Table of Contents
Mustang Journal of Law and Legal Studies
Volume 5 (2013)

Title . . . . . 1
Editor’s Notes . . . . . 3
Advisory Editors . . . . . 5-6
Table of Contents . . . . . 8
Announcement for Mustang Las Vegas Conference . . . . . 9
Announcements for Mustang Journals . . . . . 10-14
Best Paper Award Winners . . . . . 15

Karen Hosack & Joseph Solberg . . . . . 17
Punitive Damages: Does a Bright Line Exist?

Raymond Placid, Daniel Fernandez, & Christine Wright-Isak . . . . . 32
The Folklore of Academic Freedom in a Public University

David Vance . . . . . 47
Is the Federal Income Tax Unconstitutionally Vague?

Nicholas Jewczyn . . . . . 64
Tenets of Mergers and Acquisitions Theory: The Wave from 1965 to 1990

Peter Bell . . . . . 79
A Case Study Analysis of Israeli Organised Crime (IOC) (1990-2005):
Applying the Crime Business Analysis Matrix (CBAM)

Marty Ludlum, Sergey Moskalionov, Vijay Ramachandran,
& Justin Teeman . . . . . 98
Maturity, Gender and their Influence on Ethical Orientations of Future Business Managers
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Oklahoma City, Fall, 2012 Conference:

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Paper: Distance to the Border: The Impact of Own and Neighboring States Sales Tax Rates on County Retail Activity

Daniel Adrian Doss, Russ Henley & David McElreath, University of West Alabama

Ralph Bourret & Dana Roark, Northwest Oklahoma State University
Paper: Are Routine Retiring CEOs More Closely Monitored in their Last Year?
PUNITIVE DAMAGES: DOES A BRIGHT LINE EXIST?

Karen A. Hosack*
Illinois State University

Joseph J. Solberg
Illinois State University

ABSTRACT

Punitive damages have been part of the legal landscape throughout history, and soon became a part of the common law in the United States. As the size and frequency of awards increased, the United States Supreme Court addressed the due process issue of excessive awards. In Gore and State Farm, the Court provided a framework for the analysis of punitive damage awards, but avoided drawing bright lines. The Court then blinked when presented with Williams, a case with seemingly excessive punitive damages. This paper reviews the guidelines established by the Court, and then analyzes five recent lower court cases decided after Williams.

INTRODUCTION

In BMW of North America v. Gore1 and State Farm Mutual Automobile Insurance Co. v. Campbell,2 the United States Supreme Court established guideposts for courts to follow in an effort to keep punitive damage awards within the parameters of the Due Process Clause of the United States Constitution.3 Philip Morris USA, Inc. v. Williams4 tested the limits of the guideposts when punitive damages which were ninety-eight times compensatory were awarded in a lawsuit against the tobacco company. After Williams diverged so dramatically from the Court’s perceived jurisprudence, we wondered what lower courts would do in the post-Williams world. This paper will review five cases decided in the aftermath of Williams. It will first provide a brief historical overview of punitive damages jurisprudence. It will then review the Gore and State Farm decisions, which created the guideposts. Next, it will discuss Williams and the judicial battle between the Oregon state courts and the United States Supreme Court. Finally, it will analyze five cases decided after Williams: four from the state courts of California, Nevada, Florida and Oregon, and one from the Seventh Circuit Court of Appeals, in order to illustrate various approaches taken by courts in different jurisdictions.

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3 U.S. CONST. amend. XIV, section 1.
HISTORICAL OVERVIEW OF PUNITIVE DAMAGES

The concept of punitive damages has been part of the legal landscape throughout recorded history, beginning perhaps as far back as 4000 years ago with the Code of Hammurabi. They were also a part of Hittite law, the Code of Manu and the Bible, with all recognizing certain behaviors as requiring more severe consequences than others.

England developed a system of fines during the thirteenth century which were used by the government in civil and criminal cases. During the eighteenth century, the idea of exemplary damages was acknowledged in the recorded opinions, Huckle v. Money and Wilkes v. Wood, both decided in 1763. Within a short time, England permitted punitive damages in a variety of cases.

Courts in the United States soon followed suit. In the 1784 South Carolina case, Genay v. Norris, exemplary damages were awarded against the defendant physician who had laced the plaintiff’s drink with Spanish Fly. In 1791, a New Jersey court instructed the jury to consider punitive damages against a defendant who had impregnated the plaintiff’s daughter. The United States Supreme Court, at least in dicta, acknowledged that punitive damages may be an appropriate remedy in Day v. Wentworth, an 1852 decision. By the early 1900s, a majority of states had enacted legislation allowing for punitive damages. Because courts recognized that punitive damage awards serve important state interests with respect to deterrence and punishment, states have historically had wide latitude to establish their own procedures regarding such awards.

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7 For example, Exodus Chapter 22:1 states that “If a man steals an ox or sheep and kills or sells it, he shall pay five oxen for an ox, or four sheep for a sheep.” In Chapter 19 of Luke’s Gospel, Zacchaeus, a tax collector, offers to pay back four times the amount he has cheated. Luke 19: 1-8.
8 95 Eng. Rep. 768 (K.B. 1763). The case involved the arrest of the plaintiff for allegedly libeling the King. The plaintiff received damages of three hundred pounds, though compensatory damages of twenty pounds would have been appropriate. Id.
9 98 Eng. Rep. 489 (K.B. 1763). In this case a jury awarded punitive damages to a plaintiff whose house had been searched and property confiscated under an improper warrant. Id.
10 1 S.C.L. (1 Bay) 6 (1784).
11 Coryll v. Colbaugh, 1 N.J.L. 77 (N.J. 1791). The Justice told the jury that they “were not to estimate the damages by any particular proof of suffering or actual loss: but to give damages by example’s sake, to prevent such offenses in the future…” Id.
12 54 U.S. 363 (1852). The case involved a claim of trespass against the defendant. Justice Grier wrote that it is appropriate for a jury to “inflict what are called exemplary, punitive, or vindictive damages upon a defendant, having in view the enormity of his offense rather than the measure of compensation to the plaintiff.” Id. at 371 (dictum).
13 See Efting, supra note 6 at 76.
14 See 1 Linda L. Schlueter, Punitive Damages §1.4(A) (5th ed. 2005).
PRE-GORE CONSTITUTIONAL CONCERNS

As the size and frequency of punitive damages began to increase, constitutional challenges began to emerge. An Eighth Amendment argument was raised in *Browning-Ferris Industries of Vermont, Inc. v. Kelco Disposal, Inc.* a case decided in 1989. The jury had awarded Kelco $6 million in punitive damages in addition to compensatory damages of $51,146 (a ratio of 117 to 1). The defendant argued that this violated the Excessive Fines Clause of the Eighth Amendment. However, the Court ruled that the Excessive Fines Clause did not apply to cases between private parties.

*Pacific Mutual Life Insurance Co. v. Haslip,* decided in 1991, signaled a shift in the Court’s punitive damages jurisprudence. Even though the award was upheld, Justice Blackmun’s majority opinion suggested that a four to one punitive to compensatory ratio, as was the case in *Pacific Mutual,* might approach the line of constitutionality. *Pacific Mutual* was followed in 1993 by *TXO Production Co. v. Alliances Resources,* a case in which the Court, perhaps surprisingly, upheld a $10 million punitive damage award. This amount was 526 times the compensatory damages of $19,000 awarded in the case. The Court was cognizant of the disparity, but Justice Stevens’ plurality opinion took note of the potential harm that could have been caused to the plaintiff and other potential victims by the defendant’s “fraud, trickery and deceit.” Though there was no majority opinion in the case, a majority of the justices did not believe that due process concerns required that the award be overturned.

Finally, in *Honda Motor Co. Ltd., et al. v. Oberg,* decided in 1994, the Court, on procedural due process grounds, overturned a punitive damages award. An Oregon jury had awarded Oberg $919,390 in compensatory damages and $5 million dollars in punitive damages in a products liability case brought against the company. The Court ruled that a provision in the Oregon Constitution, which provided that no fact tried by a jury could be re-examined unless a court could say there was no evidence to support the verdict, violated due process.

GORE AND STATE FARM

*Gore* involved a paint job and acid rain. Dr. Gore bought a BMW, and while the car was in transit across the Atlantic to Alabama, it was hit by acid rain, which damaged the paint. The dealer who sold the car to Dr. Gore touched it up and sold the car to him without disclosing that fact. Upon discovery, Gore sued for fraud. He was awarded $4,000 in compensatory damages at

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17 See Miller, supra note 5 at 525-26.
19 Id.
20 Id. at 275.
22 Id. at 23-24.
23 509 U.S. 443.
24 Id.
25 Id. at 462.
27 Id. at 418.
28 Id. at 432.
29 Supra note 1.
30 Gore, 517 U. S. at 563.
trial and $4 million in punitive damages (emphasis added). The Alabama Supreme Court reduced the punitive award to $2 million, or five hundred times the compensatory amount. The United States Supreme Court reviewed the punitive damages award and remanded the case to the Alabama courts to reconsider the amount. In its opinion, the Court articulated three guideposts for courts to follow in awarding punitive damages so that they comport with due process. The first is the degree of reprehensibility in the defendant’s conduct. The second is the ratio of punitive to compensatory damages. The final guidepost concerns the relationship between possible civil penalties for the conduct and the punitive damages awarded.

The Court then analyzed the facts of Gore in light of the guideposts. It determined that the behavior was not overly reprehensible because the harm caused to Dr. Gore was economic and not physical. It determined that the ratio of 500 to 1 regarding punitive to actual damages violated due process. Finally, the Court noted that the extent of civil penalties available against BMW was a $2000 fine under Alabama’s Deceptive Trade Practices Act. Upon applying the guideposts to the facts of Gore, the Court ruled that the punitive damage award was unconstitutional on due process grounds.

State Farm, decided seven years after Gore, involved a car crash. The lawsuit against the company involved its alleged bad faith for failing to settle a claim within the policy limits in an accident involving one of its policyholders, Campbell, who was clearly at fault. The Campbells, State Farm’s insured, were awarded $2.6 in compensatory and $145 million in punitive damages. The trial court reduced both awards, allowing $25 million in punitive damages and $1 million in compensatory. The Utah Supreme Court, however, reinstated the initial awards. On appeal, the United States Supreme Court ruled that the punitive award violated due process as delineated in Gore. In so doing, the Court took a close look at the first two guideposts, the degree of reprehensibility and the ratio of punitive to compensatory damages. Regarding reprehensibility, the Court held that the jury was improperly permitted to consider out-of-state conduct alleged to have been committed by State Farm. The Court ruled

31 Id. at 565.
32 Id. at 567.
33 Id. at 575.
34 Id. at 580-83.
35 Id. at 583-86.
36 Gore, 517 U.S. at 576.
37 Id. at 582.
38 Id. at 584.
39 Id. at 585-86.
40 Supra note 2.
41 Supra note 1.
42 State Farm, 538 U.S. at 413-14. Campbell caused an accident that led to the death of one person and the permanent disabling of a second.
43 Id. at 415.
44 Id.
45 Id.
46 Id. at 416.
47 Id. at 418-26.
48 The Court set out factors regarding reprehensibility, which include whether: (1) the harm caused was physical as opposed to economic; (2) the tortious conduct evinced an indifference to or a reckless disregard of the health or safety of others; (3) the target of the conduct had financial vulnerability; (4) the conduct involved repeated actions or was an isolated incident; or (5) whether the harm suffered was the result of intentional malice, trickery, or deceit, or rather a mere accident. Id. at 419.
that the 145 to 1 ratio was thus too high in light of the harm suffered by the Campbells.\textsuperscript{49} Finally, though the Court suggested that few punitive awards providing in excess of nine times compensatory would comport with due process, it did not set that ratio in stone,\textsuperscript{50} perhaps imagining the fact pattern of Williams.\textsuperscript{51} The Court also cautioned that “when compensatory damages are substantial,” then due process might require a lesser ratio, “perhaps only equal to compensatory damages.”\textsuperscript{52}

WILLIAMS TRIAL BACKGROUND

Jessie Williams began smoking in the 1950s while serving his country in Korea.\textsuperscript{53} He continued to smoke heavily until his death from cancer in 1997.\textsuperscript{54} Though his family tried to get him to give up cigarettes, he refused, citing reports that cigarette smoking did not conclusively cause cancer.\textsuperscript{55} Those reports formed the basis upon which his widow sued Philip Morris for fraud.\textsuperscript{56} Evidence produced at trial indicated that the defendant was involved, with others, in a decades-long campaign to plant in the minds of smokers that the effects of smoking were unclear.\textsuperscript{57} The jury, in a case heard in Oregon state court in 2002, awarded $821,000 in compensatory and $79.5 million in punitive damages.\textsuperscript{58} The trial court lowered the award to $32 million,\textsuperscript{59} reducing the 98 to 1 ratio to approximately 39 to 1. Both parties appealed.\textsuperscript{60} This set the stage for a fascinating battle between the Oregon appellate courts and the U.S. Supreme Court, the former intent on keeping the $79.5 million intact while the latter, in vain as it would turn out, seeking to reduce the award to something closer to what it thought due process required.

WILLIAMS ON APPEAL

The Oregon Court of Appeals reinstated the $79.5 million punitive award.\textsuperscript{61} In so doing, it stressed that Philip Morris was aware that smoking caused lung cancer, yet nevertheless engaged in a forty year business strategy of publicly claiming that the issue was unresolved.\textsuperscript{62} The court concluded that because the defendant’s conduct was particularly reprehensible and affected others in addition to Williams, a significant punitive damages award was justified.\textsuperscript{63} The United States Supreme Court accepted the case in 2003 and sent it back for reconsideration of the punitive damages award\textsuperscript{64} in light of its decision in State Farm.\textsuperscript{65}

\textsuperscript{49} State Farm, 538 U.S. at 426.
\textsuperscript{50} Id. at 425.
\textsuperscript{51} Supra note 4.
\textsuperscript{52} Supra note 2 at 425.
\textsuperscript{53} Williams v. Philip Morris, Inc. 48 P.3d 824 (2002).
\textsuperscript{54} Id. at 829.
\textsuperscript{55} Id.
\textsuperscript{56} Id. at 828.
\textsuperscript{57} Id. at 831.
\textsuperscript{58} Id. at 828.
\textsuperscript{59} Williams, 48 P.3d at 828..
\textsuperscript{60} Id.
\textsuperscript{61} Williams, 48 P.3d at 841-42.
\textsuperscript{62} Id. at 838-39.
\textsuperscript{63} Id. at 840-41.
\textsuperscript{64} See Philip Morris USA Inc. v. Williams, 540 U.S. 801 (2003).
\textsuperscript{65} Supra notes 18-28.
The Oregon Court of Appeals again upheld the original award, focusing on the reprehensibility guidepost. The court set out factors to be analyzed in assessing reprehensibility, considered them in light of the facts of the case, and determined that the $79.5 million in punitive damages was appropriate. In concluding that the defendant’s behavior justified the award, the court noted that the conduct was “more reprehensible than any of the cases we have discussed.” While acknowledging that the ratio was well over the single digit ratio suggested in *State Farm*, the court determined that it was warranted in this case because “it is difficult to conceive of more reprehensible misconduct for a longer duration of time on the part of a supplier of consumer products to the Oregon public than what occurred in this case.”

The Oregon Supreme Court was the next stop. The court upheld the award, and in its discussion of the reprehensibility factor the court concluded:

The harm to Williams was physical – lung cancer cost Williams his life. Philip Morris showed indifference to and reckless disregard for the safety not just of Williams, but of countless other Oregonians, when it knowingly spread false or misleading information to keep smokers smoking. Philip Morris’s actions were no isolated incident, but a carefully calculated program spanning decades. And Philip Morris’s wrongdoing certainly involved trickery and deceit.

Regarding the ratio, the court determined that *State Farm* contemplated that “some awards exceeding single-digit ratios would satisfy due process.” This was such a case, at least in the eyes of Oregon’s Supreme Court.

The case reached the U.S. Supreme Court for the second time in 2007. The Court again sent the case back to Oregon, concerned that the jury might have considered evidence of harm caused to non-litigants to punish Philip Morris, which is forbidden, rather than as evidence of reprehensibility, which is permitted.

Upon remand, the Oregon Supreme Court noted that the U.S. Supreme Court did not address the size of the award in its opinion. The Oregon court then characterized the case as a procedural issue related to jury instructions. The court determined that the procedural issue made *Williams* a state case, rather than one involving a federal constitutional question. The court then ruled against Philip Morris on the issue, and upheld the $79.5 million award.

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67 *Id.* at 138 (citing *Campbell*, 538 U.S. 408, 419 (2003)). *Supra* note 48.
68 *Id.* at 126.
69 *Id.* at 142.
70 *Supra* notes 18-28.
71 *Williams*, 92 P.3d at 145.
73 *Id.* at 1181-82.
74 *Id.* at 1177.
75 *Id.* at 1181.
76 *Id.* at 1181-82.
78 *Id.* at 353-55.
80 *Id.* at 1256.
81 *Id.* at 1260.
82 *Id.* at 1264.
The United States Supreme Court received the case for the third time, but after initially granting certiorari, changed course and dismissed the writ as “improvidently granted.”83 Thus, lower courts, after perhaps thinking that further guidance from the Supreme Court would be forthcoming, were placed back at square one. This led to the following quote from a frustrated Oregon Supreme Court justice in his dissent in Hamlin v. Hampton Lumber Mills, Inc.,84 a punitive damages case decided in 2011:

I add one final note: a plea to the Supreme Court of the United States. For years this court generally, and I personally, have struggled to apply Gore and State Farm faithfully to the cases before us….The courts are in need of – indeed, I will assert that we deserve – further guidance that only the Court can provide. Whether the Court agrees with my analysis, or the majority, or something in between, does not matter to me. But it would be a responsible act of comity for the Court to say something clear to help in future cases.85

Thus the stage is set. The Supreme Court, enunciating guideposts in Gore and then expanding upon them in State Farm, seemingly blinked in the headlights of Williams and the punitive damages awarded to punish a cigarette manufacturer. Courts were left to wonder what might have happened had the Court taken up Williams one last time. Would it have provided more specific guidance to the states? Would it have determined that Williams was the one case with conduct egregious enough to justify punitive damages well in excess of a single digit ratio? Would the Court have addressed the issue of what constitutes substantial compensatory damages, given the size of the award in Williams and the corresponding amount of the punitive award? The paper now moves to a discussion of several post-Williams cases and their analyses of the constitutionality of punitive damages awards.

**WYETH V. SCOFIELD**

**Wyeth v. Scofield**86 involved three women who claimed that they developed breast cancer after taking Wyeth’s Premarin and Prempro menopause drugs. The trial court determined that Wyeth had acted with malice or fraud in hiding the breast-cancer risks of the medicines and awarded the plaintiffs $22.8 million in compensatory and $35 million in punitive damages.87 On appeal to the Nevada Supreme Court, Wyeth argued that the punitive award was excessive and thus a violation of its due process rights.88 The court first addressed the reprehensibility of Wyeth’s conduct.89 Because the case involved breast cancer and the surgeries and treatment resulting therefrom, the harm was physical. Thus, the court concluded, since Wyeth had misrepresented the risks and benefits of its drugs, it had shown reckless disregard for the health and safety of the users of its products.90 Noting that the harm suffered by respondents was “the result of Wyeth’s malicious activities and deceit,” the Nevada Supreme Court rather handily disposed of the reprehensibility guidepost.91

84 246 P.3d 1121 (2011).
85 Id. at 1136. (Gillette, J., dissenting).
86 244 P.3d 765 (2010), cert. denied, 131 S. Ct. 3028 (2011).
87 Id. at 775.
88 Id. at 784.
89 Id.
90 Id. at 785.
91 Id.
Turning to the ratio guidepost, the court’s disposition was even quicker. The court simply noted that the punitive damage awards in the case were less than three times the compensatory awards, and thus “well within the accepted ratios.”92 Even though the compensatory damages award was seemingly substantial, the court did not even address the possibility that an award in excess of a one to one ratio might violate due process, as the United States Supreme Court had suggested might be the case in in State Farm.93

Finally, the court compared the punitive damages award with possible civil penalties for comparable misconduct and referred to testimony from a regulatory expert that a recent comparable fine for a company that promoted its drug for unapproved benefits was $600 million.94 The Nevada Supreme Court thus concluded that the punitive damage awards were not excessive.95

The Nevada Supreme Court’s holding in Wyeth appears, on the surface at least, to provide a clear-cut example of a state court faithfully applying the due process guidelines. The court, in conducting its de novo review, provided an extensive analysis of the evidence used to support the reprehensibility of Wyeth’s actions and thus uphold what it deemed to be a ratio well within due process limits. However, the court did not mention the possibility that the compensatory damages award might be considered substantial, and therefore subject to the possibility of a one-to-one ratio restriction. It is thus unclear whether the court implicitly determined that the award was not substantial and therefore merited no further analysis, or whether the court did not consider the State Farm one-to-one ratio language as relevant.

**BULLOCK V. PHILIP MORRIS**

In Bullock v. Morris,96 a California appellate court upheld a punitive damages award that was sixteen times the compensatory award. The California Court of Appeal (Second District, Division Three) found that a $13.8 million punitive damages award was not constitutionally excessive, even though the compensatory damages award was $850,000.97 This case spanned a decade, bouncing up and down the California trial and appellate court systems.

Betty Bullock brought suit against Philip Morris in April of 2001, seeking to recover damages for personal injury based on products liability and fraud.98 Betty began smoking in 1956, at the age of 17, and continued until her diagnosis of lung cancer in 2001.99 After determining that the cigarette manufacturer was guilty of malice, fraud or oppression, the jury awarded Bullock $850,000 in compensatory damages and $28 billion (emphasis added) in punitive damages.100 The trial judge reduced the punitive award to $28 million in January of 2003 and both parties appealed.101 After Betty’s death in February of 2003, her daughter was substituted as plaintiff.102

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92 Id.
93 Supra note 2.
94 244 P.3d at 785.
95 Id.
96 131 Cal. Rptr. 3d 382 (2011).
97 Id.
98 Id. at 391.
99 Id. at 387.
100 Id. 391.
101 Id.
102 Bullock, 131 Cal. Rptr. 3d at 391.
The appellate court concluded that the punitive award was not constitutionally excessive and thus affirmed the judgment. However, on appeal, the California Supreme Court transferred the case back to the appellate court with directions to vacate and reconsider in light of the United States Supreme Court’s opinion in *Williams*. Upon examining the case as instructed, the appellate court concluded that the trial court had improperly refused Philip Morris’ proposed jury instruction that the jury could not punish the defendant for harm to others. The appellate court remanded the case for a new trial with respect to the amount of punitive damages only. In August of 2009, the jury returned a punitive damages award of $13.8 million; the compensatory damages remained at $850,000 in accordance with the original award.

In August of 2011, the California appellate court, in a 2-1 decision, affirmed the trial court’s judgment. In reaching its conclusion that the $13.8 million punitive award was not excessive, the court first addressed the reprehensibility of the defendant’s conduct. After detailing the actions of Philip Morris in intentionally deceiving smokers and the public concerning the adverse health effects of cigarette smoking, the court concluded that its conduct was extremely reprehensible in light of the five reprehensibility factors identified in *State Farm*.

The court next considered the ratio guidepost, discussing at length the limits imposed by due process, including an analysis of *State Farm’s* language with respect to substantial compensatory damages awards. While acknowledging that the United States Supreme Court stated in *State Farm* that punitive awards may be limited to compensatory awards when compensatory amounts are substantial, the appellate court specifically noted that the Court did not definitely determine that such a bright line existed. The court then rationalized that relative to the financial condition of Philip Morris, a compensatory award of $850,000 was not substantial, and thus justified a higher than single digit ratio.

The dissenting judge agreed that the conduct of Philip Morris was “highly reprehensible,” but would have held that the punitive award violated due process because the award significantly exceeded a single-digit ratio. The dissenting judge also argued that the financial condition of Philip Morris was not relevant to the determination of whether a compensatory award is “substantial” for purposes of the ratio guidepost and that a defendant’s wealth “cannot justify punitive damages unconstitutionally disproportionate to compensatory damages.”

**R.J. REYNOLDS TOBACCO COMPANY V. TOWNSEND**

In the 2012 case of *R.J. Reynolds Tobacco Company v. Townsend*, a Florida appellate court reversed a punitive damages award on the basis that it was constitutionally excessive. Frank Townsend, a long-time smoker of cigarettes manufactured by RJ Reynolds, died of lung cancer.
The jury awarded Lyantie Townsend, as personal representative of the estate of Frank Townsend, her late husband, $10.8 million in compensatory and $80 million in punitive damages. The jury found RJ Reynolds 51% responsible and the trial court thus reduced the compensatory award to $5.5 million and the punitive award to $40.8 million. However, for purposes of examining the ratio between the two, the court used the pre-apportionment compensatory award of $10.8 million and the post-apportionment punitive award of $40.8 million, which resulted in a 3.7 to 1 ratio.

The appellate court began its due process analysis by addressing the three criteria required for evaluating punitive damages under Florida law:

1. “the manifest weight of the evidence does not render the amount of punitive damages assessed out of all reasonable proportion to the malice, outrage or wantonness of the tortious conduct”; (2) the award “bears some relationship to the defendant’s ability to pay and does not result in economic castigation or bankruptcy to the defendant”; and (3) a reasonable relationship exists between the compensatory and punitive amounts awarded.

The first criterion was easily satisfied, decided the court, given the evidence of the “decades-long, wanton and intentional conduct” by RJ Reynolds with respect to the sale of its cigarettes. Observing that the net worth of RJ Reynolds was in the neighborhood of $8 billion, the court handily disposed of the second criterion, noting that a $40.8 million punitive damage award would not cause “financial ruin.”

With respect to the third criterion, the court noted that the typical measure was the ratio between the punitive and compensatory awards. The court further noted that while Florida has not adopted a “bright-line standard,” the Florida Supreme Court has nevertheless observed that single-digit ratios “are more likely to comport with due process, while still achieving the State’s goals of deterrence and retribution.” The court then concluded that the 3.7 to 1 ratio was constitutionally excessive, particularly given the substantial compensatory damages awarded in the case. The court observed that the United States Supreme Court had not identified “concrete constitutional limits” with respect to the ratio guideline. However, the Florida court noted, in State Farm, the Court had cautioned that in cases with substantial compensatory awards, a one-to-one ratio might be constitutionally appropriate. While recognizing that the $10.8 million award was “substantial by any measure,” the court held that a one to one ratio was not warranted because of the “extreme reprehensibility” of RJ Reynolds’ conduct. The court reversed the punitive award accordingly and remanded the case, with the instructions that Mrs.

