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IN BUSINESS
ACADEMIC SERIES

BUSINESS ETHICS

Case Studies and Selected Readings

MARIANNE M. JENNINGS

EIGHTH EDITION

Business Ethics

Case Studies and Selected Readings

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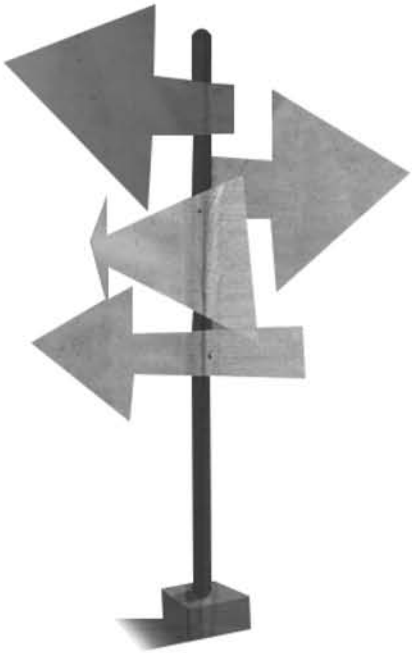
EIGHTH EDITION

MARIANNE MOODY JENNINGS

Arizona State University



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Preface

"Never trust the people you cheat with. They will throw you under the bus. Just ask Michael Vick."
—Marianne M. Jennings

"Three people can keep a secret if two are dead."
—Hell's Angels (Quoting Ben Franklin)

"Ethical standards and practices in the workplace are the pillars of successful employment and ultimately the benchmark for a strong business."
—Franklin Raines, former CEO of Fannie Mae (ousted in 2005); with a $6 billion restatement of its financials, the board concluded that "[management was] manipulating earnings and creating an 'unethical and arrogant culture.'"

"We are doing God's work."
—Jeffrey Skilling, former CEO of Enron (completing a 24.6-year sentence for fraud)'"
—Lloyd Blankfein, CEO of Goldman Sachs

The Josephson Institute released its data for 2012 on cheating in high school and found that 52 percent of the students surveyed say that they have cheated on an exam in the past year, and 82 percent say that they have lied to a teacher in the past year. A *New York Times* survey of high school students puts the cheating level at 90 percent.[1] When the Josephson researchers asked the high school students if they had copied another's homework, 76 percent said that they had but did not consider it cheating. "Team work" was their label for this practice. The Center for Academic Integrity at Clemson University and Professor Donald McCabe of Rutgers report that college cheating has grown from 11 percent in 1963 to 49 percent in 1993 to 75 percent in 2006.[2] Another study puts the level at 85 percent.[3] Professor McCabe also found that MBAs have the highest rate of self-reported academic dishonesty (57 percent) of all graduate disciplines. In the spring of 2013, Harvard expelled 60 students for cheating on an exam in their required course on Congress.[4] Longitudinally, it would seem we have a decline. Many argue that there is no decline; rather, they offer, we are simply more honest about our ethical breaches. There is little comfort in this reassurance that we're more honest about our cheating. And there remains a disconnect between this conduct and an understanding of what ethics is. The Josephson Institute also found that the high school students who report that they cheat feel very comfortable about their behavior, with 95 percent saying they are satisfied with their character and ethics. Perhaps we are more honest about our cheating. But perhaps that honesty results from our belief that cheating is not an ethical issue.

Research indicates that if students cheat in high school, they will bring the practices into college. And if they cheat in college, they will bring those practices into the workplace. A look at some of the events in business since the publication of the seventh edition of this book tells us that we are not quite there yet in terms of helping business people understand when they are in the midst of an ethical dilemma and how those dilemmas should be resolved. Following the collapses of Enron and WorldCom, and the ethical lapses at Tyco and Adelphia, we entered the Sarbanes-Oxley era with fundamental changes in the way we were doing business and audits. However, we did not make it even five years before we found ourselves in the midst of the collapse of the housing market and revelations about shoddy and undisclosed lending practices for mortgages. The end result was a dramatic drop in the stock market and a recession because of all the secondary instruments tied to the risky mortgages. The reforms enacted by the Dodd-Frank bill (Wall Street Reform and Consumer Protection Act) have not yet been implemented, and as the work of implementation proceeds, we find that British banks were fixing the LIBOR interest rate; MF Global was using funds from customer accounts to cover margin calls; and Bernie Madoff pulled off an 18-year, $50 billion Ponzi scheme. Government pension plans collapsed for lack of funding based on flawed

[1] "Main Street Woes," *Forbes*, November 17, 2008, p. 20.

[2] The Center for Academic Integrity study has been conducted by Professor Donald McCabe on a regular basis over the years. This survey had 4,500 student respondents. For more information on Professor McCabe and his work on academic integrity and the Center for Academic Integrity, go to http://www.cai.org.

[3] Corey Ciochetti, "The Uncheatable Class," Proceedings, Academy of Legal Studies in Business, August 2013 (unpublished paper).

[4] Richard Pérez-Peña, "Students Accused of Cheating Return Awkwardly to a Changed Harvard," *New York Times*, September 17, 2013, p. A12.

actuarial studies, and municipal bankruptcies have revealed that government officials received personal benefits for awarding everything from bond underwriting agreements to construction contracts. Insider trading charges affected more than a dozen traders at SAC Capital, with SAC agreeing to settle civil and criminal charges.

And then there are those events that fall short of criminal conduct or civil fines misconduct. These are the day-to-day ethical breaches that capture media headlines and cause continuing concerns about the ethical culture of business. There are the questions about television reality shows: Was the storage locker a setup, or were those things really in there? And why did Facebook not disclose the problems it knew about on its advertising revenues before its IPO? Did Subway really cut us short with an 11-inch sub sandwich when we thought we were buying a footlong? The world of sports brought us questions such as, “Is it really cheating if everyone does the same thing?” Lance Armstrong’s admissions about his use of performance-enhancing drugs found us all debating that issue. BP’s spill from the Deepwater Horizon rig off the coast of Louisiana resulted in a $20 billion down payment by the company on damages, and resulting issues of fraud in claims against that fund.

From analysts not offering their true feelings about a company’s stock to the factory workers producing peanut base for cookies and crackers, pressure often got in the way of moral clarity in business decisions. Those pressures then translated into ethical lapses that involve everything from pushing the envelope on truth to earnings management that crosses over into cooking the books and fraud. Weak product designs and products’ defects often produce a chain of memos or e-mails in the company that reflect employee concerns about product safely. College sports, baseball, and politics all have their ethical issues. The cycles between major ethical and financial collapses seem to be growing shorter. Businesses do exist to make a profit, but business ethics exists to set parameters for earning that profit. Business ethics is also a key element of business decision processes and strategies, because the cases in this book teach us that the long-term perspective, not the short-term fix, serves businesses better in that profit role.

This book of readings and cases explores those parameters and their importance. This book teaches, through detailed study of the people and companies, that business conducted without ethics is a nonsustainable competitive model. Ethical shortcuts translate into a short-term existence. Initially, these shortcuts produce a phenomenon such as those seen with Lehman Brothers, Merrill Lynch, and Countrywide Mortgage. These companies are no longer viable entities because they crossed ethical lines. For a time, they were at the top of their game—flummoxing their competitors on how they were able to do what they were doing—and so profitably. But then that magnificent force of truth finds its way to the surface, and the company that does not factor in the ethics of its decisions, and conduct finds itself falling to the earth like a meteor’s flash. Long-term personal and business success demand ethics. This edition takes a look at everything from the subprime lending market, a market that brought easy pickings in terms of profit so long as real-estate values held firm, to the world of sports and the downfall of so many. This book connects the moral sentiments of markets with the wealth of nations. Business without ethics is self-destructive.

New to This Edition

A Slightly New Structure and Approach to Address the Chronic Repetition of the Ethical Lapses

We’ve been down this road before, and the historic patterns are now emerging for study and insight. In 1986, before Ivan Boesky was a household name and Michael Douglas was Gordon Gekko in *Wall Street*, I began teaching a business ethics course in the MBA program in the College of Business at Arizona State University. The course was an elective. I had trouble making the minimum enrollments. However, two things changed: my enrollments and my fate. First, the American Association of Collegiate Schools of Business (AACSB) changed the curriculum for graduate and undergraduate business degree programs and required the coverage of ethics. The other event actually was a series of events. Indictments, convictions, and guilty pleas by major companies and their officers—from E.F. Hutton to Union Carbide, to Beech-Nut, to Exxon—brought national attention to the need to incorporate values in American businesses and instill them in business leaders.

Whether out of fear, curiosity, or the need for reaccreditation, business schools and students began to embrace the concept of studying business ethics. My course went from a little-known elective to the final required course in the MBA program. In the years since, the interest in business ethics has only increased. Following junk bonds and insider trading, we rolled into the savings and loan collapses; and once we had that straightened out, we rolled into Enron, WorldCom, HealthSouth, Tyco, and Adelphia, and we even lost Martha Stewart along the way. We were quite sure—what with all the Sarbanes-Oxley changes and demands on boards, CEO, CFOs, and auditors—that we were through with that level of misconduct. We were, however, wrong. New Century Financial, one of the first of the subprime lenders to collapse, found one angry bankruptcy trustee. The trustee's report concluded that he found astonishing the acquiescence of the auditor to the client's refusal to write down the bad loans in what he called "the post-Enron era." The Lehman Brothers bankruptcy trustee found a letter from a risk officer at the investment banker who tried to warn the CEO and CFO that the firm's financial reports violated its code of ethics. The trustee also found that the risk officer was fired.

Three decades plus after Boesky, we have the SAC Capital insider trading web emerge in 2012 with a staggering repetitiveness that finds us wondering, "Do they not see the ethical and legal issues? Do they just not know that they are crossing these lines? Do they see the patterns from business history?" The good thing about repetitive patterns is that we gain insight into the paths, the reasoning, and the pressures of those involved. The key is to bring out those patterns and train our new business leaders to recognize them and, most importantly, to stop the train of self-destruction those patterns set off. This edition is reorganized to offer greater insights, knowledge, and perspective on these patterns for a new generation of leaders. Today, nearly 100 percent of the Fortune 500 companies have a code of ethics. We are up to over 75 percent of companies having some form of ethics training. But we are not quite there until our business leaders grasp the perspective of ethics and its relationship to economics, organizational behavior, company culture, reputation, and financial performance. This edition is structured to walk us through all aspects and types of ethical dilemmas and how we can cope with the pressures that often deprive us of good ethical analysis.

Unit 1: Our Ethics

Unit 1 addresses the following questions: What is this ethics thing? How do I manage to work philosophy into my decision processes? How do I find solutions to ethical dilemmas? How do I know when I am really analyzing as opposed to rationalizing or succumbing to pressure? This unit begins with introspection, a right-out-of-the-blocks focus on developing a credo—a way of helping us to think about ethical issues in advance and decide what we would and would not do in a situation. If we think about issues in advance, then when the pressure hits, we at least have the cognitive dissonance of realizing that we did see the issues differently when we were not under so much pressure.

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Unit 2: Solving Ethical Dilemmas and Personal Introspection

Once we have focused on our ethical standards and ourselves, we move into analysis of ethical issues in business. This unit offers the introspection of this question: Are my personal ethical standards different when I am at work? Should they be? Why are they different? Further, the magnitude of the mistakes that business people continued to make, despite all the warnings from ongoing debacles, did not indicate that these were close calls. Something had gone awry in their ethics training in business school for them to drift so far from virtue. I continue to emphasize in teaching, consulting, and writing that helping students and business people see that personal ethics and business ethics are one and the same is critical to making virtue a part of business culture. Virtue is the goal for most of us in all aspects of our lives. Whether we commit to fidelity in a personal relationship or honesty in taking the laundry detergent back into the store to pay because we forgot it was on the bottom of our grocery cart, we show virtue. Ethics in business is no different, and we need not behave differently at work than we do in that grocery store parking lot as we make the decision to be honest and fair with the store owner. Substitute a shareholder and the disclosure of option dates and true costs, and we have our laundry detergent example with a stock market twist.

This unit also focuses on the patterns that interfere with good ethical analysis in business such as pressure, hubris, and a singular focus on moral relativism as opposed to a deeper look at the consequences of reliance on that model. This unit allows us to switch back and forth from personal dilemmas to business dilemmas so that we are able to see that the ethical issues are the same in our personal lives as they are in business—only the fact patterns change. We can see that honesty is important, whether studying the complexities of Goldman’s laddering sales structures or the simple questions contractors face when homeowners ask them to include additional repair work as part of a storm damage claim to their insurers. Instructors and students gain the ability to reduce the most complex of financial cases to the common denominators found in returning that laundry detergent to the store—is this honest? Is this fair? With this understanding of the common denominators, we are free to focus on the psychology of our decision processes rather than on the details of the underlying transactions. The obligation of good faith in dealing with each other does not change simply because we are buying a CDO rather than Tide. This unit also includes the overarching theme of the book over all of its editions: plenty of real-life examples from newspapers, business journals, and my experiences as a consultant and board member. Knowing that other instructors and students were in need of examples, I have turned my experiences into cases and coupled them with the most memorable readings in the field to provide a training and thought-provoking experience on business ethics.

Unit 3: Business, Stakeholders, Social Responsibility, and Sustainability

Unit 3 offers us the bigger perspective—once we slog through the decision processes of fraud, embezzlement, puffing résumés, and cheating on our travel expenses, we move to discussion and understanding of the role of business in society. The cases in this unit are broken into an introduction to business and society, the obligations of business toward our moral ecology, and the issues of the environment and sustainability.

Unit 4: Ethics and Organizational Culture

Unit 4 is the psychology section that tackles companies’ ethical lapses, with the realization that beyond individual ethical lapses (as with one bad apple), there are barrel factors that must be addressed to prevent ethical lapses. This section, through the finance cases and the weaving in of corporate governance, explores those barrel factors with the recognition that beyond individual lapses there are company, industry, and societal norms that do cause companies and individuals to move that line away from ethical standards to "everybody does it" here at the company, in our industry, and in society. The cases here explore how incentives, organizational behavior practices and processes, reporting mechanisms, industry practices, and societal norms contribute to poor ethical analysis, decisions, and that self-destructive behavior. Recognizing and addressing those barrel issues is the theme of Unit 4.

New to this edition is a restructuring that becomes clear in Unit 4. The cases on government and nonprofit ethical lapses have been integrated into the other units. The cases in these two areas were set aside in separate units in previous editions. Through reviews and the study of ethical debacles in these two sectors, a realization brought about the structural change: The psychology of organizations and employee decision making in those organizations does not change because they work in a nonprofit or government agency. Nonprofit employees have the pressures of raising funds. Government employees experience the pressure of dealing with the powerful and the prospect of losing their jobs. The issues these employees and organizations face are the same as those in for-profit businesses. Indeed, the addition of their issues in an integrative fashion in this edition helps drive home the point that the questions and dilemmas are the same. The principles of ethics are universally applicable.

Unit 5: Ethics and Contracts

Unit 5 is new to this edition, with a special focus on the ethics of contracts, from advertising through negotiations, to performance. Issues related to pension promises and certification of minority status for government contracts are a part of this new unit. The ethical challenges in contract formation and performance, again, cross all sectors, so this unit has nonprofit and government examples integrated as well.

Unit 6: Ethics in International Business

This unit helps students understand the need for better and deeper ethical analysis of the issues in international business and the importance of analyzing the countries and their ethical standards prior to doing business there. The section addresses the risks and costs of ethical lapses and succumbing to local standards as opposed to establishing company standards prior to those pressure points that occur in international competition. New to this edition is a discussion of the emerging safety issues in international production facilities. Fires, collapsing buildings, and unsafe working conditions have brought headlines, and a great deal of backlash toward companies that use these facilities for product manufacturing.

Unit 7: Ethics, Operations, and Rights

This new unit is one that draws together all the cases on workplace issues that affect employees and managers: from safety to conflicts, to privacy, to diversity, to the lost art of confrontation about employee conduct, this section is the one for understanding how ethics bumps shoulders with production demands, technology, profits, and privacy. From honesty in letters of recommendations to office romances, all matters that affect employers and employees are now in one unit.

Unit 8: Ethics and Products

Unit 8 includes all the issues related to product development, sales, safety, and advertising. From recalls to racy dolls, to advertising, to the contracts themselves, this section focuses on the ethical issues that involve the how, what, and where of sales of products. The issues of social responsibility and products are found here in cases that address everything from Barbie not liking math to Bucky Balls, the product that could not be made safe.

Unit 9: Ethics and Competition

Unit 9 has the luxury of focusing entirely on competition. With the contracts issues grouped in Unit 7 on products, this unit has expanded coverage of the ever-growing concerns about covenants not to compete and employee breaches of those covenants. The societal issues of infringement are emphasized as students analyze cases that illustrate the costs of not honoring intellectual property rights.

What's New and What's Back

The eighth edition continues the features students and instructors embraced in the first seven editions, including both short and long cases, discussion questions, hypothetical situations, and up-to-the-moment current, ongoing, and real ethical dilemmas. Some of the long-standing favorites remain by popular demand—such as the Nestlé infant formula experience and Union Carbide in Bhopal, with their long-standing lessons in doing the right thing. There are so many "oldies but goodies" when it comes to ethics cases, but length constraints do not allow me to continue to include in this book all the oldies along with the new cases that promise to be "oldies but goodies." Check out the availability of custom options noted at the end of this section in order to keep using those "oldies but goodies." Now there are further opportunities to integrate cases from previous editions into your course.

The eighth edition continues the new training tool introduced in the previous edition to help business people who are working their way through an ethical dilemma. Following the discussion questions for many of the cases, the "Compare and Contrast" questions continue. These are questions provide an example of a company making a decision different from the one made by management in the case at hand. For example, in the Tylenol case (Case 8.7—an "oldie but goodie" that has been updated for this edition to include the company's recent problems with metal flecks in its infant products), students find a question that highlights this company's past conduct in comparison with its conduct in a current situation in which the FDA has accused the company of surreptitiously buying up tainted product in order to avoid a recall. There is a contrast between its recall of a product in the 1980s, which was so rapid and received so much acclaim, and its behavior in this event. Why do some companies choose one path, whereas others succumb to pressure? What was different about their decision-making processes? What did they see that the other companies and their leaders did not take into account? This feature is a response to those who worry that students are not given examples of "good companies." The problem with touting goodness is that it is impossible to know everything a company is or is not doing. For example, Fannie Mae was named the most ethical company in America for two years running. Yet it had to do a $7 billion restatement of earnings and is now defunct as a shored-up government entity. BP was an environmental darling for nearly a decade for its responsible environmental programs. However, recent events cast doubt on how much environmental and safety dedication the company had. There is a risk in learning of goodness if that goodness is superficial or limited. Studying individual scenarios of contrasting behavior is the learning tool, not the touting of a single company that can always have a lapse. There are no saints in this journey, and keeping the text credible requires a recognition of that limitation but uses it to emphasize the vigilance we all need, as individuals and in business, to avoid lapses and progress in moral development.

Finding and Studying the Cases and Readings

The eighth edition continues the classic readings in business ethics that provide insight into the importance of ethics in business and how to resolve ethical dilemmas. The eighth edition also continues the presence of integrated readings throughout the book to provide substantive thoughts on the particular areas covered in each section. The organizational structure and indexes, continued from the seventh edition, make material, companies, people, and products easy to locate. A case can be located using the table of contents, the alphabetical index, the topical index, the people index, or the product index, which lists both products and companies by name. An index for business disciplines groups the cases by accounting, management, and the other disciplines in colleges of business. A case can also be located using the Ethical Common Denominator Chart," which is explained below.

How to Use the "Ethical Common Denominators Across Business Topics Chart"

The Ethical Common Denominators Across Business Topics chart, or simply the ECD chart, is a tool that appears along with the indexes for the book, can be used to help students understand the point that only the facts change, but the ethical dilemmas remain the same. This chart provides some ease for that slight discomfort some instructors have with the financial cases and helps students understand that underlying every ethical dilemma are the common patterns of psychology and pressure as well as the need for solid ethical analysis. The ECD chart provides instructors with the opportunity to structure their courses in a way that is comfortable for them. All an instructor needs to know is a general business term; that term can then be referenced in the ECD chart in various ways for instruction, according to instructor preference, needs, and time constraints. The chart groups the cases by the usual business and ethics topics. If, for example, you wanted to cover the environmental cases all in one fell swoop, simply go to "environmentalism" or "sustainability," and you find the cases and readings listed there. However, if you are looking for a variety of fact patterns to teach, for example, pressure's role in ethical decision making, you could look under that topic and find the BP case (also an environmental case) as well as the financial factors in the Enron case. If you wanted students to see what pressure can do in the area of contracts, you can use the Facebook decision not to publicly disclose the realization of their losses of ad revenues on the eve of the company's IPO. Students will learn that pressure affects all aspects of business operations. Adam Smith and his theories on markets appear in Section 9, but there is no reason this reading could not be shifted back to the coverage of the philosophical foundations.

An instructor can mix in cases from all the units in covering ethical analysis. The ECD includes a case from each unit under "Ethical Analysis," because you can pick and choose what topics to cover as you teach how to analyze ethical issues. The ECD chart allows you to introduce that broad exposure to the pervasiveness of ethical issues early in your course, or you can simply use the cases in that unit and go on to topical areas. The chart also allows you to break up the finance cases into areas of discussion on psychology, culture, organizational behavior, hubris, and pressure. You need not focus on the structure of CDOs and secondary instruments markets to understand the culture at Lehman and how its culture led its sales force and managers down a path that proved to be self-destructive. Likewise, you can mix in a Ponzi scheme in a nonprofit with Bernie Madoff, to help students understand how similar the cases are in the issues missed as those running the organizations pursued a business model that could not be sustained over time. The case on the Medtronics and research funding and journal publication teaches students about conflicts, but it would fit well in Unit 1 as you ask students to deal with the importance of speaking up when they see an ethical dilemma. The ECD chart allows a mix-and-match approach or a straight topical approach—both of which allow us to see that the facts change, but good ethical analysis applies, always.

Supplements

Access to Companion Site Resources

To access additional course materials and companion resources, please visit www.cengagebrain.com. At the CengageBrain.com home page, search for this book's ISBN (found on the back cover of your book), using the search box at the top of the page. This will take you to this book's product page, where free companion resources can be found. Instructors must go to login.cengage.com for access to instructor materials.

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The instructor's manual with Test Bank is updated with more sample test objective- and essay-answer questions of varying lengths and structures. The questions have been coded for topic and even some for case-specific questions so that exams can be created by subject area. The PowerPoint package, which includes illustrative charts to assist instructors in walking classes through the more complex cases, has been updated and expanded. Instructors can access the Instructor's Manual with Test Bank at login.cengage.com.

PowerPoint Slides

Developed by the author, Microsoft PowerPoint slides are available for use by students as an aid to note taking, and by instructors for enhancing their lectures. Instructors can access PowerPoint files at login.cengage.com.

Business Law Digital Video Library

The Digital Library offers more than 90 videos and helps your students link their everyday experiences to legal ideas; sparks classroom discussion; and reinforces core concepts. The videos are available with on http://www.cengage.com/blaw/dvl.

The library is organized into five series: Legal Conflicts in Business (includes specific modern business and e-commerce scenarios); Ask the Instructor (presents straightforward explanations of concepts for student review); Drama of the Law (features classic business scenarios that spark classroom participation); Real World Legal (explores conflicts that arise in a variety of business environments); and LawFlix (contains clips from many popular films). Access for students is provided via a code when bundled with a new textbook, or it can be purchased at www.cengagebrain.com.

Customized Selections of Case Studies and Readings

Instructors always have the option to customize your choice of cases and readings. Case studies and readings from both the sixth and seventh editions of Jennings's *Business Ethics* are available by working with your learning consultant. Selections can be used to create an affordable course companion or to integrate material into your customized textbook. Visit www.compose.cengage.com.

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I am grateful to my parents for the values they inculcated in me. Their ethical perspective has been an inspiration; a comfort; and, in many cases, the final say in my decision-making processes. I am especially grateful to my father for his continual research on and quest for examples of ethical and not-so-ethical behavior in action in the world of business. I am grateful for my family's understanding and support. I am most grateful for the reminder their very presence gives me of what is truly important. In a world that measures success by "stuff" acquired, they have given me the peace that comes from devotion, decisions, and actions grounded in a personal credo of "others first." This road less taken offers so many rich intangibles that we can, with that treasure trove, take or leave "the stuff." My hope is that those who use this book gain and use the same perspective on "stuff."

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Ethical Theory, Philosophical Foundations, Our Reasoning Flaws, and Types of Ethical Dilemmas

UNIT ONE

In the 21st century will occur something worse than the great wars, namely, the total eclipse of all values. The pain the human beast will feel when he realizes he can believe in … nothing … will be worse than any he has felt before."

—Nietzsche

I respect them and think they have integrity. They're proud of their achievements in college, and sometimes the only way you could have gotten there is to kind of botch your ethics for a couple of things.

—Stuyvesant High School (elite New York City high school) student on revelations that seventy-one Stuyvesant students cheated in most of their courses, a discovery made after the students had gone on to elite colleges[1]

Before we begin the study of business ethics, we should do some introspection: What does ethics mean to you personally? The purpose of this unit is to provide you with an introspective look at yourself and your views on ethics before we bring the business component to you and ethics.

This unit explains three things: what ethics are, why we should care about ethics, and how to resolve ethical dilemmas. The materials in this unit serve as the foundation for the study of issues in business ethics. We begin with a personal look at ethics, discuss why it matters, and then decide how to resolve ethical dilemmas.

[1] Vivian Yee, "The How and Why of Cheating," *New York Times*, September 26, 2012, p. A1.

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SECTION A

Defining Ethics

Reading 1.1

You, Your Values, and a Credo

We have a tendency to look at folks who get into ethical and legal trouble and say, "I know I would never behave like that." You probably would not, but you are only seeing them at their last step. You did not see the tiny steps that led to their eventual downfall. Study how and why they made the decisions they made. The idea is to try to avoid feeling superior to those who have made mistakes; real learning comes with understanding how easily we can fall into ethical missteps through flaws in our analyses and reasoning processes and because of pressures that allow us to feel justified in our actions. Your goal is to develop a process for analysis and reasoning, one that finds you looking at ethical issues more deeply instead of through the prism of emotions, desires, and pressures. You are not just studying ethics; you are studying business history. And you are also studying you. Try to relate your vulnerabilities to theirs. Remember as you read these cases that you are reading about bright, capable, and educated individuals who made mistakes. The mistakes often seem clear when you study them in hindsight. But the ethical analyses of those who made those mistakes were flawed whether through poor perspective; pressure; or sometimes, the stuff of Greek tragedies, hubris.

One of the goals of this text is to help you avoid the traps and pitfalls that consume some people in business. As you study the cases in this unit and the others that follow, try not to be too hard on the human subjects. Learn from them and try to discover the flaws in their ethical analyses.

One step that can give us greater clarity when we face ethical dilemmas is a credo. A credo is different from a code of ethics and does not consist of the virtues that companies usually list in a code of ethics, such as, for example, "We are always honest; we follow the laws." The credo demands more because it sets the parameters for those virtues. A credo is virtue in action. A credo defines you and your ethical boundaries.

You get your personal credo with introspection on two areas of questions:

1. Who are you? Many people define themselves by the trappings of success, such as how much money they have or make, the type of cars they drive, their clothes, and all things tangible and material. A credo grounds you and means that you need to find a way to describe yourself in terms or qualities that are part of you no matter what happens to you financially, professionally, or in your career. For example, one good answer to "Who are you?" might be that you have a talent and ability for art or writing. Another may be that you are kind and fair, showing those Solomon-like virtues to others around you. List those qualities you could have and keep regardless of all the outer trappings.
2. The second part of your credo consists of answering these questions: What are the things that you would never do to get a job? To keep a job? To earn a bonus? To win a contract or gain a client? The answers to these questions result in a list, one that you should be keeping as you read the cases and study the individual businesspeople who made mistakes. Perhaps the title of your list could be "Things I Would Never Do to Be Successful," "Things I Would Never Do to Be Promoted," or even "Things I Would Never Do to Make

> Money." One scientist reflected on the most important line that he would never cross, and after you have studied a few of the product liability cases, you will come to understand why this boundary was important to him, "I would never change the results of a study to get funding or promise anyone favorable results in exchange for funding." A worker at a refinery wrote this as his credo: "I would never compromise safety to stay on schedule or get my bonus." An auditor in a state auditor general's office wrote, "I would never sign a document that I know contains false information." The credo is a detailed list, gleaned from reading about the experiences of others, that puts the meat on Polonius's immortal advice to his son, Laertes, in Shakespeare's *Hamlet*: "To thine own self be true" *(Hamlet,* Act I, Scene III). We quote Polonius without really asking, "What does that mean?" The credo takes us from eloquent advice to daily action. The credo is a personal application of the lessons in the cases. You will spot the lack of definitive lines in these case studies and begin to understand how their decision processes were so shortsighted. The goal is to help you think more carefully, deeply, and fully about ethical issues.

A woman who had been a lawyer for thirty years reflected back on her career and realized that she had conducted her professional life in line with two admonitions a senior partner had given to her on her first day as a young associate and new hire in a law firm. The senior partner came into her office and said, "I want you to remember two things: Don't ever lie to a client. Don't ever lie to the FBI." She recalled wondering most of that first day, "What kind of firm am I working for that these are the only two rules? I would never lie to a client. I would never lie to the FBI." Within days she would understand the senior partner's wisdom, as well as that she had a credo. A client called and wondered how far along she was on a project for him. She had not even begun the project, but human tendency is to want to say, "Fine. Making progress. Coming along." However, because of the credo parameters, she told the truth. "I have not started the project yet, but I have set aside two days next week to really get at it—could I call you then?" The client stayed with her and the firm.

She also noted that she came up short on her billable hours that first month and considered adding a few minutes here and there to clients' bills, but then reasoned, "That would be lying to a client!" She stopped herself over what might have been rationalized away as, "Oh, it's such a little thing!" She then had a government agent (not FBI) visit her to ask questions about a classmate who had applied for a government job and had to be vetted. She recalled thinking that she should paint the best picture possible about the classmate, even though he had a checkered past. "Instead," she explained, "I just told the truth." As she reflected on her decades-long career she noted, "I can't tell you how many times those two simple rules from that first day have saved me from mistakes." That's what a credo does for you.

As you think about your credo, especially who you are, keep the following thought from Jimmy Dunne III in mind. Mr. Dunne was the only partner who survived the near destruction of his financial firm, Sandler O'Neill, when the World Trade Center collapsed on September 11, 2001. Only seventeen of Sandler O'Neill's eighty-three employees survived the tower's collapse. Mr. Dunne has been tireless in raising money for the families of the employees who lost their lives that day. When asked by *Forbes* magazine why he works so hard, Mr. Dunne responded, "Fifteen years from now, my son will meet the son or daughter of one of our people who died that day, and I will be judged on what that kid tells my son about what Sandler O'Neill did for his family." His personal credo focuses on both the long-term reputation of his firm and the impact his choices can have on his children's reputations.

Discussion Question

Explain the role that "How do I want to be remembered?" plays in your credo?

Reading 1.2

The Parable of the Sadhu: Pressure, Small Windows of Opportunity, and Temptation[2]

Bowen H. McCoy

[In 1982], as the first participant in the new six-month sabbatical program that Morgan Stanley has adopted, I enjoyed a rare opportunity to collect my thoughts, as well as do some traveling. I spent the first three months in Nepal, walking 600 miles through 200 villages in the Himalayas and climbing some 120,000 vertical feet. On the trip my sole Western companion was an anthropologist who shed light on the cultural patterns of the villages we passed through.

During the Nepal hike, something occurred that has had a powerful impact on my thinking about corporate ethics. Although some might argue that the experience has no relevance to business, it was a situation in which a basic ethical dilemma suddenly intruded into the lives of a group of individuals. How the group responded I think holds a lesson for all organizations, no matter how defined.

The Sadhu

The Nepal experience was more rugged and adventuresome than I had anticipated. Most commercial treks last two or three weeks and cover a quarter of the distance we traveled.

My friend Stephen, the anthropologist, and I were halfway through the 60-day Himalayan part of the trip when we reached the high point, an 18,000-foot pass over a crest that we'd have to traverse to reach the village of Muklinath [*sic*], an ancient holy place for pilgrims.

Six years earlier I had suffered pulmonary edema, an acute form of altitude sickness, at 16,500 feet in the vicinity of Everest base camp, so we were understandably concerned about what would happen at 18,000 feet. Moreover, the Himalayas were having their wettest spring in 20 years; hip-deep powder and ice had already driven us off one ridge. If we failed to cross the pass, I feared that the last half of our "once in a lifetime" trip would be ruined.

The night before we would try the pass, we camped at a hut at 14,500 feet. In the photos taken at that camp, my face appears wan. The last village we'd passed through was a sturdy two-day walk below us, and I was tired.

During the late afternoon, four backpackers from New Zealand joined us, and we spent most of the night awake, anticipating the climb. Below we could see the fires of two other parties, which turned out to be two Swiss couples and a Japanese hiking club.

To get over the steep part of the climb before the sun melted the steps cut in the ice, we departed at 3:30 A.M. The New Zealanders left first, followed by Stephen and myself, our porters and Sherpas, and then the Swiss. The Japanese lingered in their camp. The sky was clear, and we were confident that no spring storm would erupt that day to close the pass.

At 15,500 feet, it looked to me as if Stephen were shuffling and staggering a bit, which are symptoms of altitude sickness. (The initial stage of altitude sickness brings a headache and nausea. As the condition worsens, a climber may encounter difficult breathing,

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disorientation, aphasia, and paralysis.) I felt strong, my adrenaline was flowing, but I was very concerned about my ultimate ability to get across. A couple of our porters were also suffering from the height, and Pasang, our Sherpa sirdar (leader), was worried.

Just after daybreak, while we rested at 15,500 feet, one of the New Zealanders, who had gone ahead, came staggering down toward us with a body slung across his shoulders. He dumped the almost naked, barefoot body of an Indian holy man—a sadhu—at my feet. He had found the pilgrim lying on the ice, shivering and suffering from hypothermia. I cradled the sadhu's head and laid him out on the rocks. The New Zealander was angry. He wanted to get across the pass before the bright sun melted the snow. He said, "Look, I've done what I can. You have porters and Sherpa guides. You care for him. We're going on!" He turned and went back up the mountain to join his friends.

I took a carotid pulse and found that the sadhu was still alive. We figured he had probably visited the holy shrines at Muklinath [*sic*] and was on his way home. It was fruitless to question why he had chosen this desperately high route instead of the safe, heavily traveled caravan route through the Kali Gandaki Gorge. Or why he was almost naked and with no shoes, or how long he had been lying in the pass. The answers weren't going to solve our problem.

Stephen and the four Swiss began stripping off outer clothing and opening their packs. The sadhu was soon clothed from head to foot. He was not able to walk, but he was very much alive. I looked down the mountain and spotted below the Japanese climbers marching up with a horse.

Without a great deal of thought, I told Stephen and Pasang that I was concerned about withstanding the heights to come and wanted to get over the pass. I took off after several of our porters who had gone ahead.

On the steep part of the ascent where, if the ice steps had given way, I would have slid down about 3,000 feet, I felt vertigo. I stopped for a breather, allowing the Swiss to catch up with me. I inquired about the sadhu and Stephen. They said that the sadhu was fine and that Stephen was just behind. I set off again for the summit.

Stephen arrived at the summit an hour after I did. Still exhilarated by victory, I ran down the snow slope to congratulate him. He was suffering from altitude sickness, walking fifteen steps, then stopping, walking fifteen steps, then stopping, walking fifteen steps, then stopping. When I reached them, Stephen glared at me and said: "How do you feel about contributing to the death of a fellow man?"

I did not fully comprehend what he meant.

"Is the sadhu dead?" I inquired.

"No," replied Stephen, "but he surely will be!"

After I had gone, and the Swiss had departed not long after, Stephen had remained with the sadhu. When the Japanese had arrived, Stephen had asked to use their horse to transport the sadhu down to the hut. They had refused. He had then asked Pasang to have a group of our porters carry the sadhu. Pasang had resisted the idea, saying that the porters would have to exert all their energy to get themselves over the pass. He had thought they could not carry a man down 1,000 feet to the hut, reclimb the slope, and get across safely before the snow melted. Pasang had pressed Stephen not to delay any longer.

The Sherpas had carried the sadhu down to a rock in the sun at about 15,000 feet and had pointed out the hut another 500 feet below. The Japanese had given him food and drink. When they had last seen him he was listlessly throwing rocks at the Japanese party's dog, which had frightened him.

We do not know if the sadhu lived or died.

For many of the following days and evenings Stephen and I discussed and debated our behavior toward the sadhu. Stephen is a committed Quaker with deep moral vision.

He said, "I feel that what happened with the sadhu is a good example of the breakdown between the individual ethic and the corporate ethic. No one person was willing to assume ultimate responsibility for the sadhu. Each was willing to do his bit just so long as it was not too inconvenient. When it got to be a bother, everyone just passed the buck to someone else and took off. Jesus was relevant to a more individualist stage of society, and how do we interpret his teaching today in a world filled with large, impersonal organizations and groups?"

I defended the larger group, saying, "Look, we all cared. We all stopped and gave aid and comfort. Everyone did his bit. The New Zealander carried him down below the snow line. I took his pulse and suggested we treat him for hypothermia. You and the Swiss gave him clothing and got him warmed up. The Japanese gave him food and water. The Sherpas carried him down to the sun and pointed out the easy trail toward the hut. He was well enough to throw rocks at a dog. What more could we do?"

"You have just described the typical affluent Westerner's response to a problem. Throwing money—in this case food and sweaters—at it, but not solving the fundamentals!" Stephen retorted.

"What would satisfy you?" I said. "Here we are, a group of New Zealanders, Swiss, Americans, and Japanese who have never met before and who are at the apex of one of the most powerful experiences of our lives. Some years the pass is so bad no one gets over it. What right does an almost naked pilgrim who chooses the wrong trail have to disrupt our lives? Even the Sherpas had no interest in risking the trip to help him beyond a certain point."

Stephen calmly rebutted, "I wonder what the Sherpas would have done if the sadhu had been a well-dressed Nepali, or what the Japanese would have done if the sadhu had been a well-dressed Asian, or what you would have done, Buzz, if the sadhu had been a well-dressed Western woman?"

"Where, in your opinion," I asked instead, "is the limit of our responsibility in a situation like this? We had our own well-being to worry about. Our Sherpa guides were unwilling to jeopardize us or the porters for the sadhu. No one else on the mountain was willing to commit himself beyond certain self-imposed limits."

Stephen said, "As individual Christians or people with a Western ethical tradition, we can fulfill our obligations in such a situation only if (1) the sadhu dies in our care, (2) the sadhu demonstrates to us that he could undertake the two-day walk down to the village, or (3) we carry the sadhu for two days down to the village and convince someone there to take care of him."

"Leaving the sadhu in the sun with food and clothing, while he demonstrated hand-eye coordination by throwing a rock at a dog, comes close to fulfilling items one and two," I answered. "And it wouldn't have made sense to take him to the village where the people appeared to be far less caring than the Sherpas, so the third condition is impractical. Are you really saying that, no matter what the implications, we should, at the drop of a hat, have changed our entire plan?"

The Individual vs. the Group Ethic

Despite my arguments, I felt and continue to feel guilt about the sadhu. I had literally walked through a classic moral dilemma without fully thinking through the consequences. My excuses for my actions include a high adrenaline flow, a superordinate goal, and a once-in-a-lifetime opportunity—factors in the usual corporate situation, especially when one is under stress.

Real moral dilemmas are ambiguous, and many of us hike right through them, unaware that they exist. When, usually after the fact, someone makes an issue of them, we tend to resent his or her bringing it up. Often, when the full import of what we have done (or not done) falls on us, we dig into a defensive position from which it is very difficult to emerge. In rare circumstances we may contemplate what we have done from inside a prison.

Had we mountaineers been free of physical and mental stress caused by the effort and the high altitude, we might have treated the sadhu differently. Yet isn't stress the real test of personal and corporate values? The instant decisions executives make under pressure reveal the most about personal and corporate character.

Among the many questions that occur to me when pondering my experience are: What are the practical limits of moral imagination and vision? Is there a collective or institutional ethic beyond the ethics of the individual? At what level of effort or commitment can one discharge one's ethical responsibilities?

Not every ethical dilemma has a right solution. Reasonable people often disagree; otherwise, there would be no dilemma. In a business context, however, it is essential that managers agree on a process for dealing with dilemmas.

The sadhu experience offers an interesting parallel to business situations. An immediate response was mandatory. Failure to act was a decision in itself. Up on the mountain we could not resign and submit our résumé to a headhunter. In contrast to philosophy, business involves action and implementation—getting things done. Managers must come up with answers to problems based on what they see and what they allow to influence their decision-making processes. On the mountain, none of us but Stephen realized the true dimensions of the situation we were facing.

One of our problems was that as a group we had no process for developing a consensus. We had no sense of purpose or plan. The difficulties of dealing with the sadhu were so complex that no one person could handle it. Because it did not have a set of preconditions that could guide its action to an acceptable resolution, the group reacted instinctively as individuals. The cross-cultural nature of the group added a further layer of complexity. We had no leader with whom we could all identify and in whose purpose we believed. Only Stephen was willing to take charge, but he could not gain adequate support to care for the sadhu.

Some organizations do have a value system that transcends the personal values of the managers. Such values, which go beyond profitability, are usually revealed when the organization is under stress. People throughout the organization generally accept its values, which, because they are not presented as a rigid list of commandments, may be somewhat ambiguous. The stories people tell, rather than printed materials, transmit these conceptions of what is proper behavior.

For twenty years I have been exposed at senior levels to a variety of corporations and organizations. It is amazing how quickly an outsider can sense the tone and style of an organization and the degree of tolerated openness and freedom to challenge management.

Organizations that do not have a heritage of mutually accepted, shared values tend to become unhinged during stress, with each individual bailing out for himself. In the great takeover battles we have witnessed during past years, companies that had strong cultures drew the wagons around them and fought it out, while other companies saw executives, supported by their golden parachutes, bail out of the struggles.

Because corporations and their members are interdependent, for the corporation to be strong the members need to share a preconceived notion of what is correct behavior, a "business ethic," and think of it as a positive force, not a constraint.

As an investment banker I am continually warned by well-meaning lawyers, clients, and associates to be wary of conflicts of interest. Yet if I were to run away from every difficult situation, I wouldn't be an effective investment banker. I have to feel my way through conflicts. An effective manager can't run from risk either; he or she has to confront and deal with risk. To feel "safe" in doing this, managers need the guidelines of an agreed-on process and set of values within the organization.

After my three months in Nepal, I spent three months as an executive-in-residence at both Stanford Business School and the Center for Ethics and Social Policy at the Graduate Theological Union at Berkeley. These six months away from my job gave me time to assimilate twenty years of business experience. My thoughts turned often to the meaning of the leadership role in any large organization. Students at the seminary thought of themselves as antibusiness. But when I questioned them, they agreed that they distrusted all large organizations, including the church. They perceived all large organizations as impersonal and opposed to individual values and needs. Yet we all know of organizations where people's values and beliefs are respected and their expressions encouraged. What makes the difference? Can we identify the difference and, as a result, manage more effectively?

