, Santandreu, & Shurden, 2010) conclude based upon surveys and case analyses that ethical education has a positive impact on students' ethical awareness, sensitivity, and/or reasoning. However, Bloodgood, Turnley, & Mudrack (2010) found that there was no relationship between students having taken an ethics course (or not) and their attitude towards cheating. So while students might be ethically aware and able to make the "right" decision, their attitudes might not be as ethical as we might hope.

A number of studies have recorded the reaction of customers who have been given too much change at a check-out counter (Muncy & Vitell, 1992; Steenhaut & Kenhove, 2005; Vitall, 2003). The dilemma is simply "Do I report the error and return the excess, or should I keep what is not rightly mine?" All of the studies showed that the higher the degree of relationship commitment between the customer and the retailer, the more likely he was to return the money. However, a significant number of customers admitted to keeping the extra money. These and similar studies (Chan, Wong, & Leung, 1998; Erffmeyer, Keilor, & LeClair, 1999; Polosky, Brito, Pinto, & Higgs-Kleyn, 2001) have examined the behavior of customers who have received more than that to which he was entitled.

Much research has been conducted to ascertain whether students will make the "ethical" decision when presented with a hypothetical case. Little research has focused on whether students will make the "right" decision when they themselves are confronted with an ethical dilemma. This study was created in a like manner to the customer studies. The goal was to determine whether a student's predicted ethical behavior was actually implemented by the student or whether the hedonism found in earlier studies manifested itself in reality. To accomplish this goal, MBA students were first presented with several hypothetical, ethical dilemmas and asked what course of action they would follow. Their actual behaviors were then tested by either inflating or deflating a grade they earned on a class assignment. Thus, the study was created to measure whether a student's future course of action in a real dilemma would follow his stated (or predicted) action.

### Data Collection

Since the current research involves the use of temporary grade changes which are not part of normal instruction, Institutional Review Board (IRB) approval was obtained prior to data collection.

Data was collected from students enrolled in MBA 7660 (Advanced Quantitative Methods) & WMBA 6040 (Advanced Quantitative Methods) during Fall 2009 and from students enrolled in WMBA 6010 (Managerial Accounting) & WMBA 6100 (Operations Management) during Spring 2010.

Students enrolled in the above courses completed a Business Ethics Quiz that was developed to measure students' stated ethical behavior when placed in 4 business scenarios. The scenarios contained vignettes of various ethical dilemmas faced by a business professional and

asked students to state their reaction to it, e.g. would a student return compensation wrongly paid to him as an employee. The Business Ethics Quiz was completed during the first three weeks of the semester and measured *Stated Behavior*.

The second survey designed to measure student *Actual Behavior* was implemented during the last two weeks of the semester. A random sample of students for whom *Stated Behavior* was measured in the first survey, were given erroneous grades on a major assignment. The correct grades had been communicated to these students earlier. For a sample of 30% of the students who completed the first survey, grades were inflated. Half of the sample was given a “substantial” grade inflation of 20% and the other half was given a “nominal” grade inflation of 10%. Similarly, for a random sample of 30% of the students who completed the first survey, grades were deflated. Half of the sample was given a “substantial” grade deflation of 20% and the other half was given a “nominal” grade deflation of 10%.

<b>Error type</b>	<b>Sample size</b>	<b>Type of Error</b>
Inflation	30%	15% - substantial inflation
		15% - nominal inflation
Deflation	30%	15% - substantial deflation
		15% - nominal deflation

Students had an entire week to report the error in grade to the professor. The objectives of the 2 surveys were to measure students’ *Stated Behavior*, students’ *Actual Behavior* and to determine whether students actually behave as they said they would when placed in an ethical dilemma.

In addition to student responses on both surveys, data was also collected for several additional variables for students completing these surveys: gender, age, GPA, and years of work experience.

**TABLE 1**  
**Method of Inflation/Deflation**

<b>Error type</b>	<b>Sample size</b>	<b>Type of Error</b>
Inflation	20% of students in class	1/2 - substantial inflation
		1/2 - nominal inflation
Deflation	20% of students in class	1/2 - substantial deflation
		1/2 - nominal deflation

Of the original sample of 155 students who completed the Business Ethics Quiz in phase 1 of the research, the final sample consisted of 71 students whose grades were either inflated or deflated and for whom data on all additional variables was obtained (Table 2).

**TABLE 2**  
**Descriptive Statistics**

<b>Respond</b>	<b>Grade Change (I=Inflate; D=Deflate)</b>	<b>Gender</b>	<b>Mean Age</b>	<b>Mean CGPA</b>	<b>N</b>
<b>N</b>	<b>D</b>	<b>F</b>	33.50	3.38	4
		<b>M</b>	33.23	3.36	13
	<b>I</b>	<b>F</b>	32.21	3.37	14
		<b>M</b>	34.50	3.52	16
<b>Y</b>	<b>D</b>	<b>F</b>	31.20	3.39	5
		<b>M</b>	35.33	3.51	15
	<b>I</b>	<b>F</b>	42.50	2.90	2
		<b>M</b>	40.00	3.13	2
<b>Total</b>					71

#### Development of Hypotheses

The following hypotheses (stated in their alternative form) will be tested:

- H1: Graduate business students whose grades are deflated will be more likely to report the error than graduate business students whose grades are inflated.
- H1a: The greater the amount of grade deflation, the more likely graduate business students will be to report the error.
- H1b: The greater the amount of grade inflation, the less likely graduate business students will be to report the error.
- H2: Graduate business students' stated behavior will have no correlation to their actual behavior.
- H3: Female graduate business students will be more likely to behave ethically than male graduate business students.
- H4: Non-traditional graduate business students will be more likely to behave ethically than traditional graduate business students.

H5: Graduate business students with relatively high cumulative GPAs will be more likely to behave ethically than graduate business students with relatively low cumulative GPAs.

The following definitions were used for the variables contained in our research. The students' answers to question 3 of the quiz became their "Stated Behavior." Question 3 asked whether the student would report and return compensation not earned. If the student selected choice of 'c' on question 3 of the quiz, which stated that the student *would* report and return compensation not earned, that response was considered to be ethical. Any other response to that question was considered unethical.

*Actual Behavior* was considered to be ethical if a student reported an inflated or deflated grade to the instructor, and unethical if he did not. A traditional student was defined as being less than or equal to 30 years old. A "high" cumulative GPA was defined as a GPA of 3.0 or higher on a 4.0 scale.

For H1 and H2, ethical behavior was defined as ethical when the student reported the grade error regardless of its direction, up or down. For H1, H1a and H2, the number of subjects were 71 (n=71). However, one could argue that even unethical students would report a grade deflation error. Ethical behavior is demonstrated when one reports a grade *inflation* error, something that is not in the student's self-interest. Therefore, all the remaining hypotheses are tested only on the sub-sample that experienced grade inflation errors (n = 34).

If students reported the grade not earned, and had predicted that they would return the compensation not earned, then their *Actual Behavior* would match their *Stated Behavior*. Students had an entire week or more to report the grade inflation to the professor.

*Fisher's exact test* is a more precise analysis than the standard chi-square test of independence. Dawson and Trapp (2004, p. 153) define this test as the following: "Fisher's exact test gives the exact probability of the occurrence of the observed frequencies, given the assumption of independence and the size of the marginal frequencies (row and column totals). . . The null hypothesis tested with both the chi-square test and Fisher's exact test is that the observed frequencies or *frequencies more extreme* could occur by chance, given the fixed values of the row and column totals. For Fisher's exact test, the probability for each distribution of frequencies more extreme than those observed must therefore also be calculated, and the probabilities of all the more extreme sets are added to the probability of the observed set." Fisher's exact test is recommended for analysis in preference to the less exact chi-square test of independence when either 2 x 2 classification tables are utilized (O'Rourke, Hatcher, and Stepanski, 2005) or when sample sizes are small (Dawson and Trapp, 2004). The chi-square test is not considered to be valid in cases where either the expected frequencies in a cell are less than five or the observed frequency is zero (SAS Learning Module). The *Fisher's exact test* is strongly recommended when either of these situations exists. Based on these recommendations, this study is analyzed with the *Fisher's exact test*.

## Results

H1: Graduate business students whose grades are deflated will be more likely to report the error than graduate business students whose grades are inflated.

The results support this hypothesis. Table 3 indicates that students with deflated grades are more likely to ask for correction of their grades than students with inflated grades. The results reflect a significant difference (Fisher’s Exact Test = 0.0001, ‘*p*’value = 0.0001). Of the 71 students whose grades were temporarily manipulated, 37 were deflated and 34 were inflated. Twenty (54%) of the students whose grades were deflated reported the error to the instructor. Four (12%) of the students whose grades were inflated reported the error to the instructor.