116 Id. at 310. The court mentioned in a footnote that punitive damages are not typically subject to apportionment based on comparative fault, but noted that the plaintiff had consented to the trial court’s reduction of the award on that basis.
117 Id. at 311.
118 Id. at 313.
119 Id.
120 Townsend, 90 So.3d at 313. Id. The court observed that RJ Reynolds faced significant potential liability from the other pending tobacco-related cases, but its review was limited to the impact of the award in the case currently before the court. The court also noted that under Florida law, protections presumably existed that RJ Reynolds would be able to raise in future cases with respect to the cumulative effect of prior awards. Id. at 313-14.
121 Id. at 314.
122 Id. at 315.
123 Id.
124 Id.
125 Id. at 316. The dissenting judge disagreed with the majority opinion that “a 1 to 1 ratio [was] unwarranted.” Id.
Townsend could choose between a new jury trial for the purpose of determining punitive damages, or allow the trial court to establish the amount of the punitive award.\footnote{Id.}

**NEUROS CO. V. KTURBO, INC.**

In *Neuros Co. v. KTurbo, Inc.*,\footnote{698 F.3d 514 (7th Cir. 2012).} the Seventh Circuit Court of Appeals affirmed a punitive damages award that was five times the amount of the compensatory award. Neuros and KTurbo, competing manufacturers of high-speed turbo blowers used by waste water treatment plants, had both bid on a contract to supply equipment to a plant in Utah.\footnote{Id. at 516.} After Neuros won the bid, KTurbo prepared a power point presentation accusing Neuros of fraudulently representing the performance of its products.\footnote{Id.} The presentation, which KTurbo posted on its website and also gave to multiple engineering companies in the industry, was unsuccessful in moving business from Neuros to KTurbo.\footnote{Id. at 519, 522.} Neuros brought suit against KTurbo for, among other claims, defamation.\footnote{Id. at 517.} After a bench trial, Neuros won the defamation claim and was awarded $10,000 in general damages and $50,000 in punitive damages.\footnote{Id. at 519.} On appeal, KTurbo asserted that the award of punitive damages should be set aside because Neuros had not shown any evidence that it had been injured by KTurbo’s false claims.\footnote{Id. at 519.}

Writing for the court, Judge Posner first noted that defamation per se is an exception to the general rule that “no injury no tort,” and explained that as it relates to a business victim, means “defamation that impugns the defendant’s competence or honesty.”\footnote{Id.} Posner easily found that KTurbo committed defamation per se, noting that “it was hard to imagine a more damaging accusation to make against a business” than the accusation of criminal fraud made by KTurbo against Neuro.\footnote{Id.} Thus, the plaintiff was entitled to both general compensatory damages and punitive damages.\footnote{Id.} Addressing the constitutional issue, Judge Posner found that the punitive damages award was too small (emphasis added), given the outrageousness of KTurbo’s conduct,\footnote{Neuros, 698 F.3d at 520.} and remarked that KTurbo “should consider itself fortunate” that Neuros had not challenged the adequacy of the punitive award.\footnote{Id. at 519.} Judge Posner dismissed any constitutional concerns regarding the five-to-one ratio, noting that KTurbo’s conduct was “reprehensible,”\footnote{Id. at 519.} and that since it was a substantial company, it should have been ordered to pay “substantial

\footnotesize{\textsuperscript{126} Id.}  
\footnotesize{\textsuperscript{127} 698 F.3d 514 (7th Cir. 2012).}  
\footnotesize{\textsuperscript{128} Id. at 516.}  
\footnotesize{\textsuperscript{129} Id.}  
\footnotesize{\textsuperscript{130} Id. at 519, 522.}  
\footnotesize{\textsuperscript{131} Id. at 517.}  
\footnotesize{\textsuperscript{132} Neuros, 698 F.3d at 518.}  
\footnotesize{\textsuperscript{133} Id. at 519.}  
\footnotesize{\textsuperscript{134} Id.}  
\footnotesize{\textsuperscript{135} Id.}  
\footnotesize{\textsuperscript{136} Id.}  
\footnotesize{\textsuperscript{137} Neuros, 698 F.3d at 520.}  
\footnotesize{\textsuperscript{138} Id.}  
\footnotesize{\textsuperscript{139} Id. at 519.}
punitive damages.” Judge Posner reiterated the Seventh Circuit’s previous position that the proper focus of the ratio analysis is “the adequacy of the combined award of compensatory and punitive damages to motivate the prosecution of a meritorious claim. If compensatory damages are slight, a single-digit ratio is likely to be insufficient.”

**LITHIA MOTORS, INC. V. YOVAN**

For our final case, we return to Oregon. In *Lithia Motors, Inc. v. Yovan*, decided in December of 2012, the Oregon Court of Appeals reinstated a jury award in which punitive damages were two hundred times (emphasis added) the amount of the compensatory award. Shawn Yovan had purchased a car from Lithia and soon found a discrepancy between the mileage on the odometer and the actual mileage. After an extended dispute between the two, Lithia sued Yovan for rescission based on mutual mistake. Yovan filed a counterclaim, alleging that Lithia had violated Oregon’s Unlawful Trade Practices Act. Yovan alleged that Lithia had threatened him with arrest or criminal prosecution. Yovan prevailed at trial, and the jury awarded him $500 in noneconomic compensatory damages and $100,000 in punitive damages. The trial court determined that the two hundred-to-one ratio was unconstitutional and reduced the punitive award to $2,000. The Oregon Court of Appeals affirmed the trial court’s ruling, but the Oregon Supreme Court vacated the decision and remanded for reconsideration in light of its decision in *Hamlin*. In *Hamlin*, the Oregon Supreme Court had seized on the United States Supreme Court’s “repeated refusal” to provide a rigid benchmark for punitive damage awards. Presumably emboldened by its successful showdown with the Court in *Williams*, the Oregon Supreme Court in *Hamlin* ignored its own previously articulated bright-line standards, and instead crafted new rules for small-damage cases.

On remand, the Oregon Court of Appeals first noted that in cases where the compensatory damage award is small, the *Hamlin* decision had “reshaped the evaluation of the constitutionality of punitive damages awards.” The court concluded that Lithia’s conduct, which was the most

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140 *Id.* at 520. Judge Posner posited that in ordering KTurbo to pay a “slap-on-the-wrist” award, the district judge may have been concerned that a multiple greater than five would “run afoul” of the Supreme Court’s due process cases. *Id.*
141 *Id.* (quoting Gavin v. AT & T Corp., 464 F.3d 634, 641 (7th Cir. 2006)).
143 *Id.* at 310.
144 *Id.* at 311.
145 *Id.* at 309.
146 *Id.*
147 *Id.*
149 *Id.*
150 *Supra* note 85. In *Hamlin*, the dissenting judge expressed his exasperation at the United States Supreme Court for its lack of clarity in cases involving excessive punitive damage awards. *Id.*
151 *Hamlin*, 246 P.3d at 1125-26. Hampton, the defendant, had failed to reinstate Hamlin, its employee, after he suffered a hand injury at work. The jury’s award of compensatory damages of $6,000 and punitive damages of $175,000 resulted in a ratio of 22 to 1; the Oregon Supreme Court reinstated the punitive award. *Id.*
152 *Id.* The Oregon Supreme Court further explained that under certain circumstances, namely when compensatory damages are small, the second guidepost (with its ratio test) is of limited value in determining “whether the amount of a jury’s punitive damages award meets or exceeds state goals of deterrence and retribution.” *Id.* at 1128.
important guidepost, was more than “minimally reprehensible” and would thus support an award in excess of a single-digit multiplier.\textsuperscript{154} The court concluded that it was not bound by the single-digit ratio in this case, and turned to the final analysis imposed by \textit{Hamlin}: a determination that the amount actually awarded was not grossly excessive.\textsuperscript{155} The court concluded that, given the deterrent function that the punitive award serves and the resources of the dealership to pay the award, the amount was not grossly excessive.\textsuperscript{156} Accordingly, the court determined that the punitive to compensatory ratio could exceed a single digit multiplier, and thus reinstated the jury award.\textsuperscript{157}

**CONCLUSION**

The United States Supreme Court, in its decisions in \textit{Gore} and \textit{State Farm}, avoided drawing bright lines in cases involving potentially excessive punitive damages awards. Instead, the Court focused on providing a framework for state courts to use when analyzing the constitutionality of punitive awards. The three guideposts provided by \textit{Gore} included the reprehensibility of the defendant’s conduct, the ratio of punitive to compensatory and the relationship of possible civil penalties, if any, to punitive awards. \textit{State Farm} set out factors to consider when determining reprehensibility and also announced that while declining to draw a bright line, few punitive awards in excess of nine times compensatory would survive a due process challenge. The Court also noted that when compensatory damages were substantial, a one-to-one ratio might be the upper limit. In \textit{Williams}, when presented with an opportunity to provide clarity, not only seemed to back away from the challenge, but arguably opened the door to even greater uncertainty.

\textit{Wyeth}, \textit{Bullock} and \textit{Townsend} were all cases involving substantial compensatory damages, physical harm, and highly reprehensible behavior. The result in \textit{Wyeth} was seemingly well within the constitutional boundaries suggested by the Court; the punitive to compensatory ratio was a narrow 1.5 to 1. However, even though the compensatory damages were substantial ($22.8 million), the Nevada court made no mention of a possible one-to-one constitutional limit. In \textit{Bullock}, the California court acknowledged that a compensatory amount of $850,000 was indeed substantial, but nevertheless upheld a 16 to 1 ratio on the basis that such an award was insubstantial, given the financial condition of the defendant. The dissenting judge, however, argued that the defendant’s worth should not be used to justify a punitive award that exceeded a single-digit ratio. Indeed, the relevance of the defendant’s financial condition is another unanswered question. In \textit{Townsend}, while stopping short of mandating a one-to-one ratio, the Florida court suggested that that the compensatory award of $10.8 might be substantial enough for that ratio to be appropriate.

At the other end of the spectrum, \textit{Neuros} and \textit{Lithia} were cases with low compensatory damages and non-physical harm. In \textit{Neuros}, Judge Posner dismissed any constitutional concerns over a five-to-one ratio, and emphasized the Seventh Circuit’s previous position that the ratio analysis should focus not on a bright line, but on the adequacy of the combined awards in order to create an adequate deterrence and provide an incentive for cases to be brought. In \textit{Lithia}, the court noted that in the aftermath of \textit{Williams}, the Oregon Supreme Court had developed its own guidelines for small-damage cases. The \textit{Lithia} court thus had no trouble concluding that a ratio

\textsuperscript{154} \textit{Id.} at 323.

\textsuperscript{155} \textit{Id.} at 327.

\textsuperscript{156} \textit{Id.} at 329.

\textsuperscript{157} \textit{Id.} at 327.
of 200-to1 was permissible when compensatory damages were only $500 and the defendant’s behavior was “minimally reprehensible.”

In light of the five cases and analyzed in this paper, we can safely conclude that a bright line does not currently exist. Nevertheless, lower courts seem to be making an effort to reach appropriate decisions as they continue to shape the landscape for punitive damage awards. Perhaps the Court is satisfied, for now, with the framework that allows lower courts to exercise discretion within the guidelines and also flesh out other relevant issues. With Williams, the Court was presented with, but chose to sidestep, an opportunity to provide additional guidance, particularly with respect to conduct that might be sufficiently reprehensible to justify an award in excess of a single digit ratio. Likewise, the Court might have addressed the issues of what constitutes substantial damages and the relevance of the financial condition of the defendant. Perhaps the Court will step back in and provide additional clarification when presented with a case that it considers to have awarded very high compensatory damages and correspondingly excessive punitive damages.

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THE FOLKLORE OF ACADEMIC FREEDOM IN A PUBLIC UNIVERSITY: TRUTHS, HALF TRUTHS AND CONTRACT PRIVILEGES

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ABSTRACT

This article addresses recent case law that could alter the course of academic freedom in the twenty-first century for a public university. We examine current folklore that Academic Freedom may be a right that: a) gives the institution the right to determine for itself on academic grounds who may teach, what may be taught, how it shall be taught, and who may be admitted to study; b) grants the faculty the right to research and teach without interference from non-peers; and c) is a special concern of the First Amendment to the U.S. Constitution. We find truths, half truths and conduct an historical re-examination of rights, finding them to be privileges that need faculty vigilance to retain them. While each one of the above statements describing what “may be rights” are true, each of them are half-truths which have contributed to a common folklore about academic freedom. We conclude, in light of the recent case law, that academic freedom is a contractual privilege that should be closely guarded by members of the academy for future generations.

INTRODUCTION

The world changed at the dawn of the twenty-first century. Nowhere is that more evident than in the area of academic freedom. Since the turn of the millennium, there have been over 200 reported controversies in federal courts dealing with this subject.¹ This represents a sharp contrast from the previous century, where by the turn of the twentieth century there were no reported controversies in federal courts concerning academic freedom.² It was not until the 1950’s that the academic freedom cases began to surface with frequency, as illustrated by the following chart:

¹http://campus.westlaw.com - search - academic freedom federal cases.
²Id.
As can be seen from the above chart, in the 50’s there were fewer than ten federal cases that dealt with academic freedom. In the 70’s and the 90’s the number of controversies shot up to 135 and 197, respectively. If this chart is indicative of the future, academic freedom controversies will continue to increase given that we are on the frontier of bio-medical and stem cell research, the discovery of the “God Particle” through string theory, along with the ability to alter, clone and create synthetic life forms.

Part of the controversy surrounding academic freedom is that it has resulted in a conundrum that produces a paradox for education. In one version of the theory, academic freedom provides faculty members with the freedom to search for the truth. The countervailing view is that academic freedom provides the university, as an institution, with the right to determine who may teach, what may be taught, how it shall be taught, and who may be admitted to study. This paradox is exacerbated when the institution is funded by the state, because government employees do not share the same freedoms in the workplace as private sector employees. This distinction is produced by the public employee doctrine.

The U.S. Supreme Court has had little success in solving the conundrum. The Supreme Court has stated that academic freedom is a special concern of the First Amendment but to date the Court has not given academic freedom constitutional status. At best, the Supreme Court has developed an amorphous quasi-legal concept for academic freedom with questionable precedent. With respect to the public employee doctrine, the principles developed by the Supreme Court could imperil the academic freedom rights of professors at public universities.

The public employee doctrine and academic freedom are on a collision course. This article will explore the folklore of academic freedom in light of the emerging public employee doctrine. As we shed light on this subject, we will separate fact from fiction with respect to academic freedom. We will confine our expedition to public university systems that are located in the United States of America.

As mentioned earlier, part of the confusion concerning academic freedom is that there are two general interpretations of the freedom – one was conceived by the academic guilds (i.e., faculty) to protect the rights of inquiry and the other was promulgated by the legal system to protect the university at the institutional level from

3 Id.
4 See Benjamin Ginsberg, The Fall of the Faculty: the rise of the all administrative university and why it matters, (2011), Chap. 5, There is no such thing as academic freedom (For Professors) – The rise and fall of the tenure system.
5 Id.
8 See, Uroššky v. Gilmore, 216 F.3d 401 (4th Cir. 2000).
10 See Garcetti v. Ceballos, 547 U.S. 410 (2006), 126 S.Ct. 1951 (2006), where a prosecutor’s scope of discretion in a case was overridden by his supervisor.
external interference with the educational process. We will initially examine the evolution of both freedoms (i.e., faculty and institutional) and then examine the recent case law concerning the public employee doctrine in order to provide a conceptual framework for asserting that the truth behind the folklore of academic freedom is buried in contract law.

I. EVOLUTION OF FACULTY ACADEMIC FREEDOM

In the United States of America, the concept of academic freedom did not exist in higher education until the latter part of the nineteenth century. Prior to that period, college faculty had little or no control over their destiny or the subject matter to which they taught. For the most part, curricula focused on classical philosophy derived from European Renaissance education and the faculty devoted much of their time to training students in the area of liberal arts and philosophy in order to produce gentlemen for the elite professions. College faculties were viewed as employees of the institution rather than its constituents and were controlled by the will of the board of trustees, most of whom were clergymen or politicians. During this period, Jeffersonian republicanism and Emersonian idealism influenced education, but Christian moralism controlled it.

By the latter part of the nineteenth century, the philosophy of higher education began to change. Where religion had controlled the philosophical ideologies of the early American University, Horace Mann’s conception of a “common school” opened the way to a more secular approach to education.

With the change in the philosophy of higher education came a change in the structure of American Universities. The composition of the board of trustees began to shift from clergymen to businessmen, which led to a change in the status of the university president. During this period, the university president was viewed as an institutional executive and educational entrepreneur, rather than the most eminent member of the faculty. This footprint became the model for managing the modern day university.

The structural changes in the university systems in the post-civil war era were accompanied by changes in the mission of higher education and its faculty. Universities began to move away from its religious-philosophical roots and focus on the sciences. American Universities became training facilities for both the industrial careers and the elite professions. For example, by 1870, many universities began to expand their curricula to include the study of Chemistry, Botany, Biology and Geology among other natural observational subjects. As part of this change, faculty were expected to extend the frontier of knowledge through scientific methods. The scientific method is based on systematic observation guided by theoretical expectations that are verified or disproved by subsequent observations and then shared with other scientists who can replicate the conditions and the results.

While universities increasingly sought institutional autonomy of science from clerical constraints, faculty wanted to take control over the evaluation of the scientific method from those without scientific competence, in this case,

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14 Hofstadter and Metzger,(1955), pgs. 287-89 and pgs. 295-98.
16 Hofstadter and Metzger,(1955), pgs. 375-77.
20 See Christopher Jencks & David Riesman, The Academic Revolution 15–20 (1968);
23 Hofstader and Metzger, (1955), pgs. 348-49.
24 Hofstader and Metzger, (1955), pgs.371 and 381.
In the minds of the faculty, the scientific method demanded scholarly thought that was pure and untainted by the political or religious opinions of lay people because these opinions would interfere with this scientific process and hinder the search for the truth. In essence, scholarly thought and the related expression of such thought was a form of elite speech that demanded protection from popular prejudices.

At the turn of the 20th Century, the academic freedom concept became a formal doctrine. In 1915, the American Association of University Professors (“AAUP”) promulgated the following statement with respect to academic freedom:

There are three fields of human inquiry in which the race is only at the beginning: natural science, social science, philosophy and religion. … In all of these domains of knowledge, the first condition of progress is complete and unlimited freedom to pursue inquiry and publish its results. …The trustees, whose views would be based on self-interest and informal experience, must be prevented from forcing their opinions on academics.

Even though the AAUP espoused the notion that academicians needed “unlimited freedom” to pursue the truth, the AAUP was careful to limit the view that academic freedom implied an absolute right of free utterance for the individual faculty member and leaned more in favor of a qualified version of academic freedom, as evidenced below:

The claim to freedom of teaching is made in the interest of the integrity and of the progress of scientific inquiry; it is, therefore, only those who carry on their work in the temper of the scientific inquirer who may justly assert this claim. The liberty of the scholar within the university to set forth his conclusions, be they what they may, is conditioned by their being conclusions gained by a scholar's method and held in a scholar's spirit; that is to say, they must be the fruits of competent and patient and sincere inquiry, and they should be set forth with dignity, courtesy, and temperateness of language.

From the AAUP’s perspective, unrestrained freedom of speech would destroy the university, which is the very enterprise that verifies new knowledge as scientific. The AAUP insisted on a clear distinction between speech that was academic and that which was merely political or sectarian.

In 1940, the AAUP codified the academic freedom doctrine, which has been endorsed by over 200 higher education organizations in the nation. This was an attempt to reconcile the tension between the needs of the university to substantiate verified knowledge and the needs of individual professors to pursue inquiry freely. The 1940 statement provides, in part, that:

1. Teachers are entitled to full freedom in research and in the publication of the results, subject to the adequate performance of their other academic duties…
2. Teachers are entitled to freedom in the classroom in discussing their subject, but they should be careful not to introduce into their teaching controversial matter which has no relation to their subject.
3. College and university teachers are citizens, members of a learned profession, and officers of an educational institution. When they speak or write as citizens, they should be free from

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26 Hofstadter and Metzger, (1955), pgs.365-66 and 381.
28 Id. It should be noted from the quoted materia that, even with the advancement of the scientific method, the AAUP recognized that scholars in the fields of “…social science, philosophy and religion…” should be afforded “…freedom to pursue inquiry and publish its results….”
30 Id.
31 Id.
institutional censorship or discipline, but their special position in the community imposes special obligations. … [T]hey should at all times be accurate, should exercise appropriate restraint, should show respect for the opinions of others, and should make every effort to indicate that they are not speaking for the institution.33

In essence, academic freedom was perceived as an adjustment of rights among participants in the university system and disputes were generally resolved internally within the university system. In other words, the analysis of respective rights of academic freedom should begin with the contractual relationship between the university and its faculty.

II. INSTITUTIONAL ACADEMIC FREEDOM

In the 1950’s, academic freedom became the target of McCarthyism.34 As university professors began to use their classrooms and research papers as a forum for alternative political ideologies (e.g., Socialism and Communism), the government began to regulate this behavior. Eventually the judicial system was summoned to resolve the issue. The first major case to discuss academic freedom was Sweezy v. New Hampshire, decided by the Supreme Court of the United States in 1957.35

Paul Sweezy was an assistant professor at Harvard and a confirmed Marxist.36 In 1945, Sweezy resigned from Harvard to enter the armed forces.37 Sweezy later became a journalist and guest lecturer.38 During one of his guest lectures at the University of New Hampshire, Sweezy’s lecture took an apparently subversive turn, which prompted the Attorney General of New Hampshire to interrogate Sweezy concerning his Marxist activities.39 There were two subjects on which Sweezy refused to answer questions posed by the Attorney General, i.e., his lectures at the University of New Hampshire, and his knowledge of the Progressive Party and any of its members.40 Sweezy was later put on trial before a state tribunal and convicted of contempt for failure to answer the questions.41 The Supreme Court of the United States reversed the conviction on the grounds that the Attorney General's questioning violated Sweezy's due process rights.42 The Court reasoned that the state legislature had made a "broad and ill-defined" delegation of its investigative power to the Attorney General.43

It should be noted that even though the AAUP was requested to file an amicus curie brief before the Supreme Court in Sweezy, the Association declined the invitation.44 The AAUP was concerned about the consequences of having judges rather than professors elaborate and apply the protective rules of academic life because of the fear of what the courts give, they may take away, and that having thus given and taken away, academic freedom may be left in a weaker position than it was before it became a concern of the law.45 The AAUP preferred to let the meaning and practice of academic freedom take shape, as it has in the past, on a private, voluntary basis through the collective efforts of teachers, institutions of higher learning and educational associations.


37Id.
38Sweezy, 354 U.S. at 244; 77 S. Ct. 1208.
39Id.
40Id.
41Sweezy, 354 U. S. at 243; 77 S. Ct. 1208.
42Sweezy, 354 U. S. at 254–255; 77 S. Ct. at 1213 – 1214.
43Sweezy, 354 U. S. at 245; 77 S. Ct. at 1209.
45Id.
The interesting phenomenon about the Sweezy case is that it is generally considered the judicial genesis of academic freedom even though the facts and the holding of the case have little to do with academic freedom. The Court actually framed the central issue of the case to be “…whether the investigation deprived Sweezy of due process of law under the Fourteenth Amendment.”\(^{46}\) Factually, Sweezy did not hold an academic position at a university and therefore he could not utilize the academic freedom doctrine to protect his speech. Instead, Sweezy utilized the due process clause and the First Amendment (i.e., free speech) to shield himself from criminal liability.\(^{47}\) Likewise, the holding is not predicated upon the maxims of academic freedom but rather upon first amendment notions and the due process principles imbedded in the constitution.\(^{48}\)

In spite of these anomalies, the notion that the power of the government should not be used to interfere with the academic freedom of an institution of higher education can be found in Justice Frankfurter’s concurring opinion. He said:

“[T]he four essential freedoms" of a university [are] to determine for itself on academic grounds who may teach, what may be taught, how it shall be taught, and who may be admitted to study.\(^{49}\)

The discussion in Sweezy of academic freedom did pave the way for similar cases, as illustrated by Keyishian v. Board of Regents.\(^{50}\) In Keyishian, a group of faculty members at a university challenged a state law that required the members to sign an affidavit stating that they were not members of the Communist Party. The Supreme Court invalidated the state law on the grounds that the statute was vague insofar as it proscribed mere knowing membership without any showing of specific intent to further the unlawful aims of the Communist Party. With respect to academic freedom, the Supreme Court stated in dicta that:

Our nation is deeply committed to safeguarding academic freedom, which is of transcendent value to all of us and not merely to the teachers concerned. That freedom is therefore a special concern of the First Amendment, which does not tolerate laws that cast a pall of orthodoxy over the classroom. ‘The vigilant protection of constitutional freedoms is nowhere more vital than in the community of American schools… The classroom is peculiarly the ‘marketplace of ideas.’ The Nation's future depends upon leaders trained through wide exposure to that robust exchange of ideas which discovers truth 'out of a multitude of tongues, (rather) than through any kind of authoritative selection. … . Scholarship cannot flourish in an atmosphere of suspicion and distrust. Teachers and students must always remain free to inquire, to study and to evaluate, to gain new maturity and understanding; otherwise our civilization will stagnate and die.’\(^{51}\)

In 1990, the Supreme Court distinguished the precedential value of Keyishian and Sweezy concerning academic freedom in University of Pennsylvania v. Equal Employment Opportunity Commission.\(^{52}\) In that case an associate professor sued a University through the Equal Employment Opportunity Commission (“EEOC”) for denial of tenure. The professor alleged that she had been the victim of sexual harassment by the board chairman, and that the board discriminated against her because of her Chinese-American heritage. The EEOC requested the promotion file

\(^{46}\)Sweezy, 354 U. S. at 235; 77 S. Ct. at 1204.
\(^{47}\)See Sweezy v. New Hampshire, 354 U. S. 234; 77 S. Ct. 1203(1957), Brief for Appellant, Jurisdictional Statement at 4 where Sweezy also argued that New Hampshire’s law deprived him “of liberty and property without due process of law, contrary to the Fourteenth Amendment. See also, Justice Frankfurter’s Concurring Opinion, 354 U. S. 256; 77 S. Ct. at 1215.
\(^{48}\)See Sweezy,354 U. S. at 250, 77 S. Ct. at 1212, where the plurality opinion relied on the incorporation argument: “[T]he right to engage in political expression and association . . . was enshrined in the First Amendment of the Bill of Rights”. See also Sweezy, 354 U. S.at 266, 77 S. Ct. at1220, where Justice Frankfurter in his Concurring Opinion discusses “the concept of ordered liberty' implicit in the Due Process Clause of the Fourteenth Amendment.”
\(^{49}\)Sweezy,354 U. S. at 263, 77 S. Ct. at 1218, quoting: The Open Universities in South Africa 10-12. (A statement of a conference of senior scholars from the University of Cape Town and the University of the Witwatersrand, including A. v. d. S. Centlivres and Richard Feetham, as Chancellors of the respective universities.
\(^{50}\)385 U.S. 589, 603, 87 S. Ct. 675, 684 (1967).
\(^{51}\)Keyishian, 385 U.S. at 603, 87 S. Ct. 683.
which the University refused to produce citing, *inter alia*, constitutional protection under the First Amendment. The Supreme Court ruled against the University and refused to expand the First Amendment right of academic freedom to protect the promotion materials from disclosure. With respect to the academic freedom argument postulated by the University, the Supreme Court stated:

> In our view, petitioner's [i.e., the University] reliance on the so-called academic-freedom cases [*Sweezy* and *Keyishian*] is somewhat misplaced. In those cases government was attempting to control or direct the content of the speech engaged in by the university or those affiliated with it. In *Sweezy*, for example, the Court invalidated the conviction of a person found in contempt for refusing to answer questions about the content of a lecture he had delivered at a state university. Similarly, in *Keyishian*, the Court invalidated a network of state laws that required public employees, including teachers at state universities, to make certifications with respect to their membership in the Communist Party. When, in those cases, the Court spoke of “academic freedom” and the right to determine on “academic grounds who may teach” the Court was speaking in reaction to content-based regulation.  

What is interesting about this quote is that the Supreme Court uses the language “so-called academic-freedom cases”, as if to cast a cloud over the use of such cases as precedent for academic freedom. Indeed, the Supreme Court’s concern about the so-called academic freedom cases is well founded. The main issue before the *Keyishian* Court concerned a type of regulation that is most offensive to a free society: loyalty oaths not academic freedom. As a consequence, the statements concerning academic freedom by *Keyishian* Court are dicta. In addition, the *Keyishian* Court cites the *Sweezy* case, to support its statements concerning academic freedom. However, the statements in *Sweezy* concerning academic freedom are also dicta. As discussed previously, the *Sweezy* case had nothing to do with academic freedom, as the facts in the case involved a journalist who could not assert the right to academic freedom because he was not employed by a university. The holding in the *Sweezy* was predicated upon due process and first amendment principles, not academic freedom.

The lower courts have struggled with the academic freedom dicta promulgated by the Supreme Court, as illustrated by *Urofsky v. Gilmore*. In *Urofsky*, faculty members of a University were prohibited by the University and state law from accessing sexually explicit material, on computers that were owned or leased by the state, in order to conduct research. The Professors argued that the requirement of prior university approval for access to sexually explicit material on the Internet (related to their research) infringed on their *individual* right of academic freedom. The appellate court ruled against the faculty members.