The word "ethics" turns off many and confuses more. Yet the notions of shared values and an agreed-on process for dealing with adversity and change—what many people mean when they talk about corporate culture—seem to be at the heart of the ethical issue. People who are in touch with their own core beliefs and the beliefs of others and are sustained by them can be more comfortable living on the cutting edge. At times, taking a tough line or a decisive stand in a muddle of ambiguity is the only ethical thing to do. If a manager is indecisive and spends time trying to figure out the "good" thing to do, the enterprise may be lost.

Business ethics, then, has to do with the authenticity and integrity of the enterprise. To be ethical is to follow the business as well as the cultural goals of the corporation, its owners, its employees, and its customers. Those who cannot serve the corporate vision are not authentic business people and, therefore, are not ethical in the business sense.

At this stage of my own business experience I have a strong interest in organizational behavior. Sociologists are keenly studying what they call corporate stories, legends, and heroes as a way organizations have of transmitting the value system. Corporations such as Arco have even hired consultants to perform an audit of their corporate culture. In a company, the leader is the person who understands, interprets, and manages the corporate value system. Effective managers are then action-oriented people who resolve conflict, are tolerant of ambiguity, stress, and change, and have a strong sense of purpose for themselves and their organizations.

If all this is true, I wonder about the role of the professional manager who moves from company to company. How can he or she quickly absorb the values and culture of different organizations? Or is there, indeed, an art of management that is totally transportable? Assuming such fungible managers do exist, is it proper for them to manipulate the values of others?

What would have happened had Stephen and I carried the sadhu for two days back to the village and become involved with the villagers in his care? In four trips to Nepal my most interesting experiences occurred in 1975 when I lived in a Sherpa home in the Khumbu for five days recovering from altitude sickness. The high point of Stephen's trip was an invitation to participate in a family funeral ceremony in Manang. Neither experience had to do with climbing the high passes of the Himalayas. Why were we so reluctant to try the lower path, the ambiguous trail? Perhaps because we did not have a leader who could reveal the greater purpose of the trip to us.

Why didn't Stephen with his moral vision opt to take the sadhu under his personal care? The answer is because, in part, Stephen was hard-stressed physically himself and because, in part, without some support system that involved our involuntary and episodic community on the mountain, it was beyond his individual capacity to do so.

I see the current interest in corporate culture and corporate value systems as a positive response to Stephen's pessimism about the decline of the role of the individual in large organizations. Individuals who operate from a thoughtful set of personal values provide the foundation of a corporate culture. A corporate tradition that encourages freedom of inquiry, supports personal values, and reinforces a focused sense of direction can fulfill the need for individuality along with the prosperity and success of the group. Without such corporate support, the individual is lost.

That is the lesson of the sadhu. In a complex corporate situation, the individual requires or deserves the support of the group. If people cannot find such support from their organization, they don't know how to act. If such support is forthcoming, a person has a stake in the success of the group, and can add much to the process of establishing and maintaining a corporate culture. It is management's challenge to be sensitive to individual needs, to shape them, and to direct and focus them for the benefit of the group as a whole.

For each of us the sadhu lives. Should we stop what we are doing and comfort him; or should we keep trudging up toward the high pass? Should I pause to help the derelict I pass on the street each night as I walk by the Yale Club en route to Grand Central Station? Am I his brother? What is the nature of our responsibility if we consider ourselves to be ethical persons? Perhaps it is to change the values of the group so that it can, with all its resources, take the other road.

Discussion Questions

1. In 2006, the Bowen McCoy phenomenon repeated itself. Forty climbers passed by Briton David Sharp as he lay by the side of the path on an Everest trek. David Sharp died on the mountain. However, the following week, American guide Dan Mazur stayed with Australian Lincoln Hall until help could arrive. Mr. Hall survived, but Mr. Mazur had to forgo his climb and suffer the resulting financial losses from not being able to lead his group to the summit. What questions and analysis might affect the decision processes in these two situations? Some gripping information to think about as you consider the issues: since Sir Edmund Hillary's initial conquest of Everest in 1953, some 3,000 climbers have made it to the top, and 200 have died trying; and the cost of a climb, at that time, was $60,000. Do you have some thoughts on your credo based on Mr. McCoy's and Mr. Mazur's experiences and actions?
2. Why do you think no one made sure the sadhu was going to be fine? What would they have had to do to be sure that the sadhu would live?
3. Are the rules of the mountain different from the rules of our day-to-day lives? Is it survival of the fittest on the mountain?
4. Why do you think Mr. McCoy wrote about his experience?

Reading 1.3

What Are Ethics? From Line-Cutting to Kant

The temptation is remarkable. The run is long. The body screams, "No more!" So, when some runners in the New York City Marathon hit the Queensboro Bridge, temptation sets in, and rather than finishing the last 10 miles through Harlem and the Bronx, they hop a ride on the subway and head toward the finish line at Central Park. A total of forty-six runners used the subway solution to finish the race in the 2008 New York City Marathon. We look at this conduct and react, "That is *really* unfair." Others, particularly the forty-six, respond, "So I skipped a few boroughs. I didn't do anything illegal." That's where ethics come in; ethics apply where there are no laws, but our universal reaction is, "It just doesn't seem right."

We all don't run marathons (or run partial marathons), but we do see ethical issues and lapses each day. A high school student was required to memorize the Preamble to the U.S. Constitution for an in-class quiz. When he reported to class, one of his classmates, not known for his sartorial splendor, was wearing a suit and tie. When asked why he was so dressed up, the student lifted his tie to show the inside, where he had taped a copy of the Preamble. We call it cheating on a quiz, but there is no criminal act involved in cheating. However, the other students, who have taken the time to memorize the Preamble, look at this conduct and exclaim, "That's not fair!"

In college, some students use apps to print out labels for their soda cans and chip bags that seem to be normal but have exam information embedded in everything from the bar code to the trademark. Students who study and rely on memory watch others use these unauthorized materials and think, "That's cheating!" No one will be arrested, but it is not fair. And the grading system will not reflect accurately who really knows the material and who has skated through, although their GPAs will be virtually the same. That idea of self-policing, of stopping ourselves when we take advantage of others, even though our conduct does not violate a law, is the self-restraint that ethics brings.

We are probably unanimous in our conclusion that those in the examples cited all behaved unethically. We may not be able to zero in on what bothers us about their conduct, but we know an ethics violation, or an ethical breach, when we see one.

But what is ethics? What do we mean when we say that someone has acted unethically? Ethical standards are not the standards of the law. In fact, they are a higher standard. A great many philosophers have gone round and round trying to define ethics and debated the great ethical dilemmas of their time and ours. They have debated everything from the sources of authority on what is right and what is wrong to finding the answers to ethical dilemmas. An understanding of their language and views might help you to explain what exactly you are studying and can also provide you with insights as you study the cases about personal and business ethics. Ethical theories have been described and evolved as a means for applying logic and analysis to ethical dilemmas. The theories provide us with ways of looking at issues so that we are not limited to concluding, "I think …" The theories provide the means for you to approach a dilemma to determine why you think as you do, whether you have missed some issues and facts in reaching your conclusion, and if there are others with different views who have points that require further analysis.

Normative Standards as Ethics

Sometimes referred to as *normative standards* in philosophy, ethical standards are the generally accepted rules of conduct that govern society. Ethical rules are both standards and expectations for behavior, and we have developed them for nearly all aspects of life. For example, with the exception of the laws covering lines for boarding the vehicle ferries in Washington, no statute makes it a crime for someone to cut in line in order to save the waiting time involved by going to the end of the line. But we all view those who "take cuts in line" with disdain. We sneer at those cars that sneak along the side of the road to get around a line of traffic as we sit and wait our turn. We resent those who tromp up to the cash register in front of us, ignoring the fact that we were there first and that our time is valuable too.

If you have ever resented a line-cutter, then you understand ethics and have applied ethical standards in life. Waiting your turn in line is an expectation society has. Waiting your turn is not an ordinance, a statute, or even a federal regulation. Waiting your turn is an age-old principle developed because it was fair to proceed with the first person in line being the first to be served. Waiting your turn exists because when there are large groups waiting for the same road, theater tickets, or fast food at noon in a busy downtown area, we found that lines ensured order and that waiting your turn was a just way of allocating the limited space and time allotted for the movie tickets, the traffic, or the food. Waiting your turn is an expected but unwritten behavior that plays a critical role in an orderly society.

So it is with ethics. Ethics consists of those unwritten rules we have developed for our interactions with each other. These unwritten rules govern us when we are sharing resources or honoring contracts. Waiting your turn is a higher standard than the laws that are passed to maintain order. Those laws apply when physical force or threats are used to push to the front of the line. Assault, battery, and threats are forms of criminal conduct for which the offender can be prosecuted. But these laws do not address the high school taunters who make life miserable for the less popular. In fact, trying to make a crime out of these too-cruel interactions in the teen years often finds the courts ruling that the statute is too vague. But ethical standards do come in to fill that gap. The stealthy line-cutter who simply sneaks to the front, perhaps using a friend and a conversation as a decoy for edging into the front, breaks no laws but does offend our notions of fairness and justice. One individual put him or herself above others and took advantage of their time and too-good natures.

Because line-cutters violate the basic procedures and unwritten rules for line formation and order, they have committed an ethical breach. Ethics consists of standards and norms for behavior that are beyond laws and legal rights. We don't put line-cutters in jail, but we do refer to them as unethical. There are other examples of unethical behavior that carry no legal penalty. If a married person commits adultery, no one has committed a crime, but the adulterer has broken a trust with his or her spouse. We do not put adulterers in jail, but we do label their conduct with adjectives such as *unfaithful* and even use a lay term to describe adultery: *cheating*.

Speaking of cheating, looking at someone else's paper during an exam is not a criminal violation. You may be sanctioned by your professor, and there may be penalties imposed by your college, but you will not be prosecuted by the county attorney for cheating. Your conduct was unethical because you did not earn your standing and grade under the same set of rules applied to the other students. Just like the line-cutter, your conduct is not fair to those who spent their time studying. Your cheating is unjust because you are getting ahead using someone else's work.

In these examples of line-cutters, adulterers, and exam cheaters, there are certain common adjectives that come to our minds: "That's *unfair!*" "That was *dishonest!*" and "That was *unjust!*" You have just defined ethics for yourself. Ethics is more than just common, or normative, standards of behavior. Ethics is honesty, fairness, and justice. The principles of ethics, when honored, ensure that the playing field is level, that we win by using our own work and ideas, and that we are honest and fair in our interactions with each other, whether personally or in business. However, there are other ways of defining ethical standards beyond just the normative tests of what most people "feel" is the right thing to do.

Divine Command Theory

The Divine Command Theory is one in which the resolution of dilemmas is based upon religious beliefs. Ethical dilemmas are resolved according to tenets of a faith, such as the Ten Commandments for the Jewish and Christian faiths. Central to this theory is that decisions in ethical dilemmas are made on the basis of guidance from a divine being. In some countries the Divine Command Theory has influenced the law, as in some Muslim nations in which adultery is not only unethical but also illegal and sometimes punishable by death. In other countries, the concept of natural law runs in parallel with the Divine Command Theory. Natural law proposes that there are certain rights and conduct controlled by God, and that no matter what a society does, it should not drift from those tenets. For example, in the United States, the Declaration of Independence relied on the notion of natural law, stating that we had rights because they were given to us by our Creator.

Ethical Egoism Theory: Ayn Rand and *Atlas*

Ethical Egoism holds that we all act in our own self-interest and that all of us should limit our judgment to our own ethical egos and not interfere with the exercise of ethical egoism by others. This view holds that everything is determined by self-interest. We act as we do and decide to behave as we do because we have determined that it is in our own self-interest.

One philosopher who believed in ethical egoism was the novelist Ayn Rand, who wrote books such as *The Fountainhead* and *Atlas Shrugged* about business and business leaders' decisions in ethical dilemmas. These two famous books made Ms. Rand's point about ethical dilemmas: the world would be better if we did not feel so guilty about the choices we make in ethical dilemmas and just acknowledged that it is all self-interest. Ms. Rand, as an ethical egoist, would maintain order by putting in place the necessary legal protections so that we did not harm each other.

"Hobbesian" Self-Interest and Government

Philosopher Thomas Hobbes also believed that ethical egoism was the central factor in human decisions, that self-interest was part of human nature. However, Hobbes warned that there would be chaos because of ethical egoism if we did not have laws in place to control that terrible drive of self-interest. Hobbes felt we needed great power in government to control ethical egoism and that we all subscribe to that control through a social contract as outlined in his work *Leviathan*, a book that describes the chaos and confusion that would result without government.

Adam Smith, Self-Interest, and Moral Sentiments

Although he too believed that humans act in their own self-interest, and so was a bit of an ethical egoist, Adam Smith, a philosopher and an economist, also maintained that humans define self-interest differently from the selfishness theory that Hobbes and Rand feared would consume the world if not checked by legal safeguards. Adam Smith wrote, in *The Theory of the Moral Sentiments*, that humans are rational and understand that, for example, fraud is in no one's self-interest—not even that of the perpetrator, who does benefit temporarily until, as in the case of so many executives today, federal and state officials come calling with subpoenas and indictments. (For an excerpt from Adam Smith's *Moral Sentiments*, see Reading 9.4.) That is, many believe that they can lie in business transactions and get ahead. Adam Smith argues that although many can and do lie to close a deal or get ahead, they cannot continue that pattern of selfish behavior because just one or two times of treating others this way results in a business community spreading the word: Don't do business with them because they cannot be trusted. The result is that they are shunned from doing business at least for a time, if not forever. In other words, Smith believed that there was some force of long-term self-interest that keeps businesses running ethically and that chaos only results in limited markets for limited periods as one or two rotten apples use their ethical egoism in a selfish, rather than self-interest, sense, to their own temporary advantage.

The Utilitarian Theory: Bentham and Mill

Philosophers Jeremy Bentham and John Stuart Mill moved to the opposite end of ethical egoism and argued that resolution of ethical dilemmas requires a balancing effort in which we minimize the harms that result from a decision even as we maximize the benefits. Mill is known for his *greatest happiness principle*, which provides that we should resolve ethical dilemmas by bringing the greatest good to the greatest number of people. There will always be a few disgruntled souls in every ethical dilemma solution, so we just do the most good that we can.

Some of the issues to which we have applied utilitarianism include those that involve some form of rationing of resources in order to provide for all, such as with providing universal health care, even though some individuals may not be able to obtain advanced treatments, in the interest of providing some health care for all. There is a constant balancing of the interests of the most good for the greatest number when the interests of protecting the environment are weighed against the need for electricity, cars, and factories. Utilitarianism is a theory of balancing that requires us to look at the impact of our proposed solutions to ethical dilemmas, from the viewpoints of all those who are affected, and try to do the greatest good for the greatest number.

The Categorical Imperative and Immanuel Kant

Philosopher Immanuel Kant's theories are complex, but he is a respecter of persons. That is, Kant does not allow any resolution of an ethical dilemma in which human beings are used as a means by which others obtain benefits. That might sound confusing, so Kant's theory reduced to simplest terms is that you cannot use others in a way that gives you a one-sided benefit. Everyone must operate under the same usage rules. In Kant's words, "One ought only to act such that the principle of one's act could become a universal law of human action in a world in which one would hope to live." Ask yourself this question: If you hit a car in a parking lot and damaged it, but you could be guaranteed that no one saw you do it, would you leave a note on the other car with contact information? If you answered, "No, because that's happened to me twelve times before, and no one left me a note," then you are unhappy with universal behaviors but are unwilling to commit to universal standards of honesty and disclosure to remedy those behaviors.

Philosophers are not the easiest folks to reason along with, so an illustration will help us grasp their deep thoughts. For example, there are those who find it unethical to have workers in developing nations labor in garment sweatshops for pennies per hour. The pennies-per-hour wage seems unjust to them. However, suppose the company were operating under one of its universal principles: Always pay a fair wage to those who work for it. A "fair wage" in that country might be pennies, and the company owner could argue, "I would work for that wage if I lived in that country." The company owner could also argue, "But if I lived in the United States, I would not work for that wage, would require a much higher wage, and would want benefits, and we do provide that to all of our U.S. workers." The employer applies the same standard, but the wages are different.

The company has developed its own ethical standard that is universally applicable, and those who own the company could live with it if it were applied to them, but context is everything under the categorical imperative. The basic question is, are you comfortable living in a world operating under the standards you have established, or would you deem them unfair or unjust?

There is one more part to Kant's theory: you not only have to be fair but also have to want to do it for all the right reasons. Self-interest was not a big seller with Kant, and he wants universal principles adopted with all goodwill and pureness of heart. So, to not engage in fraud in business because you don't want to get caught is not a sufficient basis for a rule against fraud. Kant wants you to adopt and accept these ethical standards because you don't want to use other people as a means to your enrichment at their expense.

The Contractarians and Justice

Blame philosophers John Locke and John Rawls for this theory, sometimes called the *theory of justice* and sometimes referred to as the *social contract*. Kant's flaw, according to this one modern and one not-so-modern philosopher (Rawls is from the twentieth century, and Locke from the seventeenth), is that he assumed we could all have a meeting of the minds on what were the good rules for society. Locke and Rawls preferred just putting the rules into place via a social contract that is created under circumstances in which we reflect and imagine what it would be like if we had no rules or law at all. If we started with a blank slate, or *tabula rasa* as these philosophers would say, rational people would agree—perhaps in their own self-interest, or perhaps to be fair—that certain universal rules must apply. Rational people, thinking through the results and consequences if there were not rules, would develop rules such as "Don't take my property without my permission" and "I would like the same type of court proceeding that rich people have, even if I am not so rich."

Locke and Rawls have their grounding in other schools of thought, such as natural law and utilitarianism, but their solution is provided by having those in the midst of a dilemma work to imagine not only that there are no existing rules but also that they don't know how they will be affected by the outcome of the decision, that is, which side they are on in the dilemma. With those constraints, Locke and Rawls argue, we would always choose the fairest and most equitable resolution of the dilemma. The idea of Locke and Rawls is to have us step back from the emotion of the moment and make universal principles that will survive the test of time.

Rights Theory

The Rights Theory is also known as an *Entitlement Theory* and is one of the more modern theories of ethics, as philosophical theories go. Robert Nozick is the key modern-day philosopher on this theory, which has two big elements: (1) Everyone has a set of rights, and (2) it's up to the governments to protect those rights. Under this big umbrella of ethical theory, we have the protection of human rights that covers issues such as sweatshops, abortion, slavery, property ownership and use, justice (as in court processes), animal rights, privacy, and euthanasia. Nozick's school of thought faces head-on all the controversial and emotional issues of ethics including everything from human dignity in suffering to third-trimester abortions. Nozick hits the issues head-on, but not always with resolutions because governments protecting those rights are put into place by Egoists, Kantians, and Divine Command Theory followers.

A utilitarian would resolve an ethical dilemma differently from a Nozick follower. Think about the following example. The FBI has just arrested a terrorist who is clearly a leader in a movement that plans to plant bombs in the nation's trains, subways, and airports. This individual has significant information about upcoming planned attacks but refuses to speak. A utilitarian would want the greatest good for the greatest number and would feel that harsh interrogation methods would be justified to save thousands of lives. However, Nozick might balk at such a proposal because the captured terrorist's human rights are violated. These ideological differences enhance our ability to see issues from a 360-degree perspective as we analyze them.

Moral Relativists

Moral relativists believe in time-and-place ethics. Arson is not always wrong in their book. If you live in a neighborhood in which drug dealers are operating a crystal meth lab or crack house, committing arson to drive away the drug dealers is ethically justified. If you are a parent and your child is starving, stealing a loaf of bread is ethically correct. The proper resolution to ethical dilemmas is based upon weighing the competing factors at the moment and then making a determination to take the lesser of the evils as the resolution. Moral Relativists do not believe in absolute rules, virtue ethics, or even the social contract. Their beliefs center on the pressure of the moment and whether the pressure justifies the action taken. Former Enron Chief Financial Officer Andrew Fastow, in his testimony against his former bosses at their criminal trial for fraud, said, “I thought I was being a hero for Enron. At the time, I thought I was helping myself and helping Enron to make its numbers” (Andrew Fastow, trial testimony, March 7, 2006). In classic moral relativist mode, a little fraud to help the company survive was not ethically problematic at the time for Mr. Fastow. In hindsight, Mr. Fastow would also comment, “I lost my moral compass.”

Back to Plato and Aristotle: Virtue Ethics

Although it seems odd that Aristotle and Plato are last in the list of theorists, there is reason to this ethical madness. Aristotle and Plato taught that solving ethical dilemmas requires training, that individuals solve ethical dilemmas when they develop and nurture a set of virtues. Aristotle cultivated virtue in his students and encouraged them to solve ethical dilemmas using those virtues that he had integrated into their thoughts. One of the purposes of this book is to help you develop a set of virtues that can serve as a guide in making both personal and business decisions. Think of your credo as the foundation for those virtues.

Solomon’s Virtues

Some modern philosophers have embraced this notion of virtue ethics and have developed lists of what constitutes a virtuous businessperson. The following list of virtue ethics was developed by the late Professor Robert Solomon:

Virtue Standard	Definition
Ability	Being dependable and competent
Acceptance	Making the best of a bad situation
Amiability	Fostering agreeable social contexts
Articulateness	Ability to make and defend one’s case
Attentiveness	Listening and understanding
Autonomy	Having a personal identity
Caring	Worrying about the well-being of others despite power
Charisma	Inspiring others
Compassion	Sympathetic
Coolheadedness	Retaining control and reasonableness in heated situations
Courage	Doing the right thing despite the cost
Determination	Seeing a task through to completion
Fairness	Giving others their due; creating harmony

Virtue Standard	Definition
Generosity	Sharing; enhancing others' well-being
Graciousness	Establishing a congenial environment
Gratitude	Giving proper credit
Heroism	Doing the right thing despite the consequences
Honesty	Telling the truth; not lying
Humility	Giving proper credit
Humor	Bringing relief; making the world better
Independence	Getting things done despite bureaucracy
Integrity	Being a model of trustworthiness
Justice	Treating others fairly
Loyalty	Working for the well-being of an organization
Pride	Being admired by others
Prudence	Minimizing company and personal losses
Responsibility	Doing what it takes to do the right thing
Saintliness	Approaching the ideal in behavior
Shame (capable of)	Regaining acceptance after wrong behavior
Spirit	Appreciating a larger picture in situations
Toughness	Maintaining one's position
Trust	Dependable
Trustworthiness	Fulfilling one's responsibilities
Wittiness	Lightening the conversation when warranted
Zeal	Getting the job done right; enthusiasm

Source: From *A Better Way to Think About Business* by Robert Solomon, copyright © 1999 by Robert Solomon, p. 18. Used by permission of Oxford University Press. See also Kevin J. Shanahan and Michael R. Hyman, "The Development of a Virtue Ethics Scale," 42 *Journal of Business Ethics*, 2002, pp. 197, 200.

The list offers a tall order because these are difficult traits to develop and keep. But as you study the companies, issues, and cases, you will begin to understand the mighty role that these virtues play in seeing the ethical issues, discussing them from all viewpoints, and finding a resolution that enable businesses to survive over the long term.

Discussion Questions

1. Your friend, spouse, child, or parent needs a specialized medical treatment. Without the specialized treatment, your friend, your spouse, or your child cannot survive. You are able to get that treatment for him or her, but the cost is $6,800. You don't have $6,800, but you hold a job in the Department of Motor Vehicles. As part of your duties there, you process the checks, money orders, and other forms of payment sent in for vehicle registration. You could endorse these items, cash them, and have those funds. You feel that because you open the mail with the checks and money orders, no one will be able to discover the true amounts of funds coming in, and you can credit the vehicle owners' accounts so that their registrations are renewed. Under the various schools of thought on ethics, evaluate whether the embezzlement would be justified.
2. Three employees of a department store were conversing about their futures. One employee was sharing that when 2013 arrived, in just a few days, most of them would be going to part-time status because of slow sales, the economy, and health care costs. The remaining two employees seemed crestfallen. But the knowledgeable employee explained that there was something that they could do. "Get yourself fired because the money you make on unemployment will be better than part-time work here, and you can get ninety-nine weeks of unemployment. Plus, you are

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eligible for medical care through the government because you are unemployed. It's a better deal. It is so not worth it to keep working." When they asked how they could get fired, he had a solution: "Just don't meet your numbers. You'll be gone in no time." Classify the suggestion of getting yourself fired and collecting unemployment under the appropriate ethical school of thought.

3. In the movie *Changing Lanes*, Ben Affleck plays a young lawyer who is anxious to become a senior partner in a law firm in which one of the senior partners is his father-in-law, played by the late Sidney Pollack. Affleck discovers that his father-in-law has embezzled from clients, forged documents, and committed perjury, all felonies and all certainly grounds for disbarment. Affleck finally confronts Pollack and asks, "How do you live with yourself?" Pollack responds that he did indeed forge, embezzle, and perjure himself, but with the money that he made he became one of the city's greatest philanthropists. "At the end of the day, if I've done more good over here than bad in making the money, I'm happy." Under which ethical theories would you place the characters' ethical postures?
4. Could businesses use moral relativism to justify false financial reports? For example, suppose that the CFO says, "I did fudge on some of the numbers in our financial reports, but that kept 6,000 employees from losing their jobs." What problems do you see with moral relativism in this situation?

Reading 1.4

The Types of Ethical Dilemmas: From Truth to Honesty to Conflicts

The following twelve categories were developed and listed in *Exchange*, the magazine of the Brigham Young University School of Business.

Taking Things That Don't Belong to You

Everything from the unauthorized use of the Pitney Bowes postage meter at your office for mailing personal letters to exaggerations on travel expenses belongs in this category of ethical violations. Using the copy machine at work for your personal copies is another simple example of the type of conduct that fits into this category. Regardless of size or motivation, unauthorized use of someone else's property or taking property under false pretenses still means taking something that does not belong to you. A chief financial officer of a large electric utility reported that after taking a cab from LaGuardia International Airport to his midtown Manhattan hotel, he asked for a receipt. The cab driver handed him a full book of blank receipts and drove away. Apparently the problem of accurately reporting travel expenses involves more than just employees.

Saying Things You Know Are Not True

This category deals with the virtue of honesty. Assume you are trying to sell your car, one in which you had an accident, but which you have repaired. If the potential buyer asks whether the car has been in an accident and you reply, "No," then you have given false information. If you take credit for someone else's idea or work, then you have, by your conduct, said something that is not true. If you do not give credit to others who have given you ideas or helped with a project, then you have not been forthright. If, in evaluating your team members on a school project, you certify that all carried their workload when, in fact, one of your team members was a real slacker, you have said something that was not true. If you do not disclose an accident that you had in the last year on an insurance application, you have not told the truth. If you state that you have a college degree on your résumé, but have not yet graduated, you have committed an ethical breach. If, in filling out a credit application, you put the salary you have now when your employer has announced a 25 percent pay cut beginning next quarter, you have not told the truth.

Giving or Allowing False Impressions

This category of ethical breach is the legal technicality category. What you have said is technically the truth, but it does mislead the other side. For example, if your professor asks you, "Did you have a chance to read the assigned ethics cases?" even if you had not read the cases, you could answer, "Yes!" and be technically correct. You had "a chance" to read the cases; but you did not read them. The answer is not a falsehood because you may have had plenty of chances to read the cases, but you didn't read the cases.

If you were to stand by silently while a coworker was blamed for something you did, you would leave a false impression. You haven't lied, but you allowed an impression of false blame to continue. Many offers that you receive in the mail have envelopes that make them seem as if they came from the Social Security Administration or another federal agency. The desired effect is to mislead those who receive the envelopes into trusting the company or providing information. That effect works, as attorneys general verify through their cases of fraud brought on behalf of senior citizens who have been misled by this false impression method.

During the 2013 presidential inauguration, there was great public controversy: Did Beyoncé lip-synch the national anthem? The National Marine Band did not play during her performance; instead, a tape was played, and those in charge of the event said that they felt a live performance was too risky because the singer had not had the opportunity to rehearse with the band prior to her performance. A live performance carries the implied promise of actual singing. If a singer does not perform live, then there is a false impression, especially if the singer does not disclose before or after the performance what actually was done. When Britney Spears, who is well known for lip-synching during live performances, performed in Australia, the lip-synching was so obvious that fans walked out and demanded refunds. The promoter issued refunds even without a legal action or obligation because there had been a false impression given of a live performance.

Buying Influence or Engaging in Conflict of Interest

This category finds someone in the position of conflicting loyalties. An officer of a corporation should not be entering into contracts between his company and a company that he has created as part of a sideline of work. The officer is conflicted between his duty to negotiate the best contract and price for his corporation and his interest as a business owner in maximizing his profits. In his role as an officer, he wants the most he can get at the lowest price. In his role as a business owner, he wants the highest price he can get with the fewest demands. The interests are in conflict, and this category of ethical breach dictates that those conflicts be resolved or avoided.

Conflicts of interest need not be as direct as self-dealing by an officer of the company. For example, there would be a conflict of interest if a company awarded a construction contract to a firm owned by the father of the state attorney general while the state attorney general's office is investigating that company. A county administrator has a conflict of interest by accepting paid travel from contractors who are interested in bidding on the stadium project. Certainly, it is a good idea for the administrator to see the stadiums around the country and get an idea of the contractors' quality of work. But the county should pay for those site visits, not the contractors. The administrator's job as a county employee is to hire the most qualified contractor at the best price. However, the benefits of paid travel would and could vary, and contractors could use those site visits and travel perks to influence the decision on the award of the county contract for the stadium. Their interests in obtaining the contract are at odds with the county's interest in seeking the best stadium, not the best travel perks for the administrator. The administrator's loyalties to the county and the accommodating contractors are in conflict.

In 2012, the federal government discovered that the firms that were conducting the reviews of mortgage foreclosures had what has been called "cozy" relationships with the banks whose conduct they were reviewing. The result was that the number of problems in foreclosures was underreported, with homeowners not able to get the relief from wrongful foreclosures that they were entitled to receive.

Those who are involved in these conflict-of-interest situations often protest, "But I would never allow that to influence me." The ethical violation is the conflict. Whether the conflict can or will influence those it touches is not the issue, for neither party can prove conclusively that a *quid pro quo* was not intended. The possibility exists, and it creates suspicion. Conflicts of interest are not difficult. They are managed in one of two ways: don't do it, or disclose it.

Hiding or Divulging Information

Taking your firm's product development or trade secrets to a new place of employment is the ethical breach of divulging proprietary information. Failing to disclose the results of medical studies that indicate your firm's new drug has significant side effects is the ethical breach of hiding information that the product could be harmful to purchasers. A bank that sells financial and marketing information about its customers without their knowledge or permission has divulged information that should be kept confidential. Medtronic was investigated by the federal government for its failure to adequately disclose the side effects of its bone growth products. Eventually, Medtronic agreed to release the data it had collected on patients using the product, so independent researchers could provide adequate disclosure of this pertinent information.

Taking Unfair Advantage

Many consumer protection laws exist because so many businesses took unfair advantage of those who were not educated or were unable to discern the nuances of complex contracts. Credit disclosure requirements, truth-in-lending provisions, and new regulations on soliciting students for credit cards all resulted because businesses misled consumers who could not easily follow the jargon of long and complex agreements. *USA Today* illustrated the fairness issues with a riddle. Suppose you have no cash and need to buy $100 worth of groceries. Which would cost you more?

a. Taking out a payday loan with a 450 percent APR
b. Overdrawing your debit card and paying the $27 fee

The answer is b because the $27 fee on your debit card would be equal to a 704 percent interest rate. (Assuming a fourteen-day repayment period and an average $17.25 fee per $100 for a payday loan).[3] Disclosures of the real costs of debt have been on a steady increase since 1970 as lenders and credit card companies found ways to charge fees that were not always clear from the lending and card agreements. Late fees often exceeded the unpaid card balance. While these fees were increasing, companies were also shortening the billing cycle so that customers had less time to pay. Cutoff times for payment at 9 A.M. were not disclosed as 9 A.M., which meant that the customer had to pay a day earlier because mail does not arrive by 9 A.M. These fees and practices were, for nearly a decade, an ethical issue of taking unfair advantage. Because credit card companies did not take care of the issues of unfairness, these practices are now prohibited or regulated.

[3] Kathy Chu, "Anger at Overdraft Fees Gets Hotter, Bigger and Louder," *USA Today*, September 29, 2009, p. 1 B.

Under the Credit Card Accountability and Disclosure Act of 2010 (CARD), all of these practices are now regulated by law.

Committing Acts of Personal Decadence

Although many argue about the ethical notion of an employee's right to privacy, it has become increasingly clear that personal conduct outside the job can influence performance and company reputation. Conduct in our personal lives does have an impact on how well we perform our jobs, including whether we can perform our jobs safely. For example, a company driver must abstain from substance abuse because with alcohol or drugs in his blood, he creates both safety and liability issues for his employer. Even the traditional company Christmas party and picnic have come under scrutiny, as the behavior of employees at and following these events has brought harm to others in the form of alcohol-related accidents.

Perpetrating Interpersonal Abuse

A manager who keeps asking an employee for a date not only violates the laws against sexual harassment but also has committed the ethical breach of interpersonal abuse. Interpersonal abuse consists of conduct that is demeaning, unfair, or hostile or involves others so that privacy issues arise. A manager who is verbally abusive to an employee falls into this category. The former CEO of HealthSouth, Richard Scrushy, held what his employees called the "Monday morning beatings." These were meetings during which managers who had not met their numbers goals were upbraided in front of others and subjected to humiliating criticism. A Merrill Lynch executive who dreaded the chastisement when Merrill did not match Goldman Sachs' earnings complained, "It got to the point where you didn't want to be in the office on Goldman earnings days."[4] A manager correcting an employee's conduct in front of a customer has not violated any laws, but has humiliated the employee and involved outsiders who have no reason to know of any employee issues. In some cases in this category, there are laws to protect employees from this type of conduct, but we are able to look at this conduct and see the ethical issue as we sum up with, "It's not fair" or, "It's not right."

Permitting Organizational Abuse

This category covers the way companies treat employees. This ethical category is one that is a focus of companies with their production facilities outside the United States because the issues of child labor, sweatshop conditions, and low wages emerge. For example, Foxconn Technology Group admitted that it has employed interns as young as age 14 for work in its Yantai facility, a facility that puts together Nintendo hardware for the Wii product. The young workers were sent to the facility as part of a program the company had with local vocational schools. Foxconn did not check identification for the young workers, and as a result, the young students were working in an area of the factory that produced accessories. They were paid $244 per month, but they had to work overtime if they did not complete their assigned projects. The internships usually last 3.5 months. Foxconn's labor force of 1.2 million had 2.7 percent in interns in the 14- to 16-year-old age group. Nintendo quickly denounced the use of child labor and explained that it was a violation of its company policy on social responsibility, as well as a violation of the provisions it has in its contracts with all suppliers. Apple, Nike, and other companies have all been challenged on the labor practices of their foreign contractors, using the ethical standard of organizational abuse.

[4] Randall Smith, "O'Neal Out as Merrill Reels from Loss," *Wall Street Journal*, October 29, 2007, pp. A1, A16.

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Violating Rules

Rules can be organizational rules or the laws and regulations that govern certain business activities. For example, there are currently 109,000 students participating in the work/study program created in 1961 in order to allow foreign students to obtain a visa and have a rich, cultural experience by studying in the United States while having opportunity for travel through a source of income. The rules of the program, updated as recently as 2012, require employers of these visa students to provide certain levels of wages and a rich cultural experience during the students' time in the United States. However, many officials worry that the program has become a source of cheap labor for fast-food restaurants, ski resorts, and car washes. The students earn $7.25 per hour and pay $75 per week in rent for living in crowded basement facilities, and they are required to pay more from their wages for their food. The result is that the students are unable to take classes or travel, and end up working twenty-five-hour workweeks. There is little enforcement available for the work-study visa program, but the lack of enforcement does not mean that the employers, such as McDonald's, have not violated the rules of the program.

Condoning Unethical Actions

In this category, the wrong is actually a failure to report an ethical breach in any of the other categories. For example, a state employee who was attending a business conference paid for by the state, and who was allowed to attend as part of her workweek, won an iPad in a vendor raffle. A fellow employee who also attended the conference knows that state law requires employees who win more than nominal prizes (T-shirts, pens, baseball caps) must report those prizes and turn them over to the state. The winner of the iPad tells his coworker, "If anyone asks you about the iPad, you don't know anything, and this conversation never happened." The employee who says nothing becomes part of the problem. Suppose that questions about the vendor who sponsored the raffle arose. The public disclosure of the iPad giveaway would appear nefarious as the public looks back from the perspective of problems with the vendor. Allowing ethical breaches that you know about to occur often brings greater harm to everyone involved. The employee who won the iPad, the employee who knew, and the agency would all be affected in terms of employment and reputation.

Recent studies indicate that over 80 percent of students who see a fellow student cheating would not report the cheating. A winking tolerance of others' unethical behavior is an ethical breach. Suppose that as a product designer you were aware of a fundamental flaw in your company's new product—a product predicted to catapult your firm to record earnings. Would you pursue the problem to the point of halting the distribution of the product? Would you disclose what you know to the public if you could not get your company to act?

Balancing Ethical Dilemmas

In these types of situations, there are no right or wrong answers; rather, there are dilemmas to be resolved. The headquarters for Apple's income investment is not the Silicon Valley; it is found in a small office in Reno, Nevada, and is known as Braeburn Capital. Apple does all of its investing of its profits out of this office and this subsidiary because companies pay nothing in income tax in Nevada, whereas companies pay 8.84 percent in taxes in California. Apple steers as much of its earnings as possible into Nevada, Ireland, the Netherlands, Luxembourg, and even the British Virgin Islands in order to take advantage of lower corporate tax rates in those places. With a simple office located in these countries and states, an office that does not have the Apple logo—Apple, Inc.—is able to reduce its overall tax rate.

High-tech companies are able to shelter more of their income because, unlike an auto manufacturer saddled with physical inventory and dependent upon sales of cars and trucks that are physically identifiable by location, Apple (like Google, Microsoft, and HP) earns a great deal of its income from patents and software. The physical goods sales are either nonexistent or a small part of its earnings. Intellectual property earnings are like a cloud—they float above the physical jurisdiction of a state. For example, all the income from the songs we download from iTunes is funneled off into countries with zero or low corporate income taxes.

Apple has a responsibility as a corporation to its shareholders, so it minimizes income taxes. On the other hand, stakeholders in the states in which Apple does business feel that Apple has an obligation to pay its way through taxes for the use of state resources. Apple released this statement: "Apple has conducted all of its business with the highest of ethical standards, complying with applicable laws and accounting rules. We are incredibly proud of all of Apple's contributions." There is disagreement over Apple's choices, but it is balancing the ethical issues in its dilemma.

These twelve categories are resources for you to use as you analyze the cases in this book. As you read, think through the twelve categories, and determine what ethical breaches have occurred. These categories help you in spotting the ethical issues in each of the cases.

Discussion Questions

1. Consider the following situations and determine which of the twelve categories each issue fits into.

   a. PGA golfer Phil Mickelson was scheduled to play in the 2009 Masters Tournament when he learned that his wife Amy had cancer. Mr. Mickelson had sponsors for his participation but felt that he needed to be with his wife and children. He withdrew from the tournament. As you categorize this dilemma, be sure to think about the aftermath. Mr. Mickelson did play the 2010 Masters, where his wife Amy made her first public appearance on the 13th hole of the last round. Mr. Mickelson described his win that year as being "for Amy." Discuss any lessons you can glean about balancing from this experience.

   b. A manager at a bank branch requires those employees who arrive late for work to clean the restrooms at the bank. The branch does have a janitorial service, but the manager's motto is "If you're late, the bathrooms must look great." An employee finds the work of cleaning the bathrooms in her professional clothes demeaning. Which category applies?

   c. Jack Walls is the purchasing manager for a small manufacturer. He has decided to award a contract for office supplies to Office Mart. No one knows of Jack's decision yet, but Office Mart is anxious for the business and offers Jack a three-day ski vacation in Telluride, Colorado. Jack would love to take the trip but can't decide if there is an ethical question. Help Jack decide whether there is.

2. In November 2008, golfer J. P. Hayes was participating in the PGA Tour's Qualifying Tournament, often called Q-School. Mr. Hayes, then 42, discovered after the second round of play that he had used a Titleist prototype ball for play that day, a ball not approved for PGA play. After his discovery, Mr. Hayes called a PGA official to let him know what had happened. As he suspected, Mr. Hayes was disqualified from Q-School. Achievement at Q School results in a type of automatic right to participate in the PGA's top tournaments for the year. Without Q-school status, golfers do not qualify automatically for tournament play and have to hope for getting into tournaments by other means. The difference in earnings for the year for the golfer who does not qualify at Q-School versus the golfer who does is millions. Mr. Hayes said, "I'm kind of at a point in my career where if I have a light year, it might be a good thing. I'm looking forward to playing less and spending more time with my family. It's not the end of the world. It will be fine. It is fine."[5] Classify Mr. Hayes under the ethical schools of thought. Describe his credo.

3. Ivan Fernandez Anaya is a world-class runner who stopped short of crossing the finish line in a

[5] "Hayes Turns Himself in for Using Wrong Ball, DQ'd from PGA Qualifier," espn.com news, November 23, 2008, http://sports.espn.go.com/golf/news/story?id=3712372. Accessed April 28, 2010.

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cross-country race in Burlada, Spain, because he realized that Abel Mutai, who had held a comfortable lead throughout the race, thought he had crossed the finish line but had stopped short (10 yards). His Kenyan not being as good as his Spanish, Ivan motioned and gestured to Abel to cross the finish line ahead of him. Abel caught on, finished first, and Ivan took second place. Ivan's coach said he "wasted an opportunity." Ivan responded, "I did what I had to do. I didn't deserve to win it." Into which categories would you place the ethical issues involved here?

Reading 1.5

On Rationalizing and Labeling: The Things We Do That Make Us Uncomfortable, but We Do Them Anyway

We often see ethical issues around us, and we understand ethics are important. But we are often reluctant to raise ethical issues, or sometimes we use strategies to avoid facing ethical issues. These strategies help salve our consciences. This section covers the strategies: rationalizations and avoidance techniques we use to avoid facing ethical issues.

Call It by a Different Name: "Way Harsh" Labels versus Warm Language

If we can attach a lovely label to what we are doing, we won't have to face the ethical issue. For example, some people, including U.S. Justice Department lawyers, refer to the downloading of music from the Internet as *copyright infringement.* However, many who download music assure us that it is really just the lovely practice of *peer-to-peer file sharing.* How can something that sounds so generous be an ethical issue? Yet there is an ethical issue because copying copyrighted music without permission is taking something that does not belong to you or taking unfair advantage.

When baseball star Roger Clemens was confronted with lying about steroid use, he denied it, and the language his spokesperson used to explain the statements was that Mr. Clemens "misremembered." When Connecticut Attorney General Richard Blumenthal was confronted with the fact that he had overstated his military service as being in Vietnam when he served in the Marine Reserves only in the United States, he said, "I misspoke."