**TABLE 3**  
**Deflated versus Inflated Grades (Hypothesis H1)**

Change	Respond		Total
	N	Y	
<b>Deflated</b>	17	20	37
	23.94	28.17	52.11
	45.95	54.05	
	36.17	83.33	
<b>Inflated</b>	30	4	34
	42.25	5.63	47.89
	88.24	11.76	
	63.83	16.67	
<b>Total</b>	47	24	71
	66.20	33.80	100.00
Fisher’s Exact Test	Table Probability (P)		0.0001
	Two-sided Pr <= P		0.0001

H1a: The greater the amount of grade deflation, the more likely graduate business students will be to report the error.

The results do not support this hypothesis. Table 4 reflects an insignificant difference (Fisher’s Exact Test = 0.2259, ‘*p*’value = 0.7433). Graduate students will report deflation errors, regardless of the degree of deflation. That is, increasing the level of deflation does not increase the likelihood of the error being reported. This is not entirely unexpected, however, since most students wish to improve their grade, and thus would report any error that causes his/her grade to worsen.

**TABLE 4**  
**Grade Deflation: Substantial versus Nominal (Hypothesis H1a)**

Amount of Grade Deflation (Nominal=10%, Substantial=20%)	Respond		Total
	N	Y	
Frequency Percent Row Pct Col Pct			
<b>Substantial</b>	7	10	17
	18.92	27.03	45.95
	41.18	58.82	
	41.18	50.00	
<b>Nominal</b>	10	10	20
	27.03	27.03	54.05
	50.00	50.00	
	58.82	50.00	
<b>Total</b>	17	20	37
	45.95	54.05	100.00
Fisher's Exact Test		Table Probability (P)	0.2259
		Two-sided Pr <= P	0.7433

H1b: The greater the amount of grade inflation, the less likely graduate business students will be to report the error.

This hypothesis is not supported. Table 5 reflects an insignificant difference (Fisher's Exact Test = 0.2493, 'p' value = 0.6012). Graduate students are not likely to report any inflation error, regardless of the level of inflation. A likely explanation could be that students did not believe the amount of grade inflation would result in a higher grade and therefore were not likely to report it.

**TABLE 5**  
**Grade Inflation: Substantial versus Nominal (Hypothesis H1b)**

Amount of Grade Inflation (Nominal=10%, Substantial=20%)	Respond		Total
	N	Y	
Frequency Percent Row Pct Col Pct			
<b>Substantial</b>	14	3	17
	41.18	8.82	50.00
	82.35	17.65	
	46.67	75.00	
<b>Nominal</b>	16	1	17
	47.06	2.94	50.00
	94.12	5.88	
	53.33	25.00	
<b>Total</b>	30	4	34
	88.24	11.76	100.00
Fisher's Exact Test		Table Probability (P)	0.2493
		Two-sided Pr <= P	0.6012

H2: Graduate business students' stated behavior will have no correlation to their Actual Behavior.

As shown in Table 6, the results support this null hypothesis (Fisher's Exact Test = 0.4350, 'p' value = 0.5461). On the quiz, students were asked whether they would report an overpayment of compensation. Most responded that they would report the overpayment. This study then classifies that response as the students' *Stated Behavior*. This study classifies whether the student reports an inflated grade as the student's *Actual Behavior*. If an inflated grade is reported, *Actual Behavior* is considered to be ethical.

Results show that many students did not report grade inflation, even though they had indicated that they would report an overpayment of compensation. Sixty-nine students indicated that they would report the overpayment of compensation. However, 45 (65%) of these 69 students did not report the grade inflation. Therefore, these graduate students did not respond

ethically, even though they had stated that they would act ethically. Their *Stated Behavior* and *Actual Behavior* did not match.

Two students indicated on the Quiz that they would *not* act ethically. That is, they would not report an overpayment of compensation. As predicted, these students did not report an inflated grade. Thus, their *Stated Behavior* and *Actual Behavior* matched. However, even though the Actual Behavior was previously predicted by the students, the behavior was not ethical. Maybe some consolation can be taken from that fact that the students were being honest.

**TABLE 6**  
**Stated Behavior versus Actual Behavior (Hypothesis H2)**

Stated Behavior	Respond		Total
	N	Y	
<b>Frequency</b>			
<b>Percent</b>			
<b>Row Pct</b>			
<b>Col Pct</b>			
<b>Ethical</b>	45	24	69
	63.38	33.80	97.18
	65.22	34.78	
	95.74	100.00	
<b>Unethical</b>	2	0	2
	2.82	0.00	2.82
	100.00	0.00	
	4.26	0.00	
<b>Total</b>	47	24	71
	66.20	33.80	100.00
Fisher's Exact Test		Table Probability (P)	0.4350
		Two-sided Pr <= P	0.5461

H3: Female graduate business students will be more likely to report an inflated grading error than male graduate business students.

This hypothesis is not supported. Table 7 shows that ethical behavior is *not* influenced by gender (Fisher's Exact Test = 0.3959, 'p' value = 1.0000).

This result is interesting in the light of previous research. In contrast to this result, previous research has concluded that gender is the factor that most consistently predicts ethical behavior (Gupta et al, 2009; Comer & Vega, 2007; Ruckinski & Bauch, 2006; Peterson et al, 2001).

**TABLE 7**  
**Female versus Male Students (Hypothesis H3)**

Gender	Respond		Total
	N	Y	
<b>Female</b>	14	2	16
	41.18	5.88	47.06
	87.50	12.50	
	46.67	50.00	
<b>Male</b>	16	2	18
	47.06	5.88	52.94
	88.89	11.11	
	53.33	50.00	
<b>Total</b>	30	4	34
	88.24	11.76	100.00
Fisher's Exact Test		Table Probability (P)	0.3959
		Two-sided Pr <= P	1.0000

H4: Non-traditional graduate business students will be more likely to report an inflated grading error than traditional graduate business students.

This hypothesis is supported. That is, non-traditional graduate business students are more likely to report an inflated grading error than traditional graduate business students. Table 8 reflects a significant difference (Fisher's Exact Test = 0.0660, '*p*' value = 0.1052). Non-traditional graduate business students have been defined as those who are more than 30 years old. Therefore, it appears that ethical choices are influenced by the age difference, with the more ethical decisions being made by the older non-traditional students.

**TABLE 8**  
**Traditional versus Nontraditional Students (Hypothesis H4)**

Student Profile Nontraditional if $\geq 25$ ; Traditional if $< 25$	Respond		Total
	N	Y	
Frequency Percent Row Pct Col Pct			
<b>Nontraditional</b>	14 41.18 77.78 46.67	4 11.76 22.22 100.00	18 52.94
<b>Traditional</b>	16 47.06 100.00 53.33	0 0.00 0.00 0.00	16 47.06
<b>Total</b>	30 88.24	4 11.76	34 100.00
Fisher's Exact Test		Table Probability (P)	0.0660
		Two-sided Pr $\leq P$	0.1052

H5: Graduate business students with relatively high cumulative GPAs will be more likely to report an inflated grading error than students with relatively low cumulative GPAs.

As shown in Table 9, the results do not support this hypothesis (Fisher's Exact Test = 0.1589, ' $p$ ' value = 0.1801). These results indicate that graduate business students with high GPAs are just as likely to report an inflated grade as a graduate business student who is struggling academically.

A possible explanation of this result could be that the degree of grade inflation may not have been perceived to be enough to cause a change in the current grade.

**TABLE 9**  
**Cumulative GPA: High versus Low (Hypothesis H5)**

CGPA H= if >2.99; L= if <=2.99	Respond		Total
	N	Y	
Frequency Percent Row Pct Col Pct			
<b>High</b>	25	2	27
	73.53	5.88	79.41
	92.59	7.41	
	83.33	50.00	
<b>Low</b>	5	2	7
	14.71	5.88	20.59
	71.43	28.57	
	16.67	50.00	
<b>Total</b>	30	4	34
	88.24	11.76	100.00
Fisher's Exact Test		Table Probability (P)	0.1589
		Two-sided Pr <= P	0.1801

#### Limitations and Directions for Future Research

It is likely that student ethical behavior is driven by the extent of ethics education received. One limitation of this study is that we did not control for the degree of ethics education received by the students in prior courses. This would have been a very difficult variable to quantify since several students transfer from other universities. To do so would have required evaluating the kind, extent and quality of ethics instruction across the college, a daunting, perhaps impossible task. It is theoretically possible that the results of the study may have been affected by ethics instruction, either contemporaneous or prior to the current study. The degree to which student ethical behavior may be influenced by prior ethical educational training is, however, a critical question, and can provide some insight into the importance of an increased focus on ethics education in the graduate business curriculum.