With respect to academic freedom, the *Urofsky* court said that the term academic freedom is used by the federal courts quite often but that is not very well explained by those courts. The *Urofsky* court said that academic freedom cases lack consistency and the concept is sometimes used where it has no application. While the *Urofsky* court acknowledges that the concept of academic freedom may have become a time-honored tradition in American universities, that does not imbue it with or elevate it to constitutional stature. After a lengthy review of the case law concerning academic freedom, the *Urofsky* court concluded that to the extent the Constitution recognizes any right of “academic freedom” above and beyond the First Amendment rights to which every citizen is entitled, the right of academic freedom inheres in the University and not in individual professors.

Eight years after *Urofsky* was decided, the federal district court for the Eastern District of Virginia addressed

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53 *493 U.S.* at 197, 110 S. Ct. at 586
54 *Id.*
55 *See Bishop v. Aronov*, 926 F.2d 1066, 1075 (11th Cir. 1991).
57 *Sweezy*, 354 U. S. at 235; 77 S. Ct. at 1204.
58 *216 F.3d 401,410 (4th Cir. 2000).
59 *Id.* at 410.
60 *Id.*
61 *Id.* at 411, fn 12.
62 *Id.* at 410
63 This federal district court is located within the Fourth Circuit.
the concept of academic freedom in ruling on a motion to dismiss in *Stronach v. Virginia State University.* In this case a professor had assigned a student a “D” as a grade for the course, that was subsequently changed to an “A” by the department chair, with the approval of the dean and provost. The professor sued the department chair, dean and provost claiming that he had the constitutional right to assign grades to his students as he saw fit, and contended that grading is an activity protected under the right to academic freedom contained in the First and Fourteenth Amendments. Relying on *Urofsky*, the court in *Stronach* stated that, “However definite the university's right to academic freedom is after *Sweezy*, it is clear that it is the university's right and not the professor's right.” The *Stronach* court noted that the [Supreme] Court has never recognized that professors possess a First Amendment right of academic freedom to determine for themselves the content of their courses and scholarship, despite opportunities to do so.

On the other hand, the Sixth Circuit Court in *Parate v. Isibor*, held that “a university professor may claim that his assignment of an examination grade or a final grade is communication protected by the First Amendment..." Thus, the individual professor may not be compelled, by university officials, to change a grade that the professor previously assigned to her student." The *Parate* case opens the door for an argument in favor of some limited First Amendment protection for the academic freedom rights of an individual professor.

### III. PUBLIC UNIVERSITIES AND PUBLIC EMPLOYEES

As can be seen from the above discussion, the meaning of academic freedom is a matter of perception. On the one hand, the majority of cases perceive academic freedom as an institutional right which provides the university with four essential freedoms (e.g., the rights of who may teach, what may be taught, how it shall be taught, and who may be admitted to study). On the other hand, the AAUP perceives academic freedom as a right that protects both individual the faculty member and the faculty as a whole. Academic freedom provides a faculty member with: a) a rather unlimited freedom to pursue research and publish its results; and b) a limited freedom in discussing their subject in the classroom (i.e., being “…careful not to introduce into their teaching controversial matter which has no relation to their subject….”). In a public university setting, the academic freedom rights of a faculty member could become distorted because the rights may be subject to the public employee doctrine.

### IV. PUBLIC EMPLOYEE DOCTRINE

As a general rule, public employees at a public university do not relinquish their First Amendment rights as a result of accepting employment with a government employer. However, there are limitations. If a public employee chooses to exercise his or her first amendment rights in the workplace, the speech must be related to matters of public concern if it is to enjoy constitutional protection. As part of evaluating whether an employee’s speech is constitutionally protected, the court will balance the interests of the employee speaking on matters of public concern as a citizen, with the interest of the government in efficiently performing public services through its employees as an
employer.\textsuperscript{75} Statements made by a public employee in order to conduct his official employment duties are not protected by the First Amendment.\textsuperscript{76}

The public employee doctrine has been evolving over the last fifty years in a non-university environment. As these cases have evolved, it appears that the principles tend to favor the employer, as illustrated by \textit{Garcetti v. Ceballos}.\textsuperscript{77}

In \textit{Garcetti}, a district attorney (i.e., Ceballos) questioned the validity of a search warrant obtained by police and informed his supervisor about his concerns. Despite Ceballos’ concerns about the integrity of the search warrant, his supervisor decided to proceed with the prosecution. Ceballos claimed that he was subsequently subjected to a series of retaliatory employment actions, which included reassignment to a different position, transfer to another courthouse, and denial of a promotion. He initiated an employment grievance. Upon review, the U.S. Supreme Court ruled against Ceballos. The Court found that Ceballos had acted as an employee and not as a citizen when he questioned the disposition of a pending criminal case. The Supreme Court stated that its "precedents do not support the existence of a constitutional cause of action behind every statement a public employee makes in the course of doing his or her job."\textsuperscript{78} Instead, public employees are not speaking as citizens when they are speaking to fulfill a responsibility of their job.\textsuperscript{79} Restricting such speech, which "owes its existence to a public employee's professional responsibilities," did not in the Court's view violate any rights that the employee had as a private citizen.\textsuperscript{80} Instead, the restrictions were simply the control an employer exercised "over what the employer itself has commissioned or created."\textsuperscript{81} The Court believed this result to be consistent with its precedents regarding the protected speech of public employees, because barring First Amendment claims based on "government employees' work product," as the Court characterized the speech at issue, would not prevent those employees from participating in public debate.\textsuperscript{82}

Justice Souter wrote a dissenting opinion in \textit{Garcetti} in which he voiced a concern about the breadth of holding concerning the public employee doctrine, noting that it was spacious enough to imperil even the First Amendment protection of academic freedom in public colleges and public universities.\textsuperscript{83} The majority appears to have responded to Justice Souter’s academic freedom concern when it said “[We reserve] for a future decision the issue of whether its analysis would apply in the same manner to a case involving speech related to scholarship or teaching”.\textsuperscript{84}

The case law that has followed \textit{Garcetti} does shed some light on what the future may hold as to how the courts will apply the public employee doctrine in an academic environment. For example, in \textit{Hong v. Grant}, a professor claimed that his First Amendment rights were violated when he was allegedly denied a salary increase as a result of statements that he made criticizing university employees and the university.\textsuperscript{85} The district court entered a summary judgment against the professor, which was affirmed on appeal.\textsuperscript{86} In deciphering if the professor’s statements were made as part of his official duties as a faculty member or in his capacity of a private citizen, the district court stated that:

An employee's official duties are not narrowly defined, but instead encompass the full range of the employee's professional responsibilities. While an employee's job description is not dispositive of


\textsuperscript{77}Id.

\textsuperscript{78}Garcetti, 547 U.S. at 426; 126 S. Ct. at 1962.

\textsuperscript{79}Though the speech at issue concerned the subject matter of his employment, and was expressed within his office rather than publicly, the Court did not consider either fact dispositive, and noted that employees in either context may receive First Amendment protection. The "controlling factor" was instead that his statements were made pursuant to his duties as a deputy district attorney. \textit{Garcetti},547 U.S. at 411; 126 S. Ct. at 1954.

\textsuperscript{80}Garcetti, 547 U.S. at 421 - 422, 126 S. Ct. at 1960.

\textsuperscript{81}Garcetti, 547 U.S. at 422, 176 S. Ct. at 1960.

\textsuperscript{82}Id.

\textsuperscript{83}Garcetti, 547 U.S. at 438, 126 S. Ct. at 1969.

\textsuperscript{84}Garcetti, 547 U.S. at 425, 176 S. Ct. at 1962.


\textsuperscript{86}Id. at 1161.
his official duties, activity within an “employee's uncontested employment responsibilities” is an official duty. For example, an activity that “reasonably contributes to or facilitates the employee's performance of the official duty” is considered pursuant to the employee's official duties. Even internal complaints about the employer's supervisory failures or workplace mismanagement are consistent with the type of activities the employee is professionally obligated to perform. Taken together, the small number of cases applying [Garcetti] make clear that an employee's official duties are construed broadly to include those activities that an employee undertakes in a professional capacity to further the employer's objectives. (Citations omitted.)

Within that framework, the court then examined statements made by the professor to see if they were made as part of his official duties or as a private citizen. The first statement related to Mr. Hong's criticism of another professor's mid-career review, which the court determined were part of Mr. Hong's job responsibilities at the university. The court noted that Mr. Hong's criticisms were only delivered internally: first to a full faculty meeting and then to the department's chairperson. Given their context, form and content, the court found that Mr. Hong's statements about the other professor were not protected speech because his statements were made pursuant to official duties as a faculty member. The second statement related to Mr. Hong's criticism of the department's use of adjunct professor to teach courses, which was also communicated internally over the university email system to his departmental chair and numerous other faculty members. The court noted that Mr. Hong's “portfolio” of official duties was not limited to those within the classroom and laboratory, but extended to commenting on staffing decisions which affect his teaching load as well his colleagues' teaching loads. Once again, the court determined that this statement was made pursuant to the professor's obligations as a faculty member and not in his capacity as a private citizen. The other statements made by Mr. Hong related to criticism concerning another professor's consideration for a pay increase and the alleged circumvention by the administration of the faculty's role in the hiring process. Once again, the court ruled that these statements were made pursuant to Mr. Hong's official duties as a faculty member and therefore were not protected by the First Amendment.

In Gorum v. Sessoms, a professor suffered a similar fate when he claimed that his First Amendment rights were violated after he was fired by a public university as a result of making critical statements concerning the president and the university. The District Court disposed of the case by summary judgment in favor of the defendants, which was affirmed on appeal. The professor alleged that he was fired for unpopular views that he had taken on three different occasions. First, the professor voiced opposition to the hiring of the university president at a Faculty Senate meeting, a view of which the president was aware. Second, the professor served as an advisor to a football player who violated the university’s zero-tolerance policy against weapons possession. Third, the professor rescinded an offer that was made to the university president to speak at a breakfast meeting. Apparently, the professor later heard from several people that president “was upset about the cancellation.” In affirming the lower court’s summary judgment ruling, the appellate court concluded that the professor’s speech in all three instances was made within the scope of his employment and was not a matter of public concern.

In Adams v. Trustees of the University of N.C.-Wilmington, a district court once again disposed of a case between a professor and a public university by summary judgment where a professor claimed that his First Amendment rights were violated when he was denied a promotion on concerns about his research and publications. On appeal the

87 Id. at 1166
88 Id. at 1161-1162.
89 Id. at 1167-1168.
90 Id. at 1168-1169.
91 Id.
92 Id.
93 Id.
94 561 F.3d 179 (3rd Cir. 2009).
95 Id.
96 Id. at 183.
97 Id.
98 Id.
99 Id. at 185-187.
100 Adams v. Trustees of the University of N.C.-Wilmington, 640 F.3d 550 (4th Cir. 2011).
summary judgment was reversed. This case is somewhat factually sensitive and therefore a brief summary of the pertinent facts should be illustrative. Professor Adams taught at a public university.\textsuperscript{101} After he was hired by the university, Adams became a Christian, a conversion that transformed not only his religious beliefs, but also his ideological views.\textsuperscript{102} Subsequently, Adams applied for promotion and included some of the publications that espoused his ideological views in his promotion application.\textsuperscript{103} The department chair, after consultation with senior department faculty, rejected the promotion application.\textsuperscript{104} Adams filed a complaint in the district court asserting, \textit{inter alia}, that his First Amendment rights were violated. In its holding as to Adams' First Amendment claim, the district court reasoned that when the professor had listed his columns, publications, and public appearances in his promotion application, he implicitly acknowledged that they were expressions made pursuant to his professional duties as a faculty member.\textsuperscript{105} As a result, the district court disposed of Adams' First Amendment claim by summary judgment concluding that the publications and speeches disclosed in the promotion application by the professor were made pursuant to his official duties as a government employee under the \textit{Garcetti} standard, and thus not protected speech.\textsuperscript{106} The appellate court reversed the lower court, stating that:\textsuperscript{107}

There may be instances in which a public university faculty member's assigned duties include a specific role in declaring or administering university policy, as opposed to scholarship or teaching. In that circumstance, \textit{Garcetti} may apply to the specific instances of the faculty member's speech carrying out those duties. However, that is clearly not the circumstance in the case at bar. ... [I]n this case, Adams' speech, was intended for and directed at a national or international audience on issues of public importance unrelated to any of Adams' assigned teaching duties at UNCW or any other terms of his employment found in the record. ...[N]one of Adams' speech was undertaken at the direction of UNCW, paid for by UNCW, or had any direct application to his UNCW duties. Applying \textit{Garcetti} to the academic work of a public university faculty member under the facts of this case could place beyond the reach of First Amendment protection many forms of public speech or service a professor engaged in during his employment. That would not appear to be what \textit{Garcetti} intended, nor is it consistent with our long-standing recognition that no individual loses his ability to speak as a private citizen by virtue of public employment. In light of the above factors, we will not apply \textit{Garcetti} to the circumstances of this case.

In the aftermath of \textit{Garcetti}, the above cases do provide a hint as to how the public employee doctrine may impact the academic environment. Indeed speech made by a faculty member in their administrative capacity is different than speech made by a faculty member in capacity as a researcher and publisher. But both forms of speech are job related for a faculty member. As part of shared governance, most public universities require faculty members to perform administrative functions as well as perform research and publication activities. A faculty member that does not publish could lose his or her job. In a public employee doctrine analysis, it may be difficult for a court to determine if a faculty member is satisfying the research and publication requirements to keep his job or is exercising his right to speak on matters of public concern in his capacity as private citizen. The district court in \textit{Adams} had difficulty in this area. Does it follow that speech that emanates from the administrative duties of the faculty member (“Administrative Speech”) is speech related to the official employment duties of a faculty member and therefore not a matter of public concern? Does it follow that speech made by a faculty member in capacity as a researcher and publisher is also speech that relates to the official employment duties of a faculty member and therefore is not a matter of public concern? The appellate court in \textit{Adams} seems to answer the latter question in the negative.

\section*{V. CONTRACTUAL ACADEMIC FREEDOM}

\textsuperscript{101}Id. at 553.
\textsuperscript{102}Id.
\textsuperscript{103}Id.
\textsuperscript{104}Id. at 555.
\textsuperscript{105}Id at 561-562
\textsuperscript{106}Id. at 561.
\textsuperscript{107}Id. at 563-564.
While the case law implies that there is a constitutional concern for academic freedom, as a practical matter, an analysis of the scope and extent of academic freedom in the public university setting should begin with the employment contract.

The employment relationship between a public university and its faculty members is governed in large part by contract principles. Within this contractual relationship lie the liberties of academic freedom. Unlike institutional academic freedom, which came from case law, the foundation for faculty academic freedom rests upon notions of privity. In essence, the academic freedom of a faculty member is an internal adjustment of rights between the employee(s) (i.e., the faculty members) and the employer (i.e., the public university). This adjustment of rights is accomplished through the employment contract.

Through freedom of contract, the public university grants its faculty members the right to take control over the evaluation of scholarly research and other academic activities. As a consequence, the individual faculty member is free to pursue his or her investigative endeavor without ecclesiastical, social or economic concern, which is fundamental to modern science and the pursuit of truth. The scrutiny of a faculty member’s academic pursuits is left to the members of his or her guild, which in many cases are housed in a university or institutional environment.

For the most part, freedom of contract has worked well in preserving the academic privileges of university faculty. For example, in 1940, the AAUP in conjunction with the Association of American Colleges and Universities jointly agreed on the following statement concerning academic freedom:

1. Teachers are entitled to full freedom in research and in the publication of the results, subject to the adequate performance of their other academic duties; but research for pecuniary return should be based upon an understanding with the authorities of the institution.

2. Teachers are entitled to freedom in the classroom in discussing their subject, but they should be careful not to introduce into their teaching controversial matter which has no relation to their subject. Limitations of academic freedom because of religious or other aims of the institution should be clearly stated in writing at the time of the appointment.

3. College and university teachers are citizens, members of a learned profession, and officers of an educational institution. When they speak or write as citizens, they should be free from institutional censorship or discipline, but their special position in the community imposes special obligations. As scholars and educational officers, they should remember that the public may judge their profession and their institution by their utterances. Hence they should at all times be accurate, should exercise appropriate restraint, should show respect for the opinions of others, and should make every effort to indicate that they are not speaking for the institution.  

As of the turn of the millennium, more than 200 institutions of higher learning have adopted the Statement on Academic Freedom promulgated by the AAUP in 1940. These academic freedom principles can probably be found in some form or another in the employment contract between the faculty member and the public university.

Unfortunately, freedom of contract provides limited academic freedom protection in an at will employment relationship. In an at will employment relationship, the employer can terminate the employee without cause. As a consequence, other than the due process notions set forth under the law for government employees, a public university has very few constraints in terminating the employment relationship of non-tenured faculty. On that concern, in 1915 the AAUP recommended tenure and the right to a pre-termination hearing before academic peers in

108 Id. at pgs. 3-4.
110 For faculty covered by collective bargaining agreements, that the academic freedom rights may be found in the collective bargaining agreement and incorporated by reference.
order to protect the academic freedom rights of the faculty. A similar concept was adopted by the AAUP in 1940 where it codified the academic freedom principles promulgated in 1915.\textsuperscript{112}

In addition, freedom of contract principles will be at stake where academic freedom privileges collide with the public employee doctrine. As a general rule, the university will have the right to control the activities of the faculty member under the public employee doctrine where the activities are part of the official public duties of the faculty member. Official public duties of a faculty member is generally determined from industry custom and the employment contract. As a consequence, the employment contract could be a material factor in influencing a public employee doctrine analysis. If the employment contract contains broad academic freedom privileges and the faculty member’s activities fall within such provisions, then it will be unlikely that the public employee doctrine can be used to suppress the employee’s activities because to hold otherwise would be a breach of contract.

In summary, the Supreme Court of the United States has stated that academic freedom is a special concern of the First Amendment but to date the Court has not given academic freedom constitutional status.\textsuperscript{113} At best, the Supreme Court has developed an amorphous quasi-legal concept for academic freedom with questionable precedent.\textsuperscript{114} As consequence, the analysis of academic freedom rights at a public university should begin with the employment contract where there is a dispute concerning such rights between a university and a faculty member. Within the employment contract lays the answer to the official public duties of a faculty member, which in turn could negate the impact of the public employee doctrine on academic freedom.

VI. CONCLUSION AND FUTURE RESEARCH IMPLICATIONS

The meaning of academic freedom is often a matter of perception. The majority of courts perceive academic freedom as an institutional right that provides the university with four essential freedoms (e.g., the right to determine who may teach, what may be taught, how it shall be taught, and who may be admitted to study).\textsuperscript{115} The members of the academy perceive academic freedom as a right that provides a faculty member(s) with the absolute freedom in research and publication of the results along with a limited freedom in the classroom in discussing their subject in the classroom.\textsuperscript{116}

The two perceptions of academic freedom produce a paradox for our society. It has been stated that the classroom is peculiarly the ‘marketplace of ideas’ and the nation's future depends upon leaders trained through wide exposure to that robust exchange of ideas which discovers truth 'out of a multitude of tongues, (rather) than through any kind of authoritative selection.\textsuperscript{117} Teachers and students must always remain free to inquire, to study and to evaluate, to gain new maturity and understanding; otherwise our civilization will stagnate and die.\textsuperscript{118} On the other hand,

\textsuperscript{113}See Urofsky v. Gilmore, 216 F.3d 401 (4th Cir. 2000).
\textsuperscript{115}See Sweezy, 354 US. 234, 263, 77S.Ct. 1203, 1218(1957), concurring opinion. In the area of affirmative action, university admission standards are subject to restrictions. But see, Regents of the University of California v. Bakke, 438 U.S. 265, 98 S.Ct. 2733 (1978) where the Supreme Court held that admissions based on racial quotas was unconstitutional. See also, Grutter v. Bollinger, 539 U.S. 306, 123 S.Ct. 2325 (2003), where the Supreme Court found that a race-conscious admissions process that also took into account many other factors for each individual applicant did not amount to an unconstitutional quota system.
\textsuperscript{117}See Sweezy, 354 US. 234, 250; 77S.Ct. 1203, 1212(1957).
\textsuperscript{118}Merton in his classic formulation of the ethos of science as a social institution with its own normative behaviors, points this out by drawing the connection between science as an institution of society that is not fully integrated into
academic freedom is of transcendent value to all of us and not merely to the teachers concerned. If our nation is deeply committed to safeguarding academic freedom, then given a choice which perception of academic freedom should society give preference, the institution’s or the individual’s?

The irony is that the public employee doctrine may hold the answer to this paradox, as illustrated in *Garcetti v. Ceballos*. As discussed, Ceballos was a district attorney who was reprimanded by his government employer for questioning the validity of a search warrant obtained by the police. The Supreme Court of the United States ruled in favor of the institution. In essence, the right of a public institution to efficiently perform public services was superior to an individual’s quest for the judicial truth under the circumstances of that case.\(^{119}\)

This inference does not bode well for the search for the truth in higher education. The university’s interest as a public employer should not be allowed to overshadow academic freedom rights of its faculty members. To remove this shadow, it behooves public university faculty to insure that the principles and folklore of academic freedom remain a contractual liberty in the employment contract so as to preserve these fundamental rights for the next generation of scholars.\(^{120}\)

Academic freedom flourishes in an employment relationship that respects human individuality and the values imbedded in the first amendment.\(^{121}\) In the context of a faculty member, academic freedom is a contractual liberty that has become a fundamental right in the modern day university.\(^{122}\) Further research should be conducted to determine if the legal standards adopted by the courts will have a positive or negative impact on the contractual liberties of college professors. In addition, research should be conducted in order to determine if the legal system is better equipped to develop academic freedom principles than the institutions of higher education and their constituents.

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American national social structure and how this situation can place its individual norms in opposition to those of other institutions within American society such as religion or politics. Merton, (1968) at 606-08.

\(^{119}\)See *Garcetti*, 547 U.S. at 438, 126 S. Ct. at 1969, where Justice Souter wrote a dissenting opinion in *Garcetti* in which he voiced a concern about the breadth of holding concerning the public employee doctrine, noting that it was spacious enough to imperil even the First Amendment protection of academic freedom in public colleges and public universities.

\(^{120}\)See AAUP’s 1915 Declaration of Principles(December 1915) pgs. 6-7.

\(^{121}\)Hofstadter and Metzger, (1955), at 62.

\(^{122}\)See *Sweezy*, 354 U.S. at 250, 77 S. Ct. at 1211, where the majority stated in dictum that, “We believe that there unquestionably was an invasion of petitioner's liberties in the areas of academic freedom and political expression - areas in which government should be extremely reticent to tread.”
IS THE FEDERAL INCOME TAX CODE UNCONSTITUTIONALLY VAGUE?

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ABSTRACT

Taxes are the price of living in a civilized society and no one disputes the right of the federal government to tax income. However, the federal tax code may have become so complicated that it is unconstitutionally vague. A law is unconstitutionally vague when a person of ordinary intelligence cannot determine what is required of him or her. There is a presumption that laws are constitutional and that presumption can only be rebutted by clear and convincing evidence. However, there is a broad and deep body of clear and convincing evidence that the tax code is so complex that it is unconstitutionally vague. The contribution of this article is to create a record of tax code complexity that can be used as the basis for judicial action.

INTRODUCTION

No competent jurist doubts the right of the federal government to tax income under the 16th Amendment. Taxes are part of the price of living in a civilized society. The issue is whether Congress has made the tax code so complex that it is unconstitutionally vague in violation of Fifth Amendment Due Process. A law is unconstitutionally vague when an individual of ordinary intelligence cannot determine what is required of him or her, United States v. Lanier, 520 U.S. 259, 266 (1997); Connally v. General Construction Co. 269 U. S. 385, 391 (1926).

Due process requires fundamental fairness and decency in both the law and the operation of the law. The government may not act in a manner that is arbitrary, capricious, or unreasonable. Due process includes notice of what the law demands (Lee Reed, Peter Shedd, Jere Morehead, and Marisa Anne Pagnattaro The Legal and Regulatory Environment of Business, 14th Ed. 2008). But, the tax code is so complex that few, if any, people know what the law demands in all situations.

The Supreme Court has held statutes void and unconstitutional because they are so vague that people of ordinary intelligence do not understand how to conform their behavior to the requirements of the law. Arthur C. Clark a 20th century fiction writer said, “Any sufficiently advanced technology is indistinguishable from magic” (Edward Rothstein “For Clarke, Issues of Faith, but Tackled Scientifically,” New York Times March 20 2008). Likewise, any law that is sufficiently complex can be made vague to the point where it cannot be understood.

LEGAL ANALYSIS

History

The concept of due process pre-dates the Constitution of the United States and elements of due process can be traced back to the Code of Hammurabi when laws were reduced to writing so that everyone understood their rights and duties (translated by L. W. King (1915) Yale Law Library Avalon Project 2,500 B.C). Due process was also codified in chapter 39 of the Magna Carta, in which King John promised that “[n]o free man shall be taken or imprisoned or disseized (deprived of property)… except by the lawful judgment of his peers or by the law of the land” (William McKechnie Magna Carta—A Commentary on the Great Charter of King John 375-95 1914). Due process was first incorporated into the Constitution of the United States in the Fifth Amendment which states that, “No person shall be deprived of life, liberty, or property, without due process of law.”

In Solesbee v. Balcom 339 U.S. 9, 16 (1950) the court said, “Due Process... embodies a system of rights based on moral principles so deeply imbedded in the traditions and feelings of our people as to be deemed
Fundamental to a civilized society. Due Process is that which comports with the deepest notions of what is fair and right and just," Solesbee v. Balcom, 339 U.S. 9, 16 1950, Snyder v. Massachusetts, 291 U.S. 97, 105 1934. Due process is "a historical product," Jackman v. Rosenbaum 260 U.S. 22, 31 (1922). Among other things, due process requires notice of the crime one is accused of, the right to present and cross examine witnesses and to submit evidence. None of these rights are meaningful, if a person cannot understand the law under which his or her conduct is being judged.

**Rationale for the Void for Vagueness Doctrine**


The second policy advanced by, the void for vagueness doctrine is to curb the arbitrary and discriminatory enforcement of criminal statutes. Laws must be understood both by persons who are required to obey them and by those charged with the duty of enforcing them. Adam Smith wrote, “The tax each individual is bound to pay ought to be certain and not arbitrary… The quantity to be paid ought to be clear and plain to the contributor, and to every other person. Where it otherwise, every person subject to the tax is put more or less in the power of the tax-gatherers." (Adam Smith The Wealth of Nations (Edwin Cannan, ed., Modern Amer. Lib., NY. 1937.) bk V, ch II, pt. II at 778, Maxim II 1789).

Statutes that do not carefully outline procedures by which police officers may perform an investigation, conduct a search, or make an arrest confer wide discretion upon each officer to act as he or she sees fit. Precisely worded statutes are intended to confine an officer's activities to the letter of the law. In the context of taxes, IRS agents are police officers. Vagueness is condemned where it results in government by the whim of whoever applies vague statutory language to the facts Shuttlesworth v Birmingham (1965) 382 US 87, 92.

The third, reason for the void for vagueness doctrine is that it discourages judges from attempting to apply sloppily worded laws. Like the rest of society, judges often struggle with poorly worded legislation. Even respected judges have difficulty interpreting and applying tax law Rebecca K. Crown Income Charitable Fund v. Commissioner 8 F.3d. 571, 576 (7th Cir 1993); “Eulogy of Thomas Walter Swan,” 57 Yale L.J. 167, 169 (1947). "A law fails to meet the requirements of the due process clause if it... leaves judges and jurors free to decide, without any legally fixed standards, what is prohibited and what is not in each particular case." A statute of this kind is also constitutionally objectionable on the ground that it delegates legislative power to courts and juries Giaccio v Pennsylvania 382 US 399, 402-403 (1965).