The financial practice of juggling numbers in financial statements, sometimes referred to as *smoothing earnings, financing engineering*, or sometimes just *aggressive accounting* is less eloquently known as *cooking the books*. The latter description helps us see that we have an ethical issue in the category of telling the truth or not leaving a false impression. But if we call what we are doing *earnings management*, then we never have to face the ethical issue because we are doing something that is finance strategy, not an ethics issue. One investor, when asked what he thought about earnings management, said, "I don't call it earnings management. I call it lying." Referring back to the categories helps us to be sure we are facing the issue and not skirting it with a different name.

Rationalizing Dilemmas Away: "Everybody Else Does It"

We can feel very comfortable and not have to face an ethical issue if we simply assure ourselves, "Everybody else does it." We use majority vote as our standard for ethics. A good day-to-day example is "Everybody speeds, and so I speed." There remains the problem that speeding is still a breach of one of the ethical categories: following the rules. Although you may feel the speed limit is too low or unnecessary, your ethical obligation is to follow those speed limits unless and until you successfully persuade others to change the laws because of your valid points about speed limits. One tool that helps us overcome the easy slip into this rationalization is to define the set of *everybody*. Sometimes if we just ask for a list of "everybody," our reasoning flaw becomes obvious. "There's no list," we might hear as a response; "We just know everyone does it." With the speeding example, defining the set finds you in a group with some of the FBI's most wanted criminals, such as Timothy McVeigh, the executed Oklahoma City bomber; Ted Bundy, the executed serial murderer; and Warren Jeffs, the polygamist convicted of being an accessory to rape, all of whom ran afoul of traffic laws while they were at large and were caught because they were stopped for what we do as well: minor traffic offenses.

When "everybody" is doing something, we say that the norm has shifted. Acceptable behavior has moved in a direction upward, in terms of the speed limit. However, it is important to understand that if something goes wrong while we are operating in our shifted norm, we may be surprised to learn that the shifted norm will not protect us. For example, if we have an accident while speeding within the accepted, shifted norm for the speed limit, that norm is not what standard we are held to. The rule, the actual speed limit, is applied to our conduct, and one of the causes of the accident can be listed as "excessive speed." When something goes wrong in the shifted norm, hindsight allows the attribution of cause to our falling into the "everybody does it" trap.

Rationalizing Dilemmas Away: "If We Don't Do It, Someone Else Will"

This rationalization is one businesspeople use as they face tough competition. They are saying, "Someone will do it anyway and make money, so why shouldn't it be us?" For Halloween 1994, there were O. J. Simpson masks and plastic knives, and Nicole Brown Simpson masks and costumes complete with slashes and bloodstains. When Nicole Simpson's family objected to this violation of the basic standard of decency, a costume shop owner commented that if he didn't sell the items, someone down the street would. Nothing about the marketing of the costumes was illegal, but the ethical issues surrounding profiting from the brutal murder of a young mother abound.

In the Phoenix, Arizona, area, summer storms can cause significant damage to roofs. Contractors who go to customer homes to give repair estimates are often asked by homeowners to add in other repairs in their insurance claim as "storm-caused damages" even though they were preexisting. The contractors often explain, "If I don't agree to do that for them, they will just hire another contractor who will put it in as an insurance claim." Although that may be true, it still does not allow the contractor to participate in insurance fraud.

Rationalizing Dilemmas Away: "That's the Way It Has Always Been Done"

When we hear, "That's the way it's always been done," our innovation feelers as well as our ethical radar should be up. We should be asking, "Is there a better way to do this?" Just as "Everybody does it" is not ethical analysis, neither is relying on the past and its standards a process of ethical reasoning. Business practices are not always sound. For example, the field of corporate governance within business ethics has taught for years that a good board for a company has independent directors, that is, directors who are not employed by the company, under consulting contracts with the company, or related to officers of the company. Independent boards were good ethical practice, but many companies resisted because their boards had always been structured a certain way that they wanted to continue; they'd say, "This is the way our board has always looked."

With the collapses of Enron, Adelphia, WorldCom, and HealthSouth and the scandal of substantial officer loans at Tyco, both Congress, through the Sarbanes-Oxley (SOX) Act of 2002, and the Securities and Exchange Commission (SEC), through follow-up regulations, now mandate an independent corporate board (see Reading 4.13 for a summary of the SOX and Dodd-Frank changes). When board members performed consulting services for their companies, there was a conflict of interest. But everybody was doing it, and it was the way corporations had always been governed. This typical and prevailing practice resulted in lax corporate boards and company collapses. Unquestioning adherence to a pattern or practice of behavior often indicates an underlying ethical dilemma.

Rationalizing Dilemmas Away: "We'll Wait until the Lawyers Tell Us It's Wrong"

Many people rely only on the law as their ethical standard, but that reliance means that they have resolved only the legal issue, not the ethical one. Lawyers are trained to provide only the parameters of the law. In many situations, they offer an opinion that is correct in that a company's conduct does not violate the law. Whether the conduct they have passed judgment on as legal is ethical is a different question. For example, a team of White House lawyers concluded in a memo in March 2003 that international law did not ban torture of prisoners in Iraq because they were technically not prisoners of war. However, when pictures of prisoner abuse at the Abu Ghraib prison in Iraq emerged, the reaction of the public and the world was very different. The ethical analysis, which went beyond interpretation of the law, was that the torture and abuse were wrong, regardless of their compliance with treaty standards. Following the abuse scandal, the U.S. government adopted new standards for interrogation of prisoners. Although the lawyers were perfectly correct in their legal analysis, that legal analysis did not cover the ethical breaches of interpersonal and organizational abuse.

Rationalizing Dilemmas Away: "It Doesn't Really Hurt Anyone"

We often think that our ethical missteps are just small ones that don't really affect anyone else. We are not thinking through the consequences of our actions when we rationalize rather than analyze ethical issues in this manner. For example, it is probably true that one person who misrepresents her income on a mortgage application is not going to undermine the real estate market. However, if everyone who believes his or her misrepresentation on a mortgage application is singular and isolated, we end up with a great many mortgages in default, a glut of foreclosures, and a collapsed housing market. We lived through these systemic effects, beginning in 2007, as the mortgage market collapsed. In analyzing ethical issues, we turn to Kant and other schools of thought and ask, "What if everyone behaved this way? What would the world be like?" Good ethical analysis requires a look at the impact of collective individual behaviors on the system.

When we are the sole rubberneckers on the freeway, traffic remains unaffected. But if everyone rubbernecks, we have a traffic jam. All of us making poor ethical choices would cause significant harm. A man interviewed after he was arrested for defrauding insurance companies through staged auto accidents remarked, "It didn't really hurt anyone. Insurance companies can afford it." The second part of his statement is accurate. The insurance companies can afford it—but not without cost to someone else. Such fraud harms all of us because we must pay higher premiums to allow insurers to absorb the costs of investigating and paying for fraudulent claims.

Rationalizing Dilemmas Away: "The System Is Unfair"

Somehow an ethical breach doesn't seem as bad if we feel we are doing it because we have been given an unfair hand. The professor is unreasonable and demanding, so why not buy a term paper from the Internet? Often touted by students as a justification for cheating on exams, this rationalization eases our consciences by telling us we are cheating only to make up for deficiencies in the system. Yet just one person cheating can send ripples through an entire system. The credibility of grades and the institution come into question as students obtain grades through means beyond the system's standards. If all students cheat, then the grading system is meaningless. We have no way to determine which students truly have the knowledge base and skills and which ones simply cheated to attain their standing.

Rationalizing Dilemmas Away: "It's a Gray Area"

One of the most popular rationalizations of recent years has been to claim, "Well, business isn't all black and white. There's a great deal of gray." Sometimes the extent of ethical analysis in a business situation is to merely state, "It's a gray area," and the response from the group holding the discussion is "Fine! So long as we're in the gray area, we're moving on." In an interview with *Sports Illustrated*, racecar driver Danica Patrick was asked, "If you could take a performance-enhancing drug and not get caught, would you do it if it allowed you to win Indy?" She responded, "Yeah, it would be like finding a gray area. In motorsports we work in the gray areas a lot. You're trying to find where the holes are in the rule book."[6]

However, would those involved in their gray areas change their actions and decisions with the benefit of hindsight or even just more analysis of the issue? There will always be a gray area, but it may be a short-lived strategy. The sophisticated securities that were based on pools of mortgages were easily created, sold, and resold in an unregulated area of the market. But when the mortgages went south, so also did these investments and the companies that had based their strategies for growth on these gray areas (Lehman Brothers and Bear Stearns), and some are struggling to recover (Citigroup). Ethical analysis demands more than being satisfied with "It's a gray area." Does everyone believe it is gray? Why do I want it to be gray? What if the gray area ends?

Rationalizing Dilemmas Away: "I Was Just Following Orders"

In many criminal trials and disputes over responsibility and liability, many managers will disclaim their responsibility by stating, "I was just following orders." In fact, when Lehman Brothers collapsed in 2008 because of its substantial holdings in high-risk mortgage pool instruments, many of its fund managers, who were aware of the risks, said, "I have blood on my hands." But then they explained the reason they kept selling the toxic securities even though they were aware of the problems: "They made me do it; I don't have to examine what I did."[7] Following orders does not excuse us from responsibility, both legally and ethically, for the financial harm to those who purchased those toxic securities. Judges who preside over the criminal trials of war criminals often remind defendants that an order is not necessarily legal or moral. Good ethical analysis requires us to question or depart from orders when others will be harmed or wronged.

[6] Accessed July 8, 2010, from http://sportsillustrated.cnn.com/2009/racing/06/02/Danica_PED/index.html, June 2, 2009. Ms. Patrick has subsequently said she was only kidding in her response.

[7] Louise Story and Thomas Landon, Jr., "Life After Lehman: Workers Move On," *New York Times*, September 14, 2009, p. BU 1.

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Rationalizing Dilemmas Away: "We All Don't Share the Same Ethics"

This rationalization is used quite frequently in companies with international operations. We often hear, "Well, this is culturally acceptable in other countries." We need a bit more depth and a great deal more analysis if this rationalization creeps into our discussions. Name one culture where individuals are known to claim, "There is nothing I like better than having a good old-fashioned fraud perpetrated against me," or, "I really enjoy being physically abused at work." This rationalization is a failure to acknowledge that there are some common values that demand universal application and consideration as we grapple with our decisions and behaviors around the world. You will never hear anyone, regardless of cultural differences, who says, "Well, we here in [location] readily accept being swindled." This rationalization does not take a hard look at the conduct and whether there are indeed some universal values.

Discussion Questions

1. A recent *USA Today* survey found that 64 percent of patients in hospitals took towels, linens, and other items home with them.[8] Give a list of rationalizations these patients and their families might use that give them comfort in taking the items.
2. Commercial truckers keep track of their hours on the road through paper logs. The logs were mandated in order to keep track of the federal maximums for commercial truck drivers. The law places a limit of seventy hours of driving in any eight-day period, followed by a mandated thirty-four-hour rest period. The American Trucking Association indicates that the paper logs allow truckers to drive illegally, that is, beyond the limits, something that creates a safety hazard. What rationalizations would the drivers be using for their violations of the safety standards?
3. A man has developed a license plate that cannot be photographed by the red light and speeding cameras. When asked how he felt about facilitating drivers in breaking the law, he replied, "I am not the one with my foot to the gas pedal. They are. I make a product they can use." What rationalization(s) is he using?
4. A parent has instructed his young son to not mention his Uncle Ted's odd shoes and clothing: "If Uncle Ted asks you how you like his clothes or shoes, just tell him they are very nice." His son said, "But that's not the truth, Dad." The father's response was, "It's a white lie, and it doesn't really hurt anyone." Evaluate the father's ethical posture.

Case 1.6

"I Was Just Following Orders": The CIA, Interrogation, and the Role of Legal Opinions

John Yoo, a professor of law at the University of California at Berkeley, worked in the U.S. Justice Department during the Bush 43 presidency. Mr. Yoo was the lawyer who was assigned the task of providing the executive branch with answers to three questions: (1) Were the detainees from terrorist group Al Qaeda prisoners of war under the Geneva Convention? (2) Could they be detained without counsel and without a finding of criminal conduct? and (3) Were "enhanced interrogation techniques," which including waterboarding, forms of torture under the Geneva Convention, being used to obtain information from them about future terrorist attacks?

Mr. Yoo provided his responses to those questions in a memo to then–Attorney General Alberto Gonzales on August 1, 2002.[9] The memo concluded that members of the Al Qaeda terrorist network and Taliban soldiers were not prisoners of war because

[8] "Theft a Problem at Hospitals," *USA Today*, March 5, 2010, p. 1A.

[9] The memo is available at www.justice.gov/olc/docs/memo-gonzales-aug1.pdf. Accessed August 23, 2013.

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of a U.S. Supreme Court decision, *Ex parte Quirin*, 317 U.S. 1 (1942), in which the court held:

> The spy who secretly and without uniform passes the military lines of a belligerent in time of war, seeking to gather military information and communicate it to the enemy, or an enemy combatant who without uniform comes secretly through the lines for the purpose of waging war by destruction of life or property, are familiar examples of belligerents who are generally deemed to be entitled to the status of prisoners of war, but to be offenders against the law of war subject to trial and punishment by military tribunals.[10]

Further, those who were detained were not entitled to legal counsel and all of the protections afforded defendants under the U.S. justice system:

> In modern conflicts, the practice of detaining enemy combatants and hostile civilians generally has been designed to balance the humanitarian purpose of sparing lives with the military necessity of defeating the enemy on the battlefield. The laws of war have thus long provided for the detention of enemy combatants until "the conclusion of peace." Hague Convention (IV) Respecting the Laws and Customs of War on Land, Oct. 18, 1907, art. 20, 36 Stat. 2277, 2301.… As Chief Executive and Commander in Chief, the President may order the detention of enemy combatants in order to prevent the individual from engaging in further hostilities against the United States, to deprive the enemy of that individual's service, and to collect information helpful to the United States' efforts to prosecute the armed conflict successfully. While enemy combatants may also be subject to criminal prosecution under United States or international law, no evidence of criminal liability is necessary for the U.S. Armed Forces to detain an enemy combatant. The Sixth Amendment right to counsel, which is expressly limited to "criminal proceeding[s]," has no bearing on the preventative detention of enemy combatants.[11]

On the question of enhanced interrogation, Professor Yoo concluded that there would probably be no prosecution of the United States for using these methods because they were self-enforcing and the jurisdiction of worldwide tribunals was voluntary, not mandatory.

In March 2002, at the request of Robert Hirshon, then president of the American Bar Association (ABA), the ABA Board of Governors established a Task Force on Treatment of Enemy Combatants. On August 8, 2002, the Task Force issued a Preliminary Report.[12] The report disagreed with Professor Yoo's response to the three questions and included the following contrasting views:

> [W]e must be on constant guard against an excessive use of any power, military or otherwise, that results in the needless destruction of our rights and liberties. There must be a careful balancing of interests. And we must ever keep in mind that "The Constitution of the United States is a law for rulers and people, equally in war and in peace, and covers with the shield of its protection all classes of men, at all times, and under all circumstances.[13]

The ABA report also noted that in the *Quirin* case, the Nazi soldiers who had secreted themselves into the United States in 1942 and became the "enemy combatants" were still entitled to legal counsel before they were tried, convicted, and sentenced to death.

On the question of enhanced interrogations, the ABA report noted that the Geneva Convention prohibits torture and provides that, when in doubt, assume someone is a prisoner of war and entitled to have such protections.

[10] 317 U.S., pp. 34–35.

[11] Supplemental memo of John Yoo to Alberto Gonzales, February 7, 2003, at www.justice.gov/olc/docs/johnyoo-memo-for-ag.pdf-2k-2011-03-25. Accessed August 23, 2013.

[12] http://www.americanbar.org/advocacy/governmental_legislative_work/priorities_policy/civil_liberties/enemy_combatants.html. Accessed August 23, 2013.

[13] Yoo supplemental memo, *supra* note 11.

In addition to the legal opinions, there were significant pundit debates. The following is an exchange between Liz Cheney, the daughter of former vice president Dick Cheney, and Eugene Robinson, of the *Washington Post*, after Ms. Cheney argued that the enhanced interrogation program was effective in obtaining information to prevent terrorist attacks:

Robinson: But look, efficacy isn't the only thing we should be talking about here. We should also be talking about legality. We should be talking about whether what was done was legal. If I rob a bank and get away with it, there's a lot of efficacy there, but it's not legal.

Cheney: Yeah, but that's not a fair comparison. That's not fair. Because this program was very responsibly and carefully done. And if you look at the history of it, with the CIA coming to the NSC and saying, "We need to know what we can do legally." And the very legal opinions that the administration has released are in fact the documents that set out in great detail, this is what you can do, and this is what you can't do. If you cross this line, it becomes illegal. If you cross this line, it becomes torture. You have to look at the very specific and important legal restrictions that were put in place.

Robinson: I do not think that's the case. Torture is a war crime. It is a war crime.

Cheney: That's right. And this wasn't torture. Those legal memos demonstrated where the line was, and where it would become torture.

Robinson: Waterboarding was torture during the Spanish Inquisition, it was torture when Pol Pot did it, and I believe it was torture when we did it.[14]

In 2009, the Justice Department began investigations into the conduct of CIA officials in conducting the enhanced interrogations. Some expressed concern about the criminal prosecution of these government employees when they were simply following orders of a program that had been reviewed by legal counsel and given an imprimatur. In July 2010, the Department of Justice announced that it would not be prosecuting the officials.

Discussion Questions

1. List any rationalizations you see in the case.
2. Describe the legal versus the ethical confrontation in these facts. Be sure to focus on Professor Yoo's conclusion that the United States could not be prosecuted for use of the enhanced techniques. Is that the lawyer's role, to advise on legality? What are the risks of relying on such an opinion?
3. Suppose that you were hired by the CIA and directed to conduct enhanced interrogation of enemy combatants. What would be your thoughts, reactions, emotions, and analysis of the order? Is this a question of the lesser of two evils? "Do I torture or shall I risk the loss of thousands of lives from a planned and pending terrorist plot?" Who is affected by your decision to interrogate or not interrogate? To waterboard or not to waterboard? After Osama bin Laden was found and killed by Navy Seals on May 2, 2011, it became clear that information obtained by the use of waterboarding was used to find bin Laden's location. Does the use and result of using the information affect your decision on the decision to waterboard?

Compare & Contrast

Refer to the Goldman case (Case 2.11) and compare the company's approach to the law versus the compliance with the law in this case. Did both the government and Goldman follow the same approach to legality versus ethics? Is this the role of legal counsel in the management and administration of organizations?

[14] Transcript, "Morning Joe," May 12, 2009, http://crooksandliars.com/david-neiwert/liz-cheney-waterboarding. Accessed September 30, 2013.

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Reading 1.7

The Slippery Slope, the Blurred Lines, and How We Never Do Just One Thing

In Scott Smith's book *A Simple Plan,* the lead character, Hank; his brother, Jacob: and a friend, Lou, come upon a small plane buried in the rural snowdrifts of Ohio. Upon opening the plane's door they find the decomposing body of the pilot and a duffel bag full of $100 bills in $10,000-dollar packets—$3 million total. Initially, Hank tells his brother and Lou not to touch the money so that the police can conduct a proper investigation, but then a plan is hatched. Lou and Jacob want to keep one packet of the money and ask Hank what's wrong with doing that. Hank scolds them and says, "For starters, it's stealing." Hank reminds them that with so much money involved, someone would be looking for it and would know that they had taken a packet. Hank also reminds them that even if he didn't take a packet, he would be an accomplice if Jacob and Lou did.

Lou then proposes a solution: take it all. Hank wisely warns the two that they could not spend it because everyone in their small town would know. So, Lou proposes a "simple plan." They will sit on the money for a while, and when the investigation is over and things have cooled down, they can move away and live on their shares of the money. Again, Hank reminds them that it is stealing. But Jacob calls it by a different name: lost treasure. Hank succumbs. Such an easy thing, a simple plan.

But the initial decision was flawed. Whatever its soft label, their decision to walk away with the duffel bag was indeed taking something that did not belong to them. From there, the characters begin a game of whack-a-mole. With each twist and turn, they have to cross another line to cover up their seizure of the duffel bag. There is a lie to the sheriff and the problem of a neighbor seeing them near the plane, and more problems come at them each day. Each new problem requires a resolution that involves more dastardly choices. The characters keep slipping, eventually committing murder.

Once you step outside those ethical norms, you do keep going. The proverbial slope becomes more slippery. Professor Dan Ariely of Duke University found that folks who knowingly wore fake designer sunglasses were more than twice as likely to cheat on an unrelated task given to them than those who were not wearing the fake sunglasses.[15] Once we have made peace with trademark infringement, we are willing to cross other lines. We just get comfortable with each step.

Discussion Questions

1. Marilee Jones, the former dean of admissions of the Massachusetts Institute of Technology (MIT), resigned after twenty-eight years as an administrator in the admissions office. The dean for undergraduate education received information questioning Ms. Jones's academic credentials. Her résumé, used when she was hired by MIT, indicated that she had degrees from Albany Medical College, Union College, and Rensselaer Polytechnic Institute. In fact, she had no degrees from any of these schools or from anywhere else. She had attended Rensselaer Polytechnic as a part-time nonmatriculated student during the 1974–75 school year, but the other institutions had no record of any attendance at their schools.

   When Ms. Jones arrived at MIT for her entry-level position in 1979, a degree was probably not required. However, she did progress through the ranks of the admissions office, and in 1997, she was appointed dean of admissions. She later

[15] Dan Ariely home page, http://web.mit.edu/ariely/www/MIT. Accessed July, 20, 2010.

explained that she'd wanted to disclose her lack of degrees at that point but that she had gone on for so long that she did not know how to come clean with the truth. Point to the initial decision, why it was flawed, why Ms. Jones made that decision, and what had to be done after that as a result of that choice.

2. Can you list some lines for your credo that you can glean from *A Simple Plan* and Ms. Jones's experience?

Case 1.8

Hank Greenberg and AIG, and Steve Cohen and SAC Capital

Hank Greenberg was the formidable CEO of AIG, the largest insurer in the United States. Mr. Greenberg was removed from his position when the SEC raised issues regarding the company's accounting practices and the accuracy of its financial statements. AIG eventually released financial statements that reduced its profits by $4.4 billion and, by 2008, had to be bailed out by the federal government in order to preserve the financial markets. Mr. Greenberg maintained then and maintains now that he did nothing wrong.

A story from his youth offers some insight into his ethical philosophy. When he was stationed in London during World War II, the United States and its military command were concerned about the conduct of U.S. soldiers and the impressions they left. They also recognized the need for the soldiers to have some recreation. The commanding officers gave the soldiers extra leave days if they used them for cultural events. The commanding officers had the theater, the symphony, and the ballet in mind as culture, not the usual activities for leave, such as drinking and chasing women (and, all too often, catching the women). The only requirement for the extra leave day was that the soldiers had to bring back a playbill or program from whatever cultural event they had attended. Mr. Greenberg would buy a ticket to the theater, go in, collect the playbill, and then head out the side exit to spend the time on other activities, the types of activities the commanders were trying to have the soldiers avoid, to wit, carousing. Mr. Greenberg had his proof of cultural activities, but he also had his usual fun.

SAC's Cohen

There is another example involving another wealthy and iconic financial CEO. SAC Capital Advisors appeared in the financial press nearly every day between 2011 and 2013. For the right reasons, such as outstanding performance, such coverage would be welcome. However, the coverage includes not only a reference to the firm's success but also to the ongoing arrests of analysts, traders, or other financial professionals who are somehow connected, through direct or intricate webs, to SAC. As of this writing, Steven A. Cohen, the owner of SAC, remains untouched by warrant, arrest, or regulatory actions. However, both SAC and Mr. Cohen have been affected as its clients begin to withdraw funds and distance themselves from the firm under fire.

Had investors conducted a little background research, they would have found that Mr. Cohen had an interesting background prior to his phenomenal performance at SAC. In 2009, Mr. Cohen's former wife, Patricia Cohen, filed a suit against Mr. Cohen that alleged that Mr. Cohen made a $20-million profit by trading in advance of the GE takeover of RCA based on a tip that he had received. The case was dismissed and no charges were brought. However, in 1991, Mr. Cohen was censured by the NYSE and barred from trading for four weeks because the NYSE alleged that he made a trade to inflate the price of stock that he held so as to cut a potential loss. The inflation trade cut his loss in half. Mr. Cohen was fired from that job for his conduct, and it was then that he founded SAC.[16] While trotting around the gray area to a large extent, Mr. Cohen's decisions prior to SAC could have predicted the legal maelstrom in which SAC is now emerged. Conduct in the gray area is a form of a red flag.

Discussion Questions

1. Did Mr. Greenberg violate any rules as a soldier? Isn't the lack of clarity on the part of the commanding officers what caused the problem? What's wrong with using a loophole in the system?
2. Apply the various schools of thought to see whether you can fit Mr. Greenberg into one or more. As you do, think about the following excerpt from an editorial Mr. Greenberg wrote for the *Wall Street Journal:* "So, in order to stay out of the crosshairs of government regulators, companies are avoiding risks they might otherwise take to innovate or grow their businesses: 'Keep your head down.'"[17]
3. Do you believe that both men had established patterns that surfaced as they ran their companies?
4. In a 2006 AP survey of adults, 33 percent stated that it is "okay" to lie about your age, although only to make yourself younger, not for purposes of underage drinking. What rationalization(s) are the 33 percent using?

[16] Jenny Anderson and Peter Lattman, "A Fascination of Wall Street and Investigators," *New York Times*, December 22, 2012, SB1.

[17] Maurice R. Greenberg, "Regulation, Yes. Strangulation, No," *The Wall Street Journal*, August 21, 2006, p. A10.

SECTION B

Resolving Ethical Dilemmas

Reading 1.9

Some Simple Tests for Resolving Ethical Dilemmas

Nearly every business professor and philosopher has weighed in with models and tests that can be used for resolving ethical issues. The following sections offer summaries of the thoughts and models of others in the field of ethics.

Management Guru: Dr. Peter Drucker

An internationally known management expert, Dr. Peter Drucker offers the following as an overview for all ethical dilemmas: *primum non nocere*, which in translation means "Above all do no harm." Adapted from the motto of the medical profession, Dr. Drucker's simple ethical test in a short phrase encourages us to make decisions that do not harm others. This test would keep us from releasing a product that had a defect that could cause injury. This test would have us be fair and decent in the working conditions we provide for workers in other countries. This test would also prevent us from not disclosing relevant information during contract negotiations. Johnson & Johnson has used Dr. Drucker's simple approach as the core of its business credo (see Case 8.7).

Laura Nash: Harvard Divinity School Meets Business

Ethicist Laura Nash of the Harvard Divinity School has one of the more detailed decision-making models, with twelve questions to be asked in evaluating an ethical dilemma:

1. **Have you defined the problem accurately?** For example, philosophical questions are often phrased as follows: Would you steal a loaf of bread if you were starving? The problem might be better defined by asking, "Is there a way other than stealing to take care of my hunger?" The rephrasing of the question helps us think in terms of honoring our values rather than rationalizing to justify taking property from another.
2. **How would you define the problem if you stood on the other side of the fence?** This question asks us to live by the same rules that we apply to others. For example, Donald Trump recently explained that when his employees develop a construction proposal for a customer for a price of $75 million, he simply adds on $50 to $60 million to the price and tells the customer the price is $125 million. Trump's firm then builds it for $100 million and is praised by the client for bringing the project in under price. Mr. Trump explains that the customer thinks he did a great job when he really did not. If Trump were on the other side, would he feel the same way about this method he uses for "managing customer expectations"? And note the use of the soft label here. This question forces us to look at our standards in a more universal way.
3. **How did this situation occur in the first place?** This question helps us in the future. We use it to avoid being placed in the same predicament again. For example, suppose that an employee has asked his supervisor for a letter of recommendation for a new job the employee might get if the references are good. The supervisor has always had difficulty with the employee, but has found him to be tolerable, has kept him on at the company, and has never really discussed any of his performance issues with him or even put those

concerns in his annual evaluation. Should he make things up for the letter? Should he refuse to write the letter? Should he say innocuous things in the letter such as "He was always on time for work." This reluctant supervisor is in this situation because he has never been honest and candid with the employee. The employee is not aware that the supervisor has had any problems or issues with him because the fact that he has asked for the reference shows that there has not been forthright communication.

4. **To whom and what do you give your loyalties as a person and as a member of the corporation?** Suppose that you know that your manager has submitted false travel invoices to the company. The expenses are false, padded, and unnecessary. No one in the accounting or audit department has caught on to his scheme. To say something would mean that you are loyal to your company (the corporation) but that you have sacrificed your loyalty to your manager.
5. **What is your intention in making this decision?** Often we offer a different public reason for what we are doing as a means of avoiding examination of the real issue. An officer of a company may say that "liberal" accounting interpretations help the company, smooth out earnings, and keep the share price stable. But her real intention may be to reach the financial and numbers goals that allow her to earn her bonus.
6. **How does this intention compare with the likely results?** Continuing with the previous example, the stated intention of increasing or maintaining shareholder value may work for a time, but eventually, the officer and the company will need to face the truth about the company's real financial picture. And the officer's real intention will be foiled as well, because under Sarbanes-Oxley, officers who earn bonuses based on false financial statements must repay those bonuses and face criminal penalties as well.
7. **Whom could your decision or action injure?** Under this question, think not only of the direct harm that can result from a poor ethical choice but all the ripple effects as well. For example, in the case of the marathoners who took the subway during the New York City race, the real winners in three age categories were affected because they were not given their trophies or the rankings they deserved for nearly one year. Those who sponsor marathons now have to implement physical and electronic monitors to police runners. Those who enter the race must pay additional costs to cover this monitoring. And, of course, there is the cost of the post-race investigations. Not only do we never do just one thing; there is never just one person affected when we choose to bend the rules just a bit.
8. **Can you engage the affected parties in a discussion of the problem before you make your decision?** If you are considering "cheating" on a spouse or significant other, you face an ethical dilemma. The fact that you could not discuss what you are about to do with a person who has been very close to you and whom you would betray indicates that your secret decision and action cross an ethical line.
9. **Are you confident that your position will be as valid over a long period of time as it seems now?** Sometimes cheating on an exam or purchasing a paper on the Internet seems to be an expedient way of solving time pressures, financial worries about going to school, or even just the concerns about finishing a semester or a degree. However, this question asks you to think about this small decision over the time frame of your life. When you look back, how will you feel about this decision? Or what if your friend, roommate, or even someone who happens to see you cheat carries that knowledge of your ethical indiscretion with him or her? You always have the worry that he or she will know of your misstep and perhaps would be involved in your future in such a way that this knowledge could affect your potential. For example, what if someone who knows that you cheated works for a company you very much want to work for? Suppose further that the person interviewing you sees that you went to the same school as the employee who currently works for the company. One question to that employee might be "Say, I see you went to school at Western U. I interviewed a Josh Blake from Western U. He wants to work with us. Do you know him? And what do you think of him?" Think ahead to the person's possible response: "Yes, I knew him at school. He cheated." Interestingly, this is what happened to Joseph Jett, a Wall Street investment banker who was at the heart of a trading scandal at Kidder Peabody (see Case 4.9 for more details). When his credentials, a Harvard MBA, were reported, someone from the school emerged to let the world know that although he had finished his course work at Harvard, he did not have his degree because he had not paid some fees. The fees may have been unpaid parking tickets or perhaps library fines. What seemed like an expedient budget decision at the time he was a graduate student turned out to be something that harmed Mr. Jett's credibility when he was most in need of a good reputation. Over the long term your decision might not seem as practical as it did during the pressure crunch of college.
10. **Could you disclose without qualms your decision or action to your boss, your CEO, the board of directors, your family, or society as a whole?** This question asks you to evaluate your conduct as if it

were being reviewed by those who run your company. If you are thinking of padding your expense account, you will realize that you could not talk about your actions with these people because you are betraying their trust. This question also has a second part to it: Could you tell your family? Sometimes we rationalize our way through business conduct or personal conduct but know that if we had to face our families, we would realize we had landed on the wrong side of the ethical decision. In the movie *While You Were Sleeping*, Peter is a wealthy lawyer who has fallen away from his parents' simple values. When his mother learns that Peter is engaged to marry an already married woman, she exclaims, "You proposed to a married woman?" Peter looks very sheepish. What seemed to be a fine decision in the confines of his social life suddenly looked different when his family was told.

11. **What is the symbolic potential of your action if understood? If misunderstood?** A good illustration for application of this question is in conflict-of-interest questions. For example, Barbara Walters, prior to her retirement from regular network news reporter for ABC News, was a cohost of the ABC prime-time news show *20/20.* In December 1996, Ms. Walters interviewed British composer Andrew Lloyd Webber (now Sir Andrew Lloyd Webber), and the flattering interview aired the same month as a segment on *20/20,* just prior to the opening of Sir Webber's Broadway production of *Sunset Boulevard.*

    Two months after the interview aired, a report in the *New York Post* revealed that Ms. Walters had invested $100,000 in Sir Webber's just-premiered *Sunset Boulevard.* ABC News responded that had it known of the investment, it would have disclosed it before the interview aired. ABC does have a policy on conflicts that permits correspondents to cover "businesses in which they have a minority interest."

    Sir Webber's *Sunset* cost $10 million to produce and investors received back 85 percent of their initial investment. Ms. Walters' interest in Sunset was 1 percent.

    Applying this question, even if everyone understands Ms. Walters' good intentions, the appearance is that of a conflict between her role as an investor in Webber's production and that of her role as an objective reporter, and regardless of its size the public is likely to perceive that the favorable journalism piece was done to pump up the production and hence ensure a return on her investment.

12. **Under what conditions would you allow exceptions to your stand?** You may have a strong value of always being on time for class, events, meetings, and appointments. You have adopted an absolute value on not being tardy. However, sometimes other values conflict. For example, suppose that your friend became ill and needed someone to drive her to the hospital, making you late for a meeting. You would be comfortable with that variance because your exceptions relate to the well-being of others. Likewise, you would drive more slowly and carefully in a storm to get to your meeting, something that will make you late. But, again, your exception is the safety and well-being of others. You won't be late because you stopped to talk or you didn't leave your apartment on time, but you are comfortable being late, an exception to your rule on punctuality, when safety and well-being are at stake.

These questions help us gain perspective and various views on the issue before us, and at least two of the questions focus on the past—what brought us to the dilemma and how we might avoid such dilemmas when we have caused them to arise.

A Minister and a One-Minute Manager Do Ethics: Blanchard and Peale

The late Dr. Norman Vincent Peale, an internationally known minister, and management expert Kenneth Blanchard, author of *The One Minute Manager*, offer three questions that managers should ponder in resolving ethical dilemmas: Is it legal? Is it balanced? How does it make me feel?

If the answer to the first question, "Is it legal?" is no, you might want to stop there. Although conscientious objectors are certainly needed in the world, trying out those philosophical battles with the SEC and Internal Revenue Service (IRS) might not be as effective as the results achieved by Dr. Martin Luther King Jr. or Mahatma Gandhi. There is a place for these moral battles, but your role as an agent of a business might not be an optimum place to exercise the Divine Command Theory. In early 2010, four individuals from the company Wise Guys, Inc., were indicted for wire fraud as well as gaining

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unauthorized access to computers for their cornering of the ticket markets for the 2006 Rose Bowl, the 2007 MLB playoffs, the play *Wicked*, and concerts for Bruce Springsteen and Hannah Montana.[18] The four had hired Bulgarian programmers to circumvent the controls placed on ticket sites to require entry of data prior to being able to purchase tickets. The result was that the four cornered the primary and, consequently, secondary ticket markets for the events noted. Regardless of how strongly we may feel about having access to tickets, the four are accused of violating the laws by circumventing computer access controls.

Answering the second Blanchard and Peale question, "Is it balanced?" requires a manager to step back and view a problem from other perspectives—those of other parties, owners, shareholders, or the community. For example, an M&M/Mars cacao buyer was able to secure a very low price on cacao for his company because of pending government takeovers and political disruption. M&M/Mars officers decided to pay more for the cacao than the negotiated figure. Their reason was that some day their company would not have the upper hand, and then they would want to be treated fairly when the price became the seller's choice.

Answering "How does it make me feel?" requires a manager to do a self-examination of his or her comfort level with a decision. Some decisions, though they may be legal and may appear balanced, can still make a manager uncomfortable. For example, many managers feel uncomfortable about the "management" of earnings when inventory and shipments are controlled to maximize bonuses or to produce a particularly good result for a quarter. Although they've done nothing illegal, managers who engage in such practices often suffer such physical effects as insomnia and appetite problems.

The Oracle of Omaha: Warren Buffett's Front-Page-of-the-Newspaper Test

This very simple ethical model requires only that a decision maker envision how a reporter would describe a decision or action on the front page of a local or national newspaper. For example, with regard to the NBC News report on the sidesaddle gas tanks in GM pickup trucks, the *USA Today* headline read, "GM Suit Attacks NBC Report: Says Show Faked Fiery Truck Crash." Would NBC have made the same decisions about its staging of the truck crash if that headline had been foreseen?

When Salomon Brothers' illegal cornering of the U.S. government's bond market was revealed, the *BusinessWeek* headline read, "How Bad Will It Get?"; nearly two years later, a follow-up story on Salomon's crisis strategy was headlined, "The Bomb Shelter That Salomon Built." During the aftermath of the bond market scandal, the interim chairman of Salomon, Warren Buffett, told employees, "Contemplating any business act, an employee should ask himself whether he would be willing to see it immediately described by an informed and critical reporter on the front page of his local paper, there to be read by his spouse, children, and friends. At Salomon we simply want no part of any activities that pass legal tests but that we, as citizens, would find offensive."

A manager of a company came up with a slight variation of the newspaper test by having all of his employees begin every meeting and discussion by asking, "What if the cameras were running? Would we be proud of this discussion or would we be worried?" The purpose of the "What if the cameras were rolling?" test is to have you step back

[18] Joel Stonington, "Four Charged in Bid to Buy, Resell Tickets," *The Wall Street Journal*, March 2, 2010, http://online.wsj.com/article/SB10001424052748703943504575095622582020594.html.

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from the business setting in which decisions are made and view the issue and choices from the perspective of an objective outsider.

The Jennings *National Enquirer* Test

Named for its author, the *National Enquirer* test is: "Make up the worst possible headline you can think of and then reevaluate your decision." In late 2007, when several large investment banking firms had to take multibillion-dollar losses for their excesses in the subprime lending market, the cover of *Fortune* magazine read, "What Were They Smoking?" Such a candid headline turns our heads a bit and forces us to see issues differently because of its metaphorical punch to the gut. Their views and perceptions can be quite different because they are not subject to the same pressures and biases. The purpose of this test is to help managers envision how their actions and decisions look to the outside world.

The *Wall Street Journal* Model

The *Wall Street Journal* model for resolution of ethical dilemmas consists of three components: (1) Am I in compliance with the law? (2) What contribution does this choice of action make to the company, the shareholders, the community, and others? And (3) what are the short- and long-term consequences of this decision? Like the Blanchard-Peale model, any proposed conduct must first be in compliance with the law. The next step requires an evaluation of a decision's contributions to the shareholders, the employees, the community, and the customers. For example, furniture manufacturer Herman Miller decided both to invest in equipment that would exceed the requirements for compliance with the 1990 Clean Air Act and to refrain from using rain forest woods in producing its signature Eames chair. The decision was costly to the shareholders at first, but ultimately they, the community, and customers enjoyed the benefits of a reputation for environmental responsibility as well as good working relationships with regulators, who found the company to be forthright and credible in its management of environmental regulatory compliance.

The initial consequences for Herman Miller's decisions were a reduction in profits because of the costs of the sustainability changes it made in its products and operations. However, the long-term consequences were the respect of environmental regulators, a responsive public committed to rain forest preservation, and Miller's recognition by *BusinessWeek* as an outstanding firm for 1992.

The impact of Delta CEO Gerald Grinstein's decision not to accept his bonus for bringing the airline through a massive and successful Chapter 11 restructuring had profound effects on both the stock price and the morale of company employees. A decision to accept the perfectly legal bonus could have had adverse consequences that he avoided with his thoughtful decision to forgo a $10 million payment.

Other Models

Of course, there are much simpler models for making ethical business decisions. One stems from Immanuel Kant's categorical imperative (see pp. 13–14), loosely similar to the Golden Rule of the Bible: "Do unto others as you would have them do unto you." Treating others as we would want to be treated is a powerful evaluation technique in ethical dilemmas. Another way of looking at issues is to apply your standards in all situations and think about whether you would be comfortable. In other words, if the world lived by your personal ethical standards, would you be comfortable or would you be nervous?

Discussion Questions

1. Take the various models and offer a chart or diagram to show the common elements in each.
2. After viewing the chart, make a list of the kinds of things all those who have developed the models want us to think about as we resolve ethical dilemmas. Remember, you are working to develop a 360-degree perspective on issues. Stopping at legality is not enough if you are going to think through all the consequences of decisions. Just because something is legal does not mean it is ethical.

Reading 1.10

Some Steps for Analyzing Ethical Dilemmas

Although you now have a list of the categories of ethical breaches and many different models for resolution, you may still be apprehensive about bringing it all together in an analysis. Here are some steps to help you get at the cases, issues, and dilemmas from all perspectives.

Steps for Analyzing Ethical Dilemmas and Case Studies in Business

1. Make sure you have a grasp of all of the facts available. Be sure you are familiar with all the facts.
2. List any information you would like to have, but don't, and what assumptions you would have to make, if any, in resolving the dilemma.
3. Take each person involved in the dilemma and list the concerns they face or might have. Be sure to consider the impact on those not specifically mentioned in the case. For example, product safety issues don't involve just engineers' careers and company profits; shareholders, customers, customers' families, and even communities supported by the business are affected by a business decision on what to do about a product and its safety issue.
4. Develop a list of resolutions for the problem. Apply the various models for reaching this resolution. You may also find that as you apply the various models to the dilemma, you find additional insights for questions 1, 2, and 3. If the breach has already occurred, consider the possible remedies, and develop systemic changes so that such breaches do not occur in the future.
5. Evaluate the resolutions for costs, legalities, and impact. Try to determine how each of the parties will react to and be affected by each of the resolutions you have proposed.
6. Make a recommendation on the actions that should be taken.

In some of the cases, you will be evaluating the ethics of conduct after the fact. In those situations, your recommendations and resolutions will center on reforms and perhaps recompense for the parties affected.

Each case in this book requires you to examine different perspectives and analyze the impact that the resolution of a dilemma has on the parties involved. Return to these models to question the propriety of the actions taken in each case. Examine the origins of the ethical dilemmas and explore possible solutions. As you work through the cases, you will find yourself developing a new awareness of values and their importance in making business decisions. Try your hand at a few dilemmas before proceeding to the following sections. The following diverse cases offer an opportunity for application of the materials from this section and give you the chance to hone your skills for ethical resolutions.