Another limitation of this study is that the results of this research may have been affected by the absence of any consequences to the student decision to not report an error to the instructor. It is likely that student behavior may have been more ethical if there were negative consequences associated with their unethical behavior. Future research could include a penalty, such as a grade penalty or an extra assignment, to measure whether a negative consequence may impact student ethical behavior.

It is possible that an alternative variable to chronological age, such as maturity, may affect student ethical decision-making. Future research could attempt to distinguish between chronological age and “maturity” or “judgment.”

### Summary and Conclusions

Lack of business ethics has been fairly well documented in both the academic and professional community. While earlier studies have shown that there is a positive influence of college education on a student’s ethical decision making ability, this effect is weaker for business students and mostly absent for graduate business students.

Graduate business students’ stated ethical response (*Stated Behavior*) was first measured by their responses to 4 different scenarios on a Business Ethics Quiz, one of which asked students what they would do if they were given compensation not rightfully earned by them. In a follow up several weeks later, for students who responded to the Business Ethics Quiz, grades were either inflated or deflated to determine whether their *Actual Behavior* was consistent with their *Stated Behavior*.

The results of this research indicate that, when faced with an ethical dilemma, although graduate business students may state they will make ethical choices, their *Stated Behavior* had no correlation to their *Actual Behavior*. Additional findings indicate that graduate business students’ ethical choices are not influenced by their gender or GPAs. An interesting finding of this research, however, is that ethical choices are influenced by the age difference, with the more ethical decisions being made by the older non-traditional students.

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**BANKRUPTCY CODE: SECTION 727(A)(3):  
WHEN IS A DEBTOR'S RECORD KEEPING SUFFICIENT TO MERIT A  
BANKRUPTCY DISCHARGE?**

†William T. Mawer  
††Andrew F. Emerson  
†††John Love

**I. Introduction to Section 727(a)(3)**

It has long been an established rule that complete disclosure is a condition precedent to the granting of a bankruptcy discharge.<sup>1</sup> Thus, among its eight grounds for denial of a bankruptcy discharge, Section 727 of the United States Bankruptcy Code includes the debtor's failure to maintain sufficient documentation for creditors and the trustee:

§727. Discharge

- a. The court shall grant the debtor a discharge, unless . . .
  3. the debtor has concealed, destroyed, mutilated, falsified, or *failed to keep or preserve any recorded information*, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case . . . .<sup>2</sup> (emphasis added)

Courts have described the purpose of §727 as setting forth as a condition for discharge, that the debtor has maintained sufficient records to provide creditors with adequate information to ascertain the debtor's [financial] condition and track his financial dealings with sufficient accuracy for a reasonable period.<sup>3</sup>

Section 727(a)(3) was a derivation of former Bankruptcy Act Section 14(c) and is deemed one of those grounds for denial of discharge that represents a debtor's wrongdoing in, or in connection with, a bankruptcy case.<sup>4</sup> Thus, while the statute prohibits the intentional destruction of records, wrongful intent on the part of the debtor is not required since Section 727(a)(3) imposes an affirmative duty to preserve records.<sup>5</sup> Courts have held that, consistent with the "fresh start" policy underlying the Bankruptcy Code, Section 727(a)(3) should be

†William T. (Will) Mawer, J.D., Southeastern Oklahoma State University

††Andrew Emerson, J.D., Dallas, Tx.

†††John Love, Ed.D., Southeastern Oklahoma State University

<sup>1</sup> See, e.g., *In Re Underhill*, 82 F.2d 258 (2<sup>nd</sup> Cir.), cert. *denied*, 299 U.S. 546, 57 S. Ct. 9, 81 L. Ed. 402 (1936).

<sup>2</sup> 11 U.S.C. § 727(a)(3).

<sup>3</sup> *In Re Juzwiak*, 89 F.3d 424, 427 (7<sup>th</sup> Cir. 1996); *Cadle Co. v. Terrell*, 47 Collier Bankr. Cas. 2d (N.D. Tex, 2001), *aff'd.*, 46 Fed. Appx. 731 (5<sup>th</sup> Cir., 2002); *In Re Esposito*, 44 B.R. 817, 826 (Bankr. S.D.N.Y. 1984).

<sup>4</sup> House Comments, to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92. STAT. 2549 (1978).

<sup>5</sup> *In Re Schifano*, 378 F.3d 60 (1<sup>st</sup> Cir. 2004); *Meridian Bank v. Allen*, 958 F.2d 1226 (3<sup>rd</sup> Cir. 1992); *Union Planter's Bank, N.A. v. Conners*, 283 F.3d 896 (7<sup>th</sup> Cir. 2002); *In Re Wazeter*, 209 B.R. 222 (W.D.Mich. 1997); *In Re Riley*, 305 B.R. 873 (Bankr. W.D.Mo. 2004).

construed strictly against the creditor and liberally in favor of the debtor seeking a discharge.<sup>6</sup>

### B. Elements of Section 727(a)(3) and Rules of Construction

Courts have emphasized that the bankruptcy court retains wide discretion to determine the adequacy of the Chapter 7 debtor's records under Section 727(a)(3).<sup>7</sup>

Numerous courts have adopted a factors test to determine whether or not the documentation is sufficient to merit a discharge. Numerous courts have listed the following in determining the sufficiency of the financial records produced:

1. whether the debtor was engaged in business and the complexity and volume of the business;
2. the amount of debtor's obligations to be discharge;
3. the debtor's culpability in failing to keep or preserve books and records;
4. debtor's education, business experience, and sophistication;
5. customary business practices for recordkeeping in debtor's type of business;
6. the degree of accuracy disclosed by the debtor's existing books and records;
7. the extent of any egregious conduct on the debtor's part; and
8. the debtor's courtroom demeanor.<sup>8</sup>

Several other principles have emerged in the construction of Section 727(a)(3). For example, it is insufficient for the debtor to merely provide a verbal history or recollection of the business transactions.<sup>9</sup> It is also insufficient for creditors to be forced to undertake an independent investigation to reconstruct the debtor's financial history.<sup>10</sup> Financial records must be preserved so that the trustee and creditors are not left to rely on the credibility of the debtor's recitation of his financial records. The period in which records must be presented is a "reasonable period."<sup>11</sup> However, one court has attempted to place time restrictions on record keeping for the consumer debtor by pronouncing that in the absence of evidence of questionable prior dealings on the part of the debtor, the period of documentation preservation in a consumer case should be two years.<sup>12</sup>

The bankruptcy court is granted broad discretion in determining what are sufficient records that merit a bankruptcy discharge,<sup>13</sup> This has resulted in an incredible discrepancy in the outcomes of various cases either granting or denying discharge in various cases under Section 727(a)(3).

In order to prevail on an objection to discharge under Section 727(a)(3), a creditor or trustee must establish:

<sup>6</sup> *In Re Connors*, 254 B.R. 230 (Bankr. S.D.Ill. 2000), *order aff'd.*, 273 B.R. 764 (S.D.Ill. 2001), *aff'd.*, 283 F.3d 896 (7<sup>th</sup> Cir. 2002); *In Re Emerson*, 244 B.R.1 (Bankr. D.N.H. 1999); *In Re Green*, 81 B.R. 829 (Bankr. S.D.N.Y. 1988), *aff'd.*, 103 B.R. 83 (S.D.N.Y. 1989), *aff'd.*, 904 F.2d 34 (2<sup>nd</sup> Cir. 1990).

<sup>7</sup> *In Re Morando*, 116 B.R. 14 (Bankr. D.Mass. 1990); *In Re Kowalski*, 316 B.R. 596 (Bankr. E.D.N.Y. 2004); *In re McCall*, 76 B.R. 90 (Bankr. E.D.Pa. 1987); *In Re Womble*, 289 B.R. 836 (Bankr. N.D. Tex. 2003), *aff'd.*, 108 Fed. Appx. 993, (5<sup>th</sup> Cir. 2004); *In Re Drenckhahn*, 77 B.R. 697 (Bankr. D.Minn. 1987).

<sup>8</sup> *In Re Kowalski*, 316 B.R. 596, (Bankr. E.D. N.Y. 2004); *In Re Morris*, 302 B.R. 728 (Bankr. N.D.Okla. 2003); *In Re Brenes*, 261 B.R. 322 (Bankr. D.Conn. 2001); *In Re Blanchard*, 201 B.R. 108 (Bankr. E.D. Pa. 1996).