The fourth reason for the void for vagueness doctrine is to avoid encroachment on freedoms guaranteed by the Bill of Rights. Vague laws cause uncertainty in the minds of average citizens, and some citizens will inevitably decline to undertake risky behavior that might land them in jail or subject them to penalties for underpayment of taxes. Coleen Yamaguchi writing in The Tax Lawyer said, “The principal rationale for the unconstitutional vagueness... in tax cases has been the due process concept of providing the taxpayer with fair notice of his or her legal duty” (Coleen Yamaguchi “Uncertainty in The Law: An Uncertain Defense in Criminal Tax Prosecution,” 39 The Tax Lawyer 199 1986).
Standard of Review

Courts presume laws are constitutional and will only rule them unconstitutional under extraordinary circumstances. The complexity of the tax code might constitute such an extraordinary circumstance. When evaluating the constitutionality of a law, the court first looks to see whether the law burdens a fundamental right. A fundamental right is one articulated in the Bill of Rights or one that is deeply rooted in American history and traditions Snyder v. Commonwealth of Massachusetts 291 U.S. 97 (1934).

Where the right burdened is not a fundamental right, for example the right to a driver’s license, to a building permit or the like, the court applies a rational basis test. The rational basis test says that if the law is rationally related to a legitimate government purpose, then the law is valid United States v. Carolene Products Co., 304 U.S. 144 (1938).

If the court concludes a fundamental right is burdened, it applies strict scrutiny. Under the strict scrutiny test, the court inquires into whether there is a compelling state interest. If a law is subject to strict scrutiny and no compelling state interest is found, the law may be struck down as unconstitutional. If a law burdens fundamental rights and there is a compelling state interest, the courts will balance competing interests. In this context, the phrase state interest means government interest (Tony Mauro Illustrated Great Decisions of the Supreme Court CQ Press, 37-38 2000, Sherbert v. Verner, 374 U.S. 398 1963).

Rights Burdened

Are any rights burdened by the tax code? Payment of taxes due and owing is not a legally recognizable burden. Taxes are the price of living in a civilized society, so mere payment of taxes impairs no right. Treating different taxpayers differently in terms of deductions, credits and phase outs does not, per se, burden fundamental rights to either due process or equal protection. Then what rights are burdened by the tax code?

Missteps in trying to comply with the tax code can result in substantial penalties. The Internal Revenue Code provides that “any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony…” 26 U.S.C. §7201. A taxpayer convicted of criminal fraud is subject to a fine of up to $100,000 ($500,000 in the case of a corporation) or imprisonment of up to five years (Ephraim Smith, Phillip Harmelink and James Hasselback. 2009 CCH Federal Taxation Comprehensive Topics, para. 2365 2008). Vague laws may trap the innocent by failing to provide a fair warning of what the law requires Grayned v. City of Rockford, 408 U.S. 104, 108-09 (1972). Therefore, vague laws, such as the tax code, burden the fundamental right to liberty, through imprisonment, and burden the right to property through avoidable fines, penalties and interest.

Some might argue that the “willful” provision of 26 U.S.C. §7201 precludes prosecution for a mistake in the interpretation or application of tax law. But, willfulness is an inherently fuzzy concept which is often in the eye of the beholder.

The fundamental rights of liberty and property are also burdened if the code is so vague that those charged with enforcing the laws have no standard for deciding whether taxpayer conduct was within or outside of the bounds of the law. When a law is so vague it doesn’t provide standards to those charged with enforcing the law, it can be unconstitutional Grayned (1972). On the other hand, individual rights are not absolute. They must be balanced against legitimate state interests. The Fifth Amendment acknowledges this when it says “No person… shall be deprived of life, liberty or property without due process of law…” U.S. Const. amend V.

Compelling Government Interest

The government must raise taxes to provide for defense, public health, public safety, and infrastructure. The 16th Amendment to the Constitution authorizes the income tax and no one questions the right of the United States to levy taxes and raise revenue. On the surface that would seem to provide the compelling state interest needed to uphold the constitutionality of the tax code.

Limits on Government Interest

Can the Congress write a law of unlimited complexity as long as it serves a compelling state interest? For example, can Congress write a law in Latin or Cuneiform? There are at least two limits on the laws Congress can
enact. First, a statute touching fundamental rights must be narrowly drawn to achieve the government’s interest. *Cantwell v Connecticut* (1940) 310 US 296, 311; *Elfbrandt v Russell* 34 US Law Week 4347, 4349 (1966); *Zwickler v. Koota*, 389 U.S. 241, 250 (1967); *NAACP v. Alabama*, 377 U.S. 288, 307 (1964). In other words, a law cannot be unnecessarily broad *Aptheker v Secretary of State* (1964) 378 US 500, 508. It must be surgical in its nature to protect the government’s interest while providing the minimum invasion of fundamental rights. Second, the statute must provide notice of the burdens and benefits of the law. As the Supreme Court said in *Lanier* (1997), the vagueness doctrine precludes the enforcement of "a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application."

Complexity is the functional equivalent of vagueness because it burdens due process in exactly the same way. The tax code is so complex that neither citizens, nor those charged with enforcing it, IRS employees, can determine what the law requires on a reliable and consistent basis.

Due process is a restraint on legislative, executive and judicial powers. Congress cannot make any process 'due process of law' by its mere will *Murray's Lessee v Hoboken Land and Improvement Co.* 59 U.S. (18 How.) 272, 276 (1856); *Trustees of Dartmouth College v Woodward*, 17 U.S. (4 Wheat.) 518-82 (1819); *Jones v Robbins*, 74 Mass. (8 Gray) 329 (1857). All persons within the territory of the United States are entitled to due process protection, including corporations *Sinking Fund Cases*, 99 U.S. 700, 719 (1879).

**Narrow Construction**

In addressing the issue of whether the tax code is narrowly drawn to raise revenue for the government, consider the words of the 16th Amendment:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Does levying and collecting of income taxes give rise to complexity, or does the social engineering built into the income tax code give rise to the complexity? The tax code is festooned with deductions, refundable credits, non-refundable credits, phase outs, schedules, worksheets, brackets, basis in property, and terms whose definitions differ from place to place in the tax code; instructions and forms that refer to other instructions and forms that refer to yet other instructions and forms. The code also includes the Alternative Minimum Tax which is a completely separate tax system with its own forms, schedules, worksheets, instructions, property basis and deductions. In short, the tax code is not narrowly draw to affect the legitimate state interest of levying and collecting taxes. It has become an instrument of social engineering; an artifice to reward or discourage behavior; and a means to bestow favors on those with strong lobbies or voting blocks.

The tax code burdens the fundamental rights of liberty and property because complexity coupled with tax sanctions chill taxpayer action in claiming credits and deductions legally due the taxpayer. A chilling effect occurs when legitimate speech or conduct is self-censored by fear of penalization. Vagueness in the tax code can also have a chilling effect on challenging the findings of the Internal Revenue Service. It is hard for citizens of ordinary intelligence to understand their rights and duties, and that effectively deprives taxpayers of due process.

**Counter Argument**

The counter argument is that the tax code does not burden fundamental rights and that it is more akin to economic regulation. Laws that regulate the economy are scrutinized less closely than laws that regulate individual behavior. Laws that impose civil or administrative penalties may be drafted with less clarity than laws imposing criminal sanctions (“Void for Vagueness Doctrine,” American Law Encyclopedia, Vol. 10. http://law.jrank.org/pages/11152/Void-Vagueness-Doctrine.html 2009).

The social engineering that provides preferences to some taxpayers through deductions, credits and so forth and denies them to others through phase outs and limits is arguably economic regulation. Unfortunately, this economic regulation is inextricably bound up with the revenue raising aspect of the tax code and its penal nature. “Tax… obtained by the seizure of property can rarely be extorted by any other means than those of corporal punishments.” (Edward Gibbon *Decline and Fall of the Roman Empire* 493 (Heritage Press republished 1946) 1788).
Seizure of property and criminal prosecution, two tools routinely used by the Internal Revenue Service, clearly result in deprivation of liberty and property, and thus may burden those two fundamental rights when the contours of the law are vague. Therefore, on balance, the standard of strict scrutiny should be applied to the income tax code. But even under strict scrutiny, further analysis is required because of the state’s compelling interest in raising tax revenue.

Standard of Proof

The standard of proof for unconstitutional vagueness is very high. There is a strong presumption that laws enacted by the legislature are constitutional. Distinguishing between unconstitutional vagueness and ordinary ambiguity is often difficult. "There is no exact borderline which can be drawn between a statute which is merely ambiguous and one which is unconstitutionally vague." (Wayne LaFave and Austin Scott Criminal Law § 10, at 74 1972).

The burden is on the plaintiff to show a law is unconstitutionally vague, and if there are any circumstances in which the statute is not vague, it will not be held unconstitutional Commonwealth v. Henry's Drywall Co., 366 Mass. 539, 542-544 at 542 (1974). Furthermore, a law may be constitutional as applied in one matter and may violate the constitution when applied to another Watson v. Buck 313 US 387 (1941). A statute must also be judged by its effect Waddey v. Waddey, 290 NY 251, 49 NE 2d. 8 (1943); Davis v. Mills 194 US 451, 457 (1904) and whether it provides adequate notice Wright v. Georgia (1963) 373 US 284. This leads directly to the question of how one proves vagueness. Evidence must be clear and convincing. Courts will not act without facts in the record Brotherhood of Carpenters v. McAdroy, 325 US 450 (1945). The purpose of this paper is to build a record upon which the courts can act.

FACTUAL ANALYSIS

Critique of the Tax Law Complexity


IRS Comments on Tax Complexity

The Burden of Compliance as a Measure of Complexity

The tax code has grown so large, it is difficult to measure its size, but at last count is was more than 4 million words and every year it takes taxpayers six billion hours to complete tax forms according to IRS Taxpayer Advocate Nina Olson in her annual report to Congress.

“The existing tax code makes compliance difficult, requiring taxpayers to devote excessive time to preparing and filing their returns. It obscures comprehension, leaving many taxpayers unaware how their taxes are computed and what rate of tax they pay; it facilitates tax avoidance by enabling sophisticated taxpayers to reduce their tax liabilities and provides criminals with opportunities to commit tax fraud; and it undermines trust in the system.” (Kelly Phillips Erb “Tax Code Hits Nearly 4 Million Words, Taxpayer Advocate Calls It Too Complicated,” Forbes. Jan. 10.
http://www.forbes.com/sites/kellyphillipserb/2013/01/10/tax-code-hits-nearly-4-million-words-taxpayer-advocate-calls-it-too-complicated/ 2013.)

There were 833 Tax Forms and 289 sets of instructions for those forms posted on the IRS website as of June, 2009. Consider the complexity of Form 1040. It requests 87 data elements to compute taxes, uses conjunctions like “and,” and “or” 18 times, uses logical operators like “if,” “otherwise” and “qualifying” 21 times, uses 28 exemptions, deductions and credits, requires 20 calculations like add, subtract and multiply, it references 22 schedules, and directs the taxpayer to instructions 36 times in addition to referencing 32 forms and the Alternative Minimum Tax which has all the complexity of an independent tax system with its own credits, deductions, add-backs, property basis, and tax rates.

There are many other layers of complexity as well. Form 1040 refers to Schedules A, B, EZ-C, D, and Form 1099. These forms refer to other forms, schedules and worksheets. For example, Schedule A references 8 other forms, schedules and worksheets, Schedule B references 5 other forms, schedules and worksheets, Schedule EZ-C references 12 other forms, schedules and worksheets, and Schedule D references 19 other forms, schedules and worksheets. The tax code has made something as simple as reporting dividends complex. Form 1099-Div refers to instructions for schedules A, B and D, a worksheet for schedule D and instructions for 8 other forms.

It is estimated that Americans spent between $67 billion and $378 billion in accounting costs related to filing taxes in 2012 (Jason Fichtner and Jacob Feldman “The Hidden Costs of Tax Compliance,” Mercatus Center, George Mason University, Arlington, VA. May 20 http://mercatus.org/publication/hidden-costs-tax-compliance 2013). From the point of view of companies, tax compliance is a dead weight loss. But is the cost and expense of complying with the law sufficient to render it unconstitutionally vague? Probably not.

Standards

A law may be held unconstitutionally vague if reasonably intelligent people must guess at its meaning. But what is the yardstick for measuring who is a reasonably intelligent? Justice Frankfurter said unconstitutional indefiniteness is itself an indefinite concept Winters v. New York, 333 U.S. 507, 524 (1948). So, the first order of business is to lay an objective standard for the reasonably intelligent man or woman, otherwise analysis degenerates into subjective bickering. We expect people to understand that a red light means stop 100% of the time, to understand that a stop sign mean stop 100% of the time, and to not drink and drive 100% of the time. Some may elect to not obey these laws, but we expect all to understand them. Is anyone who understands the law on red lights, stop signs and drinking and driving reasonably intelligent? If so, then these people should be used as the standard for testing whether the tax code is unconstitutionally vague.

On the other hand, there are laws we don’t expect people of ordinary intelligence to understand such as securities laws, bankruptcy, and laws governing the pharmaceutical and nuclear industries. The difference between traffic laws and laws governing specific industries is that everyone has direct contact with traffic laws. In contrast, people choose to engage in securities transactions, bankruptcy, pharmaceutical development or nuclear power operations. People have no choice when it comes to tax law. Everyone is impacted. Everyone must pay taxes. People cannot opt out of taxation. When a law touches everyone, everyone should understand it.

According to the US Census Bureau, 84.5% of the US population has graduated from high school (”Table 225 Educational Attainment by State," The 2009 Statistical Abstract: The National Data Book, US Census Bureau
Arguably, anyone who graduates from high school should be reasonably intelligent, although one might be reasonably intelligent and not be a high school graduate. For argument’s sake, say all high school graduates and half of non-graduates are reasonably intelligent in terms of knowing what the law requires. That would set our benchmark of reasonably intelligent people at 92.3% of the population. But what does actual behavior say?

Since tax preparation is expensive, we might expect only 7.7% of taxpayers, those who are not reasonably intelligent, to seek help filing their taxes. However, for 2006, 62.8% of taxpayers paid a professional to complete their tax return or bought tax preparation software ("Tax Year 2006 Taxpayer Usage Study IRS Report Number 16," Internal Revenue Service US Department of Treasury http://www.irs.gov/taxstats/article/0,,id=184856,00.html 2007). This is far higher than expected if 92.3% of taxpayers understood the tax code and only 7.7% didn’t. These data provide some evidence that the majority of reasonably intelligent taxpayers don’t understand the tax code.

A counter argument is that the tax law is perfectly clear to one trained in taxes, or the law, or accounting. The question that flows from that is whether a challenge for unconstitutional vagueness will fail if some people understand the tax code? But note the language of the cases; a statute will fail for unconstitutional vagueness if people of ordinary intelligence do not know what is required. Ordinary people are the benchmark, not experts (Calvin Jeffries “Legality, Vagueness, and the Construction of Penal Statutes” 71 Va. L. Rev. 189, 211 1985).

Complexity as Measured By Taxpayer Errors

Another method to determine whether the tax code is so complex that people of ordinary intelligence do not know what is expected of them is to analyze taxpayer errors. While it could be argued that some errors were caused by taxpayers loosing W-2s or other documentation or by deliberate attempts to reduce tax liability; no one could credibly argue that all taxpayer errors were due to these causes. Table 1 Analysis of Taxpayer Errors provides clear and convincing evidence that the tax code is so complex that people of ordinary intelligence do not understand it.
Table 1 Analysis of Taxpayer Errors

The error rate for taxpayer prepared returns provides evidence that the tax code is so complex that taxpayers do not understand what is required. Some errors could be caused by lost documentation or deliberate errors to reduce tax liability. However, no one could credibly argue these reasons account for all taxpayer errors.

<table>
<thead>
<tr>
<th>Study</th>
<th>Subject</th>
<th>Year</th>
<th>Error Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Inspector General for Tax Administration Office of Audit, Mar.30 Rpt.No.2009-40-058</td>
<td>IRS analysis of 11.4 million returns found 5.4 million contained errors. Of 13.9 million businesses eligible for telephone tax rebates 8.9 million failed to claim refunds due to complexity.</td>
<td>2009</td>
<td>47.4%</td>
</tr>
<tr>
<td>Treasury Inspector General for Tax Administration Office of Audit, Sept.17 Rpt.No.2008-30-175</td>
<td>Of 42 of 84 loss carry back claims selected for audit contained errors due to complexity.</td>
<td>2008</td>
<td>50.0%</td>
</tr>
<tr>
<td>Treasury Inspector General for Tax Administration Office of Audit, May.25 Rpt.No.2007-40-079 and IRS - 2007 Filing Season Statistic - Table 13</td>
<td>Of 4.5 million corrected and resubmitted electronic returns 1.2 million could not be processed</td>
<td>2007</td>
<td>22.1%</td>
</tr>
<tr>
<td>Treasury Inspector General for Tax Administration Office of Audit, May.25 Rpt.No.2007-40-079 and IRS - 2007 Filing Season Statistic - Table 13</td>
<td>100 million IRS notices of potential errors were sent on 138.4 million taxpayers. Analysis of 39 of 40 senior citizen returns contained social security or other errors.</td>
<td>2006</td>
<td>72.3%</td>
</tr>
<tr>
<td>Treasury Inspector General for Tax Administration Office of Audit, Rpt. 2007-30-075.</td>
<td>About 94.4% of 13.9 million eligible businesses failed to apply for telephone tax refunds due to them.</td>
<td>2006</td>
<td>97.5%</td>
</tr>
<tr>
<td>Treasury Inspector General for Tax Administration Office of Audit, Rpt. 2007-30-075.</td>
<td>A survey of 2,244 taxpayers found 1,481 made errors on routine tax matters.</td>
<td>2005</td>
<td>94.4%</td>
</tr>
</tbody>
</table>


Each year the IRS sends more than 100 million notices to taxpayers that there are errors or potential errors in their returns out of about 138.4 million returns. This means about 72.3% of returns were suspected of containing errors according to the IRS (“Opportunities Exist to Help Seniors and Many Other Taxpayers That Repeatedly Make
Over the period 2003 to 2005 about 8 million people a year filed unnecessary tax returns and collectively spent $390 million and 75 million hours per year on those returns because they didn’t understand who must file and whether they were entitled to a tax refund. The taxpayer effort on these returns was equal to 37,500 full time employees. The IRS spent $11 million processing these unnecessary returns (“Evaluation of the Characteristics of Unnecessarily Filed Individual Income Tax Returns,” Treasury Inspector General for Tax Administration Office of Audit, Aug.17 Rpt.No.2007-40-130 2007).


The foregoing list of taxpayer errors is not exhaustive, but is rather is a sample of the some errors documented by the Treasury Department, Internal Revenue Service and others. Since these studies were made, the tax code has become more complex which is likely to result in even more errors.

Overall, the error rate among taxpayers seems far higher than one might expect if 92.3% of taxpayers understood the tax code and only 7.7% didn’t understand it. This taxpayer error rate provides clear and convincing evidence that taxpayers of ordinary intelligence do not understand what the law requires.
There is no other endeavor in either public or private life where the foregoing level of errors would be tolerated. Imagine this level of errors at the supermarket checkout, in purchasing gasoline, or in drug strength. Yet Congress and the courts have failed to act to simplify the tax code to the point where ordinary individuals can no longer understand and discharge their legal duty to pay the amount of tax properly due and owing.

**Complexity as Measured by Computer Software Errors**

An argument against finding the tax code unconstitutionally vague is that tax preparation software simplifies the filing process to the extent that a taxpayer need not understand the intricacies of the tax code. The best tax preparation software tries to capture a broad understanding of taxpayer’s situation by asking a series of yes or no questions. Often taxpayers are only dimly aware of the importance or implication of those questions and as a result tax liability is incorrectly computed. Computer output can be no more accurate than the people who write the software or input the data. If the tax code is so complex those who input data or write the software do not understand the tax code, the software cannot possibly arrive at the correct tax liability.

While software has helped, it is far from erasing complexity. For example, in 2007 approximately 5.7 million of 80.0 million electronically submitted returns were rejected by the IRS giving an error rate of 7.15% on tax software. Of those, 4.5 million electronic returns were subsequently corrected and resubmitted, yet 1.2 million or 22.2% of those with initial errors still could not be processed (“Screening Electronically Filed Returns for Errors Provides a Significant Benefit and Does Not Appear to be a Barrier to Electronic Filing,” Treasury Inspector General for Tax Administration Office of Audit, May.25 Rpt.No.2007-40-079 2007; “Internal Revenue Service - 2007 Filing Season Statistic - Table 13 for the weeks ending 12/29/2006 and 12/28/2007” IRS report provided pursuant to Freedom of Information Act request 2007). Through March of 2010, about 23,902 (24 percent) of the 98,596 tax returns electronically filed were rejected, and further analysis disclosed that 19 of the 30 edit rules used by the IRS electronic filing system (63%) were rejecting returns inappropriately or without accurate explanation. Through March 2010, half a million returns were filed without a valid Social Security Number and in 40,587 cases (8%) the IRS still refunded “Making Work Pay” credits. It should be noted that in 36,116 cases taxpayers did not ask for “Making Work Pay” credits, but IRS programs computed the refund and paid taxpayers $15.9 million anyway (“Interim Results of the 2010 Filing Season,” Treasury Inspector General for Tax Administration Office of Audit, March 31 p.12 Rpt.No.2010-41-047 2010). Software errors persist into 2011. Programming errors resulted in creating faulty databases and erroneous allowance of First-time Home Buyer Credits and Non-Business Energy Property Credits (“Interim Results of the 2011 Filing Season,” Treasury Inspector General for Tax Administration Office of Audit, March 31, Rpt.No. 2011-40-032 2011).


The point is that the tax code is so complex and mutates so fast that IRS software is festooned with errors. Though in fairness to the IRS, no organization could keep up with the layered, inter-related nature of tax code language or the torrent of changes mandated by Congress.

The adequacy of tax preparation software depends on how well programmers understand the tax code. Since not even IRS computer systems, backed up by all the resources of the Internal Revenue Service can correctly interpret and apply the code, it would take faith that can move mountains to believe tax preparation software is flawless. IRS problems with tax software provide clear and convincing evidence that tax preparation software cannot solve the problem of an overly complex tax code.

**Complexity as Measured by Professional Tax Preparer Errors**

If ordinary taxpayers have a high error rate, what about professional tax preparers? If anyone understands the tax code it should be them. Over the period 1988 to 1997 Money Magazine asked 332 professionals to prepare tax returns for a hypothetical family. The overall error rate on these returns was 95.5% (Teresa Tritch and Deborah Lohse “Tax payers, start worrying!” Money March, Vol. 21 Issue 3, p88 1992; Teresa Tritch and Roberta Kirwan “Keep an eye on your tax pro” Money March Vol. 22 Issue 3, p98 1993; Teresa Tritch “Why your tax return could cost you a bundle” Money March, Vol. 26 Issue 3, p80 1997; Joan Caplin “6 Mistakes Even the Tax Pros Make,”
A 1994 *Money* survey asked 50 tax preparers questions such as the treatment of various deductions and income from tax-exempt bonds. The 50 preparers included 19 CPAs and 12 enrolled agents. None of the preparers got all 10 questions correct and only 34 got half the questions right (Teresa Tritch and Kirsten Chancellor “Odds are, your tax preparer doesn’t grasp the new law” *Money* March, Vol. 23 Issue 3, p151 1994). In 2006 the IRS conducted an undercover investigation in which it asked 28 professional tax preparers to complete returns. It found that found 17 of returns, or 60.7%, contained significant errors (“Most Tax Returns Prepared by a Limited Sample of Un-enrolled Preparers Contained Significant Errors,” Treasury Inspector General for Tax Administration Office of Audit, Sept.3 Rpt.No.2008-40-171 2008). US Senators were surveyed as to whether they prepared their own return and whether returns had errors for the year 2009. Of the 45 Senators who responded only two (4.4%) prepared their own tax returns and those were error free. However, of the 43 Senators who used professional tax preparers, 8 or 18.6% reported that the IRS found errors in their returns (“Survey of Senators Tax Preparation and Errors,” Polotico.com Feb.11. www.politico.com/news/stories/0209/18512.html 2009). The weighted average error rate for 472 professional tax preparers discussed above was 86.0% as shown in Table 2 Tax Preparer Error Rate.

In testimony before the Senate Finance Committee, Michael Rodstek, Director of Strategic Issues disclosed that 56% of professionally prepared, audited returns contained errors. This compares unfavorably to a 47% error rate for taxpayer prepared returns, although professionally prepared returns were probably more complex (Michael Brostek 2011. “Tax Gap: Complexity and Taxpayer Compliance,” Statement of Michael Brostek, Director, Tax Strategic Issues June 28. pp7-8 2011).

Table 2 Tax Preparer Error Rate

<table>
<thead>
<tr>
<th>Study</th>
<th>Year</th>
<th>n</th>
<th>Errors</th>
<th>Error Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Polotico Survey of Senators</td>
<td>2009</td>
<td>43</td>
<td>8</td>
<td>18.6%</td>
</tr>
<tr>
<td>Internal Revenue Service Study</td>
<td>2008</td>
<td>28</td>
<td>17</td>
<td>60.7%</td>
</tr>
<tr>
<td>IRS Undercover Preparer Investigation</td>
<td>2006</td>
<td>19</td>
<td>14</td>
<td>73.7%</td>
</tr>
<tr>
<td>Money Magazine Survey</td>
<td>1998</td>
<td>46</td>
<td>46</td>
<td>100.0%</td>
</tr>
<tr>
<td>Money Magazine Survey</td>
<td>1997</td>
<td>45</td>
<td>45</td>
<td>100.0%</td>
</tr>
<tr>
<td>Money Magazine Survey</td>
<td>1994</td>
<td>50</td>
<td>50</td>
<td>100.0%</td>
</tr>
<tr>
<td>Money Magazine Survey</td>
<td>1993</td>
<td>41</td>
<td>39</td>
<td>95.1%</td>
</tr>
<tr>
<td>Money Magazine Survey</td>
<td>1991</td>
<td>50</td>
<td>50</td>
<td>100.0%</td>
</tr>
<tr>
<td>Money Magazine Survey</td>
<td>1990</td>
<td>50</td>
<td>49</td>
<td>98.0%</td>
</tr>
<tr>
<td>Money Magazine Survey</td>
<td>1989</td>
<td>50</td>
<td>48</td>
<td>96.0%</td>
</tr>
<tr>
<td>Money Magazine Survey</td>
<td>1988</td>
<td>50</td>
<td>40</td>
<td>80.0%</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>472</td>
<td>406</td>
<td>86.0%</td>
</tr>
</tbody>
</table>

What would be the response among society and government if doctors, lawyers or architects had such a high error rate? No society would tolerate this level of errors in any other profession. The high rate of errors among professional taxpayers provides clear and convincing evidence that the tax code is so complex, that not even experienced professionals understand it. This alone provides sufficient evidence that the tax code, through its complexity, is unconstitutionally vague in violation of due process.
What Standard Should We Hold the IRS to?

As the police charged with enforcing the law, we should expect them to be correct 100% of the time, but can we expect any human endeavor to be correct all the time? We expect planes, trains and elevators to deliver us safely 99.999% of the time. If planes, trains and elevators didn’t exceed that standard there would be a public outcry followed by a litigation storm. Suppose we allow the IRS an error rate 1,000 times higher than would be tolerated safely 99.999% of the time. If planes, trains and elevators didn’t exceed that standard there would be a public outcry which statistical detail was published.

Complexity as Measured by IRS Volunteer Income Tax Assistance Errors

To help taxpayers comply with the law, the Internal Revenue Service has developed a network of volunteers to assist taxpayers at no cost. This program is called VITA, the Volunteer Income Tax Assistance program. VITA volunteers principally assist with simple personal returns and rarely do business returns. Do IRS sanctioned volunteers do any better that professional tax preparers? Table 3 VITA Error Rate provides an analysis of the accuracy of IRS sanctioned tax preparers.