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Reading 1.11

On Plagiarism

Clarify the distinctions among *plagiarism, paraphrasing,* and *direct citation.*

Consider the following source and three ways that a student might be tempted to make use of it:

Source: "The joker in the European pack was Italy. For a time hopes were entertained of her as a force against Germany, but these disappeared under Mussolini. In 1935, Italy made a belated attempt to participate in the scramble for Africa by invading Ethiopia. It was clearly a breach of the covenant of the League of Nations for one of its members to attack another. France and Great Britain, as great powers, Mediterranean powers, and African colonial powers, were bound to take the lead against Italy at the league. But they did so feebly and halfheartedly because they did not want to alienate a possible ally against Germany. The result was the worst possible: the league failed to check aggression, Ethiopia lost her independence, and Italy was alienated after all."[19]

Version A: Italy, one might say, was the joker in the European deck. When she invaded Ethiopia, it was clearly a breach of the covenant of the League of Nations; yet the efforts of England and France to take the lead against her were feeble and halfhearted. It appears that those great powers had no wish to alienate a possible ally against Hitler's rearmed Germany.

Comment: Clearly plagiarism. Though the facts cited are public knowledge, the stolen phrases aren't. Note that the writer's interweaving of his own words with the source's does not render him innocent of plagiarism.

Version B: Italy was the joker in the European deck. Under Mussolini in 1935, she made a belated attempt to participate in the scramble for Africa by invading Ethiopia. As J. M. Roberts points out, this violated the covenant of the League of Nations (J. M. Roberts, *History of the World* [New York: Knopf, 1976], p. 845). But France and Britain, not wanting to alienate a possible ally against Germany, put up only feeble and halfhearted opposition to the Ethiopian adventure. The outcome, as Roberts observes, was "the worst possible: the league failed to check aggression, Ethiopia lost her independence, and Italy was alienated after all" (Roberts, p. 845).

Comment: Still plagiarism. The two correct citations of Roberts serve as a kind of alibi for the appropriating of other, unacknowledged phrases. But the alibi has no force: some of Roberts's words are again being presented as the writer's.

Version C: Much has been written about German rearmament and militarism in the period 1933–1939. But Germany's dominance in Europe was by no means a foregone conclusion. The fact is that the balance of power might have been tipped against Hitler if one or two things had turned out differently. Take Italy's gravitation toward an alliance with Germany, for example. That alliance seemed so very far from inevitable that Britain and France actually muted their criticism of the Ethiopian invasion in the hope of remaining friends with Italy. They opposed the Italians in the League of Nations, as J. M. Roberts observes, "feebly and halfheartedly because they did not want to alienate a possible ally against Germany" (J. M. Roberts, *History of the World* (New York: Knopf, 1976), p. 845). Suppose Italy, France, and Britain had retained a certain common interest. Would Hitler have been able to get away with his remarkable bluffing and bullying in the later 1930s?

Comment: No plagiarism. The writer has been influenced by the public facts mentioned by Roberts, but he hasn't tried to pass off Roberts's conclusions as his own. The one clear borrowing is properly acknowledged.[20]

[19] J. M. Roberts, *History of the World* (New York: Knopf, 1976), p. 845.

[20] Quoted from Frederick Crews, *The Random House Handbook,* 6th ed. (New York: McGraw-Hill, 1992), 181–83.

Discussion Questions

1. List the important tools you have learned from this reading that will help you during your education.
2. Are there some additions you could make to your credo based on this instruction?
3. Make a list of what students gain through plagiarism. Make a list of the risks. Make a list of what students forgo when they engage in plagiarism.

Case 1.12

The Little Teacher Who Could: Piper, Kansas, and Term Papers

Piper High School is in Piper, Kansas, a town located about 20 miles west of Kansas City, Missouri. Christine Pelton was a high school science teacher there. Ms. Pelton, age 26, had a degree in education from the University of Kansas and had been at Piper for two years. She was teaching a botany class for sophomores, a course that included an extensive project as part of the course requirements. The project, which included a lengthy paper and creative exhibits and illustrations, had been part of the curriculum and Piper High School tradition for ten years. Students were required to collect twenty different leaves, write one or two paragraphs about the leaves, and then do an oral presentation on their projects.

When Ms. Pelton was describing the writing portion of the project and its requirements to her students, she warned them not to use papers posted on the Internet for their projects. She had her students sign contracts that indicated they would receive a "0" grade if they turned in others' work as their own. The paper counted for 50 percent of their grade in the course. When the projects were turned in, Ms. Pelton noticed that some of the students' writing in portions of their papers was well above their usual quality and ability. Using an online service called Turn It In (http://www.turnitin.com), she found that 28 of her 118 students had taken substantial portions of their papers from the Internet.[21] She gave the students a "0" grade on their term paper projects. The result was that many of the students would fail the semester in the course.

The students' parents protested, but both her principal, Michael Adams, and the school district superintendent, Michael Rooney, supported her decision. However, the parents appealed to the school board, and the board ordered Ms. Pelton to raise the grades. Mr. Rooney, acting at the board's direction, told Ms. Pelton that the decision of the board was that the leaf project's weight should be changed from 50 percent to 30 percent of the course's total semester grade, and that the twenty-eight students should have only 600 points deducted from their grade rather than the full 1,800 points the project was originally worth.

Ms. Pelton said, "I was really shocked at what their decision was. They didn't even talk to me or ask my side."[22] The result was that twenty-seven of the twenty-eight students avoided receiving an "F" grade in the course, but the changed weight also meant that twenty of the students who had not plagiarized their papers got a lower grade as a

[21] Another program that can be used is http://www.mydropbox.com.

[22] "School Board Undoes Teacher's F's," *Wichita Eagle*, January 31, 2002, http://www.kansas.com/mld. The original site for the article is no longer available. However, similar quotes from Ms. Pelton can be found at http://www.mskennedysclass.com/Plagiarism_Controversy_Engulfs_Kansas_School.pdf. Accessed August 23, 2013.

result. She resigned in protest on the day following the board's decision. She received twenty-four job offers from around the country following her resignation. Mr. Adams, the principal, and one teacher resigned at the end of the year to protest the lack of support for Ms. Pelton. Mr. Adams cited personal reasons for his resignation, but he added, "You can read between the lines."[23] At the time of Ms. Pelton's experience, 50 percent of the teachers had indicated they would resign. The superintendent, Michael Rooney, remained and said he stood by the teacher but did not think that the school board was wrong: "I take orders as does everyone else, and the Board of Education is empowered with making the final decisions in the school district."[24]

The board debated the case in executive session and refused to release information, citing the privacy rights of the students. The local district attorney for Wyandotte County, Nick A. Tomasik, filed suit against the board for violating open meetings laws. The board members were deposed as part of his civil action. Citizens of Piper began a recall action against several of the school board members. The local chapter of the National Education Association, representing the eighty-five teachers in the district, was brought into settlement negotiations on the suit because of its concerns that action that affects teachers can be taken without input and without understanding the nature of the issues and concerns.

The fallout for Piper has been national. *Education Week* reported the following as results of the actions of the students and the school board:

> All twelve deans of Kansas State University signed a letter to the Piper school board that included the statement "We will expect Piper students … to buy into [the university's honor code] as a part of our culture."
>
> Angered, Piper school board member James Swanson—who is one of the targets of the recall drive—wrote the university to note that the implication that Piper students might be subject to greater scrutiny because of one controversial incident involving only twenty-eight students was unfair. He received an apology from university officials.
>
> More troubling to the community, Piper students have also been mocked. At an interscholastic sporting event involving Piper, signs appeared among the spectators that read "Plagiarists."
>
> Students have reported that their academic awards, such as scholarships, have been derided by others. And one girl, wearing a Piper High sweatshirt while taking a college entrance exam, was told pointedly by the proctor, "There will be no cheating."[25]

Several of the parents pointed to the fact that there was no explanation in the Piper High School handbook on plagiarism. They also said that the students were unclear on what could be used, when they had to reword, and when quotations marks were necessary. Other parents complained about Ms. Pelton's inexperience. One teacher said, "I would have given them a chance to rewrite the paper."

Both the school board and the principal asked Ms. Pelton to stay, but she explained, "I just couldn't. I went to my class and tried to teach the kids, but they were whooping and hollering and saying, 'We don't have to listen to you any more.'"[26] Ms. Pelton began operating a day care center out of her home.

[23] Andrew Trotter, "Plagiarism Controversy Engulfs Kansas School," *Education Week*, April 3, 2003, http://www.edweek.org/ew/articles/2002/04/03/29piper.h21.html.

[24] *Id.*

[25] *Id.*

[26] *Id.*

The annual Rutgers University survey on academic cheating reveals that 15 percent of college papers turned in for grades are completely copied from the Internet. In a look at Internet papers, the New Jersey Bar Foundation found the following:

> A Rutgers University survey of nearly 4,500 high school students revealed that only 46 percent of the students surveyed thought that cutting and pasting text directly from a Web site without attributing the information was cheating, while only 74 percent of those surveyed thought that copying an entire paper was cheating. Donald McCabe, the Rutgers University researcher that conducted the survey told *USA Today*, "In the students' minds what is on the Internet is public knowledge.[27]

A senior from the Piper, Kansas, school told CBS News, "It probably sounds twisted, but I would say that in this day and age, cheating is almost not wrong."[28]

Almost one year later the school board adopted guidelines on plagiarism for use in the district's school as policy. The Center for Academic Integrity gave its Champion of Integrity Award for 2002 to Ms. Pelton and Mr. Adams.

The center's criteria for this award are that the teacher or administrator took

1. an action, speech, or demonstration that draws attention to a violation of academic integrity.
2. an action that, in an attempt to promote or uphold academic integrity, may subject the nominee to reprisal or ridicule.
3. an action motivated by commitment to and conviction about the importance of academic integrity and not by public acclaim or monetary gains.[29]

Discussion Questions

1. Do you believe the students understood that what they did was wrong? Why is this information important in your analysis?
2. Was the penalty appropriate?
3. What do you think of the grading modifications the board required? Be sure to list those who were affected when you answer this question.
4. What did the parents miss in their decisions to intervene?
5. Evaluate the statement of the senior that cheating is no longer wrong.
6. What were the consequences for Piper and the students?

Source

Jodi Wilgoren, "School Cheating Scandal Test a Town's Values," *New York Times,* February 14, 2002, pp A1, A28.

Case 1.13

Dog Walkers and Scoopers

For forty-one years, New York City has had a "pooper scooper law," a law that requires dog owners to clean up after their dogs when they are walking them. There was not much enforcement of the law because dog owners had been responsible and cleaned up after their pooches. However, the residents of New York began to complain because "we are walking around with it on our shoes half the time."[30] As a result, the city has been issuing

[27] New Jersey State Bar Foundation, http://www.njsbf.com/njsbf/student/eagle/winter03-2.cfm. Accessed July 20, 2010.

[28] Leonard Pitts, Jr., "Your Kid's Going to Pay for Cheating—Eventually," June 21, 2002, http://www.jewishworldreview.com/0602/pitts062102.asp. Accessed July 20, 2010.

[29] This statement no longer appears on the the Center for Academic Integrity's website. However, Professor McCabe's decades of work can be reviewed at http://www.business.rutgers.edu/tags/332. Accessed November 1, 2013. There is still similar information available at the Center for Academic Integrity's website: http://www.academicintegrity.org/icai/home.php.

[30] "NYC Officials Express Difficulty Enforcing Dog Clean-Up Rules," CBS New York, April 20, 2011, http://newyork.cbslocal.com/2011/04/20/nyc-officials-express-difficulty-enforcing-dog-clean-up-rules/.

citations—530 in 2010 and 377 in 2011—in an effort to get dog owners to comply with this requirement. City officials say that the citations are among the most difficult to write because they need to see owner, dog, and waste together in order to issue a citation. City officials note that they are dependent on voluntary compliance by dog owners.

Discussion Questions

1. One citizen commented that people who do not pick up after their dogs are "slackers" and "not good citizens." Are these labels that comment on the ethics of dog owners?
2. Explain who is affected by the behavior of dog owners.
3. Apply ethical tests to this conduct that might convince dog owners to do their pick-up duties.

Case 1.14

Puffing Your Résumé

Résumé Stats

The résumé is a door opener for a job seeker. What's on it can get you in the door or cause the door to be slammed in your face. With that type of pressure, it is not surprising to learn that one 2006 study by a group of executive search firms showed that 43 percent of all résumés contain material misstatements.[31] A 2008 CareerBuilder.com survey of HR managers found that 49 percent of résumés had materially false information.[32] A 2012 survey by the American Institute of Certified Public Accountants (AICPA) concludes that 54 percent of résumés contain false information and that 70 percent of college graduates' résumés contain false information.[33] A *Wall Street Journal* analysis of the credentials of 358 executive and board members at fifty-three publicly traded companies found discrepancies between their background/experience and reality in seven of the executives'/board members' claims, most dealing with them claiming to hold MBAs when they did not.[34]

The problems with résumés in the executive suite have been steady. *The Wall Street Journal* documents the following examples:

Company	Executive	Title	Problem
Bausch & Lomb	Ronald Zarrella	CEO	No MBA
RadioShack	David Edmondson	CEO	Inflated degrees
MGM Mirage	J. Terrence Lani	CEO	Questions about degrees
Herbalife	Gregory Probert	COO	Embellished degree
Veritas	Kenneth Lonchar	CFO	No MBA
A. T. Kearney	Gene Shen	CEO	Exaggerated academic credentials and work experience
CSX	Clarence Gooden	CCO	Misrepresented academic credentials[35]

[31] Dan Barry, "Cheating Hearts and Lying Résumés," *New York Times*, December 14, 1997, pp. WK1, WK4.

[32] Don Macsai, "And I Invented Velcro," *BusinessWeek*, August 4, 2008, p. 15.

[33] "Skeletons in Closet Need Not Apply," http://www.cpai.com/risk-management/employergard/resume-fraud.jsp.

[34] Keith J. Winstein, "Inflated Credentials Surface in Executive Suite," *Wall Street Journal*, November 13, 2008, p. B1.

[35] *Id.*

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What We Don't Like To Put in Our Résumés

Ed Andler, an expert in credential verification, says that one-third of all résumés contain some level of "creative writing." Mr. Andler notes that assembly-line workers don't mention misdemeanor convictions, and middle managers embellish their educational background. One reference-checking firm looked into the background of a security guard applicant and found he was wanted for manslaughter in another state. Executives also manage to remove bad management experiences from their credentials. Al Dunlap, the former CEO of Sunbeam who was forced to resign his position there when questions were raised about the company's accounting practices, omitted from his résumé his employment as president at Nitec Paper, where he resigned after the owner accused Mr. Dunlap of inflating the company's inventory.

How Easy Is It to Find out False Information in Résumés?

Vericon Resources, Inc., a background check firm, has found that 2 percent of the applicants they investigate are hiding a criminal past. Vericon also notes, however, that potential employers can easily discover whether job candidates are lying about previous employment by requesting W-2s from previous employers.

In one "résumé-puffing" case, according to Michael Oliver, a former executive recruiter and one-time director of staffing for Dial Corporation, who was a strong candidate for a senior marketing management position, said he had an MBA from Harvard and four years' experience at a previous company where he had been a vice president of marketing. Actually, a few quick phone calls uncovered that Harvard had never heard of him; he had worked for the firm for only two years; and he had been a senior product manager, not a vice president.

Some Troubling, Very Public, and Very Consequential Résumé Debacles

Yahoo! A Computer Science Degree

Scott Thompson, made CEO of Yahoo in March 2012, had the following information on his résumé, from the beginning of his career with VISA, PayPal, and other tech companies: B.S. in Accounting and Computer Science, Stonehill College, 1979. However, Stonehill College did not offer a degree in computer science until 1983. The discrepancy was uncovered by one of Yahoo's investors, the hedge fund Third Point, an investor who was not happy with Mr. Thompson's work as CEO or with the direction of the company.[36]

The then 54-year-old Thompson opted not to address the issue, either publicly or with Yahoo employees who were with him at a series of strategic meetings for the company after the public revelations about the résumé issue. Some board members and employees did not want Mr. Thompson to resign because he was a relatively new CEO and Yahoo needed stability at that time. Other board members and employees believed Mr. Thompson's credibility was damaged and that morale among employees was driven to an all-time low by the revelation. Yahoo's stock had been hovering at $10 to $20 per share for the last four years prior to the Thompson résumé issue. Microsoft was trying to acquire the company for $33 per share, trying to move in while there was shareholder dissatisfaction. Citing health reasons related to cancer, Mr. Thompson left Yahoo, but two months later, healthy and recovered, he was named as the CEO of ShopRunner,

[36] Amir Efrati and Joann S. Lublin, "Résumé Trips Up Yahoo's Chief," *Wall Street Journal*, May 5–6, 2012, p. A1. http://online.wsj.com/article/SB10001424052702304749904577384221920051852.html. See also, "Yahoo's CEO Among Many Notable Résumé Flaps": http://blogs.wsj.com/digits/2012/05/07/yahoos-ceo-among-many-notable-resume-flaps/?mod=google_news_blog.

Inc. ShopRunner executives and board members were aware of the Yahoo and résumé issues and concluded that regardless of what had happened before, Mr. Thompson was "the right person for the job."[37]

The Shakespearean Tragedy in a Résumé Falsification

In 1997, Dianna Green, a senior vice president at Duquesne Light, left her position at that utility. The memo from the CEO described her departure as one that would allow Ms. Green to pursue "other career interests she has had for many years." Despite the memo's expression of sadness at her departure, Ms. Green was fired for lying on her résumé by stating that she had an MBA when, in fact, she did not.[38]

Ms. Green had worked her way up through the company and had been responsible for handling the human resources issues in Duquesne's nine years of downsizing. At the time of her termination, she was a director at Pennsylvania's largest bank and known widely for her community service.

On the day following her termination, Ms. Green was found dead of a self-inflicted gunshot wound.[39]

Discussion Questions

1. Explain what motivates individuals to include false information in their résumés. Think about the risks, and give some examples of puffing versus falsehoods versus false impressions that you have heard of or seen in résumés.
2. Does the fact that Scott Thompson landed on his feet so quickly bother you? Does his experience teach you that dishonesty pays?
3. What do you learn from the tragedy of Ms. Green? Peter Crist, a background check expert, said, "You can't live in my world and cover stuff up. At some point in time, you will be found out if you don't come clean. It doesn't matter if it was 2 days ago or 20 years ago." As you think through these examples, can you develop some important principles that could be important for your credo?[40] Was the tragedy of Ms. Green avoidable? Was Duquesne Light justified in terminating her?
4. George O'Leary was hired by Notre Dame University as its head football coach in December 2001. However, just five days after Notre Dame announced Mr. O'Leary's appointment, Mr. O'Leary resigned. Mr. O'Leary's résumé indicated that he had a master's degree in education from New York University (NYU) and that he had played college football for three years. O'Leary had been a student at NYU, but he never received a degree from the institution. O'Leary went to college in New Hampshire but never played in a football game at his college and never received a letter as he claimed. When Notre Dame announced the resignation, Mr. O'Leary issued the following statement: "Due to a selfish and thoughtless act many years ago, I have personally embarrassed Notre Dame, its alumni and fans." Why did the misrepresentations, which had been part of his résumé for many years, go undetected? Evaluate the risk associated with the passage of time and a résumé inaccuracy. Would it be wrong to engage in résumé puffing and then disclose the actual facts in an interview? Be sure to apply the models.
5. Suppose that you had earned but had never been formally awarded a college degree, due to a hold on your academic record because of unpaid debts. Would you state on your résumé that you had a college degree?
6. Suppose that, in an otherwise good career track, you were laid off because of an economic downturn and remained unemployed for thirteen months. Would you attempt to conceal the thirteen-month lapse in your résumé?

[37] Amir Efrati and Greg Bensinger, "Ousted Yahoo Chief Lands New CEO Role," *Wall Street Journal*, July 24, 2012, p. B3.

[38] The information was revealed after Ms. Green was deposed in a suit by a former subordinate for termination. Because Ms. Green hesitated in giving a year for her degree, the plaintiff's lawyer checked and found no degree and notified Duquesne officials. Duquesne officials then negotiated a severance package.

[39] It should be noted that Ms. Green was suffering from diabetes to such an extent that she could no longer see well enough to drive. Also, during the year before her termination, her mother had died of a stroke and her youngest brother also had died. Carol Hymowitz and Raju Narisetti, "A Promising Career Comes to a Tragic End, and a City Asks Why," *Wall Street Journal*, May 9, 1997, pp. A1, A8.

[40] JoAnn S. Lublin, "No Easy Solution for Lies on a Résumé," *Wall Street Journal*, April 27, 2007, p. B2.

7. Is puffing a short-term solution in a tight job market?
8. James Joseph Minder was appointed to the board of gun manufacturer Smith & Wesson, headquartered in Scottsdale, Arizona, in 2001. In early 2004, he assumed the position of chairman of the board. One month later, he resigned as chair of the board because the local newspaper, the *Arizona Republic*, reported that Mr. Minder had completed a three-and-a-half- to ten-year prison sentence for a series of armed robberies and an escape from prison. He had carried a sawed-off shotgun during the string of robberies, committed while he was a student at the University of Michigan. Mr. Minder indicated that he had never tried to hide his past. In 1969, when he was released from prison, he finished his degree and earned a master's degree from the University of Michigan. He spent twenty years running a successful nonprofit center for inner-city youth until his retirement in 1997, when he moved to Arizona. Mr. Minder's position is that the subject of his troubled youth and criminal past never came up, so he never disclosed it.[41] Evaluate Mr. Minder's position and his silence. What do you think of Smith & Wesson's press release indicating that Mr. Minder "had led an exemplary life for 35 years"? Mr. Minder remains on the board. Why did the public react so negatively to his past and position?
9. Is there something for your credo that you learn from all of these résumé experiences?

Case 1.15

Dad, the Actuary, and the Stats Class

Joe, a student taking a statistics course, was injured by a hit-and-run driver. The injuries were serious, and Joe was on a ventilator. Although Joe did recover, he required therapy for restoring his cognitive skills. He asked for more time to complete his course work, but the professor denied the request. Joe would have to reimburse his employer for the tuition if he did not complete the course with a passing grade. Joe's father works with stats a great deal. Joe's father took the course final for Joe, and Joe earned an "A" in the course.

Discussion Questions

1. What school of ethical thought does Joe's father follow?
2. Was Joe's father justified in helping Joe, an innocent victim in an accident? Does your answer change if you learn that Joe's father is an actuary?
3. List those who are affected by Joe's father's actions.
4. Can you think of alternatives to Joe's father's solution?
5. Evaluate the systemic effects if everyone behaved as Joe's father did.

Case 1.16

Wi-Fi Piggybacking

A new issue that involves technology is developing and might require legal steps. Internet users are piggybacking onto their neighbors' wireless service providers. The original subscriber pays a monthly fee for the service, but without security, those located in the area are able to tap into the wireless network. They bog down the speed of the service. *Piggybacking* is the term applied to the unauthorized tapping into someone else's wireless Internet connection. Once limited to geeks and hackers, the practice is now common among the ordinary folk who just want free Internet service.

One college student said, "I don't think it's stealing. I always find people out there who aren't protecting their connection, so I just feel free to go ahead and use it." According to a recent survey, only about 30 percent of the 4,500 wireless networks onto which the surveyors logged were encrypted.

[41] "Smith & Wesson Chief Quits over Crime," CNN Money.com, February 27, 2004, http://money.cnn.com/2004/02/27/news/smith_wesson/?cnn=yes. Accessed July 20, 2010.

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Another apartment dweller said she leaves her connection wide open because "I'm sticking it to the man. I open up my network, leave it wide open for anyone to jump on." One of the users of another's wireless network said, "I feel sort of bad about it, but I do it anyway. It just seems harmless." She said that if she gets caught, "I'm a grandmother. They're not going to yell at an old lady. I'll just play the dumb card."

Some neighbors ask those with wireless service if they can pay them in exchange for their occasional use rather than paying a wireless company for full-blown service. But the original subscribers do not really want to run their own Internet service.

Discussion Questions

1. What do you think of the statements of the users?
2. Apply Kant's theory to this situation to determine what his rule would be.
3. What will happen if enough neighbors piggyback on their neighbors' wireless access?

Compare & Contrast

Compare this conduct to cuts in line. What's different about piggybacking from cutting in line? What similarities are there between the explanations the piggybackers give and those offered by the employees who pad their expense accounts? What role does "sticking it to the man" play in ethical analysis? What does that phrase do for piggybackers and expense account padders?

Case 1.17

Stuyvesant High School and the Cheating Culture of Excellence

Stuyvesant High School is an elite New York City high school that the "best of the best" high school students attend. Stuyvesant is ranked as the best of nine free public schools in New York City that admit students on the basis of their scores in the Specialized High Schools Admissions Test (SHSAT). The students are counseled and groomed for admission into elite colleges and universities. They also know that their grades are key determinants in getting into those schools. Stuyvesant's website posts scores of students who got into certain schools, along with their SAT scores and averages. As a result, as one student described it as follows: "It became a numbers game. It was kind of addictive in a bad way, in a sick way. People will assume, well, I have a 92, most kids who got into that school got a 94, so there's no way I can get in."[42]

As a result, 80 percent of the students at the high school indicated that they had cheated in some way while at the school, including copying homework from a Facebook site, tipping off classmates who were taking an exam in the same class later in the day, hiding formulas in sleeves or bathroom stalls and then using a restroom break to get that information, Googling questions and getting information on an iPhone (such as facts for history or a formula they had forgotten for math), and taking photos of test questions for their friends.[43]

In a bizarre way, the competitive students developed a sort of cheating cooperative in which they shared answers, workload, and talents in order to get the GPA numbers that they needed for elite colleges and universities. For example, they had tapping systems worked out for signaling each other answers on exam questions during the test.

[42] *Id.*, Yee, p. A1.

[43] James Marshall Crotty, "Stuyvesant High School Has a Cheating Problem. Here's How To Fix It," *Forbes*, September 29, 2012, http://www.forbes.com/sites/jamesmarshallcrotty/2012/09/29/new-yorks-elite-stuyvesant-high-school-has-a-cheating-problem-heres-how-to-solve-it/.

Copying homework did not carry any disciplinary actions and that's why the students felt free to post the assignments on Facebook. Students also noted that they cheated because it was a way to get into the college or university they wanted and that they could then return to ethical behavior once they reached that goal. *New York Magazine* referred to this attitude as the practice of "cheating upwards."[44]

As a result of the cheating culture, the students at Stuyvesant also cheated on their Regents exams, something that was picked up by test administrators. Those who were strong in math and physics helped their friends on those subjects on the New York State Regents Exams, whereas those weak in math and physics helped out their friends who were weak in English and foreign languages. One student said, "The lines did get a little blurry."[45] Another student said, "It's seen as helping your friend out. If you ask people, they'd say it's not cheating. I have your back, you have mine."[46]

Seventy-one Stuyvesant students were accused of cheating on their Regents exams, but many of the students had already been admitted to elite colleges and universities, and there would be no penalty for them. The Regents exam cheating took place by the simple act of one student, Nayeem Ahsan, typing the questions into his iPhone and sending them along to other students. Other students used their iPhones to send messages asking for verification of answers while they were taking the tests. Nayeem sent exam questions he had typed in via text message to 140 students. When he was caught, the penalty was his expulsion from Stuyvesant. He commented, "I didn't know I could have gotten kicked out of Stuy if I pulled this off. That was never made clear to me."[47] There was an online petition from his fellow Stuy students in support of keeping him at Stuy, part of which included this comment: "There's a lot of people that do a lot worse in Stuy. There's people that smoke weed, people that do drugs. True, it's unethical, it's an extreme breach of academic integrity, and it's at an elite school. It is bad, but I don't get how kicking you out would help anything."[48]

Discussion Questions

1. One student said that the lines got "blurry" and that's why they cheated. What did the student mean, and what have you read in Unit I that might help this student with his take on the situation at the school?
2. Is it possible to act unethically to reach a goal and then change behaviors once the goal is reached?
3. What advice would you give to the administrators of the school in order to help them curb cheating?

Case 1.18

Speeding: You Can't Survive on the Road unless You Do

The shifted norm referred to in the readings means that we have an acceptable level of conduct beyond what laws and regulations require. For example, the North Carolina State Troopers have a motto or speeding ticket philosophy that goes, "Nine you're fine; ten you're mine."

[44] Robert Kolker, "Cheating Upwards," *New York Magazine*, September 16, 2012, http://nymag.com/news/features/cheating-2012-9/.

[45] Yee, *supra* note 8.

[46] *Id.*, Yee, *supra* note 8.

[47] Robert Kolker, "Cheating Upwards," *New York Magazine*, September 16, 2012, http://nymag.com/news/features/cheating-2012-9/.

[48] *Id.*

On the television show *Speeders*, the camera follows the reaction of drivers who are pulled over for speeding. One woman who was caught speeding on "Gator Alley," aka "Alligator Alley," aka I-75, in Florida, asked the officer who had pulled her over what the speed limit was. When he explained that it was 70 mph, she then asked how fast she was going, and the officer responded, "Eighty-five." The woman then exclaimed, "That's not speeding. Look at all these cars going by. They are going faster than that!" She was relying on the shifted norm as a defense to exceeding the speed limit.

There are other reasons that we give for speeding:

- I am in a hurry and can get there faster.
- The speed limit is arbitrary and has nothing to do with safety.
- If I don't go with the flow and exceed the speed limit, I present a danger to other drivers.
- It is much safer to just keep up with traffic.

Discussion Questions

1. Think of a response to each of the reasons drivers give for speeding.
2. What are the risks in speeding? Consider who is affected by your speeding.
3. Two police officers were caught on photo radar traveling (in their police cars, but not with sirens on) at 72 and 76 mph. The two officers were issued tickets. The policy of the police department was to require the officers to pay their own tickets when caught speeding on the job (when the sirens are not on, obviously) and to disclose the citations and officers' names to the public. When the media confronted the officers about speeding on the job, one responded, "We thought the speed limit was 65 mph." The speed limit was 65 mph normally in the photo-radar segment of the freeway, but construction work had it reduced to a 55 mph rate.

   As you think about this simple example of speeding, ask yourself whether in your business or personal life there might be other areas where you are speeding but the normative standards have shifted.
4. Consider these thoughts from a former student:

   You briefly cited an example of following the traffic laws, and the members of the class took it quite out of proportion, and indeed the general reaction turned out to be one of rationalizing. But something about what you said really caused me to consider that subject and, within those five minutes of discussion, form a resolve. You see, I had always been an exceedingly excessive speeder, to the point where, if caught, I could get in *big* trouble. This always surprised people to find out about me, but I think it developed in my first year at ASU, when I had an hour commute to campus. Regardless, I terrified everyone but myself. But when you said of speeding, "Is it ethical?" it really took me aback. I looked at the fact of it itself: it is a law to follow the speed regulations, which are in place for safety and order. I looked at myself: someone who wants to be able to be ethical in all things and for all of her life. I realized that if I give room for allowances on what *I know* is wrong, then how can I know that those *allowances* won't grow? I could not allow it. And in those five minutes, when the class was going on about photo radar, I grasped an understanding of my speeding that had previously escaped me: it's just not ethical.

   It has now been five months from that day, and I can report that for five months I have not exceeded the posted speed limit. It is something of which I am constantly aware, and though I often rely on my cruise control, I have seen that choosing to be ethical, has given me strength to overcome other questions and situations. There have also been moments, as simple as that of peacefully coming to a stop at a red light, where I have been impressed with the thoughts, "That could have been a dangerous situation, but because you chose to follow the standards you are safe." I also notice that, though I may be running late or excited to get somewhere, I just have no desire to speed, and things, occurrences on the road, or actions by other drivers that may have previously upset me have no effect on me, maybe aside from chuckling at a reaction I may have seen myself having before. So I say thank you for your words and lessons, for I have seen a change in myself and a change in my life.

   What message does this student have for you?

Case 1.19

Hazing, Drinking, and Campuses

Florida A&M's marching band has performed at everything from football games to presidential inaugurations. Since 1945, the band has been known for its precision and inspiring routines. Some call the band the best in the country. However, for the past twenty years, the band often percolates into the news because of injuries to its member that result from hazing—something that appears to be a part of the band's culture. The hazing consists of paddling, kicking, and beating those who want to be part of the "Marching 100." Several years ago, one target of the hazing experienced kidney failure. The university settled with the student who experienced the kidney failure, and he recovered $1.8 million from other defendants who were named in his suit.

The hazing appears to be a ritual that band members go through in order to earn the right to ride in the charter, or "C," bus. In this ritual, known as "Crossing Bus C," the potential band member walks up and down the aisle of the "C" bus as the band members hit and attack new band members.

On November 19, 2011, Bria Shante Hunter and Robert Champion were beaten on the "C" bus after the band had performed for a game in Orlando. Ms. Hunter's thigh was broken during the hazing ritual, and Robert Champion died.[49] An autopsy report released on December 16, 2011, indicates that Mr. Champion's death was a homicide. The autopsy concludes that Mr. Champion died within one hour of the hazing due to internal bleeding that was caused by blunt-force trauma. Mr. Champion had bruises on his chest, back, shoulders, and arms. The death was declared a homicide, and an investigation by the sheriff's department began. Eventually two former band members were charged with manslaughter in connection with the death, eleven others were charged, and two of those former band members have already entered guilty pleas to lesser charges including the crime of hazing that results in death. Eleven face felony charges and two were charged with misdemeanors. The state attorney who announced the charges called what happened "homicide by hazing."[50]

The university canceled all band appearances and suspended its leader for one year. Four students who were believed to have been involved in the Champion hazing were suspended but have since been reinstated. Following the filing of a suit by Mr. Campion's parents against the university, the president resigned along with the band's director. The suit continues its progress through the courts after Mr. Campion's parents rejected a $300,000 settlement offer from Florida A&M.

Since the time of the Mr. Campion's death, there have been at least two additional hazing incidents involved band members. The university forced the faculty members responsible for oversight of the band to resign and has expelled four students. Eventually, the band was suspended for a season, and the university formed an anti-hazing committee and set up a $50,000 research fund for faculty members to study hazing on the campus, including its nature and extent.

The charges in the Florida A&M case were based on a statute passed in 2005 that makes it easier for prosecutors to treat hazing as a felony. That statute was passed as the result of the drowning death of a college student during a fraternity initiation event that involved drinking. There is current legal activity surrounding the hazing criminal statutes as well as litigation against colleges and universities for their failures to control hazing deaths. Those hazing deaths generally involve activities of fraternities and often

[49] Larry Copeland and Yamiche Alcindor, "Persistent Culture of Hazing Mars Marching Bands' Glamour," *USA Today*, December 16, 2011, p. 3A.

[50] Robbie Brown, "Criminal Charges for 13 in Florida A&M Hazing Death," *New York Times*, May 2, 2012, p. A3.

involve alcohol that results when those being initiated are forced to drink large amounts of alcohol in a short period of time. Traditionally, the courts have not held colleges and universities liable for injuries and deaths that result from the activities of organizations that are not run by the colleges or universities. However, the extent of hazing deaths has caused a number of courts to re-examine that immunity from liability.[51] Professor Andrew R. Klein has explained, "Institutions are going to need to understand that there could be greater consequences for their failure to more actively engage in the behavior of institutions that are on university-owned property."[52]

In one case in Indiana, eighteen-year-old Wabash College freshman Brian Yost and his fraternity pledge brothers decided to throw an upperclassman brother in a nearby creek to celebrate his twenty-first birthday. Afterward, they tried to do the same thing to two other upperclassman brothers, but they were unsuccessful. Shortly thereafter, four upperclassman brothers decided to carry Mr. Yost to the shower and run water on him. On the way to the bathroom, upperclassman Nathan Cravens joined the group and placed Mr. Yost in a chokehold. Yost went limp, and the brothers dropped him on the floor. He suffered physical and mental injuries and had to withdraw from school. Mr. Yost has filed suit against the national fraternity as well as Wabash College. The case is pending before the Indiana Supreme Court.

Discussion Questions

1. What are the ethical categories in hazing?
2. Why is the significance of holding colleges and universities liable for hazing? Is there an ethical category that applies to their conduct or involvement in these hazing cases?
3. What is the role of the bystanders in these situations—those who are not involved but stand by and do nothing to stop the harmful conduct?

Case 1.20

The Pack of Gum

You have just purchased $130 of groceries. Upon returning home you discover that you did not pay for a pack of gum you picked up from the assortment of gums and mints at the checkout belt at the grocery store. You have the gum, but it is not on your receipt.

Discussion Questions

1. Would you take the gum back?
2. Should you take the gum back?

[51] *Yost v. Wabash College*, 976 N.E.2d 724 (Ind. App. 2012) and 984 N.E.2d 221 (Ind. 2013).

[52] Tim Evans," Wabash College Lawsuit Raises Questions About Who Polices Fraternity Hazing," *Indystar.com*, April 17, 2013, http://www.indystar.com/article/20130416/NEWS/304160115/Wabash-College-lawsuit-raises-questions-about-who-polices-fraternity-hazing.

Solving Ethical Dilemmas and Personal Introspection

UNIT TWO

Ability may get you to the top, but it takes character to keep you there.

—The late John Wooden, former basketball coach, UCLA

A person with an ethical mind asks, "If all workers in my profession … did what I do, what would the world be like?"

—Professor Howard Gardner, Harvard University

The study of business ethics is not the study of what is legal, but of the application of ethics to business decisions. For example, regardless of legislative and regulatory requirements, most of us are committed to safety and fairness for employees in the workplace. But what happens when you have met legal and regulatory standards, yet advocacy groups are demanding more?

Employees also have certain ethical standards, such as following instructions, doing an honest day's work for a day's pay, and being loyal to their employers. But what happens when their employers are producing products that, because of inadequate testing, will be harmful to users? When does their loyalty end if there is a safety issue? To whom do employees turn if employers reject them and their concerns about the products?

Businesses, consumers, and employees too often subscribe to the "What's good for GM is good for the country" theory of business ethics. Jeff Dachis, the founder and former CEO of Razorfish, once said when he was questioned about the lack of independence on his board, "My partner and I control 10 percent of the company. What's good for me is good for all shareholders. Management isn't screwing up. We've created enormous shareholder value."[1] He spoke when his stock was worth $56 in June 1999. In May 2001, when he added three independent directors to his board and resigned as CEO, Razorfish stock was trading at $1.11 per share. No one at Razorfish did anything illegal, but it is the presence of perspective in a company through its board and also through the analytical framework of ethics that may save a company from its hubris. Businesses have now begun to realize that even though Sir Alfred Coke alleges that a corporation has no conscience, the corporation must develop one. That conscience develops as firms and the individuals within them develop perspective on and guidelines for their respective conduct.

How does a business behave when the law does not dictate its conduct or the law permits conduct that might benefit shareholders but is harmful to others? And what do businesspeople do when their personal values conflict with what's in the best interest of their companies? We may think that lobbyists are antithetical to democracy; but without lobbyists business and industry would not be represented in legislative matters. This unit deals with the overlapping ethical issues—those that affect us personally *and* in our business lives. From Carr to Drucker, you have the opportunity to explore what some of the best minds in the field of business and society have offered in thinking about ethics and business.

This unit has three parts. Section A defines business ethics and offers some insights into how business and personal ethics work together. Section B delves into the psychological factors that affect us as we work in a business setting: What gets in the way of effective ethical analysis in business? Section B also provides an important discussion of the reality of pressure at work: What gets in the way of ethics in business? Section C gives you the chance to understand a structured approach for analyzing ethical dilemmas and includes cases to help you apply all that you have learned about analysis, categories, rationalizations, and the reality of pressures in business.

[1] Erick Schonfeld, "Doing Business the Dot-Com Way," *Fortune*, March 20, 2000, p. 116.

SECTION A

Business and Ethics: How Do They Work Together?

Reading 2.1

What's Different about Business Ethics?

Based on your readings in Unit 1, you understand that society recognizes the value of ethics. The cases in Unit 1 focused on individual conduct. But businesses are groups of individuals, and those individuals' ethical standards may not translate into a group setting. In addition, businesses are accountable to shareholders, creditors, and others who may be affected but are not always part of the business's decision processes and ethical analysis.

Businesses and managers also need a framework and process for ethical analysis. Some businesses simply adopt an ethical standard of following the law. "If it's legal, then it's ethical" is their standard. However, many actions well within the law still raise ethical issues. For example, the federal standard for slaughtering cows is that they must be "standers," that is, able to stand up as they enter the pens. If they are "downers," they cannot be put into the meat supply and must be euthanized. However, motivated not to lose those sunk costs in lost cattle, the employees at Hallmark/Westland Meat Packing Co. used water hoses, electric prods, and forklifts to get the cattle to their feet so that they could be slaughtered for meat. A Humane Society undercover video documented this interpretation of the "stander" regulation. The result was the largest recall of beef in the United States. The company was following a legal standard, but by not considering the intent of the regulation or looking beyond the immediate cost savings of getting more cattle into the meat supply, its analysis did not take into account the risk of diseased meat making its way into the meat supply. Just the discovery of Hallmark/Westland's operations resulted in a shutdown of the company's operations. The plant has reopened under new ownership and is now called American Beef Packers. (See Case 4.17 for more information.) The defense of compliance with the law ignores the underlying ethical issues and the resulting risk. In other words, the company was not walking through the categories, rationalizations, and analytical steps you studied in Unit 1.

Ethical decisions require businesses to look beyond compliance. There will always be a loophole, as you studied in the discussion "It's a gray area" in Unit 1. But as you will see throughout the remainder of this unit and the book, those loopholes are temporary and risky. A standard of legal compliance is akin to a pilot shaving the treetops of legal boundaries. As military pilots advise, "You can only tie the record for low-altitude flying." Asking whether conduct is legal is but one part of an ethical analysis.

Businesses have other factors at play in ethical dilemmas, beyond just the personal introspection you studied in Unit 1. There are organizational behavior factors such as performance and incentive plans. For example, at Hallmark/Westland, the manager of the cattle pens told police that he had to meet a quota of 500 cattle per day for slaughter.[2] Those performance pressures have to be factored in as you make business decisions. The issue would be clear to us in the laboratory setting of the classroom because our job, bonus, retention, or

[2] David Kesmodel, "Oversight Flaw Led to Meat Recall," *Wall Street Journal*, March 11, 2008, p. B1.

promotion is not on the line. Business decisions are made in the midst of economic pressures that must be studied and understood in order to analyze an ethical issue completely.

Discussion Questions

1. Think of something that you did at work in the past year that still bothers you. For example, one manager wrote, "I disagreed with a performance evaluation of an employee, but I didn't speak up." Another wrote, "I let someone else take the blame for something I did." Fit these actions and your own example into one of the categories of ethical dilemmas in Unit 1. Then think through the reasons that you and these managers did something that later bothered you.
2. Now think of something you did in your personal life in the past year that still bothers you. For example, one student wrote, "I lied to relatives on the phone so that they wouldn't come and visit." Another wrote, "I filled out an insurance form for a friend who had his bike stolen. I had sold it to him for $150, and he asked me to put down that I had sold it to him for $250 so that the insurance company would pay him enough to get a new bike to replace it." Again, think through the categories that apply as well as the reasons for doing these things.
3. As you think through your bothersome business and personal actions, decide whether ethics in our personal lives and business lives are really different.

Reading 2.2

The Ethics of Responsibility[3]

Peter Drucker

Countless sermons have been preached and printed on the ethics of business or the ethics of the businessman. Most have nothing to do with business and little to do with ethics.