<sup>9</sup> *Brandt v. Carlson*, 231 B.R. 640 (Bankr. N.D.Ill. 2000); *In Re Rusnak*, 110 B.R. 771 (Bankr. W.D.Pa. 1990); *Robertson v. Dennis*, Cause No. 02-CV-1140-T-G (Bankr. E.D.La. 2002).

<sup>10</sup> *In Re Connors*, 254 B.R. 230 (Bankr. S.D.Ill. 2002); *In Re Volpe*, 317 B.R. 684 (Bankr. D.S.C. 2003).

<sup>11</sup> *In Re Strbac*, 235 B.R. 880 (B.A.P. 6<sup>th</sup> Cir. 1990); *In Re Self*, 325 B.R. 224 (Bankr. N.D.Ill. 2004); *Matter of Hughes*, 184 B.R. 902 (Bankr. E.D.La. 1995).

<sup>12</sup> *In Re Buzzelli*, 246 B.R. 75 (Bankr. N.D.Ill. 2006).

<sup>13</sup> *Id.*

1. that the debtor failed to maintain and preserve adequate records; and
2. that such failure makes it impossible to ascertain the debtors' financial condition and material business transactions.<sup>14</sup>

Once the creditor or trustee has made a prima facie case that the debtor has failed to preserve sufficient financial records, the burden of proof shifts to the debtor to demonstrate that the failure to keep adequate records was justified under all the circumstances.<sup>15</sup> Generally, the debtor's justification will be found in factors beyond his control, such as a natural disaster.<sup>16</sup> Once again, the bankruptcy court has wide discretion in determining the sufficiency of the records kept and preserved by the debtor.<sup>17</sup>

### C. Conflicting 727(a)(3) Decisions caused by Judicial Discretion

The broad discretion vested in the bankruptcy court to determine the sufficiency of records has caused, and the justification for non-preservation of records by the debtor has resulted in numerous irreconcilable decisions. Much of the conflict in the decisions can be attributed to a failure to agree upon what constitutes sufficient records to allow the trustee and creditors to see what has passed the debtor's hands. For example, numerous opinions state that the failure to maintain meaningful bank records and credit card statements constitutes grounds for denial of discharge.<sup>18</sup>

Other case decisions provide that a discharge should not be denied even when a debtor manages to produce only some of the cancelled checks, deposit slips, and bank slips that the debtor once had.<sup>19</sup> Such decisions should be contrasted with those in which the absence of complete bank records or the failure to maintain and preserve credit card statements was not

deemed a basis for denial of the discharge.<sup>20</sup> A primary factor in determining whether a debtor should be denied a discharge under Section 727(a)(3) is the relative sophistication of the debtor.<sup>21</sup> Numerous cases confirm that the Bankruptcy Code does not specify, in any respect,

<sup>14</sup> *In Re Dennis*, 330 F.3d 696 (5<sup>th</sup> Cir. 2003); *In Re Decker*, 595 F.2d 185 (3<sup>rd</sup> Cir. 1979); *In Re Womble*, 289 B.R. at 836 (Bankr. N.D. Tex. 2003), *aff'd.*, 108 Fed. Appx. 993, (5<sup>th</sup> Cir. 2004); *Meridian Bank v. Alten*, 958 F.2d 1226 (3<sup>rd</sup> Cir. 1992); *In Re Jones*, 327 B.R. 297 (Bankr. S.D.Tex. 2005).

<sup>15</sup> *Goff B. Russell Co. (In Re Goff)*, 495 F.2d 199 (5<sup>th</sup> Cir. 1974).

<sup>16</sup> *In Re Branch*, 54 B.R. 211, 215 (Bankr. D.Colo. 1985) (loss in fire); *In Re Johnson*, 68 B.R. 193, 200 (Bankr. D.Oregon 1986); *In Re Ciaregia*, 50 B.R. 455, 457 (Bankr. M.D.Fla. 1985) (theft of records).

<sup>17</sup> *Robertson v. Dennis (In Re Dennis)*, 330 F.3d 696, 703 (5<sup>th</sup> Cir. 2003).

<sup>18</sup> *The Cadle Co. v. Hughes*, 354 B.R. 801, 810-811 (N.D.Tex. 2006), *aff'd.*, 2009 U.S.App.LEXIS 2373 (5<sup>th</sup> Cir. Feb. 6, 2009); *The Cadle Co. v. Terrell*, 47 Collier Bankr. Cas.2d (M.B.) 728 (N.D.Tex. 2001); *aff'd.*, 46 Fed. Appx. 731 (5<sup>th</sup> Cir. 2002); *In Re Senese*, 245 B.R. 565, 576 (Bankr. N.D.Ill. 2000); *In Re Short*, 244 B.R. 889 (Bankr. E.D.Mich. 2000).

<sup>19</sup> *See, e.g., Vetri v Meadowbrook Mall*, 174 Bankr. 143, 146 (N.D.Fla. 1994); *In Re Fromman*, 153 B.R. 113, 118 (Bankr. E.D.N.Y. 1993); *In Re Schultz*, 71 Bankr. 711, 716-717 (Bankr. E.D.Ohio 1987).

<sup>20</sup> *In Re Splawn*, 376 B.R. 747 (Bankr. D.N.M. 2007); *In Re Saddler*, 282 B.R. 254 (Bankr. N.D.Fla. 2002) (**holding** that failure to produce cancelled checks for two checking accounts did not constitute a failure to maintain and preserve adequate records); *In Re Shoup*, 214 B.R. 166 (Bankr. N.D.Ohio 1997) (**holding that** failure to keep or produce cancelled personal checks did not warrant denial of discharge); *The Cadle Co. v. Duncan*, Adv. No. 03-4186 (Bankr. E.D.Tex. 2006), App. Pending (**holding that** failure to maintain complete bank records or credit card statements).

<sup>21</sup> *In Re Sendeky*, 283 B.R. 760 (B.A.P. 8<sup>th</sup> Cir. 2002) (**operator** of the family construction business not deemed a sophisticated investor and sloppy record keeping thus justified); *In Re Bridgeman*, 58 B.R. 91 (Bankr. S.D.Tex. 1986) (**owner** of a plumbing company not excused by "unsophistication" from denial of discharge under §727(a)(3) action); *In Re Minesal*, 81 B.R. 477 (Bankr. E.D.Wis. 1988) (**operator** of trucking business grossing six figures

what types of records or bookkeeping, if any, the debtor must keep or preserve to merit a discharge.<sup>22</sup> One bankruptcy court has sought to define the types of records that should be maintained by stating that “bank statements and credit card receipts or monthly statements form the core of what is necessary to ascertain the debtor’s financial conditions for purposes of assessing adequacy of the records...”<sup>23</sup>

The diversity and irreconcilable nature of decisions under Section 727(a)(3) are additionally manifested by cases addressing undocumented gambling losses by a debtor seeking a discharge. In this respect, a multitude of cases conclude that drug or gambling addictions or the debtor’s record-keeping habits in and of themselves do not justify a debtor from the requirement of maintaining records from which his financial condition prior to the bankruptcy might be ascertained.<sup>24</sup> The rationale used in various decisions that conclude that undocumented expenditures on gambling or drug purchases do not justify a discharge is rather elementary. Specifically, any debtor could make such claims of undocumented gambling losses or drug expenditures as a means to explain away a substantial discrepancy in assets at the time of the bankruptcy filing.<sup>25</sup>

In the face of all of these decisions finding no debtor justification for unsubstantiated gambling or drug losses, two cases find that a discharge can be granted to debtors with unsubstantiated records. More specifically, the court(s) in *Indian Head National Bank v. Mitchell* and *Cadlerock J.V. v. Sauntry* determined that the debtors’ oral explanations would be deemed sufficient to merit a discharge despite gambling losses that were largely undocumented.<sup>26</sup> In *Mitchell*, the creditor requested a denial under related Section 727(a)(5) based upon a failure to adequately explain a loss of assets. There was no documentation to justify the losses, but the court nevertheless granted a denial of the request, finding that the debtor’s oral explanation of the gambling losses was sufficient to merit a discharge.<sup>27</sup> While the gambling losses in *Mitchell* were modest, the court in *Sauntry* granted a discharge when the debtor approximated the undocumented gambling losses at \$500,000.<sup>28</sup> Debtor Sauntry was not deemed a “sophisticated debtor” despite the fact that he was college-educated and operated Texas Environmental Services. Moreover, the court conceded that there was no dispute concerning the absence of documentation:

Here, there is no dispute that the debtor’s have operated largely on a cash basis for several years or that it is impossible for them to document precisely how they spent all of their income.<sup>29</sup>

deemed a sophisticated business person who should be denied discharge for failure to maintain records); *The Cadle Co. v. Hughes*, 354 B.R. 801 (Bankr. N.D.Tex. 2006) (real estate developer who dealt in the construction of upscale residences deemed a sophisticated investor); *In Re Duncan, supra*, n. 19 (long time builder of upscale business homes not deemed to be a sophisticated debtor and bankruptcy discharge justified).