Table 3 VITA Error Rate

VITA, the Volunteer Income Tax Assistance program is an IRS sanctioned program to help taxpayers comply with the law. Audits refer to Treasury Inspector General for Tax Administration Audits. The following reflect audits for which statistical detail was published.

<table>
<thead>
<tr>
<th>Audit</th>
<th>Year</th>
<th>n</th>
<th>Errors</th>
<th>Error Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit, Mar.31 Rpt.No. 2010-41-047</td>
<td>2010</td>
<td>21</td>
<td>3</td>
<td>14.00%</td>
</tr>
<tr>
<td>Audit, Mar.30 Rpt.No.2009-40-058</td>
<td>2009</td>
<td>22</td>
<td>8</td>
<td>36.00%</td>
</tr>
<tr>
<td>Audit, Sept.18 Rpt.No.2008-40-177</td>
<td>2008</td>
<td>36</td>
<td>11</td>
<td>30.60%</td>
</tr>
<tr>
<td>Annie E. Casey Foundation EITC Quality Rpt. June</td>
<td>2008</td>
<td>198</td>
<td>30</td>
<td>15.00%</td>
</tr>
<tr>
<td>Audit, Aug.27 Rpt.No.2007-40-137</td>
<td>2007</td>
<td>39</td>
<td>17</td>
<td>44.00%</td>
</tr>
<tr>
<td>Audit, Aug.17 Rpt.No.2007-40-130</td>
<td>2007</td>
<td>36</td>
<td>12</td>
<td>33.00%</td>
</tr>
<tr>
<td>Audit, Apr.17 Rpt.No.2007-40-072</td>
<td>2007</td>
<td>18</td>
<td>8</td>
<td>44.00%</td>
</tr>
<tr>
<td>Annie E. Casey Foundation EITC Quality Rpt. Sept.</td>
<td>2007</td>
<td>200</td>
<td>70</td>
<td>35.00%</td>
</tr>
<tr>
<td>Audit, Aug.31 Rpt.No.2006-40-125</td>
<td>2006</td>
<td>36</td>
<td>22</td>
<td>61.10%</td>
</tr>
<tr>
<td>Audit, Nov. Rpt.No.2006-40-104</td>
<td>2005</td>
<td>35</td>
<td>23</td>
<td>65.70%</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>680</td>
<td>207</td>
<td>30.5%</td>
</tr>
</tbody>
</table>

7.7% based on the foregoing estimate of reasonably intelligent people, and far, far higher than the 1% error rate one would expect from authorized IRS preparers. An error rate of 30.5% among IRS sanctioned preparers is clear and convincing evidence that the tax code is so complex it is unconstitutionally vague.

**Complexity as Measured by Internal Revenue Service Employees**


so complex that IRS employees cannot always provide correct information. The weighted average error rate on complexity effectively extinguishes taxpayers' rights to due process.

IRS Commissioner thinks the tax code is too complex for his employees, trained and equipped with specialized manuals to understand, then how can the ordinary reasonably intelligent citizen expect to understand what the law requires?

These data provide clear and convincing evidence that the tax code is so complex that neither taxpayers of ordinary intelligence nor Internal Revenue Service employees understand it. But, IRS errors go far beyond giving incorrect tax advice. In 2007 about 5.1% of taxpayers were sent incorrect CP2000 notices. These notices are used to advise taxpayers the IRS plans to change their tax return and assess additional tax if necessary. About 243,345 taxpayers were over assessed because of errors. About 24% of taxpayers who called the IRS to get an explanation of the CP2000 notice received information that was incorrect. The Treasury concluded the complexity of the CP2000 notice is probably why some taxpayers did not question the information provided, even when incorrect (“Most Automated Underreported Program Notices Are Correct; However, Additional Oversight is Needed,” Treasury Inspector General for Tax Administration Office of Audit, Sept.25 Rpt.No.2008-40-180 2008). This is an example of the chilling effect that complexity has on taxpayers and so complexity effectively extinguishes taxpayers’ rights to due process.

Tax examiners incorrectly computed the Alternative Minimum Tax (AMT) for 5.7% of 52 tax returns identified by computer as having a discrepancy (“Procedures Were Not Always Followed When Resolving Alternative Minimum Tax Discrepancies,” Treasury Inspector General for Tax Administration Office of Audit, July 30.17 Rpt.No.2008-40-146 2008). Installment payments of estate tax are so complex it has not been computerized. The IRS incorrectly calculated interest on estate taxes 16% of the time on a sample of 99 estates (“Opportunities Exist to Improve Manual Interest Calculations on Estate Tax Returns,” Treasury Inspector General for Tax Administration Office of Audit, Aug.30 Rpt.No.2007-30-163 2007). Of 11,615 penalties appeals, 3,656 penalties were levied in error or about 31% (“The Office of Appeals Needs to Improve the Monitoring of Its Campus Operations Quality,”’ Treasury Inspector General for Tax Administration Office of Audit, Aug.27 Rpt.No.2007-10-071 2007). Even the IRS admits that tax code is so complex it is difficult to administer. The Treasury Inspector General filed a report concluding the Alternative Vehicle Credit was so complex it was difficult to administer (“The

### Table 4 Taxpayer Assistance Center Errors

<table>
<thead>
<tr>
<th>Report</th>
<th>Year</th>
<th>n</th>
<th>Errors</th>
<th>Error Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit, August 24, 2007 Rpt.No. 2007-40-164 returns</td>
<td>2007</td>
<td>36</td>
<td>12</td>
<td>33.3%</td>
</tr>
<tr>
<td>Audit, August 24, 2007 Rpt.No. 2007-40-164 tax law</td>
<td>2007</td>
<td>53</td>
<td>3</td>
<td>5.7%</td>
</tr>
<tr>
<td>Audit, August 2003 Rpt.No. 2003-40-158 tax law</td>
<td>2003</td>
<td>332</td>
<td>143</td>
<td>43.1%</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td></td>
<td>1351</td>
<td>437</td>
<td>32.3%</td>
</tr>
</tbody>
</table>

Former IRS Commissioner Charles O. Rossoti said, “Fundamentally we are attempting the impossible. We are expecting our employees and managers to be trained in areas that are far too broad to ever succeed, and our manuals and training courses, are therefore unmanageable in scope and complexity” (“IRS ‘Free’ Advice Often Wrong,” Today Magazine. April. Published by the Society for the Advancement of Education. pp.14-15 2004). If the IRS Commissioner thinks the tax code is too complex for his employees, trained and equipped with specialized manuals to understand, then how can the ordinary reasonably intelligent citizen expect to understand what the law requires?

The agency charged with administering the tax code should understand and implement it correctly 100% of the time, but even if a 1% error rate were allowed, the data show the IRS error rate is substantially higher than one would expect if the IRS understood the tax code. This provides still more, clear and convincing evidence that the tax code is so complex that neither a person of ordinary intelligence nor those charged with enforcing the law can understand it. Hence, the tax code is unconstitutional on due process grounds.

Complexity as Measured by the Judiciary

If ordinary citizens, tax professionals and even IRS employees fail to grasp the tax code, what about the judiciary, arguably among the smartest people in the land? Richard A. Posner, a highly respected author, academic and Chief Circuit Judge opined that, in technical areas of tax law, “we generalist judges should be loath to lay down the law on a question without the Treasury’s view,” Rebecca K. Crown Income Charitable Fund v. Commissioner 8 F.3d. 571, 576 (7th Cir 1993). In other words, tax law is so complicated, judges must defer to the Treasury Department. This gives the Treasury Department and its agent, the Internal Revenue Service, unparalleled power to apply the law in an ad hoc manner. One of the tests of whether a law is Constitutional is whether it provides sufficient guidance to limit an agency’s power. Judge Posner seems to conclude adequate guidance does not exist within the four corners of the law.

No less a legal authority than Judge Learned Hand once said, "In my own case the words of... the Income Tax (code)... merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception; couched in abstract terms that offer no handle to seize hold of; (it) leave(s) in my mind only a confused sense of something vitally important, but successfully concealed... which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time" Mutual Benefit Life Insurance Company v. Commissioner of Internal Revenue 488 F.2d 1101 (1974). If the most intelligent and learned judges in the land don’t understand the tax code, how can the reasonably intelligent citizen hope to understand it?

FORM OF RELIEF

As Chief Justice John Roberts, Jr. once stated, “Courts should be like umpires, applying the rules of others...” (Tony Mauro “For the Supreme Court, Tradition Is on Tap at Inaugural” Legal Times January 05 2009). But what if the Congress has lost the ability to reform the tax code and bring it into line with the constitutional standard of clarity? Many politicians have called for tax simplification and each attempt at simplification has made the tax code longer and more complex. If the federal tax code is unconstitutionally vague, what should the courts require?

Courts should not get into the minutia of tax rates, tax brackets, deductions and credits. Nor should courts determine how heavily the hand of taxes weighs on citizens and businesses. Those are political questions. But this doesn’t mean the courts can’t provide broad guidance.

Much of the complexity in the tax code is the result of social engineering, not raising tax revenue. While Article I, Section 8 of the Constitution authorizes Congress to promote the general welfare, nothing in the Constitution suggests that the tax code should be the exclusive tool for that purpose. One bright line courts might draw is to purge the tax code of social engineering and strictly limit it to raising tax revenue. Social goals can be addressed through direct payments rather than tax deductions, credits and so forth. Removing social engineering would simplify the tax code dramatically.

The court should provide an objective standard for the tax code that approximates the understanding of people of ordinary intelligence. For example, a tax return might be limited to one page, or it might be limited to the length of a credit card application which is often half a page. The tax code itself might be limited to, for example, the length of the Constitution of the United States, including Amendments, which is about two dozen pages. The
court might require a common set of thresholds across all types of deductions and for all types of credits. The court might limit or eliminate references to other forms or worksheets. The court might eliminate alternative computations, as for example computation of the ordinary tax and the Alternative Minimum Tax. The court might also limit the number of logic branches in the tax form and in the tax code by eliminating conditions like “If line 1 is greater than line 2 then…” The court might also limit the ability of the Treasury Department and Internal Revenue Service to add complexity by limiting all rules and interpretations to some definite length such as the length of the Constitution of the United States. As the need for new regulations arose, the Treasury and IRS should be constrained to edit out less important rules to remain within the prescribed limit.

As stated previously, taxes are the cost of living in a civilized society, so simply voiding the tax code as unconstitutional would be neither productive nor wise. The court might order the Congress to reform the tax code along the lines suggested above within a reasonable period of time, for example two years. The court might also appoint a special master to work with Congress to fashion a Constitutionally acceptable tax code. Such Special Masters are authorized by 28 USC Section 636(b) and have been used in a variety of complex matters. If the Congress refused or failed to act within the prescribed time, the Court should enjoin tax collection pursuant to the offending tax code and instead substitute a tax code designed by the special master until such time as Congress acts.

CONCLUSION

There is a substantial argument that the tax code is so complex that it is unconstitutionally vague. The test of vagueness is whether an ordinary citizen understands what the law prohibits or encourages. Laws are entitled to a strong presumption of constitutionality. However, this presumption can be rebutted. There is clear and convincing evidence that the tax law is so complex that people of ordinary intelligence no longer understand the behavior that is prohibited, encouraged or burdened. Further, those charged with implementing the tax code, the IRS, does not fully understand it and therefore the IRS is left to apply tax law in an error prone, ad hoc manner. Even judges admit the tax code is very nearly beyond understanding.

In the light of due process law, and the weight of the evidence, a thoughtful and courageous court would find the tax code unconstitutionally vague. Rather than terminate the tax law’s operation immediately, courts should allow Congress a limited time to conform the code to judicial standards. The court could appoint a Special Master to work with Congress to revise the code. If Congress failed to act after some definite period, perhaps two years, the court could strike down the existing tax code as unconstitutional and empower the Special Master to implement a substitute tax code until Congress acts.

Court guidelines for a revised tax code should ban social engineering, set a strict and short limit on the length of the tax code and Treasury or IRS interpretive regulations, and limit or ban supplemental worksheets and supporting forms, eliminate alternative calculations, and limit the length of a tax return. Such reforms would restore confidence in the tax system, eliminate much of the dead loss cost of compliance with the code and might even generate more revenue for the government.
TENETS OF MERGERS AND ACQUISITIONS THEORY: THE WAVE FROM 1965 TO 1990

Nicholas Jewczyn, Ph.D.
Eastern University

ABSTRACT

This research includes a discussion of company mergers and acquisitions (M&A) theory, including a comparison and contrast of the synthesis of M&A theory, for the merger wave occurring from 1965 to 1990. A comparison is made of efficiency theory, using the three synergies of financial, operational, and managerial, and empire building theory, and how empire building served the requirements of agency theory. Horizontal, vertical, conglomerate, arm’s length, and strategic mergers are addressed for M&A synergistic realization, absolute performance, and relative performance. An evaluation of the strengths and limitations of mergers and acquisitions theory is conducted, as espoused by the principal theorists, to establish how the theorists’ cumulative, theoretical work has contributed to the development of company mergers and acquisitions theory. This contribution develops a platform of values useful in mergers and acquisitions related to M&A synergistic realization, absolute performance, and relative performance.

INTRODUCTION

This paper includes a discussion of the various tenets of company mergers and acquisitions (M&A) and will further include a comparison and contrast of the synthesis of M&A theory during the diverse companies’ merger wave that occurred during the years 1965 to 1990. The discussion includes a comparison of efficiency theory, using the three synergies of financial, operational, and managerial, and empire building theory, and how empire building served the requirements of agency theory, in order to address mergers, including the types such as horizontal, vertical, conglomerate, arm’s length, and strategic, to address M&A synergistic realization, absolute performance, and relative performance. The discussion includes an evaluation of the strengths and limitations of the tenets of mergers and acquisitions, as espoused by the principal theorists, for the purpose of establishing how the theorists’ cumulative, theoretical work has contributed to the development of company mergers and acquisitions theory, and to the development of a platform of values that is useful in mergers and acquisitions, as it relates to M&A synergistic realization, absolute performance, and relative performance.

WAVE OF DIVERSE COMPANY MERGERS

Original source researchers leading into the period of merger activity under discussion indicated that a merger was the amalgamation of multiple companies into one economic unit, presumably on a friendly basis, whereas an acquisition was more of an unfriendly possession of a target firm (Nelson, 1959, p. 3). The twentieth century was characterized by four peaks of company merger and acquisitions activity periods or waves: the time period that occurred about the time of the early 1900s; the latter part of the 1920s; the end of the 1960s; and the 1980s (Golbe & White, 1988, p. 272). For this paper, there will be a focus upon the wave of mergers of diverse companies from about the year 1965 to the year 1990. The reason for the time period segmentation was because the 1960s were characterized by a wave of merger activity caused by valuation discrepancies that altered the rates of mergers and acquisitions activity regarding time and industry (Gort, 1969, p. 624), whereas the 1980s were characterized by mergers and acquisitions activity known as takeovers (particularly by company tender offers) such that the acquiring firm excluded management and propositioned the target company’s shareholders directly (Ravenscraft & Scherer, 1987, p. 147).

Preceding the wave of mergers and acquisitions activity for the period of 1965 to 1990, the predominant view of organizations in general and the firm in particular, was the notion that these entities were essentially living and breathing entities, not necessarily under control centrally, but instead governed by the pre-Keynesian notion (Marshall) that these entities adjusted themselves naturally to the market and that price was the ultimate determinant of firm activity in the marketplace (Coase, [1937], 2007, p. 19). The theory original sources for the aggregate wave of merger activity occurring from 1965 to 1990 echoed the sentiment, for the relationship of merger activity to
securities prices, for the period of the 1960s (Gort, 1969, p. 626) and the period of the 1980s (Ravenscraft & Scherer, 1987, p. 148). The reader may have assumed that marketplace activity mattered to industrial production, but researchers in the literature noted that merger activity was positively associated with the prices of securities and was unrelated to “industrial production levels” (Golbe & White, 1988, p. 278).

The Merger Consideration of Business Cycle Activity

Investors were shown to be merely guessing when asked questions about industry sectors or valuations, however the prime movers of merger activity have felt that merger activity could be a panacea to smooth out economic aberrations in the business cycle of cyclical industries and consequently favorably move securities prices for companies merged or acquired (Balog, 1975, p. 84). Microeconomic theory was found to contain the perspective that a firm could save costing such that, instead of a firm developing growth via internal means, the acquiring firm could simply acquire a developed firm that possessed the targeted growth and then profit when the market acknowledged those resources by the upward pricing in the business cycle of the acquired company’s securities (Lubatkin, 1987, p. 40). With regard to the business cycle, various bumps in the cycle could conceivably be smoothed over for the acquiring firm by the acquisition of a target company that was undervalued, or a part of an industry that was affected by the business cycle, and was now ready for change; this strategy was shown to expose the acquiring company to increased risk and was shown to impose a success time limit to make the strategy work (Porter, 1987, p. 52).

The Merger Consideration of Diversification

Strategies of diversification regarding the merger activity of firms were shown to differ: when firms diversified into an industry that allowed the use of core competencies, then the firms were profitable, but when the firms diversified into an industry by vertical integration where the acquired business had no relationship to the acquiring firm, the profits were minimal (Rumelt, 1982, p. 359). There were researchers who noted that the act of performing a merger was in and of itself defined to be an act of diversification for the firm (Lubatkin, 1983, p. 218). Further, it was noted, with regard to diversification, that when an acquiring firm shared marketplace rates of growth and market strengths with the acquired firm that the merger offered more potential opportunities for value creation (Lubatkin, 1987, p. 40). If a firm were considered to be similar to a security in a portfolio, portfolio theory was found to contain the notion that the profits accrued by that firm, with regard to its sensitivity relative to the remainder of the firms in the prospective portfolio (or marketplace), or systematic risk, could be mitigated by diversification, which was found to be the “only risk that matters” (Lubatkin, 1983, p. 222).

The Merger Consideration of Portfolio Hedging

Researchers suggested that it was unnecessary for firms to hedge their investment portfolios of subordinate companies since shareholders were in a position to manage the individual shareholders’ portfolios by hedging or diversification far more inexpensively than a firm could; the shareholder could simply purchase a security at market value without having to pay the “acquisition premiums” (Porter, 1987, p. 46; Lubatkin, 1983, p. 219). The accounting measures used in studies confirmed that firm hedging may have little practical value for shareholders since firm random portfolio simulations demonstrated stronger performance than the conglomerates created by the acquisition of target firms (Lubatkin, 1983, p. 221). If the acquiring firm were to attempt to hedge its portfolio of firms by hedging with the acquisition of a target firm, it was noted that when firms that merged shared a similar strategy, that it was possible to start forecasting, using aggregated mean residuals, the prospective changes in value at or beyond a certain point that was about 28 months before the merger and that the point was known as the “turning month” (Lubatkin, 1987, p. 44).

FUNCTIONAL ROLES IN MERGERS AND ACQUISITIONS

The following section will include a discussion of mergers and acquisitions between two or more firms in the same business sector, why those mergers occurred, and what the results were for management and shareholders. There will also be some discussion observations concerning the success of such merger activity and upon what it was predicated, whether the resultant combined firms produced resource usage efficiency, and whether the power of marketplace monopoly was a result. One interest to be discussed will be when possession of certain assets occurred
in mergers that, in conglomerate mergers versus the more traditional horizontal or vertical mergers acquiring firms, the average return on target company assets in conglomerate mergers was different from horizontal or vertical merger target companies. Another point in the discussion will be a comparison of the number of conglomerate mergers to the number of horizontal and vertical mergers. A further point in the discussion will be conglomerate mergers between two completely irrelevant firms and whether capital investment diversification was accrued compared with vertical or horizontal mergers. The following discussion will involve some salient points concerning the mergers and acquisitions roles of horizontal, vertical, conglomerate, arm’s length, and strategic mergers and acquisitions.

**Horizontal Mergers**

Horizontal mergers between two firms in the same business sector occurred for management to accrue: increased market share for the combined firm; operational cost savings; and to explore new market opportunities that may eventually benefit shareholders. For both horizontal and vertical mergers, it was observed that the success of such merger activity was predicated upon whether the resultant combined firms produced resource usage efficiency and the power of marketplace monopoly (Shapiro, 1970, p. 643). Among the several different types of merger activity, horizontal mergers were found to be one of the two basic types of merger activity (the other type being vertical) (Melicher & Hempel, 1971, p. 62).

If it were assumed that the target firm’s assets were of importance, and since conglomerate mergers acquired target firm assets immediately whereas the more traditional horizontal or vertical mergers acquiring firms were required to wait for those assets, it was interesting to note that the average return on target company assets in a conglomerate merger was 6.9 percent but that the return for horizontal/vertical merger target company assets was only 5.3 percent (Melicher & Hempel, 1971, p. 67). Firm managers in the marketplace must have known this returns comparison because the statistics for merger activity during the 1960s showed conclusively that conglomerate mergers exceeded horizontal and vertical mergers combined by a ratio of more than four to one (a ratio of 163 to 37) (p. 66). Although there was some sentiment regarding the fact that the most apparent way for a firm to expand was to expand horizontally, internally to meet increased market demand or externally which could cause undue attention from the Justice Department (Shapiro, 1970, p. 645), the main reason for a horizontal merger was to obtain the expertise of managers in the target firm (p. 647).

In the 1960s portion of the merger wave under consideration, the predominant shift away from horizontal mergers toward conglomerate mergers, as a result of enforcement from the Federal Trade Commission and the Justice Department of the Celler-Kefauver Act, was epitomized by the decision in 1967 by the Supreme Court concerning the merger of Procter & Gamble and Clorox (Melicher & Hempel, 1971, p. 68). During the 1980s, it was found that the conduct of a horizontal merger in industry sectors that were declining could prove to be profitable and promote value creation for the acquiring firm since the payout of cash and the pay-off of debt for the acquired firm caused resources to immediately exit the industry sector, but such mergers outside an industry were characterized by minimal or even negative returns; managers were found to be less knowledgeable about the acquired firms and the shareholders then suffered (Jensen, 1988, p. 35).

**Vertical Mergers**

Vertical mergers between two firms in the same business sector occurred for management to purchase a business supplier up the chain in order to accrue: reduced costing and thus operational cost savings; and scale economies of production that may eventually benefit shareholders. Researchers found that vertical mergers had proven to be more profitable than horizontal mergers, of the two traditional types of mergers under consideration, and that there should not only be a scale economy increase that accompanied a costing decrease, but also an increase in market power for the firm (Shapiro, 1970, p. 646).

There was evidence posited by researchers that mergers of the vertical and horizontal variety, or what was termed previously above to be traditional mergers, occurred between firms that had either: “buyer-seller relationships” or who were “direct competitors” (Melicher & Hempel, 1971, p. 61; Walsh, 1988, p. 175). During the period at the start of the merger wave under examination, the middle to late 1960s, although the predominant type of merger was the conglomerate merger that stressed the pursuit of earnings when considering performance, the more traditional vertical and horizontal mergers were characterized by the frequency of “common stock exchanges” (Melicher & Hempel, 1971, p. 67).

Evidence from the primary sources indicated that the most important consideration for an acquisition, whether the acquired company was merged in the class of vertical or horizontal merger, was the pre-existing
business connection between the firms regarding the “type and/or degree of diversification” (Kusewitt, Jr., 1985, p. 152). It was interesting to note that with regard to the firm that was acquired, that mergers of a traditional vertical or horizontal nature were characterized by acquired firms that were more highly leveraged before the merger whereas in conglomerate mergers the acquiring company was typically more highly leveraged (Melicher & Hempel, 1971, p. 69).

Conglomerate Mergers

Conglomerate mergers between two completely irrelevant firms occurred for management to accrue capital investment diversification such that neither of the firms were suppliers nor were the products produced by both firms similar: the pieces that then composed the whole new firm were not aggregated in any way that would have seemed to be a vertical or horizontal merger (Gribbin, 1976, p. 19). Theorists, during the beginning of the merger wave under consideration, noted that conglomerate mergers were, from the firm perspective, the best use of capital and that managers only undertook a conglomerate merger in order to more effectively augment or control capital and that the firm’s shareholders encouraged this sort of managerial activity to promote value creation (Shapiro, 1970, p. 643).

An important reason for the shareholders and management of the acquiring firm to agree upon and promote the conglomerate merger as a type of acquisition activity was that the average premium paid by the acquiring firm was found to be 14 percent for conglomerate mergers and 22 percent for vertical and horizontal mergers (Melicher & Hempel, 1971, p. 69). Since firms were obliged to interchange their common stock, and there was a greater expected synergy of operations for vertical and horizontal mergers, the acquiring firm’s management and the shareholders did not seem to mind paying a higher premium for target firm acquisition (p. 69). There was evidence for the notion that the principal reason that shareholders willingly acquiesced to mergers, and to conglomerate mergers in particular, was to maintain a diversified, dividend producing investment in the conglomerate firm without having to go to an alternate institution and accrue costs related to information (Shapiro, 1970, p. 653). Another reason for this implied loyalty to the conglomerate firm was that shareholders could not diversify well enough on their own and that the conglomerate merger was actually a smaller sub-categorization of diversification activity and that conglomerate mergers should generally be characterized in this sub-categorical sense (Gribbin, 1976, p. 21).

Arm’s Length Mergers

Arm’s length mergers were typically found to be a type of merger that satisfied both of two types of considerations: the merger was generally found to have been approved by what was characterized to be a board of directors of the acquiring firm that was disinterested; and the merger was generally found to have been approved by shareholders of the acquiring firm that were disinterested. One consideration of the arm’s length merger that opened the acquiring firm’s management to disdain and public challenge was the notion that the acquired firm’s management to disdain and public challenge was the notion that the acquired firm’s assets, and thus the rights and privileges of the acquired firm’s shareholders, were somehow considered to be subordinate to the acquiring firm’s management and shareholders and that the lowest bid price possible should be afforded to the target firm (Brudney & Chirelstein, 1974, p. 298). The acquired firm was found to be able to gain very little legal protection from the courts, regarding the fiduciary considerations secondary to arm’s length mergers, other than an occasional relatively nominal hearing in the case of the acquiring firm’s perpetrated fraud (p. 298).

Strategic Mergers

Strategic mergers between two firms occurred for management to basically accomplish a long-term capital holding of the target firm in order for management to: increase the acquiring firm’s market-share; widen and deepen the acquiring firm’s base for market activities; and to considerably increase the strength and corporate stature of the acquiring firm. With regard to the strategic nature of firm mergers, it was noted that the closer the strategic fit between the two firms that underwent a merger, the larger the gains in performance of the target firm in the merger (Lubatkin, 1983, p. 218). The strategy involved with a strategic merger should take into account three important considerations: with regard to the industry sectors of the firms involved in the strategic merger, whether or not it was possible to make the structural fitting of the two firms attractive; whether or not it was possible to conduct the merger without consuming all of the future anticipated gains and earnings resulting from the merger; and whether the acquired firm, the target firm, or both, would necessarily be better off in the long-run after the merger had been completed concerning “competitive advantage” (Porter, 1987, p. 46).
FUNCTIONAL ROLES IN MERGERS AND ACQUISITIONS SUMMARY

Horizontal mergers between two firms in the same business sector occurred for management to accrue: increased market share for the combined firm; operational cost savings; and to explore new market opportunities that may eventually benefit shareholders. For both horizontal and vertical mergers, it was observed that the success of such merger activity was predicated upon whether the resultant combined firms produced resource usage efficiency and the power of marketplace monopoly. Among the several different types of merger activity, horizontal mergers were found to be one of the two basic types of merger activity (the other type being vertical). Since conglomerate mergers acquired target firm assets immediately whereas the more traditional horizontal or vertical mergers acquiring firms were required to wait for those assets, the average return on target company assets in a conglomerate merger was 6.9 percent but that the return for horizontal or vertical merger target company assets was only 5.3 percent. The statistics for merger activity during the 1960s showed conclusively that conglomerate mergers exceeded horizontal and vertical mergers combined by a ratio of more than four to one. During the 1980s, it was found that the conduct of a horizontal merger in industry sectors that were declining could prove to be profitable and promote value creation for the acquiring firm, but such mergers outside an industry were characterized by minimal or even negative returns; managers were found to be less knowledgeable about the acquired firms and the shareholders then suffered. Conglomerate mergers between two completely irrelevant firms occurred for management to accrue capital investment diversification such that neither of the firms were suppliers nor were the products produced by both firms similar: the pieces that then composed the whole new firm were not aggregated in any way that would have seemed to be a vertical or horizontal merger.