One main topic is plain, everyday honesty. Businessmen, we are told solemnly, should not cheat, steal, lie, bribe, or take bribes. But nor should anyone else. Men and women do not acquire exemption from ordinary rules of personal behavior because of their work or job. Nor, however, do they cease to be human beings when appointed vice-president, city manager, or college dean. And there has always been a number of people who cheat, steal, lie, bribe, or take bribes. The problem is one of moral values and moral education, of the individual, of the family, of the school. But there neither is a separate ethics of business, nor is one needed.

All that is needed is to mete out stiff punishments to those—whether business executives or others—who yield to temptation. In England a magistrate still tends to hand down a harsher punishment in a drunken-driving case if the accused has gone to one of the well-known public schools or to Oxford or Cambridge. And the conviction still rates a headline in the evening paper: "Eton graduate convicted of drunken driving." No one expects an Eton education to produce temperance leaders. But it is still a badge of distinction, if not privilege. And not to treat a wearer of such a badge more harshly than an ordinary workingman who has had one too many would offend the community's sense of justice. But no one considers this a problem of the "ethics of the Eton graduate."

The other common theme in the discussion of ethics in business has nothing to do with ethics.

Such things as the employment of call girls to entertain customers are not matters of ethics but matters of esthetics. "Do I want to see a pimp when I look at myself in the mirror while shaving?" is the real question.

The first responsibility of a professional was spelled out clearly 2,500 years ago, in the Hippocratic oath of the Greek physician: *Primum non nocere*: "Above all, not knowingly to do harm."

[3] From Peter F. Drucker, *Management: Tasks, Responsibilities, Practices* (New York: Harper & Row, 1974), pp. 366–367. Copyright © 1973, 1974 by Peter F. Drucker. Reprinted by permission of HarperCollins Publishers Inc.

No professional, be he doctor, lawyer, or manager, can promise that he will indeed do good for his client. All he can do is try. But he can promise that he will not knowingly do harm.

Discussion Questions

1. Does Dr. Drucker believe personal ethics and business ethics can be separated?
2. What is the Drucker test for ethics for business managers?

Reading 2.3

Is Business Bluffing Ethical?[4]

Albert Z. Carr

In the following classic reading, Albert Carr compares business to poker and offers a justification for business bluffing. Mr. Carr provides a different perspective from the previous discussion with its various models and categories geared more toward absolutes.

A respected businessman with whom I discussed the theme of this article remarked with some heat, "You mean to say you're going to encourage men to bluff? Why, bluffing is nothing more than a form of lying! You're advising them to lie!"

I agreed that the basis of private morality is a respect for truth and that the closer a businessman comes to the truth, the more he deserves respect. At the same time, I suggested that most bluffing in business might be regarded simply as game strategy—much like bluffing in poker, which does not reflect on the morality of the bluffer.

I quoted Henry Taylor, the British statesman who pointed out that "falsehood ceases to be falsehood when it is understood on all sides that the truth is not expected to be spoken"—an exact description of bluffing in poker, diplomacy, and business. I cited the analogy of the criminal court, where the criminal is not expected to tell the truth when he pleads "not guilty." Everyone from the judge down takes it for granted that the job of the defendant's attorney is to get his client off, not to reveal the truth; and this is considered ethical practice. I mentioned Representative Omar Burleson, the Democrat from Texas, who was quoted as saying, in regard to the ethics of Congress, "Ethics is a barrel of worms"[5]—a pungent summing up of the problem of deciding who is ethical in politics.

I reminded my friend that millions of businessmen feel constrained every day to say *yes* to their bosses when they secretly believe *no* and that this is generally accepted as permissible strategy when the alternative might be the loss of a job. The essential point, I said, is that the ethics of business are games ethics, different from the ethics of religion.

> "He remained unconvinced. Referring to the company of which he is president, he declared: "Maybe that's good enough for some businessmen, but I can tell you that we pride ourselves on our ethics. In thirty years not one customer has ever questioned my word or asked to check our figures. We're loyal to our customers and fair to our suppliers. I regard my handshake on a deal as a contract. I've never entered into price-fixing schemes with my competitors. I've never allowed my salesmen to spread injurious rumors about other companies. Our union contract is the best in our industry. And, if I do say so myself, our ethical standards are of the highest!"

He really was saying, without realizing it, that he was living up to the ethical standards of the business game—which are a far cry from those of private life. Like a

[4] From Albert Z. Carr, "Is Business Bluffing Ethical?" *Harvard Business Review*, 46 (January/February 1968), pp. 2–8. Copyright © 1968 by the Harvard Business School Publishing Corporation; all rights reserved.

[5] *The New York Times*, March 9, 1967.

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gentlemanly poker player, he did not play in cahoots with others at the table, try to smear their reputations, or hold back chips he owed them.

But this same fine man, at that very time, was allowing one of his products to be advertised in a way that made it sound a great deal better than it actually was. Another item in his product line was notorious among dealers for its "built-in-obsolescence." He was holding back from the market a much-improved product because he did not want it to interfere with sales of the inferior item it would have replaced. He had joined with certain of his competitors in hiring a lobbyist to push a state legislature, by methods that he preferred not to know too much about, into amending a bill then being enacted.

In his view these things had nothing to do with ethics; they were merely normal business practice. He himself undoubtedly avoided outright falsehoods—never lied in so many words. But the entire organization that he ruled was deeply involved in numerous strategies of deception.

Pressure to Deceive

Most executives from time to time are almost compelled, in the interest of their companies or themselves, to practice some form of deception when negotiating with customers, dealers, labor unions, government officials or even other departments of their companies. By conscious misstatements, concealment of pertinent facts, or exaggeration—in short, by bluffing—they seek to persuade others to agree with them. I think it is fair to say that if the individual executive refuses to bluff from time to time—if he feels obligated to tell the truth, the whole truth, and nothing but the truth—he is ignoring opportunities permitted under the rules and is at a heavy disadvantage in his business dealings.

But here and there a businessman is unable to reconcile himself to the bluff in which he plays a part. His conscience, perhaps spurred by religious idealism, troubles him. He feels guilty; he may develop an ulcer or a nervous tic. Before any executive can make profitable use of the strategy of the bluff, he needs to make sure that in bluffing he will not lose self-respect or become emotionally disturbed. If he is to reconcile personal integrity and high standards of honesty with the practical requirements of business, he must feel that his bluffs are ethically justified. The justification rests on the fact that business, as practiced by individuals as well as by corporations, has the impersonal character of a game—a game that demands both special strategy and an understanding of its special ethics.

The game is played at all levels of corporate life, from the highest to the lowest. At the very instant that a man decides to enter business, he may be forced into a game situation, as is shown by the recent experience of a Cornell honor graduate who applied for a job with a large company.

This applicant was given a psychological test which included the statement, "Of the following magazines, check any that you have read either regularly or from time to time, and double-check those which interest you most. *Reader's Digest, Time, Fortune, Saturday Evening Post, The New Republic, Life, Look, Ramparts, Newsweek, Business Week, U.S. News & World Report, The Nation, Playboy, Esquire, Harper's, Sports Illustrated.*"

His tastes in reading were broad, and at one time or another he had read almost all of these magazines. He was a subscriber to *The New Republic*, an enthusiast for *Ramparts*, and an avid student of the pictures in *Playboy*. He was not sure whether his interest in *Playboy* would be held against him, but he had a shrewd suspicion that if he confessed to an interest in *Ramparts* and *The New Republic*, he would be thought a liberal, a radical, or at least an intellectual, and his chances of getting the job, which he needed, would greatly diminish. He therefore checked five of the more conservative magazines. Apparently it was a sound decision, for he got the job.

He had made a game player's decision, consistent with business ethics.

A similar case is that of a magazine space salesman who, owing to a merger, suddenly found himself out of a job:

> This man was 58, and, in spite of a good record, his chance of getting a job elsewhere in a business where youth is favored in hiring practice was not good. He was a vigorous, healthy man, and only a considerable amount of gray in his hair suggested his age. Before beginning his job search he touched up his hair with a black dye to confine the gray to his temples. He knew that the truth about his age might well come out in time, but he calculated that he could deal with that situation when it arose. He and his wife decided that he could easily pass for 45, and he so stated his age on his résumé.

This was a lie, yet within the accepted rules of the business game, no moral culpability attaches to it.

The Poker Analogy

We can learn a good deal about the nature of business by comparing it with poker. Although both have a large element of chance, in the long run the winner is the person who plays with steady skill. In both games ultimate victory requires intimate knowledge of the rules, insight into the psychology of the other players, a bold front, a considerable amount of self-discipline, and the ability to respond swiftly and effectively to opportunities provided by chance.

No one expects poker to be played on the ethical principles preached in churches. In poker it is right and proper to bluff a friend out of the rewards of being dealt a good hand. A player feels no more than a slight twinge of sympathy, if that, when—with nothing better than a single ace in his hand—he strips a heavy loser, who holds a pair, of the rest of his chips. It was up to the other fellow to protect himself. In the words of an excellent poker player, former President Harry Truman, "If you can't stand the heat, stay out of the kitchen." If one shows mercy to a loser in poker, it is a personal gesture, divorced from the rules of the game.

Poker has its special ethics, and here I am not referring to rules against cheating. The man who keeps an ace up his sleeve or who marks the cards is more than unethical; he is a crook, and can be punished as such—kicked out of the game or, in the Old West, shot.

In contrast to the cheat, the unethical poker player is one who, while abiding by the letter of the rules, finds ways to put the other players at an unfair disadvantage. Perhaps he unnerves them with loud talk. Or he tries to get them drunk. Or he plays in cahoots with someone else at the table. Ethical poker players frown on such tactics.

Poker's own brand of ethics is different from the ethical ideals of civilized human relationships. The game calls for distrust of the other fellow. It ignores the claim of friendship. Cunning deception and concealment of one's strength and intentions, not kindness and openheartedness, are vital in poker. No one thinks any the worse of poker on that account. And no one should think any the worse of the game of business because its standards of right and wrong differ from the prevailing traditions of morality in our society.

Discard the Golden Rule

This view of business is especially worrisome to people without much business experience. A minister of my acquaintance once protested that business cannot possibly function in our society unless it is based on the Judeo-Christian system of ethics. He told me:

> "I know some businessmen have supplied call girls to customers, but there are always a few rotten apples in every barrel. That doesn't mean the rest of the fruit isn't sound. Surely the vast majority of businessmen are ethical. I myself am acquainted with many who adhere to strict codes of ethics based fundamentally on religious teachings. They contribute to good causes. They participate in community activities. They cooperate with other companies to improve working conditions in their industries. Certainly they are not indifferent to ethics."

That most businessmen are not indifferent to ethics in their private lives, everyone will agree. My point is that in their office lives they cease to be private citizens; they become game players who must be guided by a somewhat different set of ethical standards.

The point was forcefully made to me by a Midwestern executive who has given a good deal of thought to the question:

> "So long as a businessman complies with the laws of the land and avoids telling malicious lies, he's ethical. If the law as written gives a man a wide-open chance to make a killing, he'd be a fool not to take advantage of it. If he doesn't, somebody else will. There's no obligation on him to stop and consider who is going to get hurt. If the law says he can do it, that's all the justification he needs. There's nothing unethical about that. It's just plain business sense."

This executive (call him Robbins) took the stand that even industrial espionage, which is frowned on by some businessmen, ought not to be considered unethical. He recalled a recent meeting of the National Industrial Conference Board where an authority on marketing made a speech in which he deplored the employment of spies by business organizations. More and more companies, he pointed out, find it cheaper to penetrate the secrets of competitors with concealed cameras and microphones or by bribing employees than to set up costly research and design departments of their own. A whole branch of the electronics industry has grown up with this trend, he continued, providing equipment to make industrial espionage easier.

Disturbing? The marketing expert found it so. But when it came to a remedy, he could only appeal to "respect for the golden rule." Robbins thought this a confession of defeat, believing that the golden rule, for all its value as an ideal for society, is simply not feasible as a guide for business. A good part of the time the businessman is trying to do unto others as he hopes others will not do unto him.[6] Robbins continued:

> "Espionage of one kind or another has become so common in business that it's like taking a drink during Prohibition—it's not considered sinful. And we don't even have Prohibition where espionage is concerned; the law is very tolerant in this area. There's no more shame for a business that uses a secret agent than there is for a nation. Bear in mind that there already is at least one large corporation—you can buy its stock over the counter—that makes millions by providing counterespionage service to industrial firms. Espionage in business is not an ethical problem; it's an established technique of business competition."

"We Don't Make the Laws."

Wherever we turn in business, we can perceive the sharp distinction between its ethical standards and those of the churches. Newspapers abound with sensational stories growing out of this distinction:

1. We read one day that Senator Philip A. Hart of Michigan has attacked food processors for deceptive packaging of numerous products.[7]

[6] See Bruce D. Henderson, "Brinkmanship in Business," *Harvard Business Review*, March–April 1967, p. 49.

[7] *The New York Times*, November 21, 1966.

2. The next day there is a congressional to-do over Ralph Nader's book *Unsafe At Any Speed,* which demonstrates that automobile companies for years have neglected the safety of car-owning families.[8]
3. Then another Senator, Lee Metcalf of Montana, and journalist Vic Reinemer show in their book, *Overcharge*, the methods by which utility companies elude regulating government bodies to extract unduly large payments from users of electricity.[9]

These are merely dramatic instances of a prevailing condition; there is hardly a major industry at which a similar attack could not be aimed. Critics of business regard such behavior as unethical, but the companies concerned know that they are merely playing the business game.

Among the most respected of our business institutions are the insurance companies. A group of insurance executives meeting recently in New England was startled when their guest speaker, social critic Daniel Patrick Moynihan, roundly berated them for "unethical" practices. They had been guilty, Moynihan alleged, of using outdated actuarial tables to obtain unfairly high premiums. They habitually delayed the hearings of lawsuits against them in order to tire out the plaintiffs and win cheap settlements. In their employment policies they used ingenious devices to discriminate against certain minority groups.[10]

It was difficult for the audience to deny the validity of these charges. But these men were business game players. Their reaction to Moynihan's attack was much the same as that of the automobile manufacturers to Nader, of the utilities to Senator Metcalf, and of the food processors to Senator Hart. If the laws governing their businesses change, or if public opinion becomes clamorous, they will make the necessary adjustments. But morally they have, in their view, done nothing wrong. As long as they comply with the letter of the law, they are within their rights to operate their businesses as they see fit.

The small business is in the same position as the great corporation in this respect. For example:

> In 1967 a key manufacturer was accused of providing master keys for automobiles to mail-order customers, although it was obvious that some of the purchasers might be automobile thieves. His defense was plain and straightforward. If there was nothing in the law to prevent him from selling his keys to anyone who ordered them, it was not up to him to inquire as to his customers' motives. Why was it any worse, he insisted, for him to sell car keys by mail than for mail-order houses to sell guns that might be used for murder? Until the law was changed, the key manufacturer could regard himself as being just as ethical as any other businessman by the rules of the business game.[11]

Violations of the ethical ideals of society are common in business, but they are not necessarily violations of business principles. Each year the Federal Trade Commission orders hundreds of companies, many of them of the first magnitude, to "cease and desist" from practices which, judged by ordinary standards, are of questionable morality but which are stoutly defended by the companies concerned.

In one case, a firm manufacturing a well-known mouth-wash was accused of using a cheap form of alcohol possibly deleterious to health. The company's chief executive, after testifying in Washington, made this comment privately:

> We broke no law. We're in a highly competitive industry. If we're going to stay in business, we have to look for profit wherever the law permits. We don't make the laws. We obey them. Then why do we have

[8] Ralph Nader, *Unsafe at Any Speed: The Designed-in Dangers of the American Automobile* (1965).

[9] U.S. Senator Lee Metcalf and Vic Reinemer, *Overcharge: How Electric Utilities Exploit and Mislead the Public, and What You Can Do About It* (1967).

[10] *The New York Times*, January 17, 1967.

[11] Cited by Ralph Nader in "Business Crime," *The New Republic*, July 1, 1967, p. 7.

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> to put up with this "holier than thou" talk about ethics? It's sheer hypocrisy. We're not in business to promote ethics. Look at the cigarette companies, for God's sake! If the ethics aren't embodied in the laws by the men who made them, you can't expect businessmen to fill the lack. Why, a sudden submission to Christian ethics by businessmen would bring about the greatest economic upheaval in history!

It may be noted that the government failed to prove its case against him.

Cast Illusions Aside

Talk about ethics by businessmen is often a thin decorative coating over the hard realities of the game:

> Once I listened to a speech by a young executive who pointed to a new industry code as proof that his company and its competitors were deeply aware of their responsibilities to society. It was a code of ethics, he said. The industry was going to police itself, to dissuade constituent companies from wrongdoing. His eyes shone with conviction and enthusiasm.
>
> The same day there was a meeting in a hotel room where the industry's top executives met with the "czar" who was to administer the new code, a man of high repute. No one who was present could doubt their common attitude. In their eyes the code was designed primarily to forestall a move by the federal government to impose stern restrictions on the industry. They felt that the code would hamper them a good deal less than new federal laws would. It was, in other words, conceived as a protection for the industry, not for the public.
>
> The young executive accepted the surface explanation of the code; these leaders, all experienced game players, did not deceive themselves for a moment about its purpose.

The illusion that business can afford to be guided by ethics as conceived in private life is often fostered by speeches and articles containing such phrases as, "It pays to be ethical," or, "Sound ethics is good business." Actually this is not an ethical position at all; it is a self-serving calculation in disguise. The speaker is really saying that in the long run a company can make more money if it does not antagonize competitors, suppliers, employees, and customers by squeezing them too hard. He is saying that oversharp policies reduce ultimate gains. That is true, but it has nothing to do with ethics. The underlying attitude is much like that in the familiar story of the shopkeeper who finds an extra twenty-dollar bill in the cash register, debates with himself the ethical problem—should he tell his partner?—and finally decides to share the money because the gesture will give him an edge over the s.o.b. the next time they quarrel.

I think it is fair to sum up the prevailing attitude of businessmen on ethics as follows:

> We live in what is probably the most competitive of the world's civilized societies. Our customs encourage a high degree of aggression in the individuals striving for success. Business is our main area of competition, and it has been ritualized into a game of strategy. The basic rules of the game have been set by the government, which attempts to detect and punish business frauds. But as long as a company does not transgress the rules of the game set by law, it has the legal right to shape its strategy without reference to anything but its profits. If it takes a long-term view of its profits, it will preserve amicable relations, so far as possible, with those with whom it deals. A wise businessman will not seek advantage to the point where he generates dangerous hostility among employees, competitors, customers, government, or the public at large. But decisions in this area are, in the final test, decisions of strategy, not of ethics.

The Individual and the Game

An individual within a company often finds it difficult to adjust to the requirements of the business game. He tries to preserve his private ethical standards in situations that call for game strategy. When he is obliged to carry out company policies that challenge his conception of himself as an ethical man, he suffers.

It disturbs him when he is ordered, for instance, to deny a raise to a man who deserves it, to fire an employee of long standing, to prepare advertising that he believes to be misleading, to conceal facts that he feels customers are entitled to know, to cheapen the quality of materials used in the manufacture of an established product, to sell as new a product that he knows to be rebuilt, to exaggerate the curative powers of a medicinal preparation, or to coerce dealers.

There are some fortunate executives who, by the nature of their work and circumstances, never have to face problems of this kind. But in one form or another the ethical dilemma is felt sooner or later by most businessmen. Possibly the dilemma is most painful not when the company forces the action on the executive but when he originates it himself—that is, when he has taken or is contemplating a step which is in his own interest but which runs counter to his early moral conditioning. To illustrate:

- The manager of an export department, eager to show rising sales, is pressed by a big customer to provide invoices which, while containing no overt falsehood that would violate a U.S. law, are so worded that the customer may be able to evade certain taxes in his homeland.
- A company president finds that an aging executive, within a few years of retirement and his pension, is not as productive as formerly. Should he be kept on?
- The produce manager of a supermarket debates with himself whether to get rid of a lot of half-rotten tomatoes by including one, with its good side exposed, in every tomato six-pack.
- An accountant discovers that he has taken an improper deduction on his company's tax return and fears the consequences if he calls the matter to the president's attention, though he himself has done nothing illegal. Perhaps if he says nothing, no one will notice the error.
- A chief executive officer is asked by his directors to comment on a rumor that he owns stock in another company with which he has placed large orders. He could deny it, for the stock is in the name of his son-in-law and he has earlier formally instructed his son-in-law to sell the holding.

Temptations of this kind constantly arise in business. If an executive allows himself to be torn between a decision based on business considerations and one based on his private ethical code, he exposes himself to a grave psychological strain.

This is not to say that sound business strategy necessarily runs counter to ethical ideals. They may frequently coincide; and when they do, everyone is gratified. But the major tests of every move in business, as in all games of strategy, are legality and profit. A man who intends to be a winner in the business game must have a game player's attitude.

The business strategist's decisions must be as impersonal as those of a surgeon performing an operation—concentrating on objective and technique, and subordinating personal feelings. If the chief executive admits that his son-in-law owns the stock, it is because he stands to lose more if the fact comes out later than if he states it boldly and at once. If the supermarket manager orders the rotten tomatoes to be discarded, he does so to avoid an increase in consumer complaints and a loss of goodwill. The company president decides not to fire the elderly executive in the belief that the negative reaction of other employees would in the long run cost the company more than it would lose in keeping him and paying his pension.

All sensible businessmen prefer to be truthful, but they seldom feel inclined to tell the *whole* truth. In the business game truth-telling usually has to be kept within narrow limits if trouble is to be avoided. The point was neatly made a long time ago (in 1888) by one of John D. Rockefeller's associates, Paul Babcock, to Standard Oil Company executives who were about to testify before a government investigating committee: "Parry

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every question with answers which, while perfectly truthful, are evasive of bottom facts."[12]

This was, is, and probably always will be regarded as wise and permissible business strategy.

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An executive's family life can easily be dislocated if he fails to make a sharp distinction between the ethical systems of the home and the office—or if his wife does not grasp that distinction. Many a businessman who has remarked to his wife, "I had to let Jones go today" or "I had to admit to the boss that Jim has been goofing off lately," has been met with an indignant protest. "How could you do a thing like that? You know Jones is over 50 and will have a lot of trouble getting another job." Or "You did that to Jim? With his wife ill and the all the worry she's been having with the kids?"

If the executive insists that he had no choice because the profits of the company and his own security were involved, he may see a certain cool and ominous reappraisal in his wife's eyes. Many wives are not prepared to accept the fact that business operates with a special code of ethics. An illuminating illustration of this comes from a Southern sales executive who related a conversation he had had with his wife at a time when a hotly contested political campaign was being waged in their state:

> "I made the mistake of telling her that I had had lunch with Colby, who gives me about half my business. Colby mentioned that his company had a stake in the election. Then he said, 'By the way, I'm treasurer of the citizens' committee for Lang. I'm collecting contributions. Can I count on you for a hundred dollars?'
>
> "Well, there I was. I was opposed to Lang, but I knew Colby. If he withdrew his business, I could be in a bad spot. So I just smiled and wrote out a check then and there. He thanked me, and we started to talk about his next order. Maybe he thought I shared his political views. If so, I wasn't going to lose any sleep over it.
>
> "I should have had sense enough not to tell Mary about it. She hit the ceiling. She said she was disappointed in me. She said I hadn't acted like a man, that I should have stood up to Colby.
>
> "I said, 'Look, it was an either–or situation. I had to do it or risk losing the business.'
>
> "She came back at me with, 'I don't believe it. You could have been honest with him. You could have said that you didn't feel you ought to contribute to a campaign for a man you weren't going to vote for. I'm sure he would have understood.'
>
> "I said, 'Mary, you're a wonderful woman, but you're way off the track. Do you know what would have happened if I had said that? Colby would have smiled and said, "Oh, I didn't realize. Forget it." But in his eyes from that moment I would be an oddball, maybe a bit of a radical. He would have listened to me talk about his order and would have promised to give it consideration. After that I wouldn't hear from him for a week. Then I would telephone and learn from his secretary that he wasn't yet ready to place the order. And in about a month I would hear through the grapevine that he was giving his business to another company. A month after that I'd be out of a job.'
>
> "She was silent for a while. Then she said, 'Tom, something is wrong with business when a man is forced to choose between his family's security and his moral obligation to himself. It's easy for me to say you should have stood up to him—but if you had, you might have felt you were betraying me and the kids. I'm sorry that you did it, Tom, but I can't blame you. Something is wrong with business!'"

[12] Babcock in a memorandum to Rockefeller (Rockefeller Archives).

This wife saw the problem in terms of moral obligation as conceived in private life; her husband saw it as a matter of game strategy. As a player in a weak position, he felt that he could not afford to indulge an ethical sentiment that might have cost him his seat at the table.

Playing to Win

Some men might challenge the Colbys of business—might accept serious setbacks to their business careers rather than risk a feeling of moral cowardice. They merit our respect—but as private individuals, not businessmen. When the skillful player of the business game is compelled to submit to unfair pressure, he does not castigate himself for moral weakness. Instead, he strives to put himself into a strong position where he can defend himself against such pressures in the future without loss.

If a man plans to take a seat in the business game, he owes it to himself to master the principles by which the game is played, including its special ethical outlook. He can then hardly fail to recognize that an occasional bluff may well be justified in terms of the game's ethics and warranted in terms of economic necessity. Once he clears his mind on this point, he is in a good position to match his strategy against that of the other players. He can then determine objectively whether a bluff in a given situation has a good chance of succeeding and can decide when and how to bluff, without a feeling of ethical transgression.

To be a winner, a man must play to win. This does not mean that he must be ruthless, cruel, harsh, or treacherous. On the contrary, the better his reputation for integrity, honesty, and decency, the better his chances of victory will be in the long run. But from time to time every businessman, like every poker player, is offered a choice between certain loss and bluffing within the legal rules of the game. If he is not resigned to losing, if he wants to rise in his company and industry, then in such a crisis he will bluff—and bluff hard.

Every now and then one meets a successful businessman who has conveniently forgotten the small or large deceptions that he practiced on his way to fortune. "God gave me my money," old John D. Rockefeller once piously told a Sunday school class. It would be a rare tycoon in our time who would risk the horse laugh with which such a remark would be greeted.

In the last third of the twentieth century even children are aware that if a man has become prosperous in business, he has sometimes departed from the strict truth in order to overcome obstacles or has practiced the more subtle deceptions of the half-truth or the misleading omission. Whatever the form of the bluff, it is an integral part of the game, and the executive who does not master its techniques is not likely to accumulate much money or power.

Discussion Questions

1. Do you agree or disagree with Carr's premise?
2. Does everyone operate at the same level of bluffing?
3. How is the phrase "Sound ethics is good business" characterized?

Compare & Contrast

Carr notes that espionage has become so common that it is no longer considered an ethical issue but an effective means of competition. Compare this comment with the list of rationalizations and apply them to the statement. What are the key differences in the two scholars' views on ethics in business? Then compare Dr. Drucker's simple means of analysis with Carr's views. Can Dr. Drucker's views help in Carr's complex situations?

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SECTION B

What Gets in the Way of Ethical Decisions in Business?

Reading 2.4

How Leaders Lose Their Way: What Price Hubris?[13]

Companies such as Enron, WorldCom, Adelphia, Lehman, New Century Financial, Fannie Mae, MF Global, UBS, Chase (companies you will study) engaged in outrageous behaviors, but their journeys into the hinterlands of huckstering was one of a gradual sort. They descended gradually to their ethical and, eventually, financial collapses.

No one in these companies sat together in the initial stages of either their success or the beginning of their declines, numbers difficulties, or inability to meet the quarterlies, and plotted, "You know what would be great! A gigantic fraud that we perpetuate on the shareholders, the creditors, and analysts. It will make us more money than we ever dreamed of. Fraud—that's the answer."

There is a tendency to create the comforting image in our minds that somehow those who engaged in these outrageous behaviors were misled, duped victims, or were so corrupt that they are part of only a limited number of souls who would dare tread in areas where the landmines of lies explode and the traps of fraud ensnare. We want to believe that they are so ethically different from the rest of us, cut from a different ethical fabric altogether and hence more susceptible to the temptations of fraud. A piece in the *Wall Street Journal*, following the collapses of Enron and WorldCom was entitled, "How Could They Have Done It?", the essence of which was the exploration of the two questions all observers posed as they watched, mouths agape, when these $9 billion frauds dribbled out: Where were their minds when they made these decisions? What on earth were they thinking?[14]

Following Martha Stewart's indictment, a reporter called to inquire, "What is the difference between us and a Martha Stewart? Or us and a Dennis Kozlowski?" My response was very simple, "Not much." They begin as entrepreneurs with novel ideas, willing to work hard to enjoy success. They end with much of their success lost and tarnished reputations from criminal trials. How do intelligent and capable people find themselves reduced to the behaviors that find them in felony trials?

Arthur Andersen, the accounting firm that met its demise because of its certification of the fraudulent financial statements of Enron, has a history peppered with examples of the firm's absolute ethical standards that went well beyond the accounting rules. In 1915, Andersen was certifying the financial statements for a steamship company, one of its biggest clients. The financial statements were for the period through December 31, 1914. However, in February 1915, as the statements were being finalized, the company lost one of its ships in a storm. Arthur Andersen refused to certify the 1914 statements

[13] Adapted from Marianne M. Jennings, "The Disconnect Between and Among Legal Ethics, Business Ethics, Law, and Virtue: Learning Not to Make Ethics So Complex," 1 *University of St. Thomas Law Journal* 995 (2004).

[14] Holman W. Jenkins Jr., "How Could They Have Done It?" *Wall Street Journal*, August 28, 2001, p. A15.

without disclosing the loss of the ship, a loss that would have a fundamental impact on income, despite the fact that it was in the next year.[15] In the 1980s, when the savings and loan industry collapsed, all of the then–Big 8 accounting firms, except for Andersen, experienced heavy losses because of their liability for audit work on the collapsed financial institutions. Andersen professionals did not think that the S&L accounting practice of including the value of deferred taxes in earnings was sound. When its S&L clients refused to change their accounting, under the guise of "everybody does it," Andersen resigned all of its S&L accounts rather than put its imprimatur to financial statements it believed contained improper accounting.[16] Yet, just a little over a decade later, Andersen, through David Duncan, was authorizing thousands of off-the-book-entities at Enron in order to hang on to a valuable audit and consulting client.

Apart from the organizational incentive systems and culture shifts that can affect reliance on absolute standards, there are individual lapses. The literature in ethical decision making indicates that the decline in ethical standards begins gradually and can consume those with tremendous ability and track records of success precisely because they have enjoyed so much success to that point.[17] These are the individuals to whom everyone turns for problem resolution, outstanding work effort, and results. Success has been the reward for their ability. They are the "go-to" people in an organization who have always been able to find resolutions for problems and ways to remove obstacles that stand in the way of achievement and success. Hubris consumes them when they find that eventual setback or obstacle they cannot conquer. Unwilling to admit that there may not always be a legal or ethical fix, they seek ways to avoid disclosure of a downturn or that they have hit a wall. They cannot get the product out on time and still guarantee its safety. They cannot complete the job on time and still meet quality standards. They are faced with the harsh reality of their human limitations. Releasing financial statements that are something less then projections when you have been on an earnings roll is difficult because you have been on a pedestal for so long.

Yet, like the figures in Greek tragedies, we all have our walls that we hit that require an admission that the fix will take a while and we may need a little help. Every successful lawyer must face that trial when no one can pull a win from the hat. Every athlete has that game or race when victory is not theirs. How do they face this setback? Too often with steroids, falsified financials, and withheld evidence. It is not always greed that drives ruthless ambition; both fiction and biography teach that hubris spawns deceit. Pride, that inability to face the wall, as the saying teaches, goeth before a fall. Even if no money were involved, it is difficult for them to step down, even if just for a time, while at the top of their go-to game.

From the Greek tragedies to Shakespeare's nobles, literature teaches us what newspapers bear out: the rise, fall and costs of hubris. Erroneous confidence and an exaggerated sense of control emerge, in fiction and nonfiction alike, in Greek mythology and in the Napoleonic wars, do drive poor ethical choices in high-pressure situations.

How do leaders know when they are losing their ways? What do the classics teach us? What have we learned from the case studies in business ethics? There are common characteristics of business people who lose their ways:

a. They become increasingly isolated because they are unwilling to tolerate dissent. They have but one perspective, a trait that is antithetical to good ethical analysis, something that requires a 360-degree perspective to remedy.

[15] Susan E. Squires, Cynthia J. Smith, Lorna McDougall, and William R. Yeack, *Inside Arthur Andersen: Shifting Values, Unexpected Consequences* (2003), p. 32.

[16] Barbara Ley Toffler, *Final Accounting: Ambition, Greed and the Fall of Arthur Andersen* (2004), at p. 19.

[17] David M. Messick and Max H. Bazerman, "Ethical Leadership and the Psychology of Decision Making," 37 *Sloan Management Review* 9 (1996).

b. They fancy themselves as being above the rules, different from the "average person," who must follow the mundane rules of the world. Like a teenager, they believe the rules do not apply to them.
c. They have defined themselves by the trappings of their success: their salaries, bonuses, cars, houses, and material possessions. The possibility of losing their material possessions and social status becomes the driving force of their decisions and leadership. They are no longer pursuing leadership for the sake of helping society with their products or services or employees by helping them advance. Their leadership is for their personal status.
d. They have a sense of invincibility—that they can solve any problem because they have been so successful for so long. That invincibility finds them taking larger risks with the hope of staying on top.
e. They have lost a good purpose in being a leader in business. Initially, their leadership role sprang from their desire to help others or improve the world. They had a good new product or they had a way of working with people that propelled them to success. When they switch from that purpose of their leadership to one of more, more, more, they lose the self-confidence and inner purpose that gave them perspective on their decisions, including the perspective of their ethical values.

Discussion Questions

1. What would the role of adherence to your credo play in preventing you from losing your way?
2. Looking at the list of how leaders lose their way, develop a list of actions that would stop these problems from taking hold.
3. Drawing on Unit 1 and "The Parable of the Sadhu," describe how Buzz McCoy lost his way as a leader on the mountain.

Compare & Contrast

William Wilberforce was a member of the British Parliament who is credited with obtaining passage of the Slavery Abolition Act of 1833 in England. Mr. Wilberforce has been credited for the persistent leadership he provided to see the act to its passage. Mr. Wilberforce was also a philanthropist and a founder of the Society for the Prevention of Cruelty to Animals. Mr. Wilberforce died just three days after the Abolition Act was passed. What distinguishing characteristics do you see in Mr. Wilberforce that are different from the characteristics that indicate a leader is losing his or her way?

Reading 2.5

Moral Relativism and the Either/or Conundrum

A typical form of flawed reasoning that businesses fall into is the either–or conundrum. This flawed analysis finds us reaching a decision because the pressure is great, the consequences even greater, and the justification compelling. Defining dilemmas in the either–or conundrum commit the ultimate flaw in logic by assuming the outcome. Defining the dilemma in this way also produces artificial choices that somehow ignore the ethics and values we brought with us before we run into the pressure of the moment. Buzz McCoy, in "The Parable of the Sadhu," fell into this trap when, in the midst of his challenge, he framed his situation as "Either I let the sadhu go and make the climb or help him and once again miss my goal." McCoy then gives us some insight on how the either–or conundrum cuts effective analysis short. At the end of his article, he adds that his most memorable experience of his time in Nepal was not reaching the pinnacle, but rather those moments he spent in the village at base camp when he had altitude sickness. The immersion in culture, the weddings experienced, and the kindness of the villagers were the true rich experiences of his climbs, not the conquest of the summit. In defining the issue by achievement of a predetermined goal, we fall victim to the either–or

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conundrum. Sometimes we reach the goal, but other times we find a wealth of experience that we use in reaching the summit or goal the next time or in understanding that we need to pursue a different summit or goal.

However, analyzing a decision by values rephrases the question from "Does our present need justify my departure from my values?" to "Is there a way to solve this problem that is consistent with my values?" For example, in 2000, the Swedish retailer Ikea was on the eve of the grand opening of its flagship store in Moscow. Government officials who run the public electric utility came requesting their personal payoffs for providing the retail store with electricity. One part of Ikea's code of ethics—indeed, its credo—is that it does not pay bribes anywhere it does business. On the other hand, Ikea did have commitments to vendors, creditors, and employees for the opening of the store. If Ikea phrases the ethical issue as "To bribe or not to bribe, that is the question," it will fall into the either–or conundrum. If, however, it phrases the question as "Is there a way to get the store open without compromising our values?" it will begin exploring alternatives rather than accepting the compromise of its ethics as the only solution. Ikea did come up with a solution; it rented generators to provide power for the store. Indeed, that approach to electricity has become its business model in Russia. Avoiding the either–or trap removes the blinders that moral relativism often imposes as we try to analyze an issue.

Discussion Questions

1. Describe a time when you have fallen into an either–or trap.
2. In 2009, Ikea discovered that the Russian executive it had hired to manage its generator contracts was accepting kickbacks from the companies that wanted to do business with Ikea.[18] What lessons should Ikea and other companies learn from this experience?

Reading 2.6

P = f(x) The Probability of an Ethical Outcome Is a Function of the Amount of Money Involved: Pressure

An article in the *Academy of Management Journal* presents research that high-performing companies are more likely to break the law.[19] The CFA Institute (Certified Financial Analysts) has a saying, $P = f(x)$. For you non–mathematicians out there, the translation is that the probability of an ethical outcome is a direct function of the amount of money involved. The more money involved, the less likely an ethical outcome. So, the slope of the line is negative.

There is the hubris, the pedestal effect, the inability to accept a setback, and the failure to understand that we all hit a wall once in a while. Sometimes we have to take a loss. Sometimes we need to step off the pedestal. When managers at high-performing companies succumb to these pressures, they do go ethically nuts.

Professor Yuri Mishina from Michigan State and his coauthor colleagues, Professors Dykes, Block, and Pollock, in "Why 'Good' Firms Do Bad Things: The Effects of High Aspirations, High Expectations and Prominence on the Incidence of Corporate Illegality," conclude that there is something about being on an earnings roll that clouds

[18] Ikea terminated the executive. Andrew E. Kramer, "Ikea Tries to Build Public Case Against Corruption," *New York Times*, September 12, 2009, p. B1.

[19] Mishna, Yuri, Bernadine J. Dykes, Emily S. Block, & Timothy G. Pollock, "Why 'Good' Firms Do Bad Things: The Effects of High Aspirations, High Expectations, and Prominence on The Incidence of Corporation Illegality," 53 *Academy of Management Journal* 701 (2010).

judgment. In addition to the cyclone of hubris, managers are trying to grapple with the pressures of sunk-cost avoidance, investor relations, and the sandbox mentality of just "making those numbers," even when they are not real.

But again, business managers face pressures similar to those we encounter in our personal lives. A friend rented a truck to help his aunt move from the large home she had enjoyed with her recently deceased husband of many years, to a more easily managed apartment. He did not take the insurance coverage for the truck because, as he said, "I know how to drive!" Safety tip for renting moving trucks: Your auto insurance probably doesn't cover you! And the coverage the truck rental business charges is expensive! The large truck proved to be a challenge, and my friend scraped the back top of the truck on some eaves as he turned a corner rather inartfully. There were two thoughts that came to his mind: (1) That's gonna be expensive; and (2) Should I try and hide this from the rental guy? Oh, that second thought! There is that little part in all of us that doesn't want to ante up, and another little part that believes we can actually dupe the other guy so that we need not pay for something that really is our responsibility. But my friend drove into the U-Haul rental center and pointed out the hole, the scratch, and the damage in all of its uninsured glory. The initial response from the rental guy was, "Wow! That's bad!" Then he paused and said, "I'm not going to worry about it."

My friend wonders how different the ending might have been had he not 'fessed up. How different this generous soul of a rental manager might have been had he discovered the damage after my friend skedaddled or skulked out of there. There is that simple but powerful and decisive model from Unit I: "If I were the U-Haul manager, how would I feel if someone tried to hide damage from me?" The fog and pressures that interfere with good ethical decisions can be managed with the simple recall of those questions.

Discussion Questions

1. Think of an example of a situation in which you resisted pressure to act unethically.
2. Refer to the Goldman case in Case 2.11 Make a list of the pressures Tourre felt.
3. How could your credo help in resisting pressure?

Case 2.7

MF Global, Jon Corzine, and a Bankruptcy

Former Goldman Sachs Chairman Jon Corzine took over MF Global Holdings Ltd. in 2010, less than a year after losing his reelection bid as governor of New Jersey. Mr. Corzine opted for investments in Portugal, Italy, Greece, and Spain (PIGS) debt because the debt of these countries brought returns of two to three times that of U.S. Treasury notes. The greater the yield, however, the higher the risk, and the PIGS were near collapse. Between 2010 (when Mr. Corzine took over as chairman at MF Global) and 2011, just before it collapsed, MF Global moved from $40 billion in assets and $3 billion in equity (a ratio of 13 to 1) to $40 billion in assets and $1 billion in equity (a ratio of 40 to 1). The heavy leverage meant that any blip could trigger bankruptcy. A blip plus a run meant the firm's demise.

Less than two years after he assumed the helm, MF collapsed because Mr. Corzine bet wrong on Greek debt instruments. For some reason, Mr. Corzine believed they were on their way up in ratings and value, although at the time, there were protests in the streets of Greece, and German Chancellor Merkel was signaling that Germany was unlikely to provide help. Adding to the intrigue of the puzzling investment is the search for $1.4 billion in missing funds. Somewhere during Mr. Corzine's tenure, the company's accountants misplaced the cash; regulators were stymied as to where it went and would spend the next two years trying to determine what happened to the funds. The transfers between and among customer accounts at the firm were not recorded in the general ledger.[20]

MF Global's History, Financial Practices, and Trading Strategy

One of the historically intriguing facts in the MF Global collapse is that it began in 2005 when it became the recipient of customer accounts from the bankruptcy trustee for Refco, a failed commodities trading firm and another stellar performer in terms of market-defying rates of returns for those customers.[21] Its origins rest in edgy, risky investment strategies.