<sup>22</sup> *In Re Boone*, 236 B.R. 275 (Bankr. M.D.Fla. 1999); *In Re Feldman*, 242 B.R. 88 (Bankr. S.D.Fla. 1999); *In Re Delancey*, 58 B.R. 762 (Bankr. S.D.N.Y. 1986).

<sup>23</sup> *Oocns v. Neems*, 323 B.R. 316 (Bankr. E.D.N.Y. 2005).

<sup>24</sup> *In Re Dolin*, 799 F.2d 251, 252 (6<sup>th</sup> Cir. 1986); *Gaudet v. Callen*, 297 F.2d 227 (5<sup>th</sup> Cir. 1961); *In Re Waldroop*, 22 B.R. 284, 286-287 (Bankr. D.N.M. 1982); *In Re Davis*, 208 F.Supp. 508, 510 (E.D.N.Y. 1962); *Comerica Bank v. Brassler*, 321 B.R. 412 (Bankr. E.D.Mich. 2005); *Clark v. Clark*, 211 B.R. 105 (Bankr. N.D.Fla. 1997); *Cassady-Pierce Co. Inc.* (Bankr. E.D.Va. 1990); *Digman v. McMahon*, 116 B.R. 857 (Bankr. N.D.Fla. 1990).

<sup>25</sup> See, e.g., *Comerica Bank v. Brassler*, 321 B.R. 412 (Bankr. E.D.Mich. 2005).

<sup>26</sup> *Indian Head National Bank v. Mitchell*, 74 B.R. 457 (Bankr. D.N.H. 1987); *Cadlerock J.V. v. Sauntry*, 390 B.R. 848 (N.D.Tex. 2008).

<sup>27</sup> *Indian Head*, 74 B.R. at 462 & n. 2.

<sup>28</sup> *Sauntry*, 390 B.R. at 852 & n. 2.

<sup>29</sup> *Id.* at 855.

In *Sauntry*, the existence of the gambling losses was primarily supported only by the verbal testimony of the debtors. Thus, the creditors had no means of determining where, when, or how the supposed gambling losses occurred. Nevertheless, the court accepted the oral testimony of the debtors and granted the discharge.<sup>30</sup> This decision was reached despite the generally accepted principle that creditors should not be required to accept the debtor's oral testimony to detail from memory what transactions he engaged in and how funds were dissipated. Rather, creditors should be presented records of completeness and accuracy for purposes of substantiating the oral testimony.<sup>31</sup>

The extreme conflicting outcomes arise from the ad hoc considerations of bankruptcy courts in determining Section 727(a)(3) cases is also well set forth by comparing series of relatively recent decisions from the Northern and Eastern Districts of Texas. In *Cadle Company v. Terrell*,<sup>32</sup> a former real estate developer produced income tax records for 1995–1998, but failed to produce any credit card records or bank statements despite the fact that he sought to discharge at least \$59,000 of debt resulting from four credit cards.<sup>33</sup> In the face of a Section 727(a)(3) challenge, the court denied Terrell a bankruptcy discharge noting numerous other decisions that justify denial of a bankruptcy discharge when credit card receipts and bank statements are not kept.<sup>34</sup>

In contrast, in *Duncan*,<sup>35</sup> the debtor was a principal in various business entities that built upscale homes worth in excess of \$1,000,000. Nevertheless, the court concluded that Duncan was an “unsophisticated investor.” Duncan further contended that much of the property in controversy constituted the separate property of his non-bankrupt wife despite Duncan's failure to produce any document reflecting a partitioning of the marital assets. The court did not demand documentation substantiating Duncan's testimony that multiple assets did not constitute joint management community property to be included in the bankruptcy estate. Rather, the court merely accepted Duncan's verbal testimony that the property was in the nature of separate property of his wife. Duncan also completely failed to provide any credit card statements despite acknowledging the use of more than a dozen credit card accounts and his intent to discharge the debts from thirteen credit cards. Similarly, the debtor's production of bank statements were useless in the sense that the bank records did not identify the payees and were not accompanied by check registers, carbon copies, cancelled checks, or other documents disclosing the payees. Without these accompanying documents, the bank statements became nothing more than mere sheets of numbers without any meaningful content.

Nevertheless, the court in *Duncan* concluded that these bank statements and the absence of credit card statements did not justify the denial of discharge on the part of the debtor. The *Duncan* decision represents one of the more far-reaching decisions relating to the court's willingness to find sufficient documentation for creditors to ascertain loss or disposition of assets and various business transactions.

The *Duncan* decision may be contrasted with a decision of the Northern District of Texas in *The Cadle Company v. Hughes*.<sup>36</sup> In *Hughes*, the debtor had been a developer of high-end

<sup>30</sup> *Id.* at 858.

<sup>31</sup> *In Re Rusnak*, 110 B.R. 771 (Bankr. W.D.Pa. 1990); *Robertson v. Dennis*, Cause No. 02-CV-1140-T-G (Bankr. E.D.La. 2002); *In Re Carlson*, 263 F.3d 748 (7<sup>th</sup> Cir. 2001); *In Re Grisham*, 245 B.R. 65 (Bankr. N.D.Tex. 2000).

<sup>32</sup> *The Cadle Co. v. Terrell*, 47 Collier Bankr. Cas.2d (M.B.) 728 (N.D.Tex. 2001).

<sup>33</sup> *Id.* at 13.

<sup>34</sup> *Id.* at 14; *In Re Short*, 244 B.R. 889 (Bankr. E.D.Mich. 2000); *In Re Senese*, 245 B.R. 576 (Bankr. N.D.Ill. 2000); *In Re Craig*, 252 B.R. 828 (Bankr. S.D.Fla.2000).

<sup>35</sup> *The Cadle Company v. Duncan*, Adv. No. 02-46291 (Bankr. E.D.Tex. March 31, 2006).

<sup>36</sup> *The Cadle Company v. Hughes*, 354 B.R. 801 (Bankr. N.D.Tex. 2006).

homes for 25 years. However, during the 80's and 90's a series of multi-million-dollar judgments were taken against Hughes by various lending institutions in the wake of the downturn in the real estate market.<sup>37</sup> In order to avoid payment of the judgment, Hughes, operated mostly on a cash basis and neither maintained nor used a personal checking account, or held credit cards or any other type of account(s) at banking institutions.<sup>38</sup> Hughes simply maintained that he generally received paychecks from Hughes Properties Inc., a development company wholly owned by his wife; cashed the paychecks; and lived on a cash basis. Thus, there were no checks produced, no credit card statements produced, and in terms of financial records the only documents provided were tax returns, paychecks, and copies of cashier's checks used to pay his children's tuition.<sup>39</sup> The court concluded that given his background, Hughes was a sophisticated debtor. Moreover, the court concluded that while the tax returns are the "quintessential documents" in a personal bankruptcy case, there simply was no record that could be traced in order to determine what funds had passed through Hughes' hands and that discharge should be denied. Thus, these decisions reflect the diversity of opinion on what constitutes a sophisticated debtor, whether relatively complete bank records for a reasonable period must be produced in order to obtain a bankruptcy discharge, and whether credit card statements must be produced in order to fulfill the full disclosure requirement.

#### **D. Conclusion and Recommendations**

The foregoing survey of the law on Section 727(a)(3) reflects the wide discrepancies and extreme discretion vested in bankruptcy judges to determine the adequacy of the financial documentation produced by the debtor. It is wholly appropriate that bankruptcy judges have discretion in determining the sufficiency of the records given the myriad factual scenarios that arise under 727(a)(3) adversary proceedings. However, an arbitrariness has been created or allowed in the application of Section 727(a)(3). Courts diverge widely on the meaning of sufficient information to ascertain the debtor's financial condition and track his financial dealings for a reasonable period of time or what constitutes sufficient records to demonstrate what has passed through the debtor's hands. The problem of arbitrariness is also manifested in conflicting decisions on issues such as whether complete bank records must be produced, whether credit card statements must be maintained, what constitutes a "sophisticated debtor," and whether oral recitations of gambling or theft losses justifies discharge if a reasonable verbal explanation is provided by the debtor? In short, whether or not the debtor is provided a discharge under Section 727(a)(3) largely depends on the particular bankruptcy judge that the debtor is assigned..