MODES IN MERGERS AND ACQUISITIONS

The Acquisition Mode in Mergers and Acquisitions

Writers from the original sources at the beginning of the merger wave under consideration noted that 70 percent of the trades on the New York Stock Exchange were conducted by institutions, so the market’s reaction to the pricing of a firm’s acquisition was essentially an institutional response to the market and trading activities (Balog, 1975, p. 84). It was noted that shareholders, prior to the 1980s, were afforded the propensity to earn a return of about zero in a merger, which was usually friendly and for stock, as opposed to a tender offer (a type of acquisition – usually unfriendly) where the offer was for cash and the shareholders earned about four percent (Jensen, 1986, pp. 4-5). The use of agents, such as managers in mergers and acquisitions, tended to create conflict and agency issues since shareholders may not have been able to earn up to the maximization of expectations; since these types of conflicts were high in unfriendly tender offer acquisitions and one-third of executives involved in them were terminated after the acquisition, this may also have been an impetus to earn more for shareholders as the result of a firm’s acquisition (Walkling & Long, 1984, p. 54).

Writers suggested that deficient markets offered the opportunity to minimize the risk of bankruptcy while affording management the prospect to create value; the allocation of resources provided by acquiring an unrelated firm resulting in a conglomerate improved the financial conditions for the merger beyond the divisional level such that efficiencies were generated through the reduced costs of capital and greater resource usage efficiency (Silhan & Thomas, 1986, p. 524). Although markets for capital were observed to be price proficient, the active management of a firm that was adequately diversified could surpass the market’s expectations by improving the management of faltering firms or by the judicious movement of capital between acquired firms (Rumelt, 1982, p. 364). Even though associated problems were reduced by the acquisition of public firms that were the subject of ineffective control, the resultant earnings may have been reduced as a result of those acquisitions but the associated problems with the acquisition usually did not diminish management’s effectiveness after the acquisition (p. 364).

The Entry Mode in Mergers and Acquisitions

Mergers and acquisitions firm entry was found to relate to enforcement issues associated with the various enforcement entities and those guidelines were found to be difficult to evaluate for comparison; when the evolution of enforcement through the wave under consideration was considered, it was noted that the Justice Department’s enforcement criteria had changed from a ratio of firm concentration in the 1968 guidelines for mergers to an index evaluation for the 1982 guideline update (Ravenscraft, 1987, p. 31). The Supreme Court was less intrusive after 1974, regarding mergers and acquisitions resulting from the ruling in the General Dynamics case, and the rate of
merger activity in the latter part of the wave of activity during the 1980s increased markedly (p. 31). Prior to the 1968 guidelines, the government resisted the proposed merger if any of the guidelines had been violated, but the repugnancy evaporated after the 1982 guidelines had been established, along with the 1984 update, such that if any one merger deficiency issue were to be remedied and it could be shown that monopoly power was absent, the merger was then approved and the acquiring firm was allowed entry (p. 32).

To begin to even ask the questions of whether a merger or acquisition had been successful, it was noted that a period of between two and seven years needed to pass to work out the issues associated with the merger’s or acquisition’s market entry (Kitching, 1967, p. 85). An evaluation of the post entry phase determined that almost half of the marketplace merger activity was of the non-traditional conglomerate type and that 81 percent of merger failures were attributable to even a single change in the organizational structure after the merger marketplace entry and 84 percent of merger failures were attributable to the mismatching of size between the acquiring firm and the target firm (p. 86). A factor noted from the sources was that the acquisition rates for firms regarding entry was found to matter; the more firms that a conglomerate acquired over time, affording market entry to the acquirer, the more successful the acquiring firm was based upon acquisition and entry experience gained (Kusewitt, Jr., 1985, p. 152).

**The Integration Mode in Mergers and Acquisitions**

Experience gained from studies of various types of mergers and acquisitions prompted the notion that if the integration of acquisitions were characterized by the growth of the acquiring firm then mergers were characterized by surprises both before and after the proposed firms’ merger (Boulden, 1969, p. 22). Most mergers do not occur because of the surprise discovery that just a few shareholders in the target company, based upon ownership, would then become majority shareholders in the acquiring firm and that those shareholders would be able to exercise control over the acquiring firm’s board (p. 22). If the price of a stock was found to be determined by the ratios of price-to-earnings (P/E) and earnings-per-share, then the prime mover of acquisitions was found to be an “immediate increase in the market value of corporate stock” (p. 22).

There were found to be three distinct phases pertaining to mergers and acquisitions: the first phase was found to be all activities up to the point where the intent to merge was formally announced; the second phase was found to be all activity up to and including the conclusion of all merger activity from the standpoint of legality; and the third phase was found to be the actual integration of the companies for the conduct of business activity (Richman, 1984, p. 177). With regard to the third phase of integration, the most important consideration involving whether or not the merger/acquisition was a success was the structures for organizational control that were set up during phase two and then implemented during the phase three integration (Kitching, 1967, p. 91). The success of the integration stemmed from the formulation of the integration strategy’s effectiveness that had been programmed into the integration during the phase two formulation more than the actual follow-through during the actual phase three implementation of those strategies and structures (p. 91).

**MERGERS AND ACQUISITIONS SYNERGIES RELATING TO EFFICIENCY THEORY**

Synergy was determined to be one of the principal one-dozen or so factors that influenced mergers and acquisitions in general, but synergy in general was not solely the factor that held sway over a firm merger or acquisition and in fact synergy did not always even need to be positive in nature (Jensen, 1988, p. 28). For example, if a firm diversified by acquiring a target firm with cash or securities shares, the conglomerate could be determined to be profitable even if the merger resulted in operational inefficiency and the synergistic effect result was effectively zero since waste of the capital had been prevented and the merger resulted in the use of cash flow that would have been lost elsewhere (p. 34). With regard to acquisitions in general, asymmetric theory contained the notion that a market that was competitively asymmetric was one where two or more firms that acquired target firms didn’t “compete for identical synergistic gains” (Lubatkin, 1987, p. 40).

For the assessment of the success or failure of a merger or acquisition, when models were used that involved measures that included return-on-equity (ROE) for performance evaluation, a synergistic effect was observed where none may have previously existed for the created conglomerate; a more effective technical means of evaluating the success of the newly created strategic business unit (SBU) was found to be the use of return-on-assets (ROA) to eliminate falsely determined synergies (Kroll & Caples, 1987, p. 677). It was noted that performance in the market resulting from a merger or acquisition was the result of the synergy realized by the firms’ coupling, secondary to the strategic suitability obtained, and the created value of the coupling realized by the resulting shareholders; the accounting value was the created profits booked and the performance in the market was determined by the attractiveness of the conglomerated shares (Kusewitt, Jr., 1985, p. 151). The following discussion
will address synergies of a financial, operational, and managerial nature.

**Mergers and Acquisitions Financial Synergies**

Some suggested that Financial Economics should have been applied to the consideration of whether financial synergy occurred as a result of a merger or acquisition in that shareholder value was determined by whether the shareholders’ wealth had improved, as result of the firms’ coupling, and whether merger theory could be applied concerning whether the shareholders’ expectations had been realized (Lubatkin, 1987, p. 39). The result was determined to be that shareholders realized an improvement in the value of common shares held, but that theory was not always applicable to mergers/acquisitions from a strategic perspective and that investor expectations were not always met in the third phase shown as integration herein above (p. 50).

Some companies were shown to incur financial windfalls as the result of acquisitions of other firms; for example, one firm reported that after acquiring 22 other firms, the average earnings of each of the acquired target firms was 78 percent higher than the earnings of the parent acquiring firm (Kitching, 1967, p. 85). Further, financial findings from mergers and acquisitions were reported such that when financial resources were aggregated and the cost of capital dropped, and the production costing was reduced by combining the means of production, that synergies resulted (p. 86) but the managing executives placed no value upon those synergies created with regard to a valuation of the resulting performance (p. 92).

**Mergers and Acquisitions Operational Synergies**

The principal operational aspect of synergies gained from mergers and acquisitions was found to stem from the operational strategy known as restructuring (Porter, 1987, p. 52). The restructuring strategy was designed to find firms or industries that were already on the cusp of major change; these were the types of firms that were characterized by a lack of market development, inefficient management, or some sort of potential peril from another firm in the marketplace (p. 52). Results from the study of mergers and acquisitions showed that operational synergy was so valuable and important that operational synergy was determined to be at least as important, and perhaps equal, to the aspect of financial synergy (Lubatkin, 1987, p. 48); even though, of all considerations, the operational similarities between firms should not be the only merger consideration (p. 48).

By definition, the rationale for the decision to merge with or acquire another firm was shown to be strategic in nature and that management was motivated by the operational personal interests of those managers so that the acquiring firm maximized earnings and manager pay but minimized staffing and the resultant operational costing (Richman, 1984, p. 178). The crux of the matter was usually the answer to the operational question of whether management could provide a product or service as the result of an internal change or whether it was necessary to venture out into the marketplace to secure the facilities necessary to provide those products or services (p. 181). Detailed examinations failed to provide answers, however, to why larger firms did not always drive smaller competing firms out of the marketplace with a price war, why economies of scale and image recognition, concerning branding, did not prevent smaller firms from catching up in the market (with larger firms), and why increased returns for the larger firms did not create operational advantages that secured permanent market placement and position (Ravenscraft, 1983, p. 29).

**Mergers and Acquisitions Managerial Synergies**

There was evidence to suggest that mergers and acquisitions activity, with regard to managerial synergy, was simply the result of managers of the acquiring firm exercising their prerogative to “maintain and increase their control over resources” (Shapiro, 1970, p. 643). The investors, who were in possession of the common shares of the acquiring company, simply acquiesced because, even though a prospective merger might not accrue phenomenal returns for the firm, there was the prospect for potential profit from the merger or acquisition of a targeted firm (p. 643). Even though agency considerations allowed potential stumbling blocks to shareholder wealth increases, and might cause disagreements between managers and shareholders of an acquiring company (Walkling & Long, 1984, p. 54), the managers were still shown to continue with the prospective merger activity, even a tender offer that might cause management’s sudden unemployment, in order to pursue conglomerate personal power and wealth increases resulting from the targeted company’s acquisition (p. 54).

If there were perfect knowledge of the state of a prospective merger and shareholders knew of all CEO actions taken or that could be taken, contracts might specify exactly what shareholders desired from a merger or
acquisition’s results; however, even though agency theory may predict that there would be enough compensation to make certain that managers acted on behalf of the shareholders, it was shown that CEOs thought of personal gain versus the costs of certain merger activities (Jensen & Murphy, 1990, p. 226). It was shown above that one reason for mergers and acquisitions activity was in effect the purchase of managerial competence within the target firm. While there were those who felt that managerial synergy resulted from short-merger considerations (Jensen, 1988, p. 22), there was evidence to suggest that the merger wave under consideration, and managerial synergy, started in 1965 because of changes to management studies, tax increases, a doubled cost for capital, and the emergence of a service economy (Shapiro, 1970, p. 644).

EMPIRE BUILDING THEORY

With regard to empire, or the building up of a firm conglomeration, a manager’s compensation and prestige were shown to be tied to the firm’s magnitude and relative changes to that firm’s size, as opposed to whether the firm was indeed profitable (Mueller, 1969, p. 644). In the pursuit of empire considerations, management was shown to pursue short-term financing to even out payment expectations for potentially profitable projects, but the same management that was expected to also maximize the wealth of shareholders would not engage in the payout dividends and increase firm leverage or indulge in new equity issues (p. 647).

In cases of a merger or in acquisition tender offers, it was shown that when the targeted firm’s management became uneasy about the future and their continued employment, the level of conflict thus increased, which added costs to the proposed, targeted company’s acquisition; it was shown that the targeted management would look to their personal utility such that personal considerations and protection came first and any agency theory considerations of a responsible fiduciary nature then came second (Walkling & Long, 1984, p. 55). Fear issues aside, if the management of both firms pursued the fiduciary tenets of agency theory and attempted to maximize shareholder wealth, then there was the possibility for synergy such that, in the case of an horizontal merger, there was the result of an improvement in power in the marketplace for the procuring firm and some scale economies that resulted in shareholder wealth (Mueller, 1969, p. 650).

Empire Building and Agency Theory

A subset of agency theory known as the “shareholder welfare hypothesis” (Walkling & Long, 1984, p. 55) was shown to describe potential managerial behavior in tender offers such that the proper activities would have been naturally pursued by acquiring firm managers to make the proper purchase of the targeted firm; targeted firms’ managers then responded by resisting the offer with the assertion that the price was just too low “since firm valuation is [was] essentially a subjective process” (p. 55). In the pursuit of agency considerations, there were three synergistic reasons for a potential merger: the management of the acquiring firm was so effective that it could be successfully applied to even an unrelated firm’s business lines; if lines of credit external to either firm were necessary, the larger firm would benefit the smaller firm with lower capital costs; (Mueller, 1969, p. 651) and there was a reduced amount of inherent risk resulting from the combined firms due to the concept known as “pooling” (p. 652). Since the premium to acquire a targeted firm was shown to be between 10 and 30 percent above a targeted firm’s share price (pre-merger), plus the addition of other associated merger costs, the acquiring firm’s management needed to be relatively certain that there was a) enough potential profit to fulfill agency considerations and b) be certain that the shareholders would be happy (p. 652).

RELATED THEORIES

The following discussion will involve theories related to mergers and acquisitions, as well as to the various synergies realized or imagined. The discussion will include thoughts about the firm’s exercise of market power that excluded other firms or products. Further, the public’s view of corporate raiders will be discussed as well as whether corporate raiding helps or hinders the firms that they target. Also, the discussion will include whether there were higher returns exhibited by targeted firms when the announcements were made about a potential corporate raid. Included will be the two reasons given for a takeover acquisition concerning valuation theory such that the acquiring firm sought to replace the targeted firm's incompetent management and then experience gains from post takeover synergies and whether the valuation of the targeted firm would improve and thus improve the associated profits for management and the shareholders. Finally, there will be sections regarding behavioral theory involving the firm and a framework for process theory and two principal considerations as well as the principal premise behind disturbance
theory. The following discussion will address the theories related to mergers and acquisitions known as monopoly theory, raider theory, valuation theory, process theory, and disturbance theory.

**Monopoly Theory**

The Field of Economics included the thought that a firm that exercised a form of market power that excluded other firms or products possessed a sort of market power that was monopolistic wherein the firm could exploit the market place for its own purposes (Edwards, 1955, p. 331). Further, the firm in question did not need to have the sort of market power in just one market, but could actually have different degrees of monopolistic power in different markets with different classes of products such as “money-making items, convenience goods, and loss leaders, and may follow different policies in selling the different classes” (p. 332). Unfortunately, the sort of difficulties created by the use of such market power by a firm may not be cured with the considerations of solutions for more traditional monopoly power or the concept of the pursuit of “internal efficiency” (p. 332). Because of the evolution of the standard market space, the concepts of firm monopoly power and size may come to have no relationship to the more traditional considerations of monopoly and efficiency (p. 332). Along with the concept of monopolistic bigness of a firm came the consideration that synergy was lost when the larger, monopolistic firms replaced smaller firms in the market, the business decisions of the smaller firms were lost to the economy, and opportunities for personal gain were remarkably diminished (p. 351).

**Raider Theory**

The public’s view of corporate raiders was found to be that there were types of individuals who were self-serving and who destroyed corporate synergies by markedly diminishing the wealth of their comrades who were also shareholders (Holderness & Sheehan, 1985, p. 556). These corporate raiders were depicted in the media as people in search of easy money and who were destructive in that they conducted themselves in a predatory manner (p. 556). The statistics showed that there were anomalously higher returns exhibited by target firms when the announcement was made that a corporate raider, who may have no management skills to foster synergy, was about to take over a prospective firm (p. 557). Even theorists seemed to hold the basic view that a corporate raider was someone who gained control of corporate wealth to the disadvantage of fellow shareholders (p. 573). The acknowledged purpose of the raiding of corporations by a few businessmen, known as raiders, was that their participation in the management of the targeted firm would have been so toxic to any synergies already in place, that the existing firm’s management re-purchased the shares from the invaders at a premium to keep them out of the firm; even so, the share prices of the firms increased after the announcement and existing shareholders were shown to have acquired wealth as a result of the raid (p. 577).

**Valuation Theory**

The final decade of the merger wave under consideration, a period in the 1980s and those periods leading up the 1980s, was characterized by tender offer acquisitions such that the acquiring firm avoided the target firm’s management by making the takeover offer attempt directly to the concerned firm’s stockholders (Ravenscraft & Scherer, 1987, p. 147). The two reasons given for this type of acquisition was that the acquiring firm sought to replace the targeted firm’s incompetent management and then experience gains from post takeover synergies; in other words, the theory was that the valuation of the targeted firm would improve and thus improve the associated profits for management and the shareholders (p. 147). Although the two prospective results were theoretically supposed to occur, high takeover premiums, friction, and inefficiencies resulted in, for the periods of the 1960s and the 1970s, a reduced ongoing value for the targeted firms and lower profits in the nine years post acquisition; taxation issues in the 1980s turned the actualization of valuation theory for tender offers into a “zero-sum game” (pp. 154-155).

**Process Theory**

The behavioral theories involving the firm were found to be a framework for process theory and two principal considerations were involved with the understanding of process theory: firms were found to be in the general habit of decision-making, but goals that were reliable and unwavering were absent; and that this particular process, decision-making absent a goal, was found to be relatively customary in “complex organizations” (Cohen,
March, & Olsen, 1972, p. 1). In other words, the resultant themes were that issues were resolved absent any recourse and there was no specific price associated with the results of those decisions made in those complex organizations (p. 1). The complex organizations were then depicted in theory as “organized anarchies” (p. 2). The principal problem was that participants to the decision-making were involved with setting in place the decision-making process, while actually engaged in the decision-making; there was no process in place and the situation was malleable and evolving as the decision-making occurred (p. 2). Studies were performed on universities in particular, but the results were found to be applicable to the firm and to firm synergies as well (p. 16).

**Disturbance Theory**

The concept of disturbance theory was shown to be applicable to the frequency of merger activity in the marketplace and was one of three theories shown to be directly applicable (as opposed to others that were indirectly applicable) to merger activity in general; the other two theories, included in the above discussion, were “economies of scale and monopoly hypotheses” (Gort, 1969, p. 625). The principal premise behind disturbance theory was found to be that valuation inconsistencies generated from disturbances of an economic nature were required to generate merger activity (p. 627). The disturbances were found to change investors’ expectations so that scalar changes occurred with respect to firm ownership by shareholders and those disturbances elicited uncertainty regarding future investors’ expectations so that inconsistencies in firm valuation increased (p. 627). The resultant forces of the disturbances discussed were not shown to improve the lot of buyers in the marketplace because the ratio of price-to-earnings (P/E) did not markedly improve and any sales premia for the selling shareholders had nothing to do with views shared by buyers and sellers; merger activity was not shown to evolve from arbitrage, namely being the result of “bargain prices for the securities of acquired firms” (p. 642).

**RELATED THEORIES’ SUMMARY**

Economics included a form of market power that excluded other firms or products and monopoly firms possessed a sort of market power wherein the firm could exploit the marketplace for its own purposes. Difficulties created by such monopoly power by a firm were not cured by solutions for more traditional monopoly power or the concept of the pursuit of internal efficiency. The concepts of firm monopoly power and size had no relationship to the more traditional considerations of monopoly and efficiency. The public's view of corporate raiders was that they were individuals who were self-serving and who destroyed corporate synergies by reducing the wealth of shareholders. However, there were shown to be higher returns in target firms when the announcement was made that a corporate raider was about to take over a prospective firm.

The 1980s, and those periods leading up the 1980s, were characterized by tender offer acquisitions by making the takeover offer attempt directly to the concerned firm's stockholders. The two reasons for tender offers were that a) the acquiring firm would replace the targeted firm's incompetent management b) to experience gains from post takeover synergies; the theory was that the valuation of the targeted firm would improve and thus improve the associated profits for management and the shareholders.

Firm behavioral theories were a framework for process theory and two principal considerations were involved with the understanding of process theory: firms were involved with the habit of decision-making absent reliable goals and that decision-making absent a goal, was found to be relatively customary in complex organizations. Issues were resolved absent any recourse and there was no specific price associated with the results of those decisions made in the complex organizations.

Disturbance theory applied to merger activity frequency and was one of three theories shown to be directly applicable to merger activity. The other two theories were economies of scale and monopoly hypotheses. Disturbance theory involved valuation inconsistencies generated from disturbances of an economic nature and were necessary to generate merger activity. The disturbances did not improve the lot of buyers or sellers in the marketplace; merger activity was not shown to evolve bargain prices for the securities of acquired firms.

**THEORIES RELEVANT TO M&A SYNERGISTIC REALIZATION, ABSOLUTE, AND RELATIVE PERFORMANCE**

Synergy was determined to be one of the principal one-dozen or so factors that influenced mergers and acquisitions in general, but synergy in general was not solely the factor that held sway over a firm merger or acquisition. Synergy did not always even need to be positive in nature. If a firm diversified by acquiring a target firm with cash or securities, the conglomerate could be determined to be profitable even if the merger resulted in
Researchers leading into the period of merger activity under discussion indicated that a merger was the amalgamation of multiple companies into one economic unit, presumably on a friendly basis, whereas an acquisition was more of an unfriendly possession of a target firm. The reason for the time period segmentation was because the 1960s were characterized by a wave of merger activity caused by valuation discrepancies that altered the rates of mergers and acquisitions activity regarding time and industry. The 1980s were characterized by mergers and acquisitions showing that operational synergy was so valuable and important that operational synergy was a general habit of decision-making, but goals that were reliable and unwavering were absent. Second, this particular principal considerations were involved with the understanding of process theory. First, firms were found to be in the views shared by buyers and sellers. Merger activity was not shown to evolve from the result of potential bargain management was shown to pursue short-term financing to even out payment expectations for potentially profitable projects. However, the same management that was expected to also maximize the wealth of shareholders would not replace the targeted firm's incompetent management and then experience gains from post takeover synergies. Investors in possession of the common shares of the acquiring company usually simply acquiesced because, even though a prospective merger might not accrue great returns for the firm, there was still the prospect for potential profit from the merger or acquisition of a targeted firm. In the pursuit of empire considerations, management was shown to pursue short-term financing to even out payment expectations for potentially profitable projects. However, the same management that was expected to also maximize the wealth of shareholders would not simultaneously engage in the payment of dividends and an increase in firm leverage or the promotion of new equity issues.

Two reasons for a takeover acquisition, concerning valuation theory, were that the acquiring firm sought to replace the targeted firm's incompetent management and then experience gains from post takeover synergies. Whether the valuation of the targeted firm would necessarily improve and thus improve the associated profits for management and the shareholders was still open to question. The behavioral theories involving the firm were found to be a framework for process theory and two principal considerations were involved with the understanding of process theory. First, firms were found to be in the general habit of decision-making, but goals that were reliable and unwavering were absent. Second, this particular process, decision-making absent a goal, was found to be relatively customary in complex organizations. In other words, the resultant themes were that issues were resolved absent any recourse and there was no specific price associated with the results of those decisions made in the complex organizations.

Studies were performed and the results were found to be applicable to the firm and to firm synergies as well. The concept of disturbance theory was shown to be applicable to the frequency of merger activity in the marketplace and was one of three theories shown to be directly applicable to merger activity in general. The other two theories were economies of scale and monopoly hypotheses. The principal premise behind disturbance theory was found to be that valuation inconsistencies generated from disturbances of an economic nature were required to generate merger activity. The disturbances were found to change investors' expectations so that scalar changes occurred with respect to firm ownership by shareholders and those disturbances elicited uncertainty regarding future investors' expectations so that inconsistencies in firm valuation increased. The resultant forces of the disturbances discussed were not shown to improve the lot of buyers in the marketplace because the ratio of price-to-earnings (P/E) did not markedly improve and any potential sales premiums for the selling shareholders had nothing to do with views shared by buyers and sellers. Merger activity was not shown to evolve from the result of potential bargain prices for the securities of acquired firms.

**THEORY SYNTHESIS**

The behavioral theories involving the firm were found to be a framework for process theory and two principal considerations were involved with the understanding of process theory. First, firms were found to be in the general habit of decision-making, but goals that were reliable and unwavering were absent. Second, this particular process, decision-making absent a goal, was found to be relatively customary in complex organizations. In other words, the resultant themes were that issues were resolved absent any recourse and there was no specific price associated with the results of those decisions made in the complex organizations.

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acquisitions activity known as takeovers (particularly by company tender offers) such that the acquiring firm excluded management and positioned the target company's shareholders directly.

Microeconomic theory contained the perspective that a firm could save costing such that, instead of a firm developing growth via internal means, the acquiring firm could simply acquire a developed firm that possessed the targeted growth and then profit when the market acknowledged those resources by the upward pricing in the business cycle of the acquired company's securities. When the possession of certain assets occurred in mergers, in conglomerate mergers versus the more traditional horizontal or vertical mergers acquiring firms, the average return on target company assets in conglomerate mergers was greater compared with horizontal or vertical merger target companies.

Arm's length mergers were typically found to be a type of merger that satisfied both of two types of considerations: the merger was generally found to have been approved by what was characterized to be a board of directors of the acquiring firm that was disinterested; and the merger was generally found to have been approved by shareholders of the acquiring firm that were disinterested. An arm's length merger occasionally opened the acquiring firm's management to disdain and public challenge. The reason was the mentality evident that the acquired firm's assets were somehow considered to be subordinate to the acquiring firm's management and shareholders and that the lowest bid price possible should be afforded to the target firm.

Strategic mergers of two or more firms occurred for management to basically accomplish a long-term capital holding of the target firm(s) in order for management to increase the acquiring firm's market-share, widen and deepen the acquiring firm's base for market activities, and to considerably increase the strength and corporate stature of the acquiring firm. Since conglomerate mergers acquired target firm assets immediately whereas the more traditional horizontal or vertical mergers acquiring firms were required to wait for those assets, the average return on target company assets in a conglomerate merger was 6.9 percent but the return for horizontal or vertical merger target company assets was only 5.3 percent. The statistics for merger activity during the 1960s showed conclusively that conglomerate mergers exceeded horizontal and vertical mergers combined by a ratio of more than four to one.

By definition, the rationale for the decision to merge with or acquire another firm was shown to be strategic in nature and that management was motivated by the operational personal interests of those managers so that the acquiring firm maximized earnings and manager pay but minimized staffing and the resultant operational costing. Larger firms did not always drive smaller competing firms out of the marketplace with a price war, the resultant economies of scale and image recognition, concerning branding, did not prevent smaller firms from catching up in the market, and increased returns for the larger firms did not create operational advantages that secured permanent market placement. Investors in possession of the common shares of the acquiring company simply agreed with a proposed merger because there was the implied prospect for potential profit from the merger with or the acquisition of a targeted firm.

Agency considerations allowed potential stumbling blocks to shareholder wealth increases and disagreements sometimes occurred between the managers and the shareholders of an acquiring company. In spite of these issues, the managers were still shown to continue with the prospective merger activity, even a tender offer that might cause management's sudden unemployment, in order to pursue conglomerate personal power and wealth increases resulting from the targeted company's acquisition. One reason for the penchant for mergers and acquisitions activity was in effect the purchase of managerial competence within the target firm.

Disturbance theory applied to merger activity frequency and was one of three theories shown to be directly applicable to merger activity. Disturbance theory involved valuation inconsistencies generated from disturbances of an economic nature and they were necessary to generate merger activity. The disturbances did not improve the lot of buyers or sellers in the marketplace; merger activity was not shown to evolve bargain prices for the securities of acquired firms.