MF Global had aggressive accounting practices. An analysis by the *Wall Street Journal* concludes that MF Global engaged in "window dressing," a practice of cutting its debt levels just prior to public reports in order to appear less leveraged and hence less risky to investors than it really was.[22] From 2009 through mid-2011, MF Global's quarter-end borrowings were 16 percent lower than the averages for the quarter and about 34 percent lower than the peak borrowings for the quarter. Professor Charles Mulford at Georgia Tech summed up the practice: "Every quarter, seven quarters in a row, it's always lower. It sounds like they are actively managing their borrowing to see that the level is lower when they report to their shareholders."[23]

In addition, Mr. Corzine followed the Goldman Sach's mantra of the highest possible returns without killing the golden goose. Mr. Corzine brought along the Goldman management mantras of "long-term greedy," which Goldman executives translated to mean "don't kill the marketplace."[24] In a telling quote in William D. Cohan's book *Money and Power, How Goldman Sachs Came to Rule the World*, Mr. Corzine eerily explained, "Until you've actually traded and had to deal with one of those Come-to-Jesus moments with a bad position and you have to make the decision about whether to eliminate, hold it, reduce it—those kinds of existential moments involving the people you work with and your firm, those are the kind of things that really get your attention."[25]

Mr. Corzine's trading philosophy permeated MF Globa's strategy. A colleague of Mr. Corzine's described his relationship at MF Global as CEO with respect to Brad Abelow, the COO, risk officer, and second in command, "Brad was never going to be listened to. Brad was the operations guy. Jon was the trader."[26] Mr. Corzine's pursuit of the market-defying returns left him with a tin ear when it came to investments. One writer phrased MF Global's strategy as follows, "How could such an esteemed lord of high finance be such an idiot?"[27]

MF Global Leadership and Scrutiny

Mr. Corzine, the former chairman of Goldman Sachs and powerful political figure, was the type of organizational leader to whom great deference was shown and who managed to escape the simplest types of questions and cursory scrutiny from third parties. By its own admission, *BusinessWeek* has indicated that one would not want to rely on their

[20] Jacob Bunge and Jacqueline Palank, "Questions Arise on Cash Shortfall," *Wall Street Journal*, November 15, 2011.

[21] Jerry A. DiColo, Dan Strumpf, and Gina Chon, "Purgatory for MF Global Customers," *Wall Street Journal*, November 16, 2011, p. C1.

[22] Michael Rapoport, "MF Global Masked Debt Risks," *Wall Street Journal*, November 4, 2011, p. A1.

[23] *Id.*, at p. A2.

[24] Matt Taibbi, "The Great American Bubble Machine," *Rolling Stone,* July 9–23, 2010, p. 54 at 56.

[25] Peter Lattman and Nelson D. Schwartz, "In Corzine Comeback, Big Risks and a Steep Fall," *New York Times*, November 2, 2011, p. A1 at A3.

[26] Justin Baer and Aaron Lucchetti, "Corzine Aide in Spotlight," *Wall Street Journal*, November 14, 2011, p. C1.

[27] "MF Global's Collapse Shows Need for Financial Oversight," *USA Today*, November 11, 2011, p. 10A.

picks for CEO or CFO of the year as a foundation for investment because their picks have included Dennis Kozlowski (who is in New York State Prison); Dick Fuld, the former CEO of Lehman Brothers (no explanation necessary); Ken Thompson, former CEO of Wachovia (no explanation necessary); William McGuire, former CEO of UnitedHealth Group (paid $468 million to settle charges that he backdated options at the company); and Maurice "Hank" Greenberg, former CEO of AIG (no explanation necessary).[28] The business magazine lauded then–New York Attorney General Eliot Spitzer as an exemplary leader and likely to uncover "the next great scandal." Of course, the next great scandal was Mr. Spitzer's resignation as governor of New York for his regular activities with a call girl.

During his tenure at MF Global, Mr. Corzine engaged in intense lobbying against additional regulations of hedge funds' use of customer funds. His position that the federal agency, the Commodities Futures Trading Commission (CFTC) was trying to "fix something that is not broken."[29] There were no questions from the business media about his motivations or MF Global's practices. In fact, Gary Gensler, the chairman of the CFTC, had longstanding ties to Mr. Corzine.[30] Mr. Gensler worked at Goldman Sachs during the 1990s when Mr. Corzine was the chairman. Mr. Gensler also gave a $10,000 donation to Mr. Corzine's campaign in 2005 when he was running for governor in New Jersey.

Before MF Global's collapse, the Financial Industry Regulatory Authority (FINRA) was sounding alarms about MF Global's lack of sufficient capital to support its trades in Italy's debts. However, Mr. Corzine traveled to Washington and was able to get a reprieve from FINRA's demands from regulators there.[31] Mr. Gensler dropped the agency's post–2008 collapse proposed reforms in how hedge funds invest the cash that is available in company accounts. The proposed regulatory reforms followed the heavy lobbying by Mr. Corzine on behalf of keeping the status quo, a standard that the CFTC adopted at the urging of then Lehman CEO Dick Fuld, in 2005.[32] Mr. Corzine's position was that such restrictions precluded hedge fund customers from enjoying the higher returns from such transactions in higher risk investments. However, proponents of the regulation argued that the customers are then at risk for losses in the bonds and foreign currency. If those higher risk investments collapse with the currency in another country (as was the case with Greece), the resulting losses at the hedge fund may mean that the fund cannot replace the customers' cash. Indeed, the result is that it may not be clear which customers' funds were used for which investments and which cash belongs to whom.

The board at MF Global also fell short on its role of providing scrutiny to management activities. Accounts of MF Global's atmosphere describe a round-the-clock and nervous Corzine trying to piece together deals, obtain cash infusion, and come up with documentation being demanded by company lawyers, potential buyers for the firm, and several regulators. Only on occasion is the board mentioned, as when it approved having MF Global being acquired (an acquisition that would fall through when MF Global discovered at least $600 million in customer funds were missing).[33]

[28] Peter Carbonara, "How Our Past Picks Panned Out," *BusinessWeek*, January 13, 2009, p. 45.

[29] Michael Rapoport, "MF Global Masked Debt Risks," *Wall Street Journal*, November 4, 2011, p. A1 at A2.

[30] Scott Patterson and Victoria McGrane, "Regulator to Skip MF Global Probe," *Wall Street Journal*, November 7, 2011, p. C1.

[31] Susanne Craig, Ben Protess, and Michael J. de la Merced, "A Collapse in Spite of Regulation," *New York Times*, November 3, 2011, p. B1.

[32] Azam Ahmed and Ben Protess, "As Regulators Pressed Changes, Corzine Pushed Back, and Won," *New York Times*, November 3, 2011, p. A1.

[33] Mike Spector, Aaron Lucchetti, and Liam Pleven, "Corzine's Firm's Final Struggles," *Wall Street Journal*, November 5–6, 2011, p. A1.

The board also failed to notice the changes in debt levels as public report dates approached and also supported with little resistance the Corzine PIGS investment strategy that was becoming riskier with each day of protest in the European nations whose default was imminent. In fact, as noted below, the board voted to raise limits on risk for Mr. Corzine. The board also failed to take action as an increasing number of private and public regulators were requesting documentation and raising questions about adequate capitalization. There were no alarms that awakened the board to action independent of Mr. Corzine's management in the year leading up to MF Global's collapse.

The Culture at MF Global

As the bankruptcy trustee's work and criminal investigations by the FBI unfold, the operations of MF Global are becoming clear. In fact, also becoming clear is employee knowledge about the company's diversion of customer funds.[34] One executive disclosed to regulators that MF Global "diverted" customer money as the problems of leverage and worthless Euro debt continued. Interestingly, one employee commented, "Probably they thought that they could pay it back. But that never happened."[35]

The fear at MF Global was perhaps justified because of what employees witnessed. Mr. Corzine fired his chief risk officer, Michael Roseman, in early 2011 because he was very vocal about the risk associated with Mr. Corzine's emphasis on Greek debt. Mr. Roseman disagreed with Mr. Corzine's strategy at a board meeting. Mr. Corzine responded by indicating that if the board did not trust him, then he would leave the company. "If you want a smaller or a different position, maybe you don't have the right guy here."[36] It was a rare showdown as board meetings go, when a lesser executive challenges the CEO in front of the board. Mr. Corzine won; the board raised his trading limits and Mr. Roseman was soon gone.[37] A CEO who had worked with Mr. Roseman said, "Mike had a very good nose for the issues. If he identified a risk, I listened to him."[38] When the new chief risk officer, Michael Stockman, took over the position in early 2011, he was not given the authority to weigh in on the effects of the trading strategies of the firm on investor confidence.[39] In other words, the new chief risk officer had little input on strategic risk issues.

The compensation system at MF Global was generous, but it was dependent upon how well the company's stock performed. In 2010, MF Global cut the pay of 1,121 employees. The 10 percent pay cut was not truly a pay cut, just an alteration in how compensation would be paid. The 10 percent, instead of being doled out in cash, would be used to purchase restricted stock in MF Global for those employees. The company saved $58 million in cash compensation with this new pay plan.[40] The cash compensation

[34] Jacob Bunge and Jacqueline Palank, "Questions Arise on Cash Shortfall," *Wall Street Journal*, November 15, 2011.

[35] Alan Farnham, "MF Global: How Not to Manage Risk—Securities Firm Goes Bankrupt With Seasoned Risk Team in Place," ABC News, November 3, 2011, http://abcnews.go.com/Business/mf-global-bankruptcy-risk-management-corzine/story?id=14868344.

[36] Azam Ahmed, Ben Protess, and Susanne Craig, "A Romance With Risk That Brought On a Panic," *New York Times*, December 12, 2011, p. A1.

[37] Aaron Lucchetti and Julie Steinberg, "Corzine Rebuffed Internal Warnings on Risk," *Wall Street Journal*, December 6, 2011, p. A1.

[38] *Id.*, at p. A2.

[39] Ben Protess and Azam Ahmed, "MF Global's Risk Officer Said to Lack Authority," *New York Times*, December 18, 2011, p. B1.

[40] Christian Berthelsen, "MF Global Staff Bitten by Pay Plan," *New York Times*, December 3, 2011, p. B1.

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that was saved translated to an average of $51,739.52 per employee in the 1,121 group. The change in pay also meant that employees would be subject to the buffetings of the market. Whether the 10 percent pay cut was indeed a pay cut depended upon how well MF Global performed. MF Global employees were not happy, "It left a bitter taste in everyone's mouth."[41] There was thus some internal pressure for higher returns. Before the collapse of the trading strategy and the resulting bankruptcy filing, MF Global shares were at $7.27. On Friday, December 2, 2011, those shares were at $0.13, so the 1,121 employees lost $113.5 million in total. One employee was outraged that the pay plan cost him $100,000.

Interestingly, MF Global was known for its generosity because Mr. Corzine brought the Goldman philosophy with him—a community presence helps business. MF Global supported causes such as CareerGear, a nonprofit that provides suits for job interviews, and Mr. Corzine was a generous donor to President Obama's campaigns as well as to Democrat candidates around the country. MF Global would match employee donations to their charitable organization up to the lesser of 2 percent of the charity's gross revenue or $200,000.

The Panic That Led to the Collapse

The story of the collapse of MF Global reveals a few days of desperate panic. On October 25, 2011, MF Global announced a $191.6 million quarterly loss. The company's share price fell 67 percent.[42] Following the announcement, the mood in the company was described as "tense," with Mr. Corzine in contact with both lawyers and investment bankers for a possible sale of the company.[43] On October 27, 2011, Moody's and Fitch downgraded MG Global shares to "junk."

On October 28, 2011, MF Global transferred $200 million to a company account at JP Morgan Chase, an account that would have been used to finance MF Global's hedge activities. Officials at JP Morgan Chase were concerned because of the reports about MF Global's teetering financial condition and the possibility that the funds may have come from customer accounts, something that would have been a violation of federal regulations.[44] Communication between Edith O'Brien, MF Globals' treasurer, and others at MF Global seem to indicate that she was aware that she was violating that critical Wall Street rule—funds in customer accounts could not be used to cover trading margins. She told a colleague that if she did not get at least $530 million that had been transferred from customer accounts covered that it would be "game over." The colleague responded, "From a regulatory perspective?" Ms. O'Brien replied, "Yep, yep."[45]

In one recorded conversation, Mr. Corzine appears to be coaching an employee on how to use client segregated funds:

Corzine: We have a money management account at Chase, if my memory serves me.

Employee #1: Yeah, it's the JP Morgan Trust account, but that's cash seg for clients—it has nothing to do with greasing our wheels for Chase to move.

[41] Berthelsen, at p. B1.

[42] Suzanne Craig, Ben Protess, and Michael J. de la Merced, "A Collapse in Spite of Regulators," *New York Times*, November 3, 2011, p. B1.

[43] Mike Spector, Aaron Lucchetti, and Liam Pleven, "Corzine Firm's Final Struggles," *Wall Street Journal*, November 5–6, 2011, p. A1.

[44] Scott Patterson and Aaron Lucchetti, "MF Global Transfer Draws Scrutiny," *Wall Street Journal*, December 21, 2011, p. C1.

[45] Ben Protess, "Suit Accuses Corzine Of a Failure At the Helm," *New York Times*, June 28, 2013, B1.

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Corzine: I understand but you put it in a tri-party, and then once the securities have started moving, then you move it back to the, urn—this is the same thing we did last night, they left it in the tri-party,the seg money.[46]

Chase officials asked for written assurance that the funds that were transferred did not include funds from customer accounts. Ms. O'Brien had received the request from Chase. Laurie Ferber, MF Global's general counsel, was asked to provide the assurance in writing. Ms. Ferber refused to provide such assurances, and by October 30, 2011, she had discovered that there was a shortfall in customer money and notified regulators.[47] MF Global declared bankruptcy the following day.

The Outcome

One thousand MF Global employees lost their jobs because only a skeleton crew was retained to help sort through the books, records, and accounts.[48] With MF Global's bankruptcy, 33,000 MF Global customers were caught in a financial purgatory. Many of them had been prescient enough to take their money out of the firm's hedge funds for holding in what they believed to be the safe haven of MF Global's bank account. However, which funds MF Global was betting in Europe remained unclear for over one year as the trustee tried to sort through what funds belonged to whom and which could be released.

By April 2013, Louis Freeh, the former head of the FBI, who conducted the formal investigation into the collapse of MF Global, issued his findings and concluded that Mr. Corzine should shoulder most of the blame for what happened at the company. In his 174-page report, Mr. Freeh mentioned Mr. Corzine 284 times and concluded that he and his management team had engaged in "negligent conduct."[49] Mr. Corzine denies that he was negligent and has accused Mr. Freeh and the authors of two other reports that likewise placed the blame on his shoulders of "Monday morning quarterbacking."[50] The Commodities Futures Trading Commission (CFTC) has brought civil charges against Mr. Corzine with failure to supervise and Ms. O'Brien with aiding and abetting misuse of customer funds.[51] The CFTC has imposed a $100 million fine on the bankruptcy estate of MF Global.

Through insurance coverage and unwinding of accounts and accounting, the bankruptcy trustee was able to return to most MF Global customers between 75 cents and 93 cents of every one dollar of their investment in the firm. Creditors will receive between 12 cents and 42 cents on every dollar the firm owed to them.

Discussion Questions

1. Identify decision points and conducts that contributed to the collapse of the firm.
2. Identify individuals and decisions whose actions were an attempt to mitigate damages.

[46] *U.S. Commodities Futures Trading Commission v. MF Global, Inc., et al.*, 13 Civ. 4463 (June 27, 2013) complaint, at p. 24.

[47] Ben Protess and Azam Ahmed, "E-Mail Clues In Tracking MF Global Client Funds," *New York Times*, December 21, 2011, p. B1.

[48] Michael J. de la Merced and Ben Protess, "Trustee Lays Off 1,000 Workers at MF Global," *New York Times*, November 12, 2011, p. B6.

[49] Aaron Lucchetti and Julie Steinberg, "Crozine Blasted in MF Global Autopsy," *Wall Street Journal*, April 5, 2013, p. A1.

[50] Ben Protess, "MF Global Liquidation Plan Wins Approval From Court," *New York Times*, April 6, 2013, p. B3.

[51] James B. Stewart, "Boss's Remark, Employee's Deed and Moral Quandary," July 6, 2013, p. B1.

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3. One trader concluded after MF Global's collapse, "I'm angry and I no longer have any confidence in our system."[52] What does his statement reflect about the importance of ethics in financial markets?
4. Where does hubris come into this case?

Case 2.8

On Saying One Thing and Doing Another: Public Perception and Deception Covering for the CEO

PR experts say that when a high-ranking executive leaves a company, there are two standard phrases used: "spending more time with family" and "pursuing other interests." However, neither phrase proves to be true, and indeed may be a temporary face-saving measure for an executive or company in trouble. For example, Jeffrey Skilling, the now-convicted former CEO of Enron, left the company just months before its collapse with the first phrase of "spending more time with his family." The termination agreements are required by regulators and must give a reason, but one PR expert notes, "Who are they kidding?"[53]

The following are examples and consequences:

Name	Title	Company	Reason	Fate
Tara Poseley	CEO	Design Within Reach	"Spend more time with family and pursue other interests."	Named President of Disney Retail Stores just five months later
Beryl B. Raff	CEO	Zales	"Well, this afternoon I'm going to be driving the carpool. And my son's very excited about that."	Named Senior VP of JCPenney three months later
John N. Ford	state senator	Tennessee	"To spend the rest of my time with my family clearing my name."	Convicted on one count of bribery for taking $55,000 in bribes from contractors; other federal charges on bribery are pending; sentenced to sixty-six months in prison
Brenda C Barnes	CEO	Pepsi NA	"To devote more time to her three young children." (1997)	Interim president Starwood Hotels (1997); took board positions (1997); CEO Sara Lee (2004)
Afshin Mohebbi	Pres COO	Qwest	"Spend more time with family." (2002)	Forty-two-count indictment (2004) immunity for testimony
Daniel P. Burnham	CEO Chairman	Raytheon	"Spend more time with family, teach, and join corporate boards." (2003)	2006 SEC filed complaint on accounting improprieties by Burnham and others; returned bonuses

[52] Jerry A. DiColo, Dan Strumpf, and Gina Chon, "Purgatory for MF Global Customers," *Wall Street Journal*, November 16, 2011, p. C1.

[53] Katie Hafner, "Canned Phrases for Making an Exit," *New York Times*, December 23, 2005, pp. B1, B7.

Name	Title	Company	Reason	Fate
Carly Fiorina	CEO	Hewlett-Packard	She felt she had been fired and refused a generic family statement because, "No, that's not the truth. Telling the truth is about what's right and wrong. It's pretty basic."[54]	Best-selling book; ran for U.S. Senate in California (2010)
Stephen Collins	CEO	Double Click	"Spend more time with family."	Still spending time with family
Steve Jobs	Late-CEO	Apple	"Health matters are private."[55]	Apple was not forthcoming with information until Mr. Jobs had to leave the company; switching him to chairman in September 2011; Mr. Jobs died in October 2011 after years of treatment, transplants, and leaves. Apple today is struggling from what is perceived to be the lack of effective succession planning

The Double Lives

However, CEOs are not the only ones who release public statements that give false impressions about their personal lives and employment status. The once champion cyclist Lance Armstrong had a history of denying his use of performance-enhancing drugs. However, over the years, as he responded to team members and others who insisted that he was using the drugs, he issued the following statements:

> **July 1999:** "I have been on my deathbed, and I'm not stupid. I can emphatically say I am not on drugs."
>
> **Dec 2000:** "We are completely innocent. We run a very clean and professional team that has been singled out due to our success … Before this ordeal I had never heard of [the performance-enhancing drug Actovegin]."
>
> **Jan 2001:** "The simple truth is that we outwork everyone. But when you perform at a higher level in a race, you get questions about doping."
>
> **Jan 2004:** "I have never had a single positive doping test, and I do not take performance-enhancing drugs."
>
> **July 2004:** "We're sick and tired of these allegations and we're going to do everything we can to fight them. They're absolutely untrue."

[54] *Id.*

[55] Used by permission of The Conference Board.

> **Aug 2005:** "I have never doped. I can say it again, but I've said it for seven years."
>
> **Aug 2005:** "Why would I enter into a sport and then dope myself up and risk my life again? That's crazy. I would never do that. No way."
>
> **Nov 2005:** "How many times do I have to say it? … Well, it can't be any clearer than 'I've never taken drugs.'"
>
> **July 2010:** "As long as I live, I will deny it. There was absolutely no way I forced people, encouraged people, told people, helped people, facilitated. Absolutely not. One hundred percent."
>
> **Jan 2011:** "If you're trying to hide something, you wouldn't keep getting away with it for 10 years. Nobody is that clever."
>
> **May 2011:** "Twenty-plus-year career, 500 drug controls worldwide, in and out of competition. Never a failed test. I rest my case."
>
> **June 2012:** "I have never doped … I have competed as an endurance athlete for 25 years with no spike in performance, passed more than 500 drug tests and never failed one."[56]

However, once the U.S. Antidoping Agency released its report on Mr. Armstrong, he had little choice but to admit his use of the drugs in January 2013. "All the fault and all the blame here falls on me. I viewed this situation as one big lie that I repeated a lot of times. I made my decisions. They are my mistakes, and I am sitting here today to acknowledge that and to say I'm sorry for that."[57] Mr. Armstrong was stripped of his Tour de France wins, but the repercussions did not end there. He lost his advertising endorsements as well, although he was once ranked as the sixtieth most effective product spokesperson. He was right up there with Brad Pitt. Now, he is ranked 1,410, with rapper Nicki Minaj.

The companies that have not renewed Mr. Armstrong's endorsement agreements or have terminated them include Nike, Radio Shack, Trek Bicycle, Easton-Bell (the makers of the Giro helmets Mr. Armstrong wore in his races), FRS Energy Foods, Anheasuer-Busch, 24 Hour Fitness, and Nissan. Mr. Armstrong earned between $15 and $17 million per year from the endorsement contracts.

Tiger Woods was in a car crash near his Florida home, and the extent of his marital infidelity came to light. Initially, Mr. Woods maintained that his private life was his private life and remained aloof. However, as more information about his infidelity and eventually his own admission of such became public, he lost endorsement contracts with Accenture, AT&T, and Gatorade. Gatorade did continue its relationship with the Tiger Woods Foundation. Nike did not drop its sponsorship, and Nike chairman and cofounder Phil Knight explained that these problems with athletes are just "part of the game" when you sign them."[58] Tag Heuer did not drop Woods because, as a spokesperson explained, "He's the best in his domain. We respect his performance in the sport. Woods' personal life is not our business."[59] Tag Heuer did, however, stop running its ads featuring Mr. Woods. Gillette also stopped running Woods ads but did not terminate the relationship until later. In the four years since his fall from advertising glory, Mr. Woods has managed some victories on the tour, and possibility of reinstatement remains.

[56] www.guardian.co.uk/sport/2013/jan/18/lance-armstrong-doping-denials-quotes.

[57] *Id.*

[58] Tom Weir, "As Idols Fall, Will Clout Ebb?" *USA Today*, February 26, 2010, p. 1C.

[59] Emily Steel and Vanessa O'Connell, "Accenture Boots Tiger Off Its Team," *Wall Street Journal*, December 14, 2009, p. B1.

Discussion Questions

1. Is it dishonest to use the family or other interests for public explanations when the reason given is not true?
2. Is there a securities law violation?
3. Why do icons such as Mr. Armstrong believe that their private and public lives can be separated and that information about them can be managed?
4. Give some rationalizations that companies and individuals could offer for their explanations.

Compare & Contrast

Manti Te'o, a Notre Dame linebacker and Heisman trophy finalist, was apparently the victim of an Internet scam that convinced him he had a girlfriend. When that relationship imploded with her apparent demise, he issued a series of statements and granted interviews about her death, continuing his story even after he knew that she had never existed. He explained his actions by saying that he'd had to lie to everyone about the relationship, including claiming that he had met her, this nonexistent person, before she died: "I kind of tailored my stories to have people think that, 'Yeah, he met her before she passed away.'"[60] Using what you have learned in the readings for this section, explain why Mr. Te'o followed this path of deception. How does his conduct compare with that of the CEOs' departures?

[60] S. L. Price, "What Just Happened?" *Sports Illustrated*, January 28, 2013, p. 51.

SECTION C

Resolving Ethical Dilemmas in Business

Reading 2.9

Framing Issues Carefully: A Structured Approach for Solving Ethical Dilemmas and Trying Out Your Ethical Skills on Some Business Cases

The issues in ethics cases may change from cleaning up after your pup to Wi-Fi piggybacking, to issues of bribery, insider trading, and capitalization of ordinary expenses, but they still hark back to the same questions and considerations (after the fact vs. in the midst of) you learned in Unit 1.

However, because you will be a businessperson evaluating ethical issues, add a few additional considerations to those given in Reading 1.10.

1. Do your numbers. Think about the costs of your decision, both long- and short-term. For example, not disclosing information about the company's financial performance buys you time and prevents a drop in the company's share price. But if things do not improve, you will be grappling with two problems: the drop in the share price and the company's loss of trust and credibility for not disclosing the information sooner. Just as ethical analysis requires you to gain a 360-degree perspective, a look at the numbers considers all costs. Will we lose customers? Will our cost of capital increase if we do have a major accident or an unsafe product? What happens if we cut the maintenance budget too much? We save money temporarily, but will the lack of maintenance affect safety?
2. Recall the categories from Reading 1.4 and be sure that you have considered all the ethical issues.
3. Make sure that you have applied all the questions that are used under the various models in Reading 1.9 to verify that you have really thought through the issue, such as whether what you want to do is even legal.
4. Check for those warm language labels and rationalizations that may find you overlooking an issue as you find comfort in avoiding real analysis.
5. Be sure to consider other cases you have studied and whether there are historical precedents that might be of help in analyzing your present situation and dilemma.
6. Bring in other areas of business to be sure you are looking at the ethical issue fully. For example, consider any strategic advantages in your decision. Be sure to apply economic principles to proposed actions. Think through the organizational behavior implications of your decision. In other words, integrate what you know about business as you analyze from an ethical perspective.
7. Watch the framing of the issue. If you look at an issue within the framework of "This could really hurt us if it went public," you are destined to make ethical mistakes and risk reputational capital. Instead, frame the issue as, "What are the consequences of what we know?" "What will happen if we do nothing to fix it and what we know becomes public?" "Am I overlooking the harm that we are doing to someone through our actions?"

Try your hand at a few business-type cases before proceeding to the following sections. This variety of business ethics cases offer an opportunity for application of the materials from this section and gives you the chance to hone your skills for ethical resolutions.

Case 2.10

Galleon Hedge Fund: Expert Networks, Friendly Discussions or Insider Trading?

Galleon Group was a hedge fund whose returns, earnings, and reputation were legendary. The founder and owner of Galleon was Raj Rajaratnam, someone who was known throughout the Silicon Valley and was presumed to employ a mathematical model that saw his company outperforming others. Mr. Rajaratnam was also known for his three homes, his extravagant parties, and status as a billionaire.

Mr. Rajaratnam carefully cultivated relationships with young executives at companies in the Silicon Valley and then used them as sources for information as simple as which customers and suppliers were doing well to eventually gaining inside information, as was later established in court. One young executive formerly at Intel, Roomy Khan, was identified as an informant in the case and had already done six months of house arrest in 2002 for passing along inside proprietary information about Intel (where she worked until her termination following the charges).[61]

Mr. Rajaratnam often paid for the receptions and dinners of young business school graduates in order to gain access to them and whatever information they had. He was known to sponsor alumni receptions and meetings for the same reason. He was also generous with sponsorships of continuing education programs for young executives.

There is a fine line between gathering information (obtained through the sweat of the brow—research and computations) and obtaining and using information that those within companies or in fiduciary relationships with those companies have improperly passed along. For example, a young Hambrecht & Quist trader wrote a letter to the SEC when he overheard a Fidelity broker sharing with a Galleon employee the level of volume Fidelity was trading. "Business is booming," is not exactly the stuff of inside information. Indeed, The SEC took no action at that time. The propriety and evolving contacts were small steps toward what would eventually become an insider trading ring. For example, just knowing how many new hires a company has made is important first-hand information that gives some indication of where the company believes it is headed. That information comes only from insiders.

Within his company, Mr. Rajaratnam cultivated fear and loyalty. He fined his traders $25 if they were late for meetings. He did cold calls in meetings to see if his analysts were prepared, and if they were weak on their analyses, he made sure that they were humiliated. In a bizarre incident he ordered an anlyst to buy a black spandex outfit from Lululemon Athletica and made the analyst walk up and down the table in the meeting, something he saw as research into the company. Employees laughed nervously, and finally the CFO ended the meeting and the humiliation of the analyst.[62] One

[61] Marianne M. Jennings, "The Lessons From Galleon Hedge Fund and the Insider Trading Ring," 14 *Corporate Finance Review* 43 (2010).

[62] Ashlee Vance and Michael J. de la Merced, "Witness in Galleon Case Is Said to Have History of Passing Secrets," *New York Times*, October 24, 2009, p. B1.

employee, concerned about what he was being asked to do in terms of finding information, consulted a lawyer who told him that Galleon was "bending the ethics bar" and not to do business the "Galleon Way."[63] When he returned to the firm and moved the line back in terms of what he would not do, he was told, "Get an edge or you're gone. Galleon is looking for that little bit of an extra edge. That's what the firm is about."[64]

The result was the largest insider trading case in over a decade and the discovery of a web of interconnected parties. The case was eight years in the making, but the result for the government is the dismantling of a web of deceit that the parties assumed was their secret. By the time the federal government infiltrated the insider trading ring, which it referred to as "Octupussy,"[65] they had a total of twenty-six indictments, including Rajat Gupta, a former Procter & Gamble and Goldman Sachs director who was convicted of three counts of securities fraud for passing along inside information to Mr. Rajaratnam. Many of the lesser employees "cooperated fully" with prosecutors, naming names and pointing fingers, with twenty-one guilty pleas.[66] Preet Bharara, the U.S. Attorney for the Southern District of New York, who was responsible for overseeing the prosecution of the cases, made an unusual public statement in announcing one of the many rounds of indictments: "I urge you to come knocking on our door before we come knocking on yours."[67] There was a 100 percent conviction rate for those who did not enter guilty pleas.

Mr. Rajaratnam was convicted on fourteen counts of securities fraud and sentenced to eleven years despite significant testimony related to his poor health.[68] His presentencing report indicated that he truly did not understand how wrong what he had done was. "In my own mind, the line between permissible 'detective work' and impermissible insider trading was not always clear, especially with regard to companies broadly covered by the news media as to which there was a wealth of publicly available information, including frequent leaks, rumors and speculation about corporate transactions and other important developments."[69] Such a statement in the presentencing report gave the judge pause.[70]

Discussion Questions

1. What was the ethical blind spot of Mr. Rajaratnam? What type of analysis might have helped him see his activities differently?
2. What analysis did the Galleon employee who quit do in analyzing what the firm was doing?
3. What does the story about the Lululemon outfit tell you about Mr. Rajratnam? About his CFO?

[63] Gregory Zuckerman, Don Clark, and Susan Pulliam, "Colleagues Finger Billionaire," *Wall Street Journal*, October 19, 2009, p. A1.

[64] *Id.*

[65] You can see a diagram of the web, in *The Dealbook*, "The Galleon Network," *New York Times*, March 8, 2011, p. B5.

[66] Susan Pulliam, "Five Cooperating Witnesses Propel Federal Probe," *Wall Street Journal*, November 6, 2009, p. A6; and Peter Lattman and Azam Ahmed, "Guilty Plea in Galleon Insider Trading Case," *New York Times*, April 27, 2011, p. B5.

[67] *New York Times*, November 8, 2009, BU2, in "The Chatter" feature.

[68] Susan Pulliam and Chad Bray, "Trader Draws Record Sentence," *Wall Street Journal*, October 14, 2011, p. A1.

[69] Glovin, David "Galleon's Rajaratnam May Face Stiffer Jail Sentence After Questioning Law," Bloomberg News, September 12, 2011.

[70] Michael Rothfield, "In Gupta Sentencing, a Judgment Call," *Wall Street Journal*, October 10, 2012, pp. C1–C2.

Case 2.11

What Was Up with Wall Street? The Goldman Standard and Shades of Gray

Humble Roots

Goldman Sachs was founded in 1869 with the humble purpose of being both an originator and a clearinghouse for commercial paper. Marcus Goldman, a German immigrant, founded the company along with his son-in-law, Samuel Sachs. The company's strategy was to provide loans for small businesses and then create a market for the loans through the sale of commercial paper. But the stodgy negotiable instruments market proved insufficient for attracting new talent, so the firm began a gradual drift from its founders' influence and its basic roots in tangible one-on-one business loans. In the late 1920s, Goldman undertook an investment strategy that would contribute to the 1929 market crash. Goldman launched the investment trust, a vehicle by which anyone could invest small or large amounts of money and hold shares in the trust, which then purchased a portfolio of stocks. The trust income then came from the returns on the stocks in the portfolio.

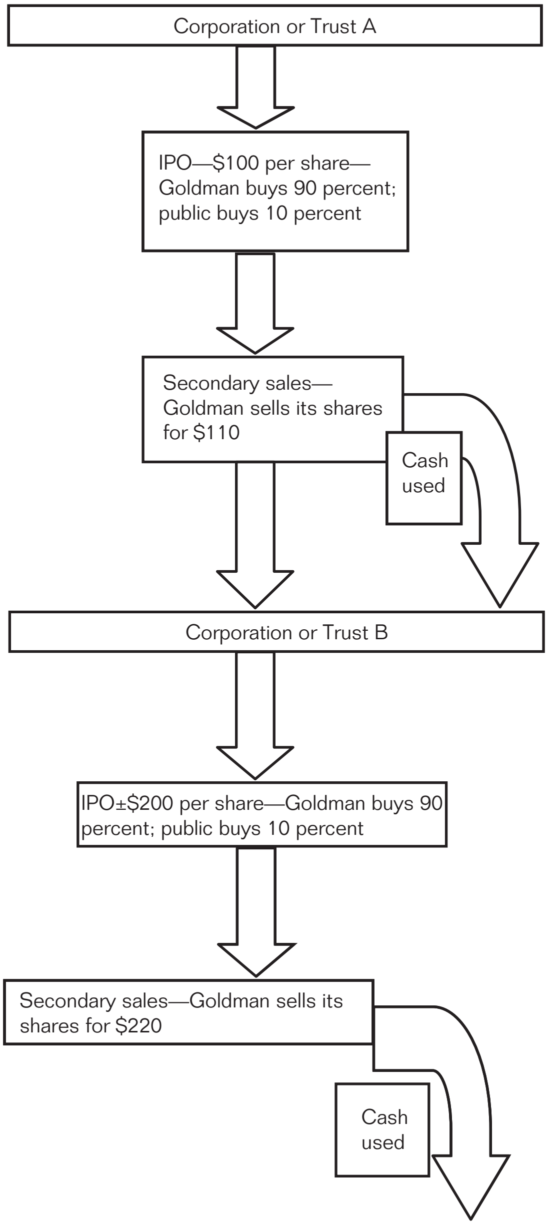
Investment Strategy

The 1920s and Layering

Even in its initial foray into the layered investment strategies that would still be in play a century later, Goldman was using its own customers to make money. The layering strategy, formulated in the late 1920s, works like this: Goldman creates an investment company and buys 90 percent of the shares in that company with its own money. Because the shares have sold so well, the public (not realizing that Goldman itself had purchased the shares and driven the price up) wants a piece of the company. So, the shares that Goldman initially bought for, say, $100, it is able to turn around and sell to the public for $110. But Goldman would continue to buy shares on the secondary market, and the price would climb to $120 and then $150 and so on. With the money Goldman made on this initial corporation, it would create a new corporation and use the same strategy to drive up the price, moving on to another new corporation with more demand and higher share prices. However, all the layers in the chain are completely dependent upon the market continuing to grow and the solvency of Goldman because as one writer has described it: Goldman invests $1.00 and borrows $9 (through the sales to the public); Goldman then takes the $1 investment and the $9 borrowed (for a total of $10) and borrows $90 with an investment of only $10 and from there moves onto $100 and $900.[71] Diagrammatically, the leveraged deals are shown next page.

Leverage extraordinaire was the theme that began in the late 1920s with this layering and continued through to the subprime mortgage secondary instrument market that resulted in the market crash of 2008. In the 1920s, the public was investing in stock portfolios. Goldman nearly collapsed when the stock market crashed in 1929.

[71] Matt Taibbi, "The Great American Bubble Machine," *Rolling Stone*, July 2, 2009, p. 54.


Corporation or Trust A
IPO—$100 per share—Goldman buys 90 percent; public buys 10 percent
Secondary sales—Goldman sells its shares for $110
Cash used
Corporation or Trust B
IPO±$200 per share—Goldman buys 90 percent; public buys 10 percent
Secondary sales—Goldman sells its shares for $220
Cash used

The 1990s and Internet IPOs

The Goldman business strategies bring to mind the classic description of all market bubbles: they were "selling air." The Holland tulip market in the 1630s has been described as follows:

> The story of the founding and growth of the Holland tulip market is a remarkably similar one. When the tulip was developed, people were enamored of it. They began buying tulips, fields of tulips and developing tulips. When tulips were no longer available, they began buying tulip bulbs because they would have a tulip at some time in the future. When there were no bulbs left, they created a market for tulip bulb futures. At the height of the market, one tulip bulb future cost $10,000 in present-day dollars. There was

> a market of air with complete dependence on the creation of bulbs in the future; these were investments in air completely dependent upon the honor of those selling these derivative tulip instruments.
>
> Eventually investors realized that those who sold the futures could not possibly deliver all that they had sold, and the market collapsed. The impact on the Holland economy was centuries in length.[72]

And "selling air" took on a double entendre in the 1990s when Goldman became the Wall Street giant on taking Internet companies public. In 1999, the same year Goldman itself went public, Goldman underwrote forty-seven companies. What was not clear to investors in this round of phenomenal market growth, just as the nature of the layers of trusts and corporations was not clear to investors in the 1920s, was that the standard underwriting practice of requiring that a company show three years of profitability before being taken public was no longer enforced. That profitability standard had been slowly eased back to one year and then to one quarter. In fact, some Internet IPOs that Goldman underwrote had not yet seen any profits, and their business plans indicated that profits were not on the immediate horizon.

It was also during the go-go Internet 1990s that Goldman began a practice it would carry forward to future transactions, a practice that does affect its clients. Goldman engaged in laddering, which is an agreement between Goldman and its best clients for the allocation of a certain portion of the IPO at a preestablished price. However, under a laddering arrangement, those clients also had to agree to purchase a certain number of shares later during the IPO rollout at prices $10 to $15 higher. To get some of the IPO, the clients had to agree to participate through laddering. Laddering is a trick, a sort of insider scam by the underwriter and its favored clients. The underwriter locks precommitted buyers at a price above the initial price, and the shares of the IPO are guaranteed to rise. Goldman knows the fixed hand, but those in the market who are evaluating the IPO do not know that the increase in price is not due to legitimate demand for the company's shares. There was no transparency to the preestablished agreements for later purchase, known as "aftermarket purchases." The market demand, spurred by the predetermined secondary pricing, is synthetic, a result of Goldman's manufactured demand. For example, in 2000, Goldman was the underwriter for eToys, whose stock was priced for the IPO at $20. Goldman had laddered the shares, and the price climbed to $75 per share by the end of the first day. By March 2001, eToys was in bankruptcy. Then–Goldman Chairman Hank Paulson condemned the practice when the firms received its SEC Wells notice for laddering but denied any charges of securities fraud. Goldman settled the SEC charges on laddering by agreeing to pay a $40 million fine.[73]

The 2000s and CDOs

Prior to its becoming a publicly traded company at the time of the dot-com bubble, Goldman had been known for giving clients back their money if there was risk to reputation or relationship. In the 2000s, however, something shifted as the market for mortgage-backed securities such as collateralized debt obligations, or CDOs, grew exponentially. When Goldman entered

[72] Marianne M. Jennings, "A Contrarian's View: New Wine in Old Bottles: New Economy and Old Ethics, Can It Work?," in *Social, Ethical, and Policy Implications of Information Technology*, edited by L. J. Brennan and V. J. Johnson (2004); Mike Dash, *Tulipomania: The Story of the World's Most Coveted Flower & the Extraordinary Passions It Aroused* (2001).

[73] *SEC v. Goldman Sachs*, January 25, 2005, http://www.sec.gov/litigation/complaints/comp19051.pdf; U.S. Securities and Exchange Commission, Litigation Release Number 19051, January 25, 2005, *SEC vs. Goldman Sachs & Co.*, 05 CV 853 (SAS) (S.D.N.Y.), "SEC Sues Goldman Sachs & Co. for IPO Violations; Goldman Sachs Will Pay $40 Million," http://www.sec.gov/litigation/litreleases/lr19051.htm. Accessed July 20, 2010.

this burgeoning market for financial instruments, it developed a different posture: a combination of defiance as well as "toes to the line" on legal issues. Goldman's October 2007 10Q reflected a shift for the firm from investment in CDOs to short sales, a bet against the mortgage-backed securities it continued to sell to its clients. "During most of 2007, we maintained a net short subprime (mortgage) position and therefore stood to benefit from declining prices in the mortgage market."[74] Nobel laureate economist Joseph Stiglitz compares Goldman's business model to gambling and concludes, "Goldman's activity is of negative social value. Its recent profits came from trading, which basically amounts to profiting from insider information at the expense of others."[75]

In 2008, Goldman changed its status from investment bank to bank holding company, a change that brought it under the regulatory arm of the Federal Reserve Bank. At the time, Goldman indicated that it made the move because investors had lost faith in the ability of the SEC to regulate investment banks. However, the change did make Federal Reserve funds available to Goldman, the types of loans that carry zero-percent interest and terms that carry no time limits. The easy availability of those funds allowed for substantial leveraging and even more expansion into the mortgage securitization market.

Diagrammatically, the structure of the CDO investment vehicles looks the same as the original 1920s model. The distinction was in the type of instrument. The financial model illustrated has not changed, nor has the risk. Because Goldman was at the foundation of all the corporations in the investment chain, any market or company misstep would cause the ripple effect and a market crash. In the 2008 stock market crash, Goldman received $10 billion in government funds in order to survive.[76] The CDO market is described in more detail in the "'Toes-to-the-Line' Activities" section.

Goldman: Its Culture and Philosophies

The company has had several management mantras. One is "long-term greedy," which Goldman executives translate to mean "don't kill the marketplace."[77] The other mantra is "Filthy rich by forty," which served as the motivational slogan for young people recruited into the firm for the long hours and demands for financial creativity in structuring offerings.[78] Somewhere in the 1990s, the two slogans were at war. Some have attributed the change to the fact that the company went public in 1999. Without the partners personally liable for company losses, many believe the investment strategies changed dramatically.

Rolling Stone magazine has described the company as "a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money."[79] Goldman has launched the wealth and careers of business moguls and political powerhouses alike. Henry Paulson and Robert Rubin, both Goldman alums, served as Secretary of the Treasury. Former New Jersey Governor Jon Corzine made his legendary fortune at Goldman. Jim Cramer, the very noisy MSNBC analyst; John Thain, former CEO at Merrill; and Robert Steel, former Wachovia CEO, cut their financial-world teeth at Goldman. Goldman remains politically well connected, with Mr. Blankfein attending two White House events between January 2009 and April 2010. Mr. Blankfein was a presidential guest at the Kennedy Center for a 2010 event. Goldman employees contributed $1 million to the Obama presidential campaign, and former White House

[74] http://www.sec.gov/Archives/edgar/data/. Accessed July 20, 2010.

[75] Pallavi Gogoi, "Goldman's Big Rebound Raises Some Eyebrows," *USA Today*, September 16, 2009, p. 1B.

[76] David Lynch, "Goldman Hearings Strike a Defiant Note," *USA Today*, April 28, 2010, p. 1B.

[77] *Id.*, p. 56.

[78] John Arlidge, "I'm Doing God's Work. Meet Mr. Goldman," *London Times Interview, The Sunday Times*, November 8, 2009, p. 1.

[79] Taibbi, "The Great American Bubble Machine," p. 52.