While vesting wide discretion in the bankruptcy judge may be proper, the simple fact is that the appellate courts have, in large part, failed to set forth sufficient standards or presumptions that would form baselines or standards for a determination of whether sufficient records have been produced. For example, the appellate courts could create a presumption that the reasonable debtor will maintain complete bank and credit card records for a period of two years. Appellate courts might more closely define what it means to produce records showing or demonstrating what passed through the debtor's hands. For example, in a simple consumer bankruptcy case, is production of tax returns alone ever sufficient? In the absence of such documentation, the courts should clarify that bank records and credit card statements should be obtained by the debtor from the financial institutions and credit card issuers if they have been destroyed. Further, the appellate courts could and should offer guidance by providing some definition on what

<sup>37</sup> *Id.* at 805.

<sup>38</sup> *Id.* at 805.

<sup>39</sup> *Id.* at 805.

constitutes business sophistication. Further, the appellate courts may wish to define whether there is a blanket rule for denial of discharge in the presence of claimed expensive gambling losses with no substantiating documentation to reflect the particular gambling transactions. This inadequacy is particularly demonstrated by the Fifth Circuit, where the decisions of the various bankruptcy courts within the Fifth Circuit Court of Appeals are frequently affirmed with little or no analysis of the bankruptcy court's reasoning.

Moreover, given the absence of the precise standards, the reviewing courts are often bound by the factual findings of the bankruptcy judge since a "clearly erroneous" standard applies to overturning any such factual findings. Thus, the bankruptcy judges are left a large playing field in which their decisions are shaped on the supposed credibility of witnesses and the judge's own predilection as to what financial records a debtor should be required to produce. Greater consistency surrounding application of Section 727(a)(3) is desperately needed. Absent definitions and standards we are destined to continue with an uncountable number of irreconcilable decisions based upon the temperament of the bankruptcy judge and his or her personal feelings concerning when a discharge should be denied.



## **INTEGRATING CORPORATE SOCIAL RESPONSIBILITY WITH A RISK MANAGEMENT METHODOLOGY: A STRATEGIC APPROACH**

Lila L. Carden, College of Technology, University of Houston  
[lcarden@central.uh.edu](mailto:lcarden@central.uh.edu)

Raphael O. Boyd, Department of Management, Clark Atlanta University  
[rboyd@cau.edu](mailto:rboyd@cau.edu)

### ***Abstract***

*Organizations make decisions about the overall framework and approach that will be administered based on their beliefs about corporate social responsibility. In the current economic, social and work climate organizations are embracing the idea that entities must be accountable for business decisions and actions. The accountability includes being socially responsible when implementing processes and procedures. This paper will discuss a corporate social responsibility model, which will serve as a basis for conducting business ethically in order to impact the bottom line of organizations.*

### **I. INTRODUCTION**

In the current economic, social and work climate organizations are embracing the idea that entities must be accountable for business decisions and actions. The accountability includes being socially responsible when implementing processes and procedures that are enacted on a daily basis to ensure efficient and effective business operations. Additionally, organizations are pressed to ensure while maintaining social responsibility that the bottom line continues to increase.

McElhaney (2009) defined corporate social responsibility as “a business strategy that is integrated with core business objectives and core competencies of the firm, and from the outset is designed to create business value and positive social change, and is embedded in day-to-day business culture and operations” (p. 31). Cross and Miller (2001) defined corporate social responsibility within the context of ethical and accountable behaviors. The new movement towards accountability has grown from the idea of transparency. Customers, suppliers, organizations and employees are demanding more information about how businesses are conducted. Thus, corporate social responsibility activities minimize the exposure to corporate watch groups that help monitor unethical behavior in the United States as well as in other countries. Additionally, because of the various developments in technology, if an organization does not administer its operations ethically, its financial gains and reputation will probably suffer (Cross & Miller, 2001). Other reasons for responding with ethical behaviors include (a) complying with environmental regulations; (b) increasing investment activities due to perceived

socially responsible behavior; and (c) reducing interference from government based on regulations to behave ethically (Cross & Miller, 2001).

Words that are synonymous with corporate social responsibility include “corporate responsibility, corporate citizenship, social enterprise, sustainability, sustainable development, or corporate ethics” (Social Performance Map, n.d., p. 12). Additionally, corporate social responsibility has been aligned with the triple bottom line. The triple bottom line reflects an integrated understanding of business performance in which social, environment, and economic bottom lines are interdependent. The aim of a triple bottom line approach is to ensure business performance that is socially responsible, environmentally sound, and economically viable” (Social Performance Map, n.d., p. 12).

Corporate social responsibility is an important component of an organization’s overall corporate strategy. More importantly, the corporate social responsibility practices can be inconsistent as it relates to profits and social and environmental goals. For example, companies in the tobacco industry sell a product that is addictive and potentially deadly. Additionally, auto and oil companies emit pollutants and environmental toxins that can not only harm individuals but also other species (Heal, 2005). Thus, the goal of corporate social responsibility is to heighten the awareness of social, environmental and human issues and put pressure on organizations to adopt policies and procedures that focus on the importance of minimizing or eliminating practices that are harmful in the aforementioned segments.

Corporate social responsibility also provides benefits in the financial area including the areas of “human resources and talent management, reputation and branding, and operational cost savings” (McElhaney, 2009, p. 31). More specifically, social responsibility has been noted to decrease risks, reduce waste, improve relationships with regulatory groups, develop brand recognition, improve employee productivity and lower the cost of capital (Heal, 2005). Corporate social responsibility can be used as an implementation approach to select, hire, and retain top talent. Thus, the approach is used to indirectly impact the bottom line.

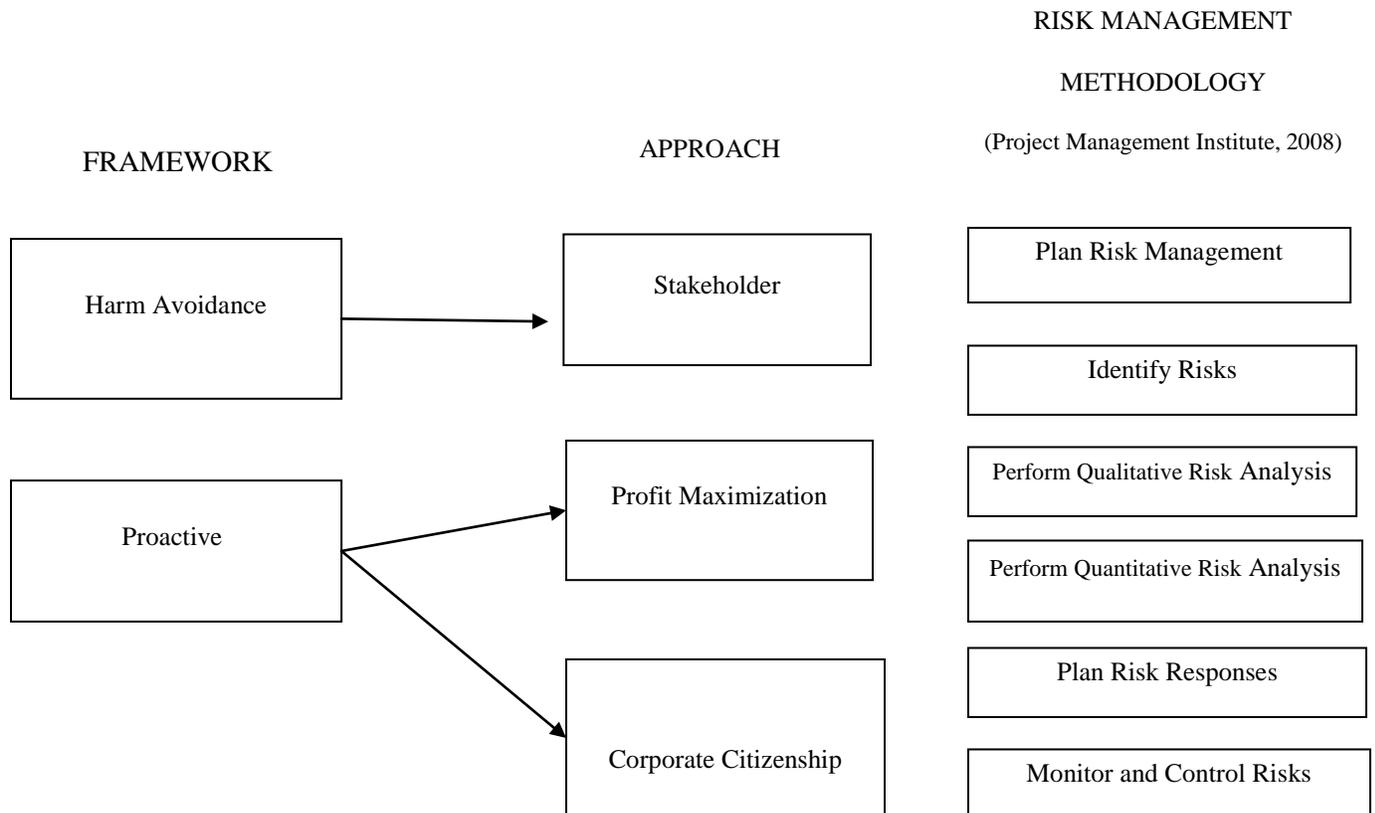
Organizations make decisions about the overall framework and approach that will be administered based on their beliefs about corporate social responsibility. For example, the Body Shop decided not to distribute cosmetics-related items that were tested on animals. Ben and Jerry’s, ice cream establishment, was founded based on the practice to share business successes with employees and the community. Both organizations administered the proactive approach to responsibility by focusing on corporate governance via a social business strategy (Glade, 2008). This paper presents a systematic approach to executing corporate social responsible activities using two business frameworks and three overarching approaches to a risk management methodology that was developed and sanctioned by Project Management Institute.