Synergy was determined to be one of the principal one-dozen or so factors that influenced mergers and acquisitions in general, but synergy in general was not solely the factor that held sway over a firm merger or acquisition. Financial Economics should have been applied to the consideration of whether financial synergy occurred as a result of a merger or acquisition. Shareholder value was determined by whether the shareholders' wealth had improved, as result of the firms' coupling, and there was the consideration of whether merger theory could be applied concerning whether the shareholders' expectations had been realized.

**SUMMARY**

This research included a discussion of the various tenets of company mergers and acquisitions (M&A) and included a comparison and contrast of the synthesis of M&A theory during the diverse companies' merger wave that occurred during the years from 1965 to 1990. The discussion included a comparison of efficiency theory, using the
three synergies of financial, operational, and managerial, and empire building theory, and how empire building served the requirements of agency theory, in order to address mergers, including the types such as horizontal, vertical, conglomerate, arm’s length, and strategic, to address M&A synergistic realization, absolute performance, and relative performance. The discussion included an evaluation of the strengths and limitations of the tenets of mergers and acquisitions, as espoused by the principal theorists, for the purpose of establishing how the theorists’ cumulative, theoretical work has contributed to the development of company mergers and acquisitions theory, and to the development of a platform of values that is useful in mergers and acquisitions, as it relates to M&A synergistic realization, absolute performance, and relative performance. The discussion above included the M&A theory discussions, and the associated explanations necessary, to provide a background for the reader to more actively participate in a reading of the ensuing research that will follow the 1965 to 1990 time period above to continue the building of a platform of values for this paper’s objective of firm mergers and acquisitions edification.

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INTRODUCTION
In common with many developed nations, organised crime in Israel grew steadily from the 1960s, initially through familial crime networks conducting traditional ‘mafia’ type activities such as illegal casinos, vice and loan sharking, ‘shakedowns’ through violence and intimidation and general gang related crime. (Katz, 2005; Rabinovitch, 2010). By the late 1980s, organized crime in Israel had been given a significant boost thanks to strong cultural links with the burgeoning crime networks of the Soviet Union, which was by then going through a process of disintegration.

However, it was not until the early 1990s that Israeli Organised Crime (IOC) networks found their principal stock-in-trade for the following twenty years and beyond; the synthetic drug 3,4 methylenedioxymethylamphetamine (MDMA), commonly known as Ecstasy. IOC networks were the first global crime phenomenon to see the many benefits of this drug as an illicit commodity; huge profits, its acceptable party image and ease of transportation and use. IOC effectively made MDMA their own, using established European black markets and crime networks originally devised for diamond smuggling and money laundering (Harpaz and Colombo, 2000; Siegel 2009). As such, extensive IOC networks now exist in Europe and the U.S. and are growing in Asia and Australasia. IOC is mainly, but not exclusively engaged in MDMA trafficking on an industrial scale. While synthetic drug trafficking is their main activity, they have a noted involvement in sex trafficking and the illegal harvesting and sale of human organs over the past twenty years (Meyer, 2006; Chaikin and Safran, 2010).

IOC networks have to date, been effective in maintaining a supply monopoly to the two largest MDMA markets, namely the U.S. and Europe (Katz, 2005). However, as criminal knowledge about production and trafficking spreads amongst the global criminal diaspora, IOC is gradually losing some market share to a range of alternative crime groups, particularly in Asia (ACC, 2011). It is posited that these developments are nothing more than the harsh reality of global market forces, largely beyond the control of IOC networks. Nonetheless, IOC continues to dominate global MDMA trafficking and remain a potent criminal force in this sector of the synthetic drug market.

This paper is comprised of two Parts. Part A provides a review of the literature as it relates to Israeli Organised Crime (IOC) and its involvement in criminal activities in particular its involvement in the European MDMA market. While, Part B provides an analysis of the
characteristics of contemporary IOC networks, using the Criminal Business Analysis Matrix (CBAM) method designed by Dean, et al. (2010).

The CBAM assesses IOC networks’ performance and characteristics against five (5) entrepreneurial capabilities (Opportunity Perspective, Resources Mobilisation, Decision in Uncertainty, People & Cooperation; and Profit Maximization) and four (4) business phases (Establishment Phase, Expansion Phase, Consolidation Phase; and the Positioning Phase). The four business phases are comprised of a total of 16 business development factors. Against these capabilities, a rating of HIGH, MEDIUM or LOW is assigned, with accompanying explanations. A graphical representation of these ratings for both capabilities and business development factors can be found at Appendix ‘A’

Approach
This case study of IOC using the CBAM (Dean, et al. 2010) incorporates a comparative review of the literature on several aspects of IOC activity, with a strong focus on those Israeli criminal networks based in the Netherlands and Belgium, which remain target countries for MDMA manufacture and wholesale distribution. Data collected against the following themes were compared and contrasted and used to complete the CBAM as proffered by Dean, et al (2010):

- History and development of IOC
- The expansion from domestic activity to Transnational status
- The nexus with, yet distinctions from Russian Organised Crime
- The advent of MDMA and IOC’s consummate exploitation of this
- The various modus operandi of IOC trafficking and money laundering
- Other organized crime activities engaged in by IOC
- Growing global recognition of the threat posed by IOC
- Evidence of change in MDMA market dynamics as new crime actors engage in production and distribution, particularly in Asia

This paper will show that IOC is experienced in identifying criminal opportunities, mobilizing the required resources and maximizing profits. However, like most organizations both illegal and legitimate, decision making during times of uncertainty remain a challenge.

Limitations of this paper
The authors acknowledge the dynamic nature of domestic and international drug markets. Therefore the data analysed in this paper is limited to the period 1990 to 2005 and is further limited by the fact that it is drawn from open sources and scholarly articles and like publications. The activities of IOC are restricted to its involvement in the European MDMA drug market for the stated period under examination.

DISCUSSION
PART A
History and development of Israeli Organised Crime (IOC)
A comparative review of the literature suggests that the term Israeli Organised Crime (IOC) entered the justice lexicon sometime in the early 1990s. According to the Israeli National Police (INP), Israel had first recognized an organised crime in Israel around 1978 and twenty years later it declared the criminal networks as a strategic threat (Rabinovitchen, 2010). Similarly, Katz (2005) described the evolution of Israel’s criminal environment since the 1960s, noting that a handful of powerful crime families in Israel had traditionally run illegal
neighborhood casinos, prostitution rings and loan sharking operations. In keeping with much of the developed world, these activities grew steadily over the following years.

Given Israel’s longstanding struggle to achieve localized security both within and at its borders it is unsurprising that organized crime networks have readily adopted the methods of terrorism to strike at competitive enemies. For example, Mohammad (2008) described the use of car bombs to eliminate rivals. This occurred during a violent dispute between organized crime factions in Israel. The war was sparked by the murder by car bomb of Yaakov Alperon, the leader of a Tel Aviv criminal gang. Mohammad notes the fact that innocent bystanders have been injured in crime killings, the battle being over a business operation and the desire for vengeance on the part of Alperon's family (Mohammad, 2008 p. 27).

In later work, Mohammad (2009) discussed the visible rise of IOC in Israel, referencing publicly visible episodes of violence, specifically in Tel Aviv, Israel. The killing of Yaakov Alperon is further examined in the context of his son Omer Alperon promising retribution for those who killed his father. At the time, the Israeli government flagged its intention to ‘crack down’ on organized crime in Israel (Mohammad 2009, p. 13).

The Jewish nation appeared to be somewhat slow in responding to the growing threat of organized crime. Adamoli, Di Nicola, Savona and Zoffi (1998) noted that in 1997 Israel introduced mutual legal assistance legislation for asset forfeiture investigations, while money laundering laws only came into being in 2000 (Shebanova, 2010). Sangaro (2007 p. 27) observed that it was not until 2003 that Israel passed an anti-organized crime law and much later, in 2008 that the INP launched a new police unit to enforce it. The phenomenon of organized crime was now in the public eye in the form of murders and drug trafficking and the Israeli government was obliged to respond (Sangero, 2007 p. 66).

The move to Transnational Status
The growth of IOC domestically appears to have been slow but steady. According to a 2005 regional security assessment, organised crime in Israel remained fragmented and opportunistic, despite the influx of Russian criminals and the subsequent turf wars experienced in the 1990s (Jane's Intelligence Review, 2005, p. 32 - 34). This assessment appears to have been focused entirely on the domestic outlook concerning IOC within Israel’s borders. However, there is clear evidence that from the late 1990s, IOC had expanded to a prime European crime base; Amsterdam. It was also utilizing its connections within the diamond industry in the nearby Belgian city of Antwerp, to provide informal banking facilities for the criminal network (Siegel, 2009).

A Complicated Nexus with Russian Organised Crime
Because of the longstanding close family and migratory links between the former Soviet States and Israel, entrenched by the post-war exodus of Jews to the new nation, significant linkages and overlaps between criminal networks of both regions can be found. While these overlaps need to be acknowledged, it is critical to avoid any equation of commonality between the two. Russian Organised Crime (ROC) presents a much larger global threat through its sheer numbers and diversity of operations. The question of delineation between IOC and ROC is further blurred by the use of terms such as ‘Jewish organised crime’ by
some to describe Russian émigré crime networks operating in U.S. cities and elsewhere in the world (Glenny 2008).

Williams (1998) observed that throughout the 1990s, criminals from the former Soviet Union flooded into Israel, exploiting both the law of return and the lack of anti-money laundering measures. In some cases, money from Russia was used in Israel to buy up businesses burgeoning on bankruptcy that would then start to make profits which eventually found their way back to Russia. In some instances, these transnational criminal organizations also created jurisdictional confusion, making it difficult for any single nation’s law enforcement agency to act effectively against them (Williams, 1998 p. 71).

Davis, Hirst and Mariani (2001, p. 16) described how post-soviet organised crime has grown and extended its operations into foreign countries aided by new travel freedoms afforded to Soviet citizens. Granville (2003) refers to Jonathon Wine (the former Deputy Assistant Secretary of State for International Law Enforcement), who claimed:

"There is not a major Russian organised crime figure who we are tracking who does not also carry an Israeli passport. An obvious attraction of such a travel document is the relationship between Israel and the U.S and limits on extradition laws with Russia”.

**MDMA**

Above all else, the arrival of the illicit recreational drug MDMA, commonly known as Ecstasy (XTC) on the world stage in the early 1990s (Agar and Schacht Reisinger 2003) has had a profound effect on the development and growth of IOC. According to Katz (2005), drugs only became available in Israel after the Six-Day War, when contact with Arab-run cannabis plantations in Lebanon and Syria occurred, and hashish was suddenly cheap and available. From the 1970s, thousands of young tourists visited Israel from colleges in North America and Europe. They volunteered on kibbutzim and, turning curious Israelis on to drugs (Katz, 2005, p. 21). MDMA is closely associated with rave/dance culture and the ‘party’ scene (Cohen, 1998).

According to Amir (2003) the ‘Ecstasy culture’ was imported to Israel in the early 1990s, as a consequence of thousands of young Israelis travelling to South America, India and other exotic party locations as an escape from the violence and conflict experienced during their military service. Some brought drugs back; others became small time dealers while the more ambitious developed into importers (Amir 2003, p. 20).

By 1998 U.S. officials were reporting on the Jewish State as a drug-consuming country and a trafficking power, with serious marijuana, hashish and heroin use, and a growing problem of cocaine, LSD, and amphetamine consumption (Katz 2005 p. 4). However, Ecstasy developed as the key commodity of IOC networks, and remains so to this day. It is primarily produced in Dutch and Belgian labs ranging from industrial-sized plants and mobile labs hidden inside trucks or on floating barges, to basements underneath farms and factories (Romano, 2002 p. 36, Katz, 2005, Siegel, 2009).

**Modus Operandi**

It is prudent to examine how IOC networks have become so adept at distributing and marketing Ecstasy globally. Israelis have had smuggling networks in place between Israel, the Netherlands and Belgium for many years (Harpaz and Colombo, 2000; Siegel, 2009). These were used for shipping stolen diamonds through Brussels and Amsterdam to points
worldwide. When a few drug dealers first encountered MDMA they successfully test-marketed the drug in Israel, before using existing diamond routes for its distribution (Katz, 2005).

Israel’s then lax banking laws, make it easy to launder the proceeds from this drug trafficking activity. But the nature of Israeli society also contributed to the success of this new MDMA venture. Katz (2005) noted:

"Israelis are industrious, intelligent, innovative, and they love to travel...They are ideally suited for the global drug trade." (Katz, 2005, p. 3).

By the 1990s it appears that IOC had made itself at home in the Netherlands, partly through the old connections with the diamond smuggling trade. Punch (1991) explored the nature of the Dutch criminal landscape through the biographies of seasoned criminals and found that the traditional underworld in the Netherlands has been replaced by organised crime in the hands of Israelis and others. IOC networks have become entrenched in the Dutch MDMA landscape, moving beyond their early roles as deal brokers and traffickers, into primary production in some instances (Blickman, 2004).

According to Guttman (2004), two classes of criminals can be distinguished among Israelis involved in the MDMA scene: the directors of the networks, who have strong connections to the Israeli underworld, and the couriers, who are responsible for getting the drugs from Europe to the States. The couriers are recruited in Europe or the U.S. in return for the promise of big profits and for the most part carry out similar missions many times (Guttman, 2004 p. 18).

Katz (2005) also noted that the Israelis were the first to see the potential for MDMA. It didn't have to be smoked, snorted or injected, nor did it expose the user to risk of HIV infection (Joseph, 2000 p. 23). Israeli dealers were not content only with local distribution. Working with Dutch and Belgian criminal connections, they were instrumental in marketing the drug and creating the demand in Europe and throughout the world (Amir, 2003).

For example, Blickman (2004) recounted how in 1994 an Israeli crime group establishing an MDMA laboratory near Amsterdam, coming to police attention when it subsequently exploded. Blickman described another IOC group’s involvement with a seized laboratory in the Netherlands in 2001. The laboratory produced 120,000 pills an hour and Israelis were violently extorting money in Israel to fund its Dutch operation.

IOC networks have successfully used Western Europe as a hub to distribute MDMA globally, primarily from its production centres in the Netherlands and Belgium. Katz (2005, p. 37) concluded that:

“... today, Israelis have a virtual monopoly on the global trade of Ecstasy”.

This domination continues to the current time, being only slightly diluted by some new global actors in the MDMA trade appearing in the past ten years (US Department of Justice - USDEA, 2004, p. 127).

By 2004, the U.S Federal Department of Justice, Drug Enforcement Administration (DEA) publicly made the claim that:

“Israeli and Russian criminal groups control most wholesale MDMA distribution in the United States …”.

While at the same time, noting that Asian, South American and Middle Eastern organized crime groups also played a role (US Department of Justice -USDEA, 2004, p. 127).

The involvement and capabilities of IOC networks in Western Europe and the U.S. are well documented (Europol, 2005). However, the reach of IOC has been increasingly global for the past twenty years, with activities being detected in Africa, Southeast Asia, Japan and Australasia (US Department of Justice -USDEA, 2004, p. 127; Katz, 2005; ACC, 2011). Katz (2005 p. 3) describes how, in September 2000, Japanese police arrested a major IOC figure for smuggling 25,000 Ecstasy tablets into Japan.

In 2009, further evidence of IOC penetration in Japan came to light when Japanese authorities uncovered a suspected drug trafficking and money laundering ring believed to be run primarily through Israeli-run jewelry kiosks in Tokyo (Lis, 2009). Authorities believe the international ring was headed by an Israeli living in Estonia. Police believe a great deal of the money was also laundered in Israel, as well as through real estate purchased abroad. One of the key Israeli criminals arrested was considered a prominent figure in Tokyo nightlife (Lis 2009, p. 1).

IOC uses both shipment and couriers to distribute MDMA globally. Packaged MDMA is sent overseas through parcel post, with IOC dispatchers drive through Holland, Belgium, and Luxembourg to post their packages or deliver locally in person. IOC networks have mainly used Israelis as mules, or couriers, to bring the drug into the United States (Office of National Drug Control Policy, 2002). Israeli nationals living in Europe and the United States, typically young and seeking some easy cash, make ideal couriers. Organisers will often oversee several couriers on flights from Europe. IOC networks have also used orthodox and Hasidic Jews from the New York area to smuggle MDMA into New York's major airports in 1999 and 2000 (Lefer, 2001, p. 1)

IOC networks have, by necessity had to become adept at financing deals and money laundering their subsequent proceeds. The entrepreneurial nature of Israelis was also highlighted by Spapens (2010) who notes that within the Israeli criminal diaspora, there are sophisticated informal systems for fund raising for both licit and illicit undertakings. Sometimes the people who raised the money will not even know precisely what the capital is being used for.

In a field study, Van Duyne (1995) observed that money exchange offices in Amsterdam appeared to play an important role in the financial management of IOC money laundering. Cash is changed into other currencies and easier money-carriers at the exchanges. Van
Duyne’s analysis of four ‘bureaux de change’ operated by an Israeli family in Amsterdam revealed a turnover of hundreds of millions of guilders per year.

**Maintaining profits in a crowded market**

Profit margins from MDMA production and trafficking are so enormous that organized crime groups from other countries are now entering the market (Katz, 2005, Rabinovitch, 2010). Some loss of market dominance by IOC is an unavoidable market consequence, as knowledge of MDMA production methods becomes common within transnational and local crime groups. For example, by 2011 the Australian Crime Commission (ACC) noted that some of the crime groups identified as involved in the trafficking and distribution of MDMA in Australia include Italian and Israeli crime groups (ACC 2011, p. 60). Increasingly, MDMA is sourced from Southeast Asia (ACC 2011, p. 60; Schloenhardt 2007, p. 64).

While MDMA remains a popular drug today, market forces have led to fluctuations in its fortunes. Klerks (2000) examined the Dutch criminal environment and MDMA market at the turn of the new millennium and observed that competition from the former Soviet countries and Israeli traffickers was stronger than ever, risking a collapse in the local MDMA market. For Dutch and Israeli drug entrepreneurs alike, this resulted in a concentrated effort to develop export markets. In an indication of market saturation, Holland in the year 2000 witnessed an unprecedented number of assassinations among criminals, a phenomenon which observers attribute at least partly to drug deals gone wrong and infighting among major ecstasy producers (Klerks, 2000 p. 14).

The Amsterdam police force interviewed in excess of a hundred criminal contacts in late 2000, in relation to the assassinations, and found many of them to be fearful for their lives and insecure about their business (Klerks, 2000 p. 15). IOC networks did not flinch at this increased level of police attention and have proved resilient in the face of market pressures and competition from new market entrants. For example, when a decline in consumption in Holland led to further fears of local market saturation the Israelis responded to this challenge, by penetrating the U.S. market still further, while establishing footholds in Australia and Japan (Katz 2005, ACC 2011, p. 60).

Brunt, Poortman, Niesinki, and Van den Brink (2010) observed that the market of illicit drugs can be considered just as dynamic as that for legal products. New synthetic drugs, known as designer drugs, are continuously appearing on the illicit drug market (Jerrard, 1990, Wodak, 2008). Brunt et al. (2010) demonstrated the instability of the MDMA market in the Netherlands, showing a decrease of tablet production by more than 50% in 2009. In addition, they describe a partial replacement of MDMA in tablets sold as ecstasy by a previously unseen substance, mephedrone (or 4-methylmethcathinone). Known intelligence on the characteristics of IOC however, suggests that they will easily adapt and evolve to any such changes in the synthetic drug market (Rabinovitch, 2010).

**PART B**

**CASE STUDY ANALYSIS - IOC MDMA**

**Crime Business Analysis Matrix (CBAM) Dean et al (2010)**

**PHASE 1: Establishment:**

Opportunity Perspective (Overall Rating: HIGH)
Entrepreneurial Vision: HIGH
The term Israeli Organised Crime (IOC) appears to have developed as a law enforcement and criminological descriptive in the mid-1990s. Domestically, organized crime had been identified by Israeli authorities as a growing threat from the late 1970s as violence and other publicly obvious traits of its presence increased within Israeli society (Katz, 2005). However, it was not until the disintegration of the Soviet Union that IOC came to be recognized as a 'strategic threat’ (Rabinovitch, 2010).

IOC’s genesis was helped by slowness of the Israeli State to develop countermeasures. Opportunities were taken to expand crime racketeering in Israel during the 1970-80s, unfettered by a distracted justice system. It can be argued that the Jewish nation was preoccupied with its immediate security environment and terrorist threats in the post war period. For example, Amir (1998) observed that Israeli academics only started to study organized crime in the 1970s and intelligence practitioners, even later.

History suggests that IOC demonstrated an extremely high level of entrepreneurial vision in realizing the potential of MDMA. Katz (2005) noted that the Israelis were the first to see the potential for MDMA; it didn't have to be smoked, snorted or injected, or expose the user to risk of HIV infection. IOC took the MDMA ‘opportunity’ and ran with it. Katz (2005) recounts that when a few Israeli drug dealers first encountered MDMA they successfully test-marketed the drug in Israel, before quickly using existing diamond routes for its distribution (Katz, 2005, p. 4). However, Israeli dealers have not been content with only local distribution (Guttman, 2004). Working with Dutch and Belgian criminal connections, they had global ambitions in marketing the drug.

Business Planning: HIGH
Limited intelligence exists in the public domain about business planning activities of IOC, yet the results of their endeavours speak towards careful planning and risk assessment (Lis, 2009). Success in the domination of the two largest MDMA markets (Europe and the U.S.) has not come about by chance, but through incremental planning (Haskew, 2001).

Crime Money Management: HIGH
IOC networks seek out legitimate means for managing the conversion of crime proceeds from illicit to licit. The natural entrepreneurial nature of Israelis also flows through to the characteristics of IOC networks, a tendency for self-employment and the conduct of business activity being ideal cover for the laundering of crime proceeds. Van Duyne’s (1995) analysis of four 'bureaux de change' operated by an Israeli family in Amsterdam revealed a turnover of hundreds of millions of guilders per year.

A similar crime money management model came to light amongst Israeli criminals operating in Japan in 2009, when Japanese authorities uncovered a suspected drug trafficking and money laundering ring run through Israeli-run jewelry kiosks in Tokyo. The money was also laundered in Israel and through real estate purchased abroad (Lis, 2009 p. 1).

Resource Mobilisation (Overall Rating: HIGH)
Financial Capital: HIGH
Israelis are widely acknowledged for their entrepreneurial skills in raising startup funds for business ventures in the licit world. IOC networks have, by necessity had to become adept at
financing deals and money laundering the subsequent proceeds. For the typical MDMA venture, the bulk of advanced funds are required to pay the typically Dutch or Belgian manufacturer. The next tranche of funds is required for transportation, short or long haul, depending on destination. Upon the split-up of shipment to wholesalers and dealers, funds start to be re-couped, bringing the ultimate ‘payday’. Sophisticated informal payment systems exist within the Israeli criminal Diaspora. This ‘informal’ banking system has many advantages; it is a ‘closed shop’ with exclusive membership, it attracts no formal paperwork or transactional trail which can be followed by law enforcement and it is an instant, liquid means of cash or asset transfer (Spapens, 2010).

**Operational Logistics: HIGH**

With the advent of MDMA, IOC had a head-start with logistical networks, through established smuggling networks between Israel, the Netherlands and Belgium (Harpaz and Colombo 2000, Siegel 2009). IOC uses both shipping and couriers to distribute MDMA globally (Amir, 2003). Packaged MDMA is sent overseas through parcel post, IOC dispatchers driving through Holland, Belgium, and Luxembourg to ship their packages to a range of European and global destinations.

**Human Resources: LOW**

In the area of personal couriers, IOC networks have mainly used Israelis as ‘mules’ to bring the drug into the United States. Israeli nationals living in Europe and the United States, typically young and seeking easy cash, are ideal for this role. Overseers will often 'shotgun' couriers on flights from Europe. IOC networks have also used orthodox and Hasidic Jews from the New York area to smuggle MDMA into New York's major airports. (Lefer, 2001)

In terms of human capital, Israelis bring some special qualifications to the table. Israel’s ongoing security environment means that several generations of Israelis have, by way of compulsory military service, developed the skills to survive conflict and adversity and problem-solve to achieve desired outcomes (Amir, 2003). Military training will bring for many an eye for detail and vigilance in relation to immediate or potential threat, be it from police or criminal.

IOC networks consistently use young, party-seeking travelers of Israeli or at least Jewish origin to facilitate MDMA trafficking. This provides at once a potential strength and weakness for IOC. By only using human resources of their own culture, religion and background, IOC networks are insuring against ‘rogue’ operatives. IOC benefits from this through preconceptions and attitudes formed from a siege mentality (resulting from Israel’s ongoing security environment). These factors encourage a collectiveness and consistency of behaviour amongst couriers. However, this almost exclusive use of Jewish personnel for global trafficking can also serve to make the parameters of IOC networks highly visible to law enforcement (US Customs Service et al. 2000). The Israeli accent, first and family names are highly distinctive and not easily disguised. These factors are perhaps IOC’s greatest vulnerability and give law enforcement a starting point when seeking out IOC drug networks for investigation (US Customs Service et al. 2000).

**PHASE 2: Expanding Implementation**

**Decision Making in Uncertainty (Overall Rating: MEDIUM)**

In the mid 1990s, Israeli drug criminals were faced with a dilemma; whether to invest heavily in the then new synthetic ‘tablet’ drug scene in a gamble that it would accelerate in popularity
past that of say, heroin or cocaine or early forms of methamphetamine. Their decision to specialize in MDMA has been vindicated in an entrepreneurial sense.

**Business Intelligence: HIGH**

Using conventional business planning and intelligence skills, IOC evaluated this risk, ultimately forming the view that prospective gains could be confidently predicted (Amir, 2003). IOC networks took a risk on the popularity of MDMA, based on logic regarding the convenience and marketed ‘safety’ of the drug. As a result, they were, relatively speaking, first into the field. As a result, IOC had no real large-scale competitors for the first fifteen years of MDMA trafficking (also being the last fifteen years of the old Millennium).

**Violence: LOW**

Israelis are largely a product of their own security environment. As a nation they have faced adversity, conflict, violence and the threat of an uncertain security environment for many years. A natural corollary of this environmental conditioning is that violence becomes a transactional commodity for some. Heightened or extreme levels of vigilance, paranoia, the direct witnessing of violence and military conflict through compulsory military service may all play some role in de-sensitization to the use of violence in Israel (Landau, 1988).

The tools of this struggle with terrorism have been used in organized crime disputes, the use of bombs to eliminate rivals in Israel now being commonplace (Mohammad, 2008). Innocent bystanders have been injured in such crime killings. One such instance was the killing by car bomb of Yaakov Alperon, the leader of a Tel Aviv criminal gang (Mohammad 2009, p. 13). In 2005 an Israeli National Police Superintendent commented publicly on this violence in Israel, observing that virtually all IOC members are retired army officers, well trained and heavily armed (Eshed, 2005 p. 1).

By marked contrast there are few indicators of Israeli MDMA networks using violence in the wider global MDMA markets. This is likely to be part of a deliberate low-profile strategy as outlined by Dean et al. (2010 p. 116) to maintain business advantage. Outside of Israel and some limited Jewish-American crime skirmishes in the U.S. IOC networks avoid such violent practices. They market their commodity in the relaxed people friendly environment of dance parties, rave events, and holiday environments that provide convenient cover to their activities (Amir, 2003).

**Corruption: LOW**

While political corruption in Israel is endemic, there are no overt indications that IOC has any great dependence or reliance on corrupt relationships with authorities or government to facilitate its activities. That is not to say that corrupt relationships do not exist between major criminals and politicians. Outside of Israel, there is no clear evidence that IOC networks rely upon corrupt practices and relationships any more or less that other known organized crime phenomena. However, this observation is qualified by the fact that not enough detail is known about IOC network operations outside Israel and North America, beyond periodic media reports on syndicate arrests.

**Counter-intelligence: HIGH**

Having been the foundation specialists in the MDMA market, IOC is deeply versed in the idiosyncrasies of their product, where and how the threats of law enforcement action will present and the detection of any signs of serious competition. The military background and
training of many of its members lends itself to a culture of vigilance and response to threat, often in the form of disinformation for the benefit of law enforcement and competitors alike (Amir, 2003).