Counsel, Gregory Craig, who left the Obama administration in January 2010 after one year of service, is serving on the Goldman defense team for the 2009 SEC charges. When asked whether he was violating the Obama administration rules on conflicts that prohibited former administration officials from working for companies as lobbyists for two years, Mr. Craig responded, "I am a lawyer, not a lobbyist."[80]

By the end of 2009, Goldman became the first large investment bank to be charged civilly for its conduct with investors and customers in that risky mortgage market. Goldman was initially defiant when the charges were announced, as it pronounced to business publications that it is "Not Guilty, Not One Little Bit."[81] Indeed, Goldman CEO Lloyd Blankfein explained Goldman's critical role in society as follows:

> We help companies to grow by helping them to raise capital. Companies that grow create wealth. This, in turn, allows people to have jobs that create more growth and more wealth. It's a virtuous cycle. We have a social purpose.[82]

Mr. Blankfein says he has never forgotten his roots, which included living in a government housing project in Brooklyn. Although he attended Harvard on a scholarship at age 16, he was part of a one-income family, and his father at one point lost his job as a truck driver. During that time, Mr. Blankfein, at age 13, sold peanuts and popcorn in Yankee Stadium to help the family make ends meet. Eventually his father landed a job as a mail sorter with the U.S. Post Office.[83] "I went to a fancy school. … But I grew up in a position to understand the stresses and strains of the real economy."[84]

Goldman's "Toes-to-the-Line" Activities and Issues

Stock Tips

The SEC prohibits an analyst from issuing reports on securities that run contrary to the analysts' true beliefs about the securities. The SEC also requires investment firms to engage in "fair dealing with its customers."[85] Whether those two requirements were met at the investment firms continues to be the subject of debate. Goldman held what were known as "trading huddles," which found analysts and traders meeting to determine short and long investments on particular shares. The conclusions of the huddles were then shared with Goldman's traders and a selected few of Goldman's thousands of clients; and those conclusions were often different from the Goldman analysts' reports and recommendations that were issued publicly. Other firms such as Morgan Stanley also have huddles in addition to their published research recommendations, but their conclusions from the weekly meetings are then sent out in an e-mail blast to all clients.

One distinction between Goldman's huddles and those of other investment firms was that Goldman's huddles did not involve equity research analysts, the analysts who are subject to the SEC rules. Rather, those who participated in the huddle were from Goldman's "Fundamental Strategies Group," a group that would be exempt from the SEC rules.[86]

[80] Peter Baker, "Ex-Adviser to Obama Now Lawyer for Goldman," *New York Times*, April 21, 2010, p. B11.

[81] Robert Farzad and Paula Dwyer, "Not Guilty. Not One Little Bit," *Bloomberg BusinessWeek*, April 12, 2010, p. 31.

[82] Arlidge, "I'm Doing God's Work," p. 2.

[83] Gogoi, "Goldman's Big Rebound Raises Some Eyebrows," pp. B1, B2.

[84] *Id.*

[85] Susanne Craig, "Goldman's Trading Trips Reward Its Biggest Clients," *Wall Street Journal*, August 24, 2009, p. A1.

[86] Andrew Ross Sorkin, "At Goldman, E-Mail Message Lays Bare Conflicts in Trading," *New York Times*, January 13, 2010, p. B1.

The complaint from market participants and other firms was that Goldman was giving an edge to certain investors and not distributing information completely. However, Goldman is not privy to inside information about the stocks. Rather, its weekly updates, it claims, are just that—updates based on new market developments. Eric Danallo, a former deputy New York attorney general, argues that the spirit of the law should control the conduct, not a strained interpretation, "Analysts should give consistent advice to all their customers, be they small investors or big trading clients."[87]

The Auction-Rate Markets

Wall Street firms were able to profit from their participation in what was known as the auction-rate markets. These securities were touted as mutual-fund grade with a higher yield. Their clients would bid on securities being sold through a once-a-month auction that the investment firms were selling. What their clients did not know is that their own investment advisers were bidding up the value of the instruments. The prices were reset weekly based on the demand, but the investment firms were creating that demand through their bids, bids that they never intended to execute because their clients would always bid more. The investment firms were setting a market floor for the market they were running even as they were encouraging their clients to get in on what appeared to be a thriving market. When Goldman, the fifth largest underwriter of the market, pulled out, there was no longer a market for the securities. Clients were left holding $40 billion in securities they were told were as good as cash. Arthur Levitt, the former chairman of the SEC, responded to the problem, "Very few issues have shaken public confidence in the integrity of our markets as much as this."[88]

Through legal action brought by New York Attorney General Andrew Cuomo, Merrill Lynch, Citigroup, UBS, Goldman, and others agreed to buy back their clients' auction-rate securities. However, Goldman only agreed to buy back its smaller investors' auction-rate securities. Goldman left its larger investors holding the unsellable securities.[89]

Betting against the Clients: Abacus, the Fabulous Fab, and CDOs

In a frank and stunning memo written to its clients in January 2010, Goldman Sachs admitted that it often made recommendations to clients that it had already positioned itself to profit from. For example, Goldman made recommendations to clients to purchase collateralized debt obligations (CDOs), the mortgage-backed debt instruments, as it was pushing to have the instruments rated high even as it was positioning itself short on the instruments. "Positioning short" means that Goldman stood to make money when the value of the CDOs declined. Internal e-mails at Goldman found the investment banker referring to CDO securities as "junk," "shit," or "crappy."[90] When Goldman executives were asked about their internal negative characterizations of securities it was touting and selling to its clients, a Goldman executive, David Viniar, responded, "I think that's very unfortunate to have on e-mail." When his response elicited laughter in the hearing room,

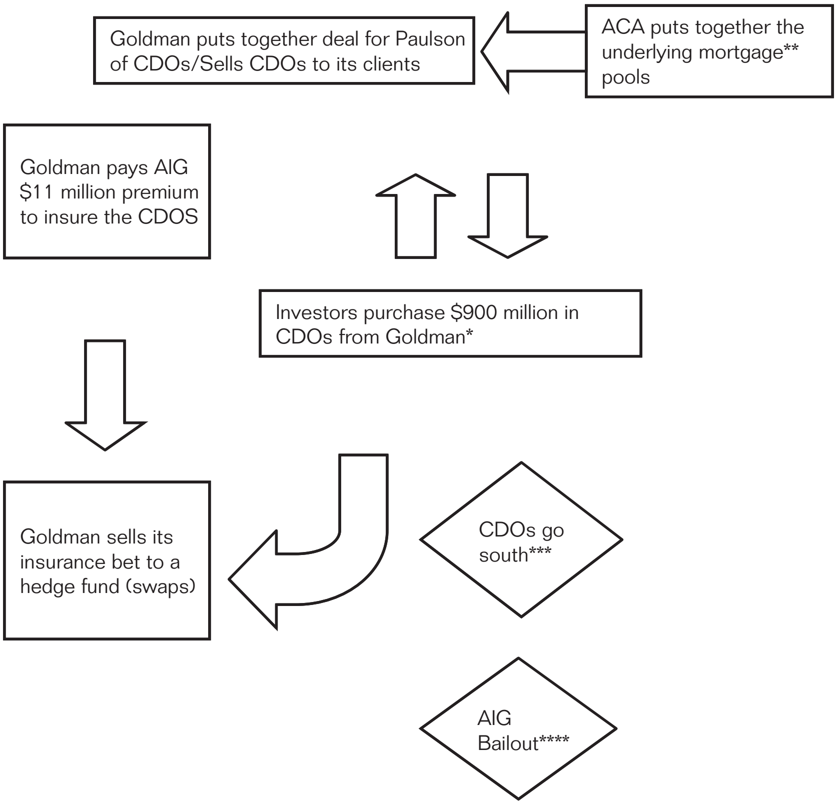
[87] *Id.*, p. A10.

[88] Liz Rappaport, "Goldman Balks at Helping Rich Clients Recover from Auction Rate' Securities," *Wall Street Journal*, August 14, 2008, p. C1.

[89] *Id.*

[90] Michael M. Phillips, "Senators Seek, Fail to Get an I'm Sorry,' "*Wall Street Journal*, April 28, 2010, pp. A3, A5.

Mr. Viniar changed his answer to, “It’s very unfortunate to have said that in any form.”[91] The following diagram is adapted from an article on the Goldman strategy.[92]


Goldman puts together deal for Paulson of CDOs/Sells CDOs to its clients
ACA puts together the underlying mortgage** pools
Goldman pays AIG $11 million premium to insure the CDOS
Investors purchase $900 million in CDOs from Goldman*
Goldman sells its insurance bet to a hedge fund (swaps)
CDOs go south***
AIG Bailout****

*Investors believe they are investing in mutual-fund grade securities and will receive returns on their purchase.

**SEC alleges Paulson had input on quality of mortgages in the pool.

***Investors lose their $900 million, which is then used by hedge funds to pay Goldman, and AIG must pay for those losses it insured.

****Federal government bails out AIG.

The SEC filed a civil action in April 2010 against Goldman for its conduct in a CDO deal known as ABACUS. According to the complaint, 31-year-old Goldman employee Fabrice Tourre put together a deal of CDOs with the mortgage pool handpicked by John Paulson, a financial wizard who planned to position himself short on the securities Goldman would sell to its clients. The SEC complaint alleges that Paulson chose mortgage pools that were dogs, that is, “crappy.” Those mortgages were chosen because having these securities “tank” was important to Goldman and Paulson because of their positions on the mortgage instrument markets. However, Mr. Tourre and Goldman had a third party, ACA Management, actually structure the deal so that they were distanced from choosing the mortgage pools for the instruments.

[91] *Id.*, p. A5.

[92] Gretchen Morgenson and Louise Story, “Banks Bundled Debt, Bet Against It and Won,” *New York Times*, December 4, 2009, pp. A1, B4.

ACA folks were curious about their role and sent e-mails to Goldman inquiring as to why Paulson would exclude Wells Fargo mortgages from the pool because Wells was known for "quality" subprime mortgages. ACA (not charged with any violations) comes across in the complaint as a firm that was asking all the right questions over and over again. It was seeking reassurance, and received it from Goldman's team. The complaint tells a story of Goldman using a trusting firm, one that was relying on Goldman's reputation, to distance itself from Paulson and what amounted to a transaction/security offering that was set up from the beginning to allow Paulson and Goldman to profit from their short positions on the CDO market.

The issue that Goldman contested initially with the charges was whether it knowingly failed to disclose its position and strategies to investors. Goldman maintained that its clients were "qualified" and/or "sophisticated" investors to whom the firm was not required to provide the detailed information that is mandated under general public offerings. Goldman's position initially was that the clients who purchased the instruments were in a position and had a level of knowledge of markets to understand and process the risk and realize that all investment bankers are positioned in the market according to their theories on risk.

Goldman also pointed out that its memo read in part, "We may trade, and have existing positions, based on trading ideas before we have discussed those ideas with you."[93] The disclosure of the Goldman client-contra positions had appeared in the fine print in Goldman's marketing materials, but the memo represented the first time that Goldman had discussed it openly with its clients. Mr. Tourre was found guilty of civil fraud in August 2013.[94]

Experts indicate that Goldman was disclosing its conflict as a way of managing client relationships and trading positions. One expert has noted that the way the markets have evolved, client and investment firm relationships are "laden with conflicts of interest."[95]

On the eve of the congressional hearings into Goldman's role as an investment banker in the collapse of the CDO market, Goldman released a series of e-mails from Tourre that served to place him in a bad light. One of the e-mails, to his girlfriend in London, contained the following:

> Darling you should take a look at this article.… Very insightful.… More and more leverage in the system, *l'edifice entier risque de s'effondrer a tout moment.… Seul survivant potentiel*, the fabulous Fab (as Mitch would kindly call me, even though there is nothing fabulous about me, just kindness, altruism and deep love for some gorgeous and super-smart French girl in London), standing in the middle of all these complex, highly levered, exotic trades he created without necessarily understanding all the implications of those monstruosities [*sic*] … Anyway, not feeling too guilty about this, the real purpose of my job is to make capital markets more efficient and ultimately provide the US consumer with more efficient ways to leverage and finance himself, so there is a humble, noble and ethical reason for my job ;) amazing how good I am in convincing myself.!! Sweetheart, I am now going to try to get away from ABX and other ethical questions, and immediately plunge into Freakonomics.… I feel blessed to be with you, to be able to learn and share special things with you. I love when you advise me on books I should be reading. I feel like we share a lot of things in common, a lot of values, topics we are interested in and intrigued by.... I just love you!!![96]

[93] Sorkin, "At Goldman, E-Mail Message Lays Bare Conflicts in Trading," p.B1

[94] Kustin Baer, Chad Bray, and Jean Eaglesham, "'Fab' Trade Liable in Fraud," *Wall Street Journal*, August 2, 2013, p. A1.

[95] *Id.*

[96] *SEC v. Goldman Sachs and Fabrice Tourre*, 10 Civ. 3229 (BJ) (S.D.N.Y. filed April 16, 2010), www.sec.gov.litigation/litreleases/2010/lr21489.htm. You can find the emails in the complaint. For access to the full emails, go to http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7626096/Goldman-fraud-charges-emails-from-Fabrice-Tourre-to-girlfriend-Marine-Serres.html. Accessed July 20, 2010.

Goldman's activities in deals such as this have been described as "Heads Goldman wins, tails you lose."[97] Professor William K. Black at the University of Missouri at Kansas City has written, "Every game has a sucker, and in this case, the sucker was not so much AIG as it was the U.S. government and the taxpayer."[98] Mr. Blankfein defended his firm's conduct in November 2009 in an interview with the *London Times* by stating that he was just a banker "doing God's work."[99]

Executive Compensation and Shareholder Say on Pay

In 2008, Goldman received $10 billion from the U.S. government as part of the national bailout of financial firms. Goldman paid no bonuses in 2008. By the end of 2009, Goldman had a record year for its profits. As a result of the earnings record, the firm's compensation and bonus plans meant that its bonus pool totaled $20 billion.

When the earnings were announced, Great Britain's Chancellor of Exchequer, Alistair Darling, announced a 50 percent tax on bonuses paid to bankers. Just a few days later President Barack Obama gave a speech in which he referred disparagingly to "fat-cat bankers."[100]

However, after a week of internal meetings, Goldman CEO Lloyd Blankfein, acknowledging that "people are pissed off, mad, and bent out of shape" at bankers, issued a statement indicating that the firm's top thirty executives would not be receiving cash bonuses for 2009.[101] Mr. Blankfein and the top four executives received $9 million in stock as their bonuses, an amount that was about one-half of the bonuses paid to Jamie Dimon, the CEO of JPMorgan Chase, and just a fraction of Mr. Blankfein's 2007 bonus of $65 million.[102] The bonuses for other Wall Street CEOs were as follows: James Gorman (Morgan Stanley), $8.1 million; Brian Moynihan (Bank of America), $800,000; and Vikram Pandit (Citigroup), $1.00.

The decision did not affect the company's 31,000 other employees (at that time) and consultants who will benefit from the bonus pool, with a resulting amount of $800,000 per employee.[103]

In meeting with shareholders, the company also released information about new pay practices:

- Bonuses for 2009 would be paid in stock, with the stock being "Shares at Risk," which means that employees cannot touch the shares for five years.
- In future years, bonuses would be paid 70 percent in "Shares at Risk" and 30 percent cash.
- All shares are subject to a claw-back provision, which means the bonus can be lost if the employee was involved in any type of securities fraud or malfeasance.
- Shareholders will have a "say on pay" in future years, with the right to cast a nonbinding vote on the company's proposed compensation plans.[104]

[97] Farzad and Dwyer, "Not Guilty, Not One Little Bit," p. 31.

[98] *Id.*, p. 32.

[99] Arlidge, "I'm Doing God's Work," p. 1.

[100] Ian Katz and Christine Harper, "The 'Fat Cats' Try to Look Slimmer," *BusinessWeek*, December 28, 2009, and January 4, 2010, p. 26.

[101] Arlidge, "I'm Doing God's Work," p. 1.

[102] Susanne Craig and Matthias Rieker, "Goldman CEO Bows on Pay," *Wall Street Journal*, February 6–7, 2010, p. A1.

[103] Susanne Craig, "Goldman Blinks on Bonuses," *Wall Street Journal*, December 11, 2009, p. A1.

[104] Louise Story, "Goldman Sachs Bars Cash Bonuses for Top Officers," *New York Times*, December 11, 2009, p. A1.

TIAA-CREF, a teachers' pension plan that holds $1 billion in Goldman shares, praised the new provisions, indicating that Goldman had set a "high standard" for Wall Street firms.[105]

In addition, Goldman is weighing the adoption of a requirement that its executives give a percentage of their bonuses to charity. If adopted, the requirement would mirror one that existed at Bear Stearns, which was that executives had to give 4 percent of their income to charity. Bear Stearns then verified the contribution by requiring executives to submit their income tax returns for review.[106]

The Bailout for the Cash-Short Executives

Jon Winkelried, Goldman's co-chief operating officer, and Gregory K. Palm, its general counsel, two of the company's largest shareholders, were short on cash. Mr. Winkelried was paid $19.7 million for about 30 percent of his holdings, and Mr. Palm was paid $38.3 million for 25 percent of his holdings.[107] Goldman feared that if the two sold their interests in the market, the result would be market turmoil from rattled investors. Another executive pledged 500,000 of his shares in exchange for a loan from Goldman.

Under Sarbanes-Oxley, publicly traded companies are prohibited from making loans to executives. Goldman indicates the transactions were not loans, but stock purchases from the executives.

Goldman Settles Up and the Future

The SEC charges had an impact on Goldman because of its nature and its focus on client trust and also because Goldman did not disclose in two 10Q filings that followed that it had received a Wells notice from the SEC on the possible charges.[108] Its market cap fell by $12.4 billion when the SEC charges were announced in April 2010, a loss of $21 billion. Its share price dropped from $190 to $145 within the two months following.

Goldman's initial defiance was tempered, and on July 16, 2010, the SEC announced a settlement with the company. Goldman agreed to pay $550 million in penalties and client reimbursements. Clients' losses have been estimated at $1 billion. Fabrice was tried on charges of civil fraud, and the jury found him guilty. As of 2013, he was enrolled in a doctoral program at the University of Chicago.

As of April 2013, Goldman remained unbowed. Mr. Blankfein has said that Goldman and JPMorgan Chase were the last two investment banks standing.[109] Goldman's earnings for its investment banking division for 2012 increased 36 percent, and its lending division's earnings were up 8 percent. However, its goal of 20 percent ROI was not met, with ROI for 2012 coming in at just 5 percent. As a result, Goldman has scaled back the 20 percent goal but has yet to share with analysts what that goal will be. In other words, Goldman has acknowledged it must learn to live with lesser returns in a new and different world with increased regulations that addressed the loopholes in so much of its business model.

[105] *Id.*

[106] Louise Story, "Goldman Weighs Requirement for Charity," *New York Times*, January 11, 2010, p. B1.

[107] Louise Story, "Goldman Bailed Out 2 Executives," New *York Times*, March 28, 2009, p. B1.

[108] "Silence Was Goldman; Will a Price Be Paid?" *Wall Street Journal*, April 19, 2010, p. C8. A Wells notice is an advance notification from the SEC to a target in an investigation.

[109] Susanne Craig, "Goldman Is Unbowed, but Caution Remains," *New York Times,* April 17, 2013, p. B1.

Discussion Questions

1. Go back through the case and make a list of each action or practice that could be called a gray area.
2. Evaluate each of the actions or practices, using ethical analysis models other than the question "Is it legal?"
3. List all those who were affected by the Goldman gray areas you have found. Describe the impact of Goldman's strategies and products up and down the economic chain.
4. What factors in the Goldman culture influenced the decisions of the employees, executives, traders, and advisers?
5. During the April 2010 hearings on Goldman's CDO transactions, Senator Claire McCaskill said to Mr. Blankfein as he testified before Congress, "It feels like you guys are betting on the game you're playing," and securities law expert, Professor John Coffee said, "I think we're seeing another one of those periodic eruptions because we see this story of investment bankers who seem to be playing both sides against the middle, and the investor looks like a sucker."[110]

   The SEC complaint on the Goldman CDOs paints a picture of a company playing both sides of a deal even as it knew the hands both sides were playing. Senator John Ensign, a senator from Nevada, was offended when other senators referred to Goldman's operations as akin to running a Las Vegas casino, because he said it was an insult to the casinos. Continuing the metaphor, Senator Ensign explained that Goldman was running the casino and using an eye-in-the-sky to figure out any hand played by its patrons. Gambling math does give the house a leg or two up anyway, but the SEC complaint paints a picture of investors never having a chance because the other side not only knew the hand they played, but the other side, Goldman, was setting up the cards to be dealt and the nature of the deck before the game began.

   Think back to the Albert Carr reading on ethics in business (Reading 2.3), and apply it to what happened in the CDO market. Was Goldman just bluffing, or did it have cards up its sleeve? Evaluate Mr. Blankfein's statement that Goldman does not have disclosure responsibilities to those who are "qualified" or "sophisticated" investors under SEC rules.
6. Howard Chen, a banking analyst, issued these observations on the Goldman settlement: (1) He observed that there would be no management changes at Goldman; and (2) said, "We do not anticipate any material long-term impact to the firm's client franchise."[111] What concerns do you have about these perhaps very accurate observations about the settlement?
7. In one of his e-mails, Fabrice Tourre, who made $1.7 million in 2007, the year of the Paulson deals, wrote, " . . . not feeling too guilty about this, the real purpose of my job is to make capital markets more efficient and ultimately provide the US consumer with more efficient ways to leverage and finance himself, so there is a humble, noble, ethical reason for my job ;). amazing how good I am in convincing myself." Describe his method of ethical analysis.

Compare & Contrast

Senator Susan Collins of Maine posed a question to several Goldman executives during the April 2010 congressional hearings, "I understand that you do not have a legal fiduciary obligation. But did the firm expect you to act in the best interests of your clients as opposed to acting in the best interests of the firm? Could you give me a yes or no [as] to whether or not you considered yourself to have a duty to act in the best interests of your clients?"[112] Fabrice Tourre responded only with, "I believe we have a duty to serve our clients well."[113] Mr. Blankfein responded with the following, "While we strongly disagree with the SEC's complaint, I also recognize how such a complicated transaction may look to many people. To them, it is confirmation of how out of control they believe Wall Street has become, no matter how sophisticated the parties or what disclosures were made. We have to do a better job of striking the balance between what an informed

[110] David Lynch, "Goldman Hearings Strike a Defiant Note," *USA Today*, April 28, 2010, p. 1B, at 2B.

[111] http://pulse.alacra.com/analyst-comments/Howard_Chen-A1904. Accessed July 20, 2010.

[112] Wall Street and the Financial Crisis: The Role of Investment Banks, Hearings of the Permanent Subcommittee on Investigations, April 27, 2010, http://hsgac.senate.gov/public/index.cfm?FuseAction-Hearings.Hearing&Hearing_ID=-f07ef2bf-914c-494c-aa66-27129f8e6282. Accessed July 20, 2010.

[113] *Id.*

client believes is important to his or her investing goals and what the public believes is overly complex and risky."[114] Other Goldman executives provided the following responses to Senator Collins, "It's our responsibility … in helping them transact at levels that are fair market prices and help meet their needs," and "Conceptually it seems like an interesting idea."[115]

Investment advisers are not considered fiduciaries under federal or state law. Without that legally imposed fiduciary duty, the advisers can legally engage in transactions that may not be in the best interests of their clients. That is, they are free to sell, sell, sell products from their firms that make more money for their firms but may not be in the best interests of the client, as was done with the CDOs. In another e-mail, Mr. Tourre wrote, "I'm [*sic*] managed to sell a few abacus bonds to widows and orphans that I ran into at the airport, apparently these Belgians adore synthetic abs cdo2." (June 17, 2007).[116] What is Senator Collins asking of the Goldman executives in terms of what you have learned about stakeholders and ethical analysis? Evaluate Mr. Tourre's and Mr. Blankfein's postures and those of the other Goldman executives on the role of business in society.

Case 2.12

Making Believe We Are at Work or Being Loyal: The Alibis of Technology

New technology permits you to answer your phone anywhere in the world—in your office or from the beach in Maui. No one even needs to know that you are not in your office. New technology allows you to turn on lights, electronics, and even control the temperature in your office. You can make it seems as if you are there. Some people have been known to go into the office in the morning, leave their jackets and briefcases, and then, using cell phone technology, control their lights, turning them off and on, and even change the screens on their computers to make it seems as if they have been in and out of the office.

There are even services that can help you boost your credibility when you are not really where you said you were going to be during the work day or workweek. The *New York Times* ran an article entitled, "For Liars and Loafers, Cell Phones Offer an Alibi."[117] The article explains, among other things, that 20-year-old Kenny Hall wished to spend a weekend in Boulder, Colorado, with a woman other than his girlfriend. Mr. Hall sent out text messages seeking help from a network of individuals who help each other miss dates, get out of obligations, cancel blind dates, ditch work and school, and generally provide alibis to each other. Mr. Hall's text message yielded a response from someone at the University of Colorado, Boulder, who offered to call Mr. Hall's girlfriend, posing as the soccer coach from that university, and indicate that Mr. Hall needed to be there for a try-out. The area code from the young volunteer's cell phone matched that of the university.

The article points out that there are even freelance deceivers who will make these types of calls for $2.99 each. One of the owners of such a freelance company indicates, "It lets you control your environment." An owner of a European alibi club shut his business down after he got a new girlfriend: "She thought it was immoral. Imagine that!"[118]

[114] *Id.*

[115] *Id.*

[116] John D. McKinnon and Susanne Craig, "Investigators Interview Tourre," *Wall Street Journal*, April 26, 2010, p. B5.

[117] Matt Richtel, "For Liars and Loafers, Cell Phones Offer an Alibi," *New York Times*, June 26, 2004, pp. B1, B14.

[118] *Id.*, at p. B1.

Discussion Questions

1. Are these alibi clubs immoral?
2. Would you participate in an alibi cell phone club? Explain your decision using the models you have applied.

Compare & Contrast

Why do you think the new European girlfriend felt so differently from others and felt so strongly about these alibi services? Be sure to think of the role of a credo in developing your answer.

Case 2.13

Make-Believe Reality TV: Storage Wars and Reconstructed Home Sales

The reality show business is a tough one. Lawsuits and allegations have emerged during 2012 and 2013 that there's a "fix" on some of the shows. For example, David Hester, one of the stars of "Storage Wars," a show in which people bid on the unknown contents of storage lockers that have been padlocked because those who rented them have not paid their fees and not returned to claim their property, has filed a suit alleging that the lockers are "salted." "Salted" means that valuable items such as a BMW or a newspaper announcing Elvis's death are planted in the storage lockers to make the show more exciting when the winning bidder gets to open the storage unit. For example, Mr. Hester paid $750 for a locker and found $90,000 worth of Elvis newspapers in it. A&E, the network on which the show airs has denied the allegations and maintains that the lockers are sealed prior to auction so that no one would have the ability to "salt" their content and alleges that Mr. Hester filed the suit only because of his termination. However, some e-mails and receipts have emerged that raise questions about whether the denial is accurate.[119]

HGTV was hit with allegations about its "House Hunters" show when a participant alleged that she was told she could not have her story featured until she had already closed on the home and that she would then "pretend" to tour other houses that she was not really considering as part of her search. In another allegation related to the international spin-off of the show, a blogger wrote about her villa in Mexico being set up as one of the "fake" almost-purchases in the show.

> The actual home-owners were American expats in their late fifties. HGTV wanted a young couple [for] a wider audience, [not] the typical retirees depicted on "House Hunters International." The producers swapped in a younger couple to play the buyers.[120]

Even TLC's *Breaking Amish* was challenged by the Amish participants who said that they had already left their Amish homes by the time the show came calling and that some were married and divorced and that they were not, as the show portrayed them, Amish young adults who were leaving their homes for the first time in order to live in New York City. Two cast members revealed near the end of the season that they had already had a child together before the season featuring their "first time in the big city" began. In this allegation, it was not clear whether the producers were aware of the cast's true pasts because they did make misrepresentations about their "first time off the farm" status.

[119] Kirsten Acuna, "'Storage Wars' Star Claims Show Is Fake After He's Fired," *Business Insider*, December 12, 2012, http://www.businessinsider.com/david-hester-says-storage-wars-is-fake-2012-12.

[120] Shana Ecker, "House Hunters, HGTV's Hit Reality Show, Is Fake: One Villa 'Seller' Reveals Her Experience," *Huff Post Home*, June 15, 2012, http://www.huffingtonpost.com/2012/06/15/hgtv-house-hunters-fake_n_1600522.html.

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Television has a long history when it comes to misrepresentations. The Robert Redford film, *Quiz Show* tells the story of the game shows of the 1950s and 1960s and the issue of contestants being given questions and/or answers in advance of the program. In some cases, the questions and answers were given in order to keep a winning and likeable champion on the air. As one producer noted at that time, "It's just entertainment."

Discussion Questions

1. Are any of these scenarios more serious ethical issues than the others?
2. One blogger has noted that even if the *House Hunter* show is all fake, she just enjoys the chance to see inside so many different house. Does "no harm, no foul" apply?
3. What is different about the Amish show, and why? Where is the ethical issue in that situation?

Case 2.14

Travel Expenses: A Chance for Extra Income

The *New York Times Magazine* profiled the problems with employees' submissions for travel and entertainment expenses reimbursement. American Express reported that employees spend $156 billion annually on travel and entertainment related to business. Internal auditors at companies listed types of expenses for which employees have sought reimbursement: hairdressers, traffic tickets, and kennel fees.

Although the IRS raised the amount allowable for undocumented expenses to $75, most companies keep their limit for employees at $25. One company auditor commented that all taxicab rides now cost $24.97, and if the company went with the IRS limit, the cab fares would climb to $74.65.

Here are some of the horror stories auditors have on travel and entertainment expenses submitted by employees:

- One employee submitted a bill for $12 for a tin of cookies. When questioned, he could not explain how it had been used but asked for reimbursement anyway because all he would have to do is "make up" a couple of taxi rides to get the money back anyway;
- $225 for three hockey tickets, when the names on the tickets were the employee's family members;
- $625 for wallpapering. The employee had included it with her other travel expenses and even had the wallpaper receipt written in a different language in order to throw off any questions; and
- $275 for a sports jacket, submitted as a restaurant bill. The travel office called the number listed on the receipt and asked if food was sold there. The response was, "No, we're a men's clothing store."[121]

Discussion Questions

1. The auditors noted that employees who are confronted often respond with similar justifications:

   "The company owes it to me."

   "It doesn't really hurt anyone."

   "Everybody does this."

   Are these justifications or rationalizations?
2. Why do employees risk questionable expenses?
3. Who is harmed by dishonest expense submissions?
4. There is a book called *How to Pad Your Expense Report … and Get Away with It!* by Employee X. Employee X says that he offers these suggestions because of the "obscene salaries" of executives. Employee X also notes that he has been cheating on his expenses for so long that he doesn't even think about it anymore. Can you see any of the rationalizations in Employee X's views? What critical point do you discern from habit and ethics working together?

[121] Paul Burnham Finney, "Hey, It's on the Company!" *New York Times Magazine*, March 8, 1998, pp. 99–100.

Case 2.15

Do Cheaters Prosper?

In a book entitled *Cheaters Always Prosper: 50 Ways to Beat the System without Being Caught*,[122] James Brazil (a pen name), a college student from the University of California, Santa Barbara, has provided fifty ways to obtain a "free lunch." One suggestion is to place shards of glass in your dessert at a fancy restaurant and then "raise hell." The manager or owner will then come running with certificates for free meals and probably waive your bill.

Another suggestion is, rather than spend $400 on new tires for your car, rent a car for a day for $35 and switch the rental car tires with your tires. So long as your car tires are not bald, the rental car company employees will not notice, and you will have your new tires for a mere $35.

Discussion Questions

1. Are these suggestions ethical?
2. Was publishing the book with the suggestions ethical?
3. Do any of these suggestions cost anyone any money?

Case 2.16

The Home Repair Contractor Tempted By Customers and Contracts

Each summer in the Phoenix area, home and property owners are plagued by the damages inflicted by monsoon—the rain and dust storms that hit the Valley of the Sun almost nightly. The result can be significant property damage, from the loss of windows to roof damage, to flooding. Contractors have their busiest season during monsoon because the extent of damage and the availability of home insurance coverage bring daily opportunities.

Craig Gunther, the owner of a small home repair business, made an estimate call on a home in the west portion of Phoenix. There had been a hailstorm the night before, and the homeowner had both roof and window damages. Craig prepared an estimate for their repairs, and the homeowner asked, "What about the air conditioner unit?" Craig replied, "Well, it's in bad shape, but it is age—there is no hail damage there." The homeowner responded, "Why can't you just put it in as part of the claim?" Craig explained that he would not feel right about doing that. The homeowner responded, "Fine. If you won't do it, I'll just call someone else, and they will do it for me. All you are doing is losing business." The next week, Craig, while doing another estimate in the area, drove by that house and noted that the roof, the windows, and the air conditioner were all being repaired.

Discussion Questions

1. Evaluate the homeowner's ethics in this situation.
2. Why did Craig refuse to submit the air conditioner as part of the storm damage claim?

[122] James Brazil, *Cheaters Always Prosper: 50 Ways to Beat the System without Being Caught* (1996).

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Case 2.17

Penn State: Framing Ethical Issues

The Penn State Nittany Lions football team, begun in 1887, has been a powerhouse. The team has had seven undefeated seasons, two national titles, two Big Ten conference titles, and five other national championships. In addition, the team has tied with Stanford University for the number ten slot on player graduation percentages, with 87 percent in 2011. The team was referred to as a "grand experiment" for its devotion to performance both on and off the field. From 1966 through 2011, the late Joseph "Joe" Paterno, fondly known as PapaJo, coached the Nittany Lions. He was, until recent events, the "winningest coach" in college football, accumulating 409 wins to 164 losses and three ties.

The National Collegiate Athletic Association (NCAA) stripped Mr. Paterno of 112 of his wins (from 1998 through 2012), required Penn State to pay a fine of $60,000,000, banned the team from bowl games, cut ten scholarships for the 2011–2012 season and twenty scholarships from 2012–2016. These levels of sanctions, just shy of the rare death penalty in college athletics in which a sports program is shut down, are generally the result of recruiting violations, payments to student-athletes, or falsification of academic records. However, the sanctions are not the result of violations in any of those areas. Penn State suffers from a near death-penalty from inaction related to the criminal activity of one of its assistant coaches, Jerry Sandusky, and the failure of Mr. Paterno, the athletic director, and other university officials to take action to stop Mr. Sandusky at any time during his long history of child abuse, from 1998–2011. Those "recent events" have resulted in a forever-changed atmosphere in State College, Pennsylvania, the home of Penn State that once carried the nickname, "Happy Valley."

To help you as you read the case, the following is a chart that identifies all of the individuals involved in the case.

Name	Title/Role
Joe Paterno	Head football coach at Penn State from 1966–2011
Gerry Sandusky	Assistant football coach at Penn State from 1969–1999
Wendall Courtney	Attorney for Sandusky charity and outside counsel for Penn State for twenty-eight years
Alycia Chambers	Psychologist in State College, PA—first contacted about abuse
Ron Schreffler	Detective at Penn State University Police Department
Jerry Lauro	Case worker who handled the first Sandusky complaint
Graham Spanier	Penn State president during Sandusky years until 2011
Tim Curley	Penn State athletic director during Sandusky years
Gary Schultz	Penn State senior VP for finance and business
Thomas Harmon	Penn State police chief
Jim Calhoun	Penn State janitor in football facilities who witnessed a Sandusky incident in 2000
Michael McQueary	Grad student and assistant football coach under Paterno
Cynthia Baldwin	Penn State general counsel
Vicky Triponey	Penn State standards and conduct officer who left the university

The First Investigation of Jerry Sandusky's Conduct

Gerald A. Sandusky (Jerry) was a Penn State University alum, having attended the university from 1962–1966. Following his graduation, Mr. Sandusky became a graduate assistant in the Penn State football program for one year.[123] He then left to take a position as a physical education instructor and coach at Juanita College for one year, from 1967–1968. He was also a physical education instructor and coach at Boston University from 1968–1969. Penn State hired Mr. Sandusky in 1969 as an assistant football coach and assistant professor of physical education, a position he held until his retirement in 1999.[124]

In 1977, with the help of attorney Wendall Courtney, Mr. Sandusky founded the "Second Mile," a nonprofit organization dedicated to providing recreational and sports experiences for disadvantaged Pennsylvania children.[125] Second Mile has a Board of Trustees, and there were many Penn State employees or members of their families who served as trustees for Second Mile. In addition, Penn State employees and their families supported Second Mile with donations and through their service at events sponsored by Second Mile. Second Mile was permitted very open access to Penn State facilities for its events. Because of this access and sporting events held on campus for Second Mile children, Mr. Sandusky was seen frequently (prior to 1998) in the showers of the Lasch Building (showers used by the Penn State football team) with those children. None of those who saw this activity, including assistant coaches, reported the shower behavior to anyone at Penn State.

Sandusky's Sexual Abuse of Second Mile Boys and University and Law Enforcement Responses

It was in 1998 that the unreported activities by Mr. Sandusky resulted in third-party involvement. On May 3, 1998, Mr. Sandusky picked up an 11-year-old boy at his home, based on a prior invitation to the boy and his mother to have the child use the exercise facilities at the Lasch Building. The young boy showered with Mr. Sandusky after exercising and was upset by Mr. Sandusky's touching and holding. Mr. Sandusky told the boy that he loved him and that they had a special relationship. When he returned home after these events, his mother was concerned because he explained that he had showered with Mr. Sandusky and also because he was behaving in a way that she knew indicated he was upset about something.

On May 4, 1998, the boy's mother called Alycia Chambers, a psychologist in State College, PA, who had been working with the young boy, seeking her advice on whether she was right to be concerned about what had happened between her son and Mr. Sandusky. Ms. Chambers told the boy's mother to report the incident to authorities.

The boy's mother then reported the incident that same morning (the morning after the shower events with her son) to Detective Ron Schreffler of the University Police Department. Detective Schreffler interviewed the boy one-half hour later and was given all the details, including the additional information that one of the boy's 10-year-old friends had experienced the same type of treatment by Mr. Sandusky in the Lasch showers.

After Ms. Chambers met with the boy, she called the Pennsylvania child abuse hotline and made a report. Her subsequent consultation with colleagues convinced her that what

[123] Freeh Sporkin & Sullivan, LLP, Report of the Special Investigative Counsel Regarding the Actions of the Pennsylvania State University Related to the Child Sexual Abuse Committed by Gerald A. Sandusky (2012), p. 39. This report will hereafter be abbreviated as "Freeh Report."

[124] Mr. Sandusky received tenure in 1980.

[125] Mr. Sandusky's book, *Touched: The Jerry Sandusky Story*, is an autobiographical tome that focuses on Mr. Sandusky's "passion for helping disadvantaged youth," Freeh Report, at p. 40.

was occurring was a “pedophile’s pattern of building trust and gradual introduction of physical touch, within a context of a ‘loving, special’ relationship.”[126]

Detective Schreffler notified the Centre County Children and Youth Services (CYS) about the investigation, but was referred to the Department of Public Welfare because of connections between CYS and the Second Mile and Mr. Sandusky. Caseworker Jerry Lauro handled the case for the Department of Public Welfare. Detective Schreffler also contacted the Centre County prosecutor, but did not notify officials at Penn State. When asked why he did not talk with university officials, he said that he did not want to have to “worry about Old Main sticking their nose in the investigation,” something he had experienced in the past.[127]

As the investigation progressed, Mr. Sandusky continued to telephone the boy, and those involved worked to develop reports and information. Ms. Chambers turned over her report to Detective Schreffler, a report that emphasized the gravity of the events. However, for some reason Mr. Lauro did not receive the Chambers report and only received a report from John Seasock, a counselor who had a contract with CYS. Mr. Seasock’s report ruled out that there was a situation in which boys were being groomed for sexual victimization and recommended only that someone visit with Mr. Sandusky about acceptable behavior with children.[128] Mr. Seasock did not see a risk because he had never heard of a 52-year-old man becoming a pedophile.[129]

About a week after the shower incident, Mr. Sandusky returned to the boy’s home and met with the boy’s mother as Detective Schreffler and a local police officer hid and listened. Mr. Sandusky, when confronted by the mother about her son’s acting odd, explained that he might have just worked him out too hard. The mother suggested that Mr. Sandusky should leave her son alone. Mr. Sandusky apologized.

One week after the apology, Mr. Sandusky again met at the home of the boy with his mother (with Detective Schreffler and a local police officer listening) and was asked about the bear hug in the shower. Mr. Sandusky said that “maybe” his private parts touched those of the boy. He denied having sexual feelings and explained that he showered with other boys. The mother asked Mr. Sandusky to stay away from her son, and he responded, “I understand. I was wrong. I wish I could get forgiveness. I know I won’t get it from you. I wish I were dead.”[130]

One week later, Detective Schreffler and Mr. Lauro talked with Mr. Sandusky in the Lasch building, and Mr. Sandusky assured them “honest to God nothing happened.”[131] After that discussion, the investigation ended without anyone discussing what had happened with the district attorney.

Between May 4 and May 30, 1998, there were notes and e-mails among and between Penn State University president, Graham Spanier; Gary Schultz, the senior vice president for finance and business at Penn State; and Tim Curley, the Penn State athletic director. It is not clear how Mr. Schultz first learned of the May 4, 1998, events, but his notes reflect that he knew almost immediately and instructed University Police Department Chief Thomas Harmon to let him know everything as the investigation proceeded. His notes concluded

[126] Freeh Report, at p. 43.

[127] Freeh Report, at p. 43.

[128] The Freeh report quotes Mr. Seasock as writing, “The intent of the conversation with Mr. Sandusky is not to cast dispersion [*sic*] upon his actions but to help him stay out of such gray area situations in the future.” Freeh Report, at p. 44.

[129] Mr. Seasock did have a contract with Penn State from 2000 through 2006, receiving payments of $11,448.86 for counseling services. No one has made any connection between his relationship to Penn State and his decisions in the 1998 case.

[130] Freeh Report, at p. 45.

[131] Freeh Report, at p. 46

that Mr. Sandusky's behavior was "at best—inappropriate @ worst sexual improprieties."[132] After he received more information about the second boy's experience and the hotline report, his notes ask, "Is this opening of pandora's box? Other children?"[133]

The correspondence and notes also indicate that Mr. Curley had notified Mr. Schultz and Coach Paterno, and both had asked to be kept informed about the investigation. Other documents indicate that Mr. Spanier was also notified, but he denied being aware of the issue and noted that he received many e-mails each day that keep him informed about an array of evolving concerns.

At some point Mr. Harmon made the decision not to make a crime log entry related to the Sandusky allegations. Mr. Harmon wrote to Mr. Schultz that "I can justify that decision because of the lack of clear evidence of a crime."[134] All the investigation paperwork was labeled "Administrative Information" and never classified as a criminal investigation.

Also, at some point the administrators and University Police made the decision not to notify the Penn State Office of Human Resources (OHR), a practice that was typical in other cases in which staff or faculty were under investigation.