In figure 1 and section II of the paper, we present and discuss the corporate social responsibility model to serve as a basis for conducting business ethically as well as efficiently and effectively in order to impact the bottom line of organizations. The model includes:

1. Harm avoidance and proactive frameworks
2. Stakeholder, profit maximization and corporate citizenship approaches

3. Risk Management methodology defined by the Project Management Body of Knowledge

**FIGURE 1: CORPORATE SOCIAL RESPONSIBILITY MODEL**



**II. CORPORATE SOCIAL RESPONSIBILITY MODEL**

The corporate social responsibility model includes considering what strategic framework and approaches organizations should consider prior to executing a predefined risk management methodology. The two approaches to corporate social responsibilities falls within the framework of harm avoidance and a proactive approach. “Harm avoidance aims to minimize any negative economic impact, bad labor conditions, corruption, human rights abuse, and environmental degradations. It calls for compliance with intentionally accepted norms, guidelines, and standards and control of social and environmental risks, liability, and any negative impact” (Social Performance Map, n.d., p. 12). The proactive approach to corporate social responsibility strives to create added value for the entity as well as the stakeholders. Some of the activities that

support harm avoidance include philanthropy and community activities that promote business operations and enhance the environment as a whole (Social Performance Map, n.d.).

Some theorists are proponents of the idea that the sole responsibility of corporate social responsibility is profit maximization while others argue that other approaches need to be considered due to the changing nature of work and organizations (Social Performance Map, n.d.). According to the Social Performance Map (n.d.) some of the reasons include but are not limited to: (1) the growth and expansion of private business have created a push for social responsibility; (2) the inability of governments to resolve some social problems have increased expectation of organizations to resolve those problems; and (3) the growth of organizations that supports transparency via the Internet and other global communications.

The harm avoidance framework to corporate social responsibility is aligned with the *stakeholder approach*. The *stakeholder approach* to corporate social responsibility is inclusive of considering all parties that are impacted by economic, labor, corruption, human rights, and environmental issues. This approach stresses that stakeholders should not only be considered when making decisions that directly or indirectly impact them financially, socially, environmentally and morally but also consider the stakeholders as partners in planning, identifying, quantifying, responding to and monitoring and controlling risks (Cross & Miller, 2001). Thus, the premise of the approach is that an organization's duty to shareholders should be balanced against duties of stakeholders. The triple bottom line concept, as mentioned herein within this paper, is aligned with the stakeholder approach in that an organization's responsibility should be to the stakeholder and not to the shareholder (Glade, 2008).

Corporate decision makers should consider not only the welfare of shareholders but also that of stakeholders ---employees, customers, suppliers, communities, and any group that has a stake in the corporation” The reasoning behind this “stakeholder view” of corporate social responsibility is that in some circumstances, one or more of these groups may have a greater stake in company decisions than do the shareholders” (Cross & Miller, 2001, p. 116). For example, “a heavily indebted corporation is facing imminent bankruptcy. The shareholder-investors have little to lose in this situation because their stock is already next to worthless. The corporation's creditors will be first in line for any corporate assets remaining. Because in this situation it is the creditors who have the greatest “stake” in the corporation, under the stakeholder view, corporate directors and officers should give greater weight to the creditors' interests than to those of the shareholders” (Miller & Cross, 2001, pp. 116-117).

The proactive approach to corporate social responsibility is rooted in the idea that organizations should be financially sound and to promote practices and procedures that are socially beneficial to not only the organization but also to society (Cross & Miller, 2001). *Profit maximization* and *corporate citizenship* are words that are coined to more closely represent the proactive approach. Profit maximization theorists believe that “corporate directors and officers have a duty to act in the shareholders' interest. Because of the nature of the relationship between corporate directors and officers and the shareholder-owners, the law holds directors and officers to a high standard of care in business decision making” (Cross & Miller, 2001, p. 116). The underlying philosophy of this view is that corporations should use their resources to implement processes and procedures that increase profits as long as the practices are not deceptive. Thus, this view is

focused on organizations contributing to the common good by generating profits (Lantos, 2001). “Because our society regards income and wealth as ethical goals, corporations, by contributing to income and wealth, automatically are acting ethically” (Miller & Cross, 2001, p. 116).

*Corporate citizenship* proponents believe “that corporations should actively promote goals that society deems worthwhile and take positive steps toward solving social problems. Because so much of the wealth and power of this country is controlled by business, business in turn has a responsibility to society to use that wealth and power in socially beneficial ways” (Cross & Miller, 2001, p. 117). Corporations are now sharing their wealth to meet social issues via the establishment of separate nonprofit foundations. Corporate citizenship also includes judging corporations on the contributions and practices in the areas of employee and human rights and “employment discrimination, human rights, environmental concerns, and so on” (Cross & Miller, 2001, p. 117).

Risk, defined within the corporate social responsibility framework, includes the measure of the probability and results of not designing, executing and monitoring a corporate social responsibility plan (Kerzner & Saladis, 2006) The project objective for corporate social responsibility as noted by some organizations is to improve “employee motivation towards achieving, an awareness of how to achieve, company goals, along with an enhanced company image and better business techniques” (Story & Price, 2006, p.43). Story and Price (2006) reported that over 25% of the organizations cited that the main advantage of a risk management methodology is to provide structure using a user friendly approach. Risk as defined is the model is based on beneficial results obtained from making early sound project decisions.

The risk management methodology presented herein is an iterative process that is based on an emergent recognition of risks that includes feedback and contributions to the process by various internal and external stakeholders including project team members (Project Management Institute, 2008). The methodology can be used to execute either one of the three approaches presented herein: stakeholder, profit maximization, or corporate citizenship. The processes for risk management as defined by Project Management Body of Knowledge include: risk management planning, risk identification, qualitative risk analysis, quantitative risk analysis, risk responses planning and risk monitoring and controlling (Project Management Institute, 2008).

The processes within the risk management methodology will be explained in the following subsections of the paper by using examples from various industries including Verizon, JPMorgan Chase and Walmart. Verizon provides information technology, security and communications solutions and consulting services (Verizon Perspective: The Business of Risk Management, n.d.). Wal-Mart is a leader in retail and its goal is to assist customers in saving money to enable better living (Walmart About Us, n.d.). JPMorgan Chase is a global financial services firm with leadership in the banking industry (Corporate Social Responsibility Report, 2009). JPMorgan Chase’s business structure includes investment banking, retail financial services, card services, commercial banking, treasury and securities and asset management.

### A. Plan Risk Management

Plan risk management is “the process of defining how to conduct risk management activities for a project” (Project Management Institute, 2008, p. 273). Risk management planning involves gathering stakeholders including internal customers, external customers, senior leadership team, and the project management team to brainstorm the strategic path for the execution of corporate social responsibility activities (Kerzner & Saladis, 2006). Some identified stakeholders for organizations include financial stakeholders, legal/governmental organizations, employees, community and operational customers (Story & Rice, 2006).