**PHASE 3: Consolidating**

**People Co-operation (Overall Rating: HIGH)**

**Crime Business Connections: HIGH**

Having strong cultural and business links to the U.S. undoubtedly aids IOC’s crime business connections. The Israeli ‘Mafia’ had operated in the United States since the late 1970's and has established a significant presence in drug trafficking and various forms of fraud and money-laundering (Abramovsky, 1995). Given the close relationship between the U.S. and Israel and the size of illicit markets for recreational drugs in the former, this strong connection at macro and micro level with the U.S. is assessed as perhaps IOC’s most powerful crime business connection. Similarly, crime connections with the former Soviet Union are equally useful.

Criminological research conducted in Israel in the last three decades pointed clearly at the existence of correlation between crime and ethnic origin as related also to immigration. For example, Rattner (1997) studied the possible relationship between ethnicity, immigration and crime, examining the involvement of Jewish Russian immigrants in crime to establish whether crime is imported or developed after immigration. Rattner (1997) found that both theories have support and that crime connections between Israel and Russia and its former States are utilised to the fullest. Israeli and Russian criminals have become mutually entwined to enhance market penetration and to gain personal protection from law enforcement (Davis, Hirst and Mariani, 2001; Granville, 2003)

**Legitimate Business Connections: HIGH**

Of the publicized arrests of major IOC leadership figures in Israel, Europe and the U.S. for MDMA trafficking over the past twenty years, several have been high-profile figures in the nightclub/entertainment industry, conducting ostensibly legitimate businesses in this realm (Lis, 2001 p. 1).

**Influential People Connections: MEDIUM**

In the U.S. in particular, some of the more successful IOC figures adopted a higher public profile through business activities. By 1999, the U.S authorities determined that one Israeli: Oded Tuito, was responsible for about 80 percent of the entire ecstasy supply in the United States and targeted him accordingly (Sweetingham, 2009). Tuito, who had built a substantial business empire, died while under investigation by the US- DEA. Despite this, there are no overt indications that IOC benefits from patronage of any corrupt political relationships or major public figures of influence.

**PHASE 4: Positioning**

**Profit Maximisation (Overall Rating: HIGH)**

**Local Market Share: HIGH**
MDMA as a drug phenomenon was imported to Israel in the mid 1990s, influenced by an already strong Ecstasy culture in Britain, Germany and Spain (Amir, 2003 p. 20). Israeli criminals naturally embraced it as a new money making opportunity. MDMA became entrenched in the party scene amongst those in Israeli society with time and expendable income for recreational drugs. For various reasons, IOC struggled to produce the drug domestically within Israel and maintained a reliance on Dutch and Belgian primary producers, yet the drug has become intensely popular in the Jewish State (Amir, 2003).

**Global Market Share: HIGH**

IOC networks have successfully used Western Europe as a hub to distribute MDMA globally from its production centres in the Netherlands and Belgium. (US Department of Justice - USDEA, 2004, p. 127). U.S. Customs data that showed that during the time period between October 1999 and April 2000 it seized four million Ecstasy tablets, up from the 750,000 tablets it found in fiscal year 1998. (Haskew, 2001 p. 1)

Despite these early indicators, the U.S. only formally acknowledged the role of IOC in MDMA trafficking around 1995 as MDMA seizures continues to rise (Blickman, 2004). U.S. federal law enforcement seizure analysis showed that the amount of MDMA smuggled into the United States had greatly increased through the 1990's (US Customs Service et al., 2000; Bureau for International Narcotics and Law Enforcement Affairs, 2003). By the mid-2000’s it was argued that IOC had a virtual monopoly on the global trade of Ecstasy (Katz, 2005).

By 2004, the U.S Federal Department of Justice, Drug Enforcement Administration (DEA) publicly claimed that: “Israeli and Russian criminal groups control most wholesale MDMA distribution in the United States”, while noting that Asian, South American and Middle Eastern organized crime groups also played a role. (Microgram Bulletin, 2004, p. 127). IOC networks have also steadily increased their operating base in Australia. According to the Australian Crime Commission (ACC) 2011 illicit drug report, some of the crime groups identified as involved in the trafficking and distribution of MDMA in Australia included ‘Italian and Israeli crime groups’ (ACC 2011, p. 60).

The market of illicit drugs can be considered just as dynamic as that for legal products. (Brunt, Poortman, Niesinkni and Van den Brink, 2010). Market forces for MDMA such as competitiveness, fluctuations in demand and commercial intelligence ‘leaks’ have seen some weakening of the IOC position in the MDMA market over time. Profit margins from MDMA are so enormous that organized crime groups from other countries were entering the MDMA market as early as ten years ago (Katz, 2005).

Some loss of market dominance by IOC is an unavoidable market phenomenon, as MDMA production methods become more commonly known in transnational and local crime groups around the world. As early as 2000 a joint U.S. federal law enforcement report predicted that the future should expect to see a small number of MDMA laboratories becoming established in Mexico and Mexican Cartels are becoming more involved in MDMA trafficking (US Customs Service et al. 2000).

This dilution of the manufacturing monopoly continued over the following decade. Changes in market share in recent years are possibly linked to MDMA having reached something of a zenith in popularity between 1998-2002. Brunt et al. (2010) demonstrated the instability of the MDMA market in the Netherlands, showing a decrease of tablet production by more than...
50% in 2009. According to the ACC, in 2006, the volume of global MDMA seizures were 37 percent less than in the peak year of 2002.

This may reflect declining production rates in European centres. In the United States there were also indications of declining rates of use and availability of MDMA in recent years, contrasting with the strong rise in seizures in Oceania and East and South East Asia (ACC, 2006 p. 4).

In 2005 law enforcement was still reporting that the majority of the world’s MDMA continued to be produced in Western Europe, but in recent years seizures have indicated that locally produced MDMA was available in Australia (ACC, 2006 p. 8). By 2011, it was increasingly clear that MDMA was sourced by developed markets such as Australia from Southeast Asia (ACC 2011, p. 60; Schloenhardt 2007, p. 64), with a growing emphasis on China as a source.

New synthetic drugs, known as designer drugs, are continuously appearing on the illicit drug market (Jerrard, 1990; Wodak, 2008). Some of these drugs continue to be loosely marketed as ‘Ecstasy’. Brunt et al. (2010) describe a partial replacement of MDMA in tablets sold as ecstasy by a previously unseen substance, mephedrone (or 4-methylmethcathinone). A further complication for IOC is the ‘blurring’ of the MDMA market in many countries. In Australia it is acknowledged that recreational drug tablets marketed and sold as ‘Ecstasy’ may contain no MDMA at all, but may be an amalgam of other synthetic chemicals and substances (ACC, 2006).

**Competitive Advantages: HIGH**

Against this backdrop of lower quality recreational drugs sold as ‘Ecstasy’, IOC networks have the important competitive advantage of being strongly associated with the original high quality version of MDMA, as was widely available from Holland around the beginning of the Millennium. IOC maintains strong capabilities in providing high quality MDMA, tempered only by manufacturing constraints and market competition.

Other competitive advantages enjoyed by IOC networks include strong links to a wider entrepreneurial Jewish community in many centres of the world, but, for the purposes of MDMA trafficking, particularly in the cities of Antwerp, Amsterdam, New York and Tel-Aviv. The Jewish (and thus Israeli) connection with Russian Organised Crime and more mainstream Jewish-American crime strengthens IOC’s advantage through sheer numbers, greater options regarding the finance of crime and access to more markets. That the majorities of IOC’s member base of drug and cash couriers are enmeshed in global travel as backpackers, the nightclub scene and rave events, presents an additional competitive advantage through access to a ready-made markets for recreational drugs.

A diagrammatical representation of the collective capabilities of IOC within the context of the MDMA industry across all four phases can be seen below as Appendix A:
Conclusion

IOC has been industrious in pursuing the criminal opportunities afforded to them, growing their MDMA enterprise into an unprecedented global operation. IOC networks were in the right place at the right time to exploit the arrival and popularity of MDMA amongst the affluent markets of Europe and the U.S. However, this in no way detracts from the high-level organization and efficiency demonstrated by IOC in building an empire based on MDMA.

Despite the likelihood of changes in the future market dynamics of MDMA and its derivatives, law enforcement can confidently predict that IOC will reform and adapt as necessary to ensure that they remain a global force in recreational drugs. IOC networks are resilient, well connected with youth culture and its recreational drug consumerism, ruthless in business and determined to maximize profits and maintain market share. IOC will likely evolve with ease to take entrepreneurial advantage of any future opportunities in the synthetic drug market as they emerge.

The earlier comment by one researcher that Israeli criminals are ‘ideally suited’ to the MDMA trade is highly pertinent here. This adds to the contention reached during this study that whatever changes occur in the future market dynamics of MDMA and its derivatives, law enforcement can confidently predict that IOC will reform and adapt as necessary to
ensure that they remain a global force in organized crime. They are resilient, well connected with youth culture and its recreational drug consumerism, ruthless in business and determined to maximize profits and are representative of the emerging entrepreneurial criminal organization discussed by Dean et al (2010).

References


MATURITY, GENDER AND THEIR INFLUENCE ON ETHICAL ORIENTATIONS OF FUTURE BUSINESS MANAGERS

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ABSTRACT

This study examined American business students to see the influence of maturity and gender on ethical views. The survey was conducted in the fall of 2004 (n=800). This study examined ethical views of students who are preparing to be the next generation of business managers. The findings indicated several maturity factors and gender showed significant results in their understanding and their views on the ethics scandals. The details were discussed. The limitations of the study were noted. Finally, implications for further research in this area were noted.

Introduction

Students do not arrive on campus as blank slates. Instead, each student arrives with some writing on his/her slate, and a great deal of blank space. Such a symbiotic relationship between the age old rivalry of “nature and nurture” continues to be embraced by behavioral scientists across the intellectual spectrum. Marcus (2004) characterizes such a relationship like this: "The initial organization of the brain does not rely that much on experience... Nature provides a first draft, which experience then revises... 'Built-in' does not mean unmalleable; it means organized in advance of experience.” The advantages of this framework are twofold, first it affirms that we cannot erase everything on one’s slate and start over. However, it also clarifies our role in shaping ethical understanding. Within this frame we work alongside our students as “editorial assistants” taking on a participatory role in the revision of their experiences with ethics.

When we do this, as educators, we are also participating in the moral development of our students. Moral development is the ability to distinguish right from wrong, to develop ethical values, and to learn to act morally (Mujtaba, Cavico, McCartney, & DiPaolo, 2009). Formal education is a vital part of this process. It is not the only part, but an important one.
What difference does education make? No one can be definite. Identifying the single influence which changes a person’s ethical views is difficult because the formal and informal education process is ongoing, everyday (Mujtaba, Cavico, & Sungkhwawan, 2011).

The authors wanted to discover whether our business students really made ethics a priority, to the extent a student understood a recent ethical crisis. This study examined American business students (n=800) and their views on Enron and related ethical beliefs. The findings were detailed and discussed. The limitations of the study were noted. Finally, implications for further research in this area were noted.

While a great deal of research is focused on business ethics, businesses are not the only sources of ethical problems. Politicians and sports figures also have their own set of moral quandaries, including sexual indiscretions, gambling and performance-enhancing drugs. Many magazines and television shows owe their existence to exposing these ethical failures. Are these events aberrations? Are these unethical actions as rare as unicorns or are they as commonplace as smart phones? We as a society hope for the former, but the truth may be closer to the later.

Ethical problems in business are splashed on the front page of every newspaper. Stories of Bernie Madoff, Enron, WorldCom, and Tyco have become part of the popular culture. Of course, these problems are not new despite media emphasis to the contrary. The Ford Pinto, the Savings and Loan Crisis of the 1980s, Watergate, and many more preceded the current problems. Beggs and Dean’s (2007) survey of faculty found that faculty should be more proactive as ethical problems will continue. Many more will follow in the future. Peter Drucker, among many others, has predicted as much (Zahra, 2003). As long as greed exists, future ethical scandals are a certainty.

What has changed in recent times is the scale of those ethical problems. Enron lost $90 billion in shareholder value in less than one month (Brewer, 2007). Lynn Brewer, the whistleblower, explained that Enron has a climate of corruption and complacency towards corruption (Brewer, 2007). The amount of greed and corruption in Enron staggers the imagination. If you lost $1 million a day, it would take over 200 years to lose as much as Enron lost in one month.

We like to think that the market will solve for these failings. Unethical firms will be eliminated from the market at least that is our hope. In a survey developed by KPMG (public accounting firm), 75% of the respondents reported they had direct knowledge of misconduct in their current organization (Williams, 2006). Verschoor (2006) using a meta-analysis found that 42% of workers thought their senior managers were unethical. It would appear that unethical behavior is not an aberration, but is present in the majority of firms.

**Literature Review**

Unethical business school graduates are a perfect example of the chicken and egg problem. Are the students who choose business as a major more likely to be unethical, or do business schools convert ethical students into unethical graduates? Many have researched this question. Kohlberg (1969) explained that moral development is a process involving socialization, education, aging, and experience, developing a six stage model for moral development. Education is one of several factors that influence moral development. It is
difficult to examine any one of these factors in isolation, since all of them occur during the same period of time.

No one aspect of maturity is definitive. That is why research on age alone has led to unclear results (Laczniak & Inderrieden, 1987; Beltramini, Peterson, & Kozmetsky, 1984). Age is just one of many facets of the concept of maturity. Many factors influence moral development, including age, marriage, having children, employment, and life experiences. The confounding problem for researchers is that all these changes are occurring at the same time. But no one aspect of maturity is the key. All are part of Kohlberg’s progression into moral maturity. In addition, the factors are not always tied together or experienced at the same time. A person can be young and married, single but have children, older but never employed. These life experiences do not have to occur together or in the same time period.

Studies on age have led to many conflicting results. Knotts, Lopez, and Mesak (2000) found that age of college students did not significantly influence their ethical judgments, as did Barnett, Brown, & Bass (1994). In addition, Poorsoltan, Amin, & Tootoonchi (1991) did not find any relationship between age and moral conduct.

In contrast, Borowski & Urgas (1998) conducted a meta-analysis of 35 studies on age and found consistent links between ethical behavior and age. Ruegger & King (1992) found that older students (over age 40) were more ethical than their younger counterparts. Similarly, Longenecker, McKinney, & Moore (1988) and Serwinek (1992) found that the older the student, the more conservative their views on ethical matters. Eweje & Brunton (2010) found that older students were more ethically oriented, at least in New Zealand. Peterson, Rhoads & Vaught (2001) found that ethical beliefs increase with age. Gupta, Walker, & Swanson (2011) found that older graduate students were more ethical than their younger (traditional) counterparts.

Besides maturity, this study explores the idea of gender as influencing ethical development. Historically, gender has been found to significantly influence ethical views in a variety of scenarios and settings. Borowski & Urgas (1998) conducted a meta-analysis of 48 studies on gender and found females were consistently more ethical than males (for example, see Ludlum, Moskalionov, & Ramachandran, 2013; Gupta, Cunningham, & Arya, 2009; Knotts, Lopez, & Mesak, 2000; Peterson, Rhoads, & Vaught, 2001; Chonko & Hunt, 1985; Kidwell, Stevens, & Bethke, 1987; Smith & Rogers, 2000; Ludlum & Moskalionov, 2004).

If socialization in education was key, the choice of major and specific courses should have a large impact on ethical attitudes. However, completing a specific course or a college degree is only part of the socialization process. Several early studies found no relationship between students’ major and their ethical beliefs (Laczniak and Inderrieden, 1987; McNichols and Zimmerer, 1985; Dubinsky and Ingram, 1984; and Goodman and Crawford, 1974). Business programs do not seem to instill ethical behaviors in their students (Roderick, Jelley, Cook, and Forcht, 1991; Bunn, Caudill, and Gropper, 1992; Kumar, Borycki, Nonis, and Yauger, 1991; Peters, 1989; Wolfe, 1993).

Curren and Harich (1996) found that a student’s discipline of study (either business of humanities) did not play a significant role in their ethical judgments. Similarly, Ludlum and Moskalionov (2003 and 2004) found that business majors did not have significant differences
from non-business majors on many questions of ethics. Reiss and Mitra (1998) similarly found that choice of major did little to influence workplace behaviors.

Even specific courses have not made a difference. Several studies (Cole and Smith, 1995; Ludlum and Moskalionov, 2004) have found that completion of an ethics course did little to influence the beliefs of business students. McCarthy (1997) found the same result dealing specifically with accounting majors and the AICPA code of ethics.

Why should business educators worry about the ethical views of our students? The attitudes students have now will translate into behaviors they will have in the business world. Today’s college students will be the next generation of business employees, owners, managers, and regulators (Rawwas and Isakson, 2000). We also must help to guard against “moral dumbfounding.” Haidt (2012) characterizes moral dumbfounding as “People having strong moral reactions to a stimulus but failing to provide any rational justification for such reactions. (E.g. knowing intuitively something is wrong but cannot explain why.) Thus reasoning about morality is seen separate from the behavior that enables moral action to take place. We as educators need to encourage both thought and action.

Methods

The data was taken from a convenience sample (n=800) of students in economics classes at a large, south-western community college during the fall semester of 2004, three years after the Enron scandal dominated the news. The college had an enrollment of 16,000 students and over 100 Faculty. Students completed the questionnaire during class time. Most students participated, but they were not required to respond. A total of 800 surveys were completed. While no surveys were rejected because of incomplete answers, there were some instances of non-responses.

The current survey examined many variables that are believed to contribute to ethical perceptions. Some of the variables examined were age, sex, major, marital status, and other variables. A complete list of the questions is in Appendix 1.

Demographics

Of the 800 respondents, 43% were male, 26% were married, and 30% had children. In student measures, 41% were business majors, 36% were upper-classmen, and 78% were traditional college-aged. In coursework, 18% had taken a course in business ethics. From a financial perspective, 63% were employed, 25% were investors in a firm, and family incomes were fairly distributed. The smoking rate was higher than expected, 27%.

Our examination includes two research hypotheses:

Hypothesis One. Maturity will not affect knowledge of the Enron scandal.

Hypothesis Two. Maturity will not affect attitudes towards unethical firms.

We will operationally define maturity as a combination of age and year in school, as well as marriage and having children. Any factor alone is not dispositive, especially age alone. These elements of maturity can be in any combination. A person can be older but not married.
A person can be married, but young or without children. A person can be single and have children. Maturity is a multi-dimensional construct. That is why the results on age are so mixed. Age is just one factor in maturity.

In addition, we examine two research hypotheses regarding gender.

Hypothesis Three. Gender will not affect knowledge of the Enron scandal.

Hypothesis Four. Gender will not affect attitudes towards unethical firms.

For each, we started with the null hypothesis, that there is no relationship between the two variables being examined. We only report on the statistically significant results. The complete statistics are in Appendix 2.

Results

We begin with hypothesis one, knowledge of the Enron scandal. We asked two basic questions on the Enron controversy. We wanted to see if the current business students could identify Enron’s industry and Enron’s wrongful action. Overall, 86% of students could identify the major area where Enron got into trouble (false financial reports) from a list of five choices. There were some statistically significant results for maturity. Year in school was positively related to knowledge of Enron ($x^2 = 57.709, df = 25, p = 0$) as was age ($x^2 = 77.266, df = 30, p = 0$). Gender was also statistically significant with females more aware of Enron than their male counterparts ($x^2 = 19.446, df = 10, p = 0.035$).

We also asked students to identify Enron’s industry. Overall, 72% could identify Enron’s industry (Oil and Electricity) from a list of five choices. Year in school was positively related to knowledge of Enron’s industry ($x^2 = 49.801, df = 30, p = 0.013$) as was age ($x^2 = 61.433, df = 36, p = 0.005$) and being married ($x^2 = 26.501, df = 18, p = 0.089$). Gender was not statistically significant.

We examined students to see if their views were affected by the events of Enron’s demise. Over half (59%) of students indicated the Enron controversy did not change their views on investing. A significant portion (37%) indicated the Enron controversy made them less likely to invest in a publicly traded company. Gender was related to desire to invest, with females being more cautious because of Enron ($x^2 = 12.304, df = 6, p = 0.046$). None of the maturity factors were statistically significant on this question.

We asked whether Enron was typical of most businesses. Less than one fourth of students (21.38%) considered Enron to be typical of American businesses. Year in school was statistically significant ($x^2 = 48.638, df = 35, p = 0.063$) as was age ($x^2 = 587.53, df = 42, p = 0$), being married ($x^2 = 557.645, df = 21, p = 0$), and having children ($x^2 = 575.554, df = 28, p = 0$). Gender was also statistically significant ($x^2 = 424.812, df = 14, p = 0$).

We asked students if businesses needed more or less regulation. The majority (52.5%) preferred the same amount, while 35% wanted more government regulation. Maturity was correlated with a desire for more regulation. Year in school ($x^2 = 43.714, df = 20, p = 0.002$), marriage ($x^2 = 301.103, df = 12, p = 0$), age ($x^2 = 351.521, df = 24, p = 0$), and having children ($x^2 = 320.356, df = 16, p = 0$) all led to a desire for more regulation. Gender was also tied to regulation, with females desiring more regulation compared to the males ($x^2 = 277.829, df = 8, p = 0$).
We also asked two related questions about students’ desires to work for a company involved in ethical scandals. Overall, 76% indicated the Enron controversy did not change their views on the desire to work for a company accused of wrongdoing. Year in school ($x^2 = 61.069$, $df = 20$, $p = 0$), marriage ($x^2 = 626.073$, $df = 12$, $p = 0$), age ($x^2 = 591.199$, $df = 24$, $p = 0$), and having children ($x^2 = 549.641$, $df = 16$, $p = 0$) all led to a decreased desire to work for a company accused of ethical wrongdoing. Gender was also statistically significant, with females having less desire for a company accused of ethical wrongdoing ($x^2 = 411.544$, $df = 8$, $p = 0$).

We changed the question to ask of students’ desires to work for a company if the student personally knew that the firm was committing ethical wrongs. A strong majority, 79% said knowing a firm was unethical made it less likely to work for that company. The difference between this question (personal knowledge) and the previous question (accusations) show that students have a stronger reaction to fact than rumors in the media.

Older, more mature students and female students do not want to work for an unethical company. The statistically significant results are year in school ($x^2 = 27.481$, $df = 15$, $p = 0.025$), marriage ($x^2 = 483.435$, $df = 9$, $p = 0$), age ($x^2 = 558.567$, $df = 18$, $p = 0$), having children ($x^2 = 509.225$, $df = 12$, $p = 0$), and gender ($x^2 = 372.114$, $df = 6$, $p = 0$).

**Discussion**

For Hypothesis One, Maturity will not affect knowledge of the Enron scandal, we found some mixed results. Both the students’ age and year in school were found to be statistically significant factors, as more mature students had greater awareness of the Enron controversy. This supports the finding that maturity is positively related to knowledge of this ethical controversy. However, neither being married nor having children yielded significant results. Perhaps this is a problem of the operational definition of maturity including too many factors.

For Hypothesis Two, Maturity will not affect attitudes towards unethical firms, we found compelling results. Maturity is strongly correlated with a stronger support for a firm being ethical. All four factors of our operational definition of maturity (age, year in school, marriage, and having children) yielded statistically significant results on all questions but one. On the question about desire to become an investor, maturity did not have any impact. One possible explanation (consistent with the other findings) is that college students, whether mature or not do not visualize themselves as investors, so the question has little relevance for them. College students (always impoverished regardless of time period or location) cannot realistically consider the prospect of being an investor with their short-term orientations in college. Put another way, poor college students are not worried about investments. Pizza for the weekend is a long term investment for them. Such a finding reaffirms a solid tenet of developmental and social psychologists. That is, core values remain fairly consistent throughout the lifespan. It is one’s priorities that are highly variable and do change with age and experience of time. Carsten and Mickels (2005) suggest that goals are set in temporal contexts. Time is seen as expansive in one’s youth which in our case means that ethics is not likely to be the highest order priority. However as one ages boundaries on one’s time become more apparent so priorities shift.

Hypothesis Three, Gender will not affect knowledge of the Enron scandal, had mixed results. Females were more knowledgeable about Enron’s wrongdoing, but had no statistically significant result for choosing Enron’s industry. While there were gender differences, both questions had high student knowledge, with both over 70% overall.

Hypothesis Four stated that gender will not affect attitudes towards unethical firms. In our research, gender was found to statistically significant on all five questions, with females
being more concerned with ethical norms than males. This supports the previous findings that females tend to be more ethical.

Implications for Further Research

This study produced some interesting results that challenge anecdotal notions of how Enron’s events influenced ethical conduct and perspectives. It was still only a snapshot of what might have occurred at that time. The process could not be replicated now as the specific scandal would need to be changed. For current college students (expected to graduate in 2016-17), the Enron scandal occurred while they were in diapers. It does serve to give us a good idea of what has occurred with a specific demographic of the population. We found that three years after the scandal broke, students were aware of the basics of the Enron controversy. While we have often complained that students ignore current events, it appeared that some details got absorbed.

We can see that many variables such as being a business major, being married, having children, and others affected their views on business ethics. A newer ethical controversy should be explored to get more recent results. Future research should examine if our ethical education keeps current on the controversies or if educators rely on more dated examples and teach them to our young students. Future projects should include a broader sample, with more schools from other regions of the United States. Additionally, other variables should be included, such as religion, race, nationality, intelligence and other factors.

Conclusion

The study of ethics is crucial to future business students and their development into leaders. However, as educators we cannot sit idly by and repeat the same lectures and hope students will develop. We must search out students who are inclined to behave ethically. For those students, the status quo works. However, we must take action to reach those students who are unaffected by the current education on ethics. By investigating which students need more ethical training and why, we can design a better ethical education for the next generation of business students and business leaders.

While we cannot create a group of blank slate students, we should not idly sit. Students need the input of faculty on ethical behavior. We should not brainwash the students into certain behaviors, but students do not arrive as blank slates to be brainwashed. The students should be exposed to ethical guides and the results of violating those ethical norms. Education with a component of ethics is vital to assist our students in moral development.

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The authors wish to thank Lea Ann Hall, who left us for heaven in 2010. She devoted many, many hours of work inputting the data on this and many other projects. This paper is dedicated to her memory.
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Appendix: Survey Questions

Please complete the following survey. Circle the correct answer. This is important for our research. All your answers are confidential. Thank you in advance for your participation.

What year in school are you presently?
Are you male or female?
Are you married?
Do you have any children?
What is your major? Business or Non-Business
Have you taken a course in business ethics?
Do you use tobacco?
Are you registered to vote?
Are you currently employed?
Would you describe yourself? Democrat-Republican-Independent
Are you presently a stockholder/investor in any publicly traded company?
What was your family’s income last year?
What is your age?

3. Enron got in trouble in the United States for:
   - Polluting Rivers
   - Hiring Illegal Immigrants
   - Refusing to Pay Taxes
   - False Financial Reports
   - Unsafe Working Conditions

4. Have the recent revelations about Enron, WorldCom and Tyco made you more likely or less likely to be an investor?
   - More likely
   - Less likely
   - About the same

5. Enron was primarily involved in what industry in the United States?
   - Medical Supplies
   - Real Estate Development
   - Oil and Electricity
   - Sporting Goods
   - Clothing – Apparel
   - Agriculture

8. Describe your views on the following statement: “The only difference between the executives at Enron and those at most other big companies is that those at Enron got caught.”
   - Strongly Agree-Agree-No Opinion-Disagree-Strongly Disagree

9. In light of recent problems, should government be more involved in regulating business, less involved, or stay the same?
   - More involved
   - About the same
   - Less involved

10. Would you want to work for a company that had been accused of unethical business practices?
11. Are you more or less likely to work for a company if you know from your own experience that the company is not ethical?
   - More likely
   - About the same
   - Less likely

Note: There were other questions not used in this project.
### Appendix 2. Statistically Significant Results by Question Number

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