A risk management plan is the deliverable generated from the risk management planning process. The plan includes how risk management will be structured and executed within the overarching framework (Project Management Institute, 2008). For example, Verizon’s approach to risk management is proactive and based on the belief that risks need to be managed across the organization within business units via Enterprise Risk Management (Verizon Perspective: The Business of Risk Management, n.d.). Additionally, Enterprise Risk Management focuses on employees’ behaviors and practices and changing the behaviors and practices so that the employees make better decisions that are more aligned with the company’s philosophy about social, environmental and financial goals and objectives. JPMorgan Chase believes that corporate social responsibility includes numerous approaches to execution with a focus on the double-bottom line, charitable contributions with employment input, environmental sustainability, supporting suppliers and promoting a culture of doing what is ethically and morally “right” (Corporate Social Responsibility Report 2009, n.d.). The execution of corporate social responsibility practices and processes within the risk management framework for companies like Verizon includes training, empowerment and trust of employees prior to and during operational decision making.

### B. Identify Risks

Identify risks is the process of assessing which risks may be realized during a project and documenting the characteristics (Project Management Institute, 2008). The tools and techniques that are used to identify risk include brainstorming, interviewing, SWOT analysis, checklist analysis, assumptions analysis, and diagramming techniques including cause and effect, influence diagrams and process flows (PMI Global, 2008). One way to view risk identification is by a Risk Breakdown Structure (RBS). The structure includes categorization of risks including technologies, production methods, contractual terms, and social and environmental impacts (Testa, n.d.).

JPMorgan Chase may identify the following as the high level categories noted in the risk breakdown structure: economic, operations, technology, environment, social, human rights, and society (Corporate Social Responsibility Report, 2009). More specifically, JPMorgan Chase’s environmental risk management policy uses the Equator Principle as a framework for identifying, assessing and managing environmental and social risk related to project financing (JPMorgan Chase: Environmental Risk Management Policy, n.d.). This principle is more aligned with harm avoidance by identifying potential violators in advance. The principle categorizes projects by high, medium or low environmental or social risks. If a project is categorized as high

or medium then the borrower is required to complete an Environmental Assessment. An example of some of the issues addressed in the assessment include sustainable development hazards, hazardous and dangerous substances, occupational safety and health, fire prevention, land acquisition and use, environment and social alternatives, efficient use of energy, waste minimization (Heal, 2005). After the risks have been identified organizations develop databases to house the risks including “the identified risks, list of potential responses, root causes of risk, and updated risk categories” (Kerzner & Saladis, 2006, p. 209).

### C. Perform Qualitative Risk Analysis

Perform qualitative risk analysis includes “the process of prioritizing risks for further analysis or action by assessing and combining their probably of occurrence and impact” (Project Management Institute, 2008, p. 273). Qualitative risk techniques are usually easy to apply and yields rank ordering to identify risks to allow for easier selection of the higher ranking items for further analysis (Kendrick, 2009). Some of the tools and techniques that are used to execute qualitative risk analysis include risk probability and impact assessment, probability and impact matrix, risk categorization ranking, and risk urgency assessment (Kerner & Saladis, 2006). More specifically, the risk categorization ranking usually lists the risks as high, medium, or low. The outputs from the aforementioned tools and techniques include (a) a ranking or priority lists including a low priority watch list, (b) risks categories, and (c) a list of risks that require additional analysis (Kerzner & Saladis, 2006).

### D. Perform Quantitative Risk Analysis

Perform quantitative risk analysis includes “the process of numerically analyzing the effect of identified risks on overall project objectives” (Project Management Institute, 2008, p. 273). The tools and techniques that are used to execute quantitative risk analysis include interviewing, expert judgment, sensitivity analysis, expected monetary value, decision trees and modeling and simulation. More specifically, sensitivity analysis uses worst case “what if” scenarios to identify the overall project impact for identified risks (Kendrick, 2009). For example, JPMorgan Chase within the operating category may use expert judgment to assign an audit score and to develop risk evaluation rankings. The outputs from the aforementioned tools and techniques include “updates to the risk register, probabilistic analysis of the project, the identified probability of achieving project objectives, and prioritized list of quantified risks” (Kerzner & Saladis, 2006, p. 210).

### E. Plan Risk Responses

Plan risk responses include the process of developing opinions and approaches to maximize opportunities and minimize threats (Project Management Institute, 2008). The tools and techniques used to execute risk response planning include identifying strategies for negative and positive risks. The strategies for negative risks include transfer and mitigate. Transfer includes shifting the responsibility to other resources and mitigate includes reducing the impact of the negative risk or threat. For example, Walmart mitigates the impact of selecting suppliers that may cause financial, social and environmental issues by categorizing the suppliers via an index on price, quality, sustainability, and stock statistics (McElhaney, 2009). The strategies for positive risks include exploit, share, enhance and accept. Exploit includes eliminating the

uncertainty associated with a particular upside risk by ensuring the opportunity definitely happens” (Project Management Institute, 2008, p. 304). For example, exploiting occurs when organizations assign the more competent resources to reduce the number of toxins from a known oil spill. Sharing includes defraying an allocated portion or all of the ownership to another party by obtaining health and safety insurance (Project Management Institute, 2008). Enhance includes activities that increase the opportunity for the exposure and acceptance includes obtaining gains from the risk if executed.

#### F. Monitor and Control Risks

Monitor and control risks is “the process of implementing risk response plans, tracking identified risks, monitoring residual risks, identifying new risks, and evaluating risk process effectiveness throughout the project” (Project Management Institute, 2008, p. 273). The tools and techniques include risk audits, variance and trend analysis, technical performance review and status meetings. The financial performance indicators are used to determine whether the company’s operational strategy yields competitive and investor advantages. The social, ethical and environmental performance indicators are more focused on aligning the economic goals with the social goals to continue to satisfy stakeholders (Testa, n.d.).

As illustrated in the article by Story and Price (2006), select organizations reported they used the following performance indicators to track, monitor and control risks: financial, audits, employee exits, number of safety infractions and media publicity. Additionally, JPMorgan Chase tracks and monitors, and evaluates economic, market presence and indirect economic impacts. More specifically, some of JPMorgan Chase’s economic indicators include: (a) defined benefit plan obligations; (b) hiring procedures, (c) range or ratios related to comparing standard and minimum wages, (d) impact of investments and services offered for public benefit (Corporate Social Responsibility Report 2009, n.d.). The outputs to the aforementioned process includes “risk register updates, requested changes, recommended corrective actions, recommended preventive actions, updates to organizational process asses, project plan updates” (Kerzner & Saladis, 2006, p. 211). In summary, key ideas for risks monitoring and control include (a) collecting data related to project status; (b) monitoring variances and trends in schedules, resources, and scope; (c) communicating clearly and frequently; and (d) conducting ongoing project reviews (Kendrick, 2009).

### III. CONCLUSION

“In the twenty-first century marketplace, businesses are increasingly showing signs of becoming conscious of ethics and human rights as well as being economically, environmentally and socially active and responsible” (Kanji & Chopra, 2010, p. 119). Implementing various approaches to corporate social responsibility, as a competitive strategy, links responsibility to core business processes and procedures which improves execution of risk management by expanding strategic intelligence and awareness of practices that are related to economic, environmental, financial and social issues. Benefits related to executing a corporate social responsibility model include financial gains, improved company image, proactive strategy for identifying and handling risks and developing a culture for implementing ethical practices and behaviors (Kanji & Chopra, 2010). The model presented herein can be used by an organization

to execute its corporate social responsibility strategy. The model considers the harm avoidance as well as the proactive approach as overarching frameworks that support three defined strategic approaches including stakeholder, profit maximization and corporate citizenship.

Organizations should also consider maximizing the benefits of corporate social responsibility after adoption of various processes and procedures. Story and Price (2006) recommended a framework for maximizing the benefits of corporate social responsibility activities including (a) noting and benchmarking performance indicators, (b) deploying adequate management systems, (c) disseminating achievements and non-achievements, and (d) monitoring feedback to measure achievement and failures. Additionally, Project Management Institute (2009) has identified the following critical success factors for risk management execution: (a) creating a culture that recognizes the value of risk management; (b) individual commitment; (c) communication channels that are open and honest; (d) organizational commitment; (e) risk efforts need to be aligned with the organization's risk beliefs and practices; and (f) risk management executed with the project management framework (Project Management Institute, 2009). Thus, corporate social responsibility includes a model herein that considers an ongoing process of identification, assessment, response planning, and monitoring and control.

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