As the investigation continued, inquiries came from the athletic department. On May 13, 1998, Mr. Curley sent an e-mail with the subject line "Jerry" to Mr. Schultz, asking, "Anything new in this department? Coach is anxious to know where it stands."[135] Mr. Curley also requested updates on May 18 and May 30, 1998.[136]

When the investigation was concluded, and after the investigators' meeting with Mr. Sandusky, Mr. Schultz sent the following e-mail to Mr. Spanier and Mr. Curley:

> [Investigators] met with Jerry on Monday and concluded that there was no criminal behavior and the matter was closed as an investigation. He was a little emotional and expressed concern as to how this might have adversely affected the child. I think the matter has been appropriately investigated and I hope it is now behind us.[137]

None of the documents or correspondence indicates that Mr. Sandusky was warned not to shower with children. There was no discussion of whether Penn State should continue to allow its facilities to be used by Second Mile and no advice given to Mr. Sandusky to seek counseling. In addition, no one in risk management was notified about the incident or the investigation. In 1999, when Mr. Sandusky retired, there was considerable correspondence regarding Mr. Sandusky's request to continue to use Penn State facilities, particularly the Lasch Building, for Second Mile programs and events. When Mr. Sandusky wrote to request "access to training and workout facilities" in his retirement, risk management officials hand wrote their response on the request, "Is this for personal use or 2nd Mile kids. No to 2nd Mile. Liability problems."[138]

[132] Freeh Report, at p. 47.

[133] *Id.*

[134] Freeh Report, at p. 48.

[135] Freeh Report, at p. 49. When Mr. Paterno testified before the Sandusky grand jury in 2011, he testified that he knew no other incidents involving "Jerry" other than the Mike McQueary report (see *infra* for more information on this incident). Freeh Report, at p. 53.

[136] When the investigation of Mr. Sandusky was before the grand jury, Mr. Curley testified that he could not recall that any incident involving Mr. Sandusky and children in the showers was ever brought to his attention. Freeh Report, at p. 52.

[137] Freeh Report, at p. 50. When the investigation of Mr. Sandusky was before the grand jury, Mr. Schultz was called as a witness. When asked about the 1998 campus investigation, Mr. Schultz said, "I was never aware that Penn State police investigated inappropriate touching in a shower in 1998." Freeh Report, at p. 52. Mr. Spanier told investigators in the later Sandusky grand jury case that the first he knew of the 1998 incident was in 2011 when he appeared before the grand jury.

[138] Freeh Report, at p. 51.

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The Impact of Inaction—1998–2001

The 2012 convictions of Mr. Sandusky for child sexual assault involved the following incidents:

- Victim 2—assaulted in the Lasch Building in February 2001
- Victim 3—assaulted in the Lasch Building on dates between July 1999 and December 2001
- Victim 4 –assaulted in Old Lasch and the Lasch Building between 1999 and 2000, as well as during a Penn State bowl game trip to Texas in December 1999
- Victim 5—assaulted in the Lasch Building in August 2001
- Victim 8—assaulted in the Lasch Building in November 2000

In Fall of 2000, Jim Calhoun, a janitor in the Lasch Building, told a coworker that he had witnessed Mr. Sandusky in the Lasch Building showers pinning a boy against the wall and sexually assaulting him. Mr. Calhoun told his coworker that he had "fought in the [Korean] War … seen people with their guts blowed out, arms dismembered … I just witnessed something in there I'll never forget."[139] Later that night the janitor who listened to Mr. Calhoun's report saw two pairs of feet in the same shower in the Lasch Building. He waited for the two to finish and then saw Mr. Sandusky and a young boy (about 12) leave the locker room holding hands. The supervisor for Mr. Calhoun and the other janitor who witnessed the Sandusky conduct advised them to report the incidents. Mr. Calhoun responded, "No, they'll get rid of all of us."[140] The second janitor responded that reporting the incidents "would have been like going against the President of the United States in my eyes. I know Paterno has so much power, if he wanted to get rid of someone, I would have been gone [because] football runs this University."[141] No report was made, there was no investigation, and University officials were unaware of the incidents witnessed by the janitors.

As noted earlier, Mr. Sandusky retired from Penn State in June 1999 with a lump-sum payment of $168,000. During the negotiations for his retirement, Mr. Spanier and Mr. Curley considered the possibility of giving Mr. Sandusky a position as assistant athletic director, but that possibility was abandoned. Mr. Sandusky had hoped to become head coach following Mr. Paterno's retirement but was told by Mr. Paterno in February 1998 that there was no way he would become head coach. There was some discussion of making Mr. Sandusky the head coach at the university's Altoona campus for a possible Division III football program there, but it proved financially unfeasible after Mr. Sandusky was given time to pull together a plan and resources for such a program. Mr. Sandusky was given emeritus rank, a retirement privilege awarded in colleges and universities on the basis of merit and career achievement. The Freeh Report concluded that Mr. Sandusky did not meet the eligibility requirements for emeritus status but also concluded that the retirement package awarded was not related to the 1998 investigation. The emeritus rank entitled Mr. Sandusky to access to university facilities, including Penn State's East Area locker room and its showers.

The 2001 Allegations against Jerry Sandusky

In February 2001, a graduate assistant with the football program, Michael McQueary, heard what he called "rhythmic slapping sounds" coming from the Lasch Hall showers at about 9:30 P.M. on a Friday evening. Using a mirror, Mr. McQueary looked into the showers and saw Mr. Sandusky with a "prepubescent" boy. Mr. Sandusky was directly

[139] Freeh Report, at p. 65.

[140] Freeh Report, at p. 65.

[141] Freeh Report, at p. 65.

behind the young boy and had his arms around the boy's waist. Mr. McQueary said that he believed Mr. Sandusky was sexually molesting the boy. Mr. McQueary slammed his locker, the conduct stopped, and Mr. Sandusky and the boy saw Mr. McQueary.

Mr. McQueary left the locker room and went to his office, where he called his father seeking advice. His father advised him to tell Mr. Paterno. Mr. McQueary called Mr. Paterno the next morning and requested a meeting. Mr. Paterno was somewhat gruff and told Mr. McQueary that he did not have a job for him and if that were the subject of the meeting, "don't bother coming over."[142] Upon Mr. McQueary's assurance that the matter was serious, the two met on the Saturday morning following the shower incident, and Mr. McQueary told Mr. Paterno that he had witnessed Mr. Sandusky involved in conduct with a young boy that was "extremely sexual in nature." Mr. Paterno told Mr. McQueary that he would figure out what needed to be done.

Mr. Paterno then had a meeting on Sunday in his home with Mr. Curley and Mr. Schultz, where he discussed what Mr. McQueary had seen. Mr. Schultz then called Penn State's outside legal counsel, Wendell Courtney, about reporting child abuse. Mr. Courtney had been Penn State's outside legal counsel for twenty-eight years, and his law firm had represented the university for almost fifty years.

The next day, February 12, 2001, Mr. Curley, Mr. Schultz, and Mr. Spanier met.[143] The three agreed to meet with Mr. Paterno later in the week to discuss their obligations to report the conduct to the state's Department of Public Welfare. Mr. Spanier asked Mr. Curley to meet with Mr. Sandusky and tell him that Second Mile boys could no longer use the showers. Prior to the meeting, Mr. Schultz had used the Internet to research the names of the Second Mile board members. Mr. Schultz also sent an e-mail to Mr. Harmon to inquire whether there were university records related to the 1998 event involving Mr. Sandusky. Mr. Harmon's e-mail response indicated that there were records and that they were in the university's "imaged archives."[144]

About ten days after he met with Mr. Paterno, Mr. McQueary met with Messrs. Schultz and Curley and discussed the incident. Messrs. Schultz, Curley, and Spanier then met again. Notes from the meeting reflect a three-step action plan of telling Mr. Sandusky that he was banished from the facilities, informing Second Mile about the incident, and notifying the Department of Public Welfare about the incident.[145]

One day later, on February 27, 2001, Mr. Curley proposed to Mr. Spanier and Mr. Schultz a different plan of simply talking to Mr. Sandusky first before involving third parties, explaining that he was uncomfortable revealing the information to others until they had Mr. Sandusky's response.[146] He then proposed that Mr. Sandusky then go with him to talk to Second Mile board members, after he was able to get

[142] Freeh Report, at p. 67.

[143] The notes of this meeting and other documents related to Mr. Sandusky were removed from Mr. Schultz's office in November 2011 by Mr. Schultz's assistant after the grand jury returned an indictment of Mr. Sandusky on criminal charges of child sexual assault. The existence of those files was not known until May 2012, as Mr. Freeh conducted his investigation of the university's actions involving Mr. Sandusky's conduct. Freeh Report, pp. 69–70. No one at the university made any attempt to find out who the boy in the showers was and inquire after his well-being.

[144] Freeh Report, at p. 71.

[145] At this point, Mr. Freeh's report indicates that the e-mails among and between university officials changed dramatically. In 1999 e-mails and pre-February 26, 2001. e-mails (those following the February 26th meeting involving Spanier, Curley, and Schultz that resulted in the three-part action plan) referred to Mr. Sandusky by name, but the 2001 e-mails referred to him as "the subject" or "person," Second Mile as "the organization," and the Department of Public Welfare as "the other organization."

[146] Mr. Freeh included some descriptions of Mr. Curley in his report, including that those at the university referred to Mr. Curley as Mr. Paterno's "errand boy" and that he was "loyal to a fault," someone who followed instructions regardless of consequences.

Mr. Sandusky to agree to disclosure to Second Mile's board. He also proposed that Mr. Sandusky be required to obtain counseling. Mr. Spanier's response was as follows:

> Tim: This approach is acceptable to me. It requires you to go a step further and means that your conversation will be all the more difficult, but I admire your willingness to do that and I am supportive. The only downside for us is if the message isn't "heard" and acted upon, and we then become vulnerable for not having reported it. But that can be assessed down the road. The approach you outline is humane and a reasonable way to proceed."[147]

Mr. Schultz also responded favorably:

> Tim and Graham, this is a more humane and upfront way to handle this. I can support this approach, with the understanding that we will inform his organization, with or without his cooperation (I think that's what Tim proposed). We can play it by ear to decide about the other organization.[148]

Mr. Curley and Mr. Sandusky both agreed that the meeting was held, that he agreed to the proposed course of action, and that Mr. Spanier and Mr. Schultz were informed about the discussion and considered the matter closed.[149] During his grand jury testimony in 2011, Mr. Paterno reflected, "I didn't know exactly how to handle it and I was afraid to do something that might jeopardize what the University procedure was. So I backed away and turned it over to some other people, people I thought would have a little more expertise than I did. It didn't work out that way. In hindsight, I wish I had done more."[150]

Neither the 2001 nor the 1998 incidents and follow-ups were disclosed to the Penn State Board of Trustees. However, the Board of Trustees was asked to approve the sale of a parcel of land to Second Mile for $168,500. Penn State had purchased the land in 1999 and then approved the sale to Second Mile in September 2001. At the time of the approval, Mr. Schultz, who handled the transaction as the vice president of finance and operations, issued a press release on the sale and lauded Mr. Sandusky for his efforts with Second Mile.

The 2011 Grand Jury Indictment and Penn State's Response

In early 2010, the Pennsylvania Attorney General issued a subpoena to Penn State for documents and also subpoenaed Messrs. Spanier, Schultz, Paterno, Curley, and other members of the athletic department. On March 31, 2011, the first news report emerged about the Sandusky investigation as well as the Penn State subpoenas and the appearances before the grand jury of Penn State administrators. Prior to the news report, neither Mr. Spanier nor the university's general counsel informed the Board of Trustees about the incidents, the investigation that had begun, the subpoenas, or the testimony of university officials before the grand jury. At the May 2011 meeting, Mr. Spanier disclosed that there was an investigation after a trustee inquired about the press reports. Mr. Spanier's tone was dismissive regarding the events and the university's involvement. One trustee referred to Mr. Spanier's report on the matter as an "oh, by the way" report given at the end of the day. Several trustees noted that Mr. Spanier did not explain why university officials had been subpoenaed in the case if the issues were, as Mr. Spanier explained, involving Second Mile. The Board took no action and there were no

[147] Freeh Report, at p. 75.

[148] Freeh Report, at p. 76.

[149] Records reflect that Mr. Curley did meet with the executive director of Second Mile and informed him that Penn State would no longer permit Second Mile children on the campus "to avoid publicity issues." When the executive director talked with Mr. Sandusky, Mr. Sandusky indicated that he felt the restriction only applied to use of the locker rooms on the campus. Freeh Report, p. 78. Two trustees of Second Mile were told about the Curley meeting and outcome and concluded that it was a "non-incident" for Second Mile. *Id.*

[150] Freeh Report, at pp. 77–78.

additional reports until the Sandusky indictment became public in November 2011. The initial article on the investigation was not circulated to the Board members.

Prior to the indictment on November 4, 2011, on October 27, 2011, the university's general counsel, Cynthia Baldwin, was informed by the state attorney general's office that Mr. Curley and Mr. Schultz would also be indicted. This news started a series of meetings among the parties, as well as interaction with the Penn State Communications Office. One draft, objected to by communications staff members but not actually voiced because of the "sheep" atmosphere at the university was as follows:

> The allegations about a former coach are troubling, and it is appropriate that they be investigated thoroughly. Protecting children requires the utmost vigilance. With regard to the other indictments, I wish to say that Tim Curley and Gary Schultz have my unconditional support. I have known and worked daily with Tim and Gary for more than 16 years. I have complete confidence in how they have handled the allegations about a former University employee. Tim Curley and Gary Schultz operate at the highest levels of honesty, integrity, and compassion. I am confident the record will show that these charges are groundless and that they conducted themselves professionally and appropriately.[151]

The above press release was issued on November 5, 2011. A board conference call resulted in several board members being concerned about the university's response. For example, despite the knowledge of the pending indictment, several Board members noted that Mr. Sandusky was in the Nittany Lion Club at the university's October 29, 2011, football game. In addition, several board members called for an independent investigation of what had happened but were opposed by both Mr. Spanier and Ms. Baldwin, who opined in an e-mail to Mr. Spanier, "If we do this, we will never get rid of this group in some shape or form. The Board will then think that they should have such a group."[152]

Following a board meeting on Sunday, November 6, 2011, the university announced that Mr. Curley would be placed on administrative leave and that Mr. Schultz would reretire. The announcements also included the fact that there would be a special task force appointed to determine how to create appropriate policies and procedures for the protection of children on the campus. The press release with the information was, as the Freeh Report notes, a turning point for the board. Because its authority and decisions were not reflected in the language of the press release, several trustees began demanding additional meetings, a new chair, and other actions so that the board could know exactly what had happened and could control actions going forward. By November 8, 2011, the board issued its own statements expressing its outrage over the "horrifying details" in the Sandusky case and creating a task force to handle issues of university leadership going forward.[153]

Prior to the next board meeting, on November 9, 2011, Mr. Paterno announced his retirement following the end of the team's season (including its bowl appearances still looming). When the board met, it quickly acted to terminate Mr. Spanier for cause. The board's debate over Mr. Paterno was a lengthier and more contentious one, with some board members urging that the "worst mistake of his life" be weighed against the good that Mr. Paterno had done for Penn State. Some trustees urged administrative leave for Mr. Paterno; others felt the board was getting ahead of the facts; and others felt that board needed to take charge and that the retirement usurped the board's authority. The final decision was to terminate Mr. Paterno. There was no plan for communication to

[151] Freeh Report, at p. 90.

[152] *Id.*, at p. 92.

[153] *Id.*, p. 94.

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Mr. Paterno of his termination and, as a result Mr. Paterno learned of his fate via a hand-delivered note from the board. Mrs. Paterno then called the board to protest the treatment of her husband. The result of this ill-managed situation was a series of student protests, some violence, and some destruction of property.

The Interrelationships

Following the public disclosure of the indictment of Mr. Sandusky, and Messrs. Curley and Schulzte, additional information about the parties' activities became public. Mr. Schultz had contacted a bank for Mr. Sandusky, to encourage the bank to meet with Mr. Sandusky about a loan for Second Mile. Mr. Schultz wrote that Second Mile "are really good people and this is a great cause related to kids."[154] The bank did meet with Mr. Sandusky.

Penn State worked with Second Mile on many events, including the Second Mile Golf Tournaments that were held at the Penn State Golf Course. Second Mile had the distribution rights on cards that had pictures of the Penn State Football players along with the Second Mile and Penn State logos on the other sides of the cards. The sale of the cards raised money for both the university and Second Mile. Football players and other student-athletes worked routinely as volunteers for Second Mile and its events. Following his retirement from Penn State, Mr. Sandusky was paid $57,000 per year plus travel expenses to serve as a consultant to Second Mile. From 1999 through 2008, Mr. Sandusky handled the six one-week-long camps that Second Mile held on university facilities. The camps involved the use of athletic fields, the outdoor swimming pools, and the football facilities on the campus.

The Sandusky Guilty Verdict

A total of eight young men testified about Mr. Sandusky molesting them. There were a total of ten boys who were molested over a fifteen-year period. One juror noted that the young men were very credible witnesses, and there was nothing to indicate that they were not telling the truth. Mr. Sandusky was convicted on all forty-five counts of child sexual abuse. Mr. Sandusky is appealing his conviction on the grounds that his lawyers said they were "rushed to trial."[155] Mr. Sandusky received the maximum sentence of 442 years. When he was taken into prison, the other inmates sang some of the lyrics from Pink Floyd's "Brick in the Wall," to wit, "Hey, teacher! Leave them kids alone." Mr. Sandusky was placed in isolation because of the attitudes of general prisoner populations toward child molesters. One expert calls the fates of child molesters in prison, "a special circle of hell."

The Conclusions of the Freeh Report

The special report, commissioned by the Board of Trustees, concluded that Mr. Paterno, Mr. McQueary, and Mr. Curley were all required, under the provisions of Pennsylvania reporting statutes, to report what they had seen or been told to the proper law enforcement authorities. Reporting the information to Mr. Schultz did not satisfy the statutes because they were required to report the information to a law enforcement official. The special report also concluded that the university had not done enough to establish policies and procedures related to the presence of children on the campus and had not trained employees on their reporting duties with regard to child sexual abuse. Indeed, even the administrators of these programs had not been given training on their

[154] Freeh report, at p. 108.

[155] Kris Maher, "Penn State Faces Years in Court," *Wall Street Journal*, June 25, 2012, p. A3.

responsibilities toward children in the campus programs. The report noted that the processes for background checks were not known or understood. The investigation revealed several occasions in which university employees expressed concerns about these policies, the failure to follow them, and the resulting risk to the university. Employees who raised concerns were dismissed because their concerns were not seen as consequential.

Board Governance

The special report was scathing in its indictment of the inaction and inappropriate actions of the Board of Trustees in their responses to an evolving situation. The report also noted that strengthening the governance processes and procedures of the board would help it to be more effective in its role as a checks-and-balance mechanism for management actions and inactions.

The "Penn State Way" and Culture

The report recommended changes in the culture of the university, noting that "The Penn State Way" philosophy had permeated the organization to such an extent that other perspectives or outside advice were seen as unnecessary. The report recommends creation of a values- and ethics-centered community as a substitute for the somewhat arrogant approach of "The Penn State Way." In addition to establishing values, the report also recommends ethics training for faculty, staff, and students so that values and rules are clear and that all who are on the campus have mechanisms for ethical decision making. Details in the report include the creation of an ethics council as well as the appointment of an ethics officer. The report also recommends additional efforts on transparency, communication, and reporting requirements.

In addition, the report recommends that decision processes and the interaction of departments and colleges, as well as the athletic department, be transparent and that the processes not be overridden through deference to the football program or collegiate athletics. Dissenting opinions were not a part of "The Penn State Way." One incident that was troubling in this area of culture involved a clash between Penn State's standards and conduct officer and Mr. Paterno over the level of discipline that was appropriate for student-athletes who violated the university's code of conduct (and worse). At one point, the then–standards and conduct officer, Dr. Vicky Triponey, wrote to Mr. Spanier about her concerns following assaults by football players on other students. "I would respectfully ask that you do something to stop this atrocious behavior before this team and an entire generation of Penn State students leave here believing that this is appropriate and acceptable behavior within a civil university community."[156] Dr. Triponey would soon resign her position, citing "philosophical differences."

The Aftermath

Penn State faces years of litigation, as most of the 15 boys have retained counsel and some have already filed suit against the university for its failure to report the Sandusky early incidents. The university accepted the Freeh report without taking exception, and as of November 2012 had implemented one-half of the 199 changes Mr. Freeh had recommended. The first lawsuits were settled for undisclosed amounts in August 2013.

Mr. Curley and Mr. Schultz have entered "not guilty" pleas to their felony charges of perjury and failure to report. Mr. Spanier was fired when the indictments were announced but was given a $2.5 million severance package in addition to his salary of $700,000 that he had earned for 2011. The University said that it was bound to honor

[156] Reed Albergotti, "A Discipline Problem," *Wall Street Journal*, November 22, 2011, p. A3.

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the terms of its contract with Dr. Spanier, and because he was "terminated without cause," the severance package applied.[157] One year later Mr. Spanier was indicted on eight counts of conspiracy, endangering child welfare, and perjury.[158] The charges are related to what the state attorney general has called "a conspiracy of silence."[159] In addition, the state attorney general is investigating the current governor's role in the case, because he served as attorney general during the time that the case was first reviewed and also served as a trustee on Penn State's board when he became governor.

Mr. Paterno, suffering from lung cancer that was revealed following the Sandusky indictment, died on January 22, 2012. His family still maintains that he did not know about the 1998 incident and felt that he did the right thing in reporting Mr. McQueary's eyewitness report to university officials. Mr. McQueary has filed a whistle-blower lawsuit against Penn State, alleging that the University's response has made it impossible for him to find employment as a coach and that the atmosphere at Penn State is hostile. Mr. McQueary is a key witness for many of the plaintiffs in the civil actions filed against the university.

As noted earlier, the NCAA imposed sanctions on the university's football program, sanctions that the university accepted without protest or a hearing. The NCAA executive committee chair, Oregon State President Ed Ray, in announcing the sanctions, indicated, "I was so appalled at just the thought of those children and what was being done, and that nobody made a phone call, for God's sake."[160] When the NCAA sanctions were accepted, the University removed the statue of Coach Paterno from in front of the stadium during the wee hours of the morning.

After the first season following the trial and conviction and the revelations of the Freeh Report, Penn State disclosed that its operating revenue was down $7.9 million, although its donations increased by 350 percent.[161] However, the case brings to mind poignant line of the prince in *Romeo and Juliet* as he realizes the loss of two young lives and those of so many of their family and friends: "All are punished."[162]

Discussion Questions

1. "Penn State is an honorable institution that is trying desperately to defend it's [*sic*] ethics and all of the individuals who had nothing to do with this horrific scandal, which have been destroyed by the actions/inactions of a few individuals ..."

   The quote comes from a blog on the Penn State scandal. Evaluate the accuracy of the blogger's thoughts. Why does it happen that many are punished for the actions of a few? Or is that an accurate assessment—is it the actions of a few?
2. Oregon State President Ed Ray, who announced the Penn State sanctions, said that what happened occurred because of the Penn State culture, that the football program had consumed the values of the university. What does he mean? What can you point to in the case that illustrates his point?
3. List all of the categories of ethical issues you see that occurred over the course of the events.
4. Make a list of all the stakeholders in this case.
5. What does the case teach us about the importance of speaking up? Of raising objections? Give examples of why people did not speak up in this case.

[157] Jack Stripling, "Penn State Paid Spanier $3.3 Million in 2011," *The Chronicle of Higher Education*, November 28, 2012, http://chronicle.com/article/Penn-State-Paid-Spanier/135970/.

[158] Kris Maher, "Penn State's Ex-president Charged," *Wall Street Journal*, November 2, 2012, p. A2.

[159] Steve Eder, "Former Penn State President Is Charged in Sandusky Case," *New York Times*, November 2, 2012, p. B9.

[160] "NCAA Chair Ray: "I was so appalled," *USA Today*, July 30, 2012, p. 2C.

[161] Steve Berkowitz and Jodi Upton, "Athletics Revenue Falls at Penn State," *USA Today*, April 9, 2013, p. 1C.

[162] William Shakespeare, *Romeo and Juliet*, Act V, Scene III, l. 295.

Business, Stakeholders, Social Responsibility, and Sustainability

UNIT THREE

The people that build Porsches, you don't want your gasoline taken away from you. You're trying to work at the top of your field.

—Chef Casey Lane on *foie gras* being banned in California because of the producers' practices of stuffing the geese in order to produce more foie gras

Why don't you tell those chefs to have a duck cram a lot of food down their gullets and see how they like it?

—John Burton, the California legislator who wrote the legislation banning *foie gras*[1]

There will be a time for them to make profits, and there will be a time for them to get bonuses. Now's not that time.

—President Barack Obama in a speech to Wall Street on January 29, 2009

To be a great philanthropist with other people's money really is not very persuasive.

—U.S. District Judge Leonard Sand, sentencing John and Timothy Rigas for looting hundreds of millions from Adelphia Communications

Still another level of ethics is the responsibility of the corporation to its community—what contributions and efforts should corporations make to others beyond their shareholders? A company produces high-yield goose liver, but with cruelty to the ducks and geese. A company that manufactures athletic shoes finds cheap labor in developing nations. The company pays minimum wage for that country, but those wages wouldn't bring enough in one month to allow a worker to buy a pair of the company's shoes. Call centers in India have young people working round-the-clock on shifts that result in the loss of their personal and family time. Factory conditions meet that nation's standards but violate nearly all U.S. minimum standards. Without the cheap labor, the shoe manufacturer believes it can't compete. Without the jobs, the nation can't develop, but children are working fifty-hour weeks in these Third World countries. Fair and just treatment in the workplace is an issue the company must face in making a decision for foreign outsourcing of labor. But there are compelling points even the workers in those countries and the parents of the children make about the use of cheap labor as a benefit to them and their countries' economic development.

And how do corporations best contribute to communities and societies? Through boycotts or through economic development? These are difficult questions that have brought some of the past century's greatest minds in search of answers. This unit provides you with the depth of their thought on the social responsibility of corporations.

[1] Jesse McKinley, "Waddling Into the Sunset," *New York Times*, June 6, 2012, D1.

SECTION A

Business and Society: The Tough Issues of Economics, Social Responsibility, and Business

In the following readings, the late Dr. Milton Friedman, a Nobel Laureate, and Professor Edward Freeman present different views on the role of ethics in business as well as the role of business in society. The views of other philosophers and practitioners are also presented to help you understand the extent of these difficult questions. Added to the issues involved in resolving business dilemmas are the additional factors of a person's position and the position of the company and those individuals involved in the situation.

Reading 3.1

The Social Responsibility of Business Is to Increase Its Profits[2]

Milton Friedman

When I hear businessmen speak eloquently about the "social responsibilities of business in a free-enterprise system," I am reminded of the wonderful line about the Frenchman who discovered at the age of 70 that he had been speaking prose all his life. The businessmen believe that they are defending free enterprise when they declaim that business is not concerned "merely" with profit but also with promoting desirable "social" ends; that business has a "social conscience" and takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution, and whatever else may be the catchwords of the contemporary crop of reformers. In fact, they are—or would be if they or anyone else took them seriously—preaching pure and unadulterated socialism. Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades.

The discussions of the "social responsibilities of business" are notable for their analytical looseness and lack of rigor. What does it mean to say that "business" has responsibilities? Only people can have responsibilities. A corporation is an artificial person and in this sense may have artificial responsibilities, but "business" as a whole cannot be said to have responsibilities, even in this vague sense. The first step toward clarity in examining the doctrine of the social responsibility of business is to ask precisely what it implies for whom.

Presumably, the individuals who are to be responsible are businessmen, which means individual proprietors or corporate executives. Most of the discussion of social responsibility is directed at corporations, so in what follows I shall mostly neglect the individual proprietor and speak of corporate executives.

[2] Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *New York Times Magazine*, September 13, 1970, 32–33, pp. 122–126. Copyright © 1970 by The New York Times Company.

In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. Of course, in some cases his employers may have a different objective. A group of persons might establish a corporation for an eleemosynary purpose—for example, a hospital or a school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services.

In either case, the key point is that, in his capacity as a corporate executive, the manager is the agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them.

Needless to say, this does not mean that it is easy to judge how well he is performing his task. But at least the criterion of performance is straightforward, and the persons among whom a voluntary contractual arrangement exists are clearly defined.

Of course, the corporate executive is also a person in his own right. As a person, he may have many other responsibilities that he recognizes or assumes voluntarily—to his family, his conscience, his feelings of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job, for example, to join his country's armed forces. If we wish, we may refer to some of these responsibilities as "social responsibilities." But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he had contracted to devote to their purposes. If these are "social responsibilities," they are the social responsibilities of individuals, not of business.

What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire "hard-core" unemployed instead of better-qualified available workmen to contribute to the social objective of reducing poverty.

In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.

The stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so. The executive is exercising a distinct "social responsibility," rather than serving as an agent of the stockholders or the customers or the employees, only if he spends the money in a different way than they would have spent it.

But if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other.

This process raises political questions on two levels: principle and consequences. On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. We have established elaborate constitutional, parliamentary, and judicial provisions to control these functions, to assure that taxes are imposed so far as possible in accordance with the preferences and desires of the public—after all, "taxation without representation" was one of the battle cries of the American Revolution. We have a system of checks and balances to separate the legislative function of imposing taxes and enacting expenditures from the executive function of collecting taxes and administering expenditure programs and from the judicial function of mediating disputes and interpreting the law.

Here the businessman—self-selected or appointed directly or indirectly by stockholders—is to be simultaneously legislator, executive, and jurist. He is to decide whom to tax by how much and for what purpose, and he is to spend the proceeds—all this guided only by general exhortations from on high to restrain inflation, improve the environment, fight poverty, and so on and on.

The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for "social" purposes. He becomes in effect a public employee, a civil servant, even though he remains in name an employee of a private enterprise. On grounds of political principle, it is intolerable that such civil servants—insofar as their actions in the name of social responsibility are real and not just window-dressing—should be selected as they are now. If they are to be civil servants, then they must be selected through a political process. If they are to impose taxes and make expenditures to foster "social" objectives, then political machinery must be set up to guide the assessment of taxes and to determine through a political process the objectives to be served.

This is the basic reason why the doctrine of "social responsibility" involves the acceptance of the socialist view that political mechanisms, not market mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses.

On the grounds of consequences, can the corporate executive in fact discharge his alleged "social responsibilities"? On the one hand, suppose he could get away with spending the stockholders' or customers' or employees' money. How is he to know how to spend it? He is told that he must contribute to fighting inflation. How is he to know what action of his will contribute to that end? He is presumably an expert in running his company—in producing a product or selling it or financing it. But nothing about his selection makes him an expert on inflation. Will his holding down the price of his product reduce inflationary pressure? Or, by leaving more spending power in the hands of his customers, simply divert it elsewhere? Or, by forcing him to produce less because of the lower price, will it simply contribute to shortages? Even if he could answer these questions, how much cost is he justified in imposing on his stockholders, customers, and employees for this social purpose? What is his appropriate share and what is the appropriate share of others?

And, whether he wants to or not, can he get away with spending his stockholders', customers', or employees' money? Will not the stockholders fire him? (Either the present ones or those who take over when his actions in the name of social responsibility have reduced the corporation's profits and the price of its stock.) His customers and his employees can desert him for other producers and employers less scrupulous in exercising their social responsibilities.

This facet of "social responsibility" doctrine is brought into sharp relief when the doctrine is used to justify wage restraint by trade unions. The conflict of interest is naked and clear when union officials are asked to subordinate the interest of their members to some more general social purpose. If the union officials try to enforce wage restraint, the consequence is likely to be wildcat strikes, rank-and-file revolts and the emergence of strong competitors for their jobs. We thus have the ironic phenomenon that union leaders—at least in the U.S.—have objected to government interference with the market far more consistently and courageously than have business leaders.

The difficulty of exercising "social responsibility" illustrates, of course, the great virtue of private competitive enterprise—it forces people to be responsible for their own actions

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and makes it difficult for them to "exploit" other people for either selfish or unselfish purposes. They can do good—but only at their own expense.

Many a reader who has followed the argument this far may be tempted to remonstrate that it is well and good to speak of government's having the responsibility to impose taxes and determine expenditures for such "social" purposes as controlling pollution or training the hard-core unemployed, but that the problems are too urgent to wait on the slow course of political processes, that the exercise of social responsibility by businessmen is a quicker and surer way to solve pressing current problems.

Aside from the question of fact—I share Adam Smith's skepticism about the benefits that can be expected from "those who affected to trade for the public good"—this argument must be rejected on grounds of principle. What it amounts to is an assertion that those who favor the taxes and expenditures in question have failed to persuade a majority of their fellow citizens to be of like mind and that they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures. In a free society, it is hard for "good" people to do "good," but that is a small price to pay for making it hard for "evil" people to do "evil," especially since one man's good is another's evil.

I have, for simplicity, concentrated on the special case of the corporate executive, except only for the brief digression on trade unions. But precisely the same argument applies to the newer phenomenon of calling upon stockholders to require corporations to exercise social responsibility (the recent GM crusade, for example). In most of these cases, what is in effect involved is some stockholders trying to get other stockholders (or customers or employees) to contribute against their will to "social" causes favored by the activists. Insofar as they succeed, they are again imposing taxes and spending the proceeds.

The situation of the individual proprietor is somewhat different. If he acts to reduce the returns of his enterprise in order to exercise his "social responsibility," he is spending his own money, not someone else's. If he wishes to spend his money on such purposes, that is his right, and I cannot see that there is any objection to his doing so. In the process, he, too, may impose costs on employees and customers. However, because he is far less likely than a large corporation or union to have monopolistic power, any such side effects will tend to be minor.

Of course, in practice the doctrine of social responsibility is frequently a cloak for actions that are justified on other grounds rather than a reason for those actions.

To illustrate, it may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, [or] it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects. Or it may be that, given the laws about the deductibility of corporate charitable contributions, the stockholders can contribute more to charities they favor by having the corporation make the gift than by doing it themselves, since they can in that way contribute an amount that would otherwise have been paid as corporate taxes.

In each of these—and many similar—cases, there is a strong temptation to rationalize these actions as an exercise of "social responsibility." In the present climate of opinion, with its widespread aversion to "capitalism," "profits," the "soulless corporation" and so on, this is one way for a corporation to generate goodwill as a by-product of expenditures that are entirely justified in its own self-interest.

It would be inconsistent of me to call on corporate executives to refrain from this hypocritical window-dressing because it harms the foundations of a free society. That would be to call on them to exercise a "social responsibility"! If our institutions, and the attitudes of the public, make it in their self-interest to cloak their actions in this way, I cannot summon much indignation to denounce them. At the same time, I can express admiration for those individual proprietors or owners of closely held corporations or stockholders of more broadly held corporations who disdain such tactics as approaching fraud.

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Whether blameworthy or not, the use of the cloak of social responsibility, and the nonsense spoken in its name by influential and prestigious businessmen, does clearly harm the foundations of a free society. I have been impressed time and again by the schizophrenic character of many businessmen. They are capable of being extremely far-sighted and clear-headed in matters that are internal to their businesses. They are incredibly short-sighted and muddle-headed in matters that are outside their businesses but affect the possible survival of business in general. This short-sightedness is strikingly exemplified in the calls from many businessmen for wage and price guidelines or controls or incomes policies. There is nothing that could do more in a brief period to destroy a market system and replace it by a centrally controlled system than effective governmental control of prices and wages.

The short-sightedness is also exemplified in speeches by businessmen on social responsibility. This may gain them kudos in the short run. But it helps strengthen the already too prevalent view that the pursuit of profits is wicked and immoral and must be curbed and controlled by external forces. Once this view is adopted, the external forces that curb the market will not be the social consciences, however highly developed, of the pontificating executives; it will be the iron fist of government bureaucrats. Here, as with price and wage controls, businessmen seem to me to reveal a suicidal impulse.

The political principle that underlies the market mechanism is unanimity. In an ideal free market resting on private property, no individual can coerce any other, all cooperation is voluntary, all parties to such cooperation benefit or they need not participate. There are no "social" values, no "social" responsibilities in any sense other than the shared values and responsibilities of individuals. Society is a collection of individuals and of the various groups they voluntarily form.

The political principle that underlies the political mechanism is conformity. The individual must serve a more general social interest—whether that be determined by a church or a dictator or a majority. The individual may have a vote and a say in what is to be done, but if he is overruled, he must conform. It is appropriate for some to require others to contribute to a general social purpose whether they wish to or not. Unfortunately, unanimity is not always feasible. There are some respects in which conformity appears unavoidable, so I do not see how one can avoid the use of the political mechanism altogether.

But the doctrine of "social responsibility" taken seriously would extend the scope of the political mechanism to every human activity. It does not differ in philosophy from the most explicitly collectivist doctrine. It differs only by professing to believe that collectivist ends can be attained without collectivist means. That is why, in my book *Capitalism and Freedom*, I have called it a "fundamentally subversive doctrine" in a free society, and have said that in such a society, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

Discussion Questions

1. How does Dr. Friedman characterize discussions on the "social responsibilities of business"? Why?
2. What is the role of a corporate executive selected by stockholders?
3. What analogy does Dr. Friedman draw between trade union wages and corporations' decisions based on social responsibilities?

Compare & Contrast

Would Dr. Friedman ever support voluntary actions on the part of a corporation (e.g., conduct not prohibited specifically or mandated by law)? For example, Dr. Friedman has made use of the Gary, Indiana, example. At one point, Gary experienced intense air pollution from the operation of steel mills there. The emissions from the mills were legal at that time. Dr. Friedman has noted that if an executive could show that reducing emissions voluntarily would save the company money on health costs and enhance its ability to recruit employees and managers, then such voluntary and socially responsible actions would be consistent with the corporation's role in society. How does his position in this situation compare and contrast with his position on corporate philanthropy? Can he make the same argument for donations in a community?

Reading 3.2

A Look at Stakeholder Theory

Stakeholder theory is unique because it crosses over so many areas of business: the fields of business ethics, management and corporation law have all focused on stakeholder theory. While there is one name, stakeholder theory is used in different ways in these silos of business.

Proponents of the stakeholder theory believe that employees, creditors, suppliers, customers, and communities, in addition to shareholders, all contribute to the success of the corporation, and that the company directors, therefore, have responsibilities to all of these constituencies.[3]

Stakeholder theory dates back to the 1930s when the idea of the central state was prominent in political theory, debate, and legislation, and the existence of self-governing corporations was seen as something that could undermine the utilitarian view that all entities should function for the good of the whole.[4] However, very little was done with the notion of corporations' responsibility to society until, citing the efforts of the 1930's scholars, the work of Edward Freeman on strategic management emerged in the 1980s.[5] With Freeman's work, stakeholder theory not only became a basis for business strategy, it became a foundation for corporate governance.[6] In addition, the use of stakeholder theory as a utilitarian tool reemerged in the new scholarship.

There are three basic issues in stakeholder theory: (1) Who is a stakeholder? (2) What is the responsibility of a business to those stakeholders? and (3) Does consideration of stakeholder interests benefit society and shareholders?

Who Are Stakeholders?

The definition of a stakeholder carries some disagreement among scholars in the field. Below are some general definitions:

> "an individual or group that asserts to have one or more stakes in a business, [7]
>
> "any individual or group who feel that they have a stake in the consequences of management's decisions and who have the power to influence current or future decisions."[8]
>
> "an individual, a coalition of people, or an organization whose support is essential or whose opposition must be negated if major strategic change is to be successfully implemented," [9]

[3] Joseph F. Johnson, *An American Lesson for European Company Directors*, Research Report #33 CNA PRO (2000).

[4] For a review of the history of corporate governance see Marianne M. Jennings, *Teaching Stakeholder Theory: It's For Strategy, Not Business Ethics*, 16 J. OF LEGAL STUDIES EDUCATION 203 (1988).

[5] Freeman's work first appeared in R. Edward Freeman, *Strategies Management: A Stakeholder Approach* (1984).

[6] For example, H.R. 887 (hearings held in October 1999) proposed two changes with regard to corporate charitable contributions: (a) that all contributions be disclosed in the annual proxy; and (b) that shareholders and others would have input on the company's charitable contribution.

[7] ARCHIE B. CARROLL, BUSINESS AND SOCIETY: ETHICS AND STAKEHOLDER MANAGEMENT 60 (2d ed., 1993).

[8] " FREDERICK D. STURDIVANT and HEIDI VERNON-WORTZEL, BUSINESS AND SOCIETY: A MANAGERIAL APPROACH 64 (4th ed., 1990).

[9] IAN C. MACMILLAN & PATRICIA E. JONES, STRATEGY FORMULATION: POWER AND POLITICS, 60 (2d ed., 1986).

> "persons that have, or claim, ownership, rights, or interests in a corporation and its activities, past, present, or future," [10]
>
> "stakeholders are persons or groups with legitimate interests in procedural and/or substantive aspects of corporate activity," [11]

The definitions' variations are in wording, "group" vs. "coalition" vs. "organization" and role, "stake in consequences" vs. "opposition to be negated." Perhaps an easier way to understand who stakeholders are is through an example. The Yucca Mountain Nuclear Waste Repository was first proposed for construction in 1987 as a place for storing spent nuclear fuel rods from the nuclear plants (about 120 of them) in the United States. The corporations that operated the plants needed a permanent place for disposition of the fuel rods, and the federal government had authorized the use of Yucca Mountain, land located in Nevada, for the construction of such a repository. Stakeholders include those who live near the site in Nevada. Other stakeholders include those who were concerned about the possible effect of the spent-rod storage on underground water sources, which included ranchers, farmers, and others who drew from underground water tables. We can discover stakeholders by going up and down the supply chain in any situations. The employees at nuclear plants are affected by whether the repository is built because of the safety issues with temporary storage of spent rods at their sites. Without permanent storage for the spent fuel, the plants would need to cease operations. Without the plants operating, those living in the states and regions surrounding the plants would be affected because nuclear plants are base-load plants and provide the electricity needs for homes, businesses, and factories. Without electricity, business and factory operations halt, and the jobs of those employed there are at risk. Companies that build nuclear plants, manufacturers of fuel for the plants, and vendors that sell everything from tools to paper supplies to nuclear plants are also affected. Looking at issues through stakeholder theory gives us a picture of an interconnected web. That is, the decisions of a corporation or any business are never made in isolation – there is a web of interconnection that we have through our actions, as depicted in Figure 3.1.

Regardless of the decision made on the nuclear repository, other companies, customers, communities, and future generations will be affected. Stakeholder theory asks that organizations consider the stakeholders in making their decisions about their actions. The first step, then, in applying stakeholder theory is to identify stakeholders.

What Is the Responsibility of Businesses to Stakeholders?

The answer to this question varies among academics, business people, and individuals. Some believe that if the organization stays focused on its mission that it will benefit society. For a corporation, that view means that the corporation does not dabble in stakeholders. Rather, the corporation focuses on product development, marketing, and sales and thereby creates benefits for customers, jobs for communities, and, to borrow one proponent's view, become a rising tide that lifts all boats (i.e., all stakeholders). Others believe that such a view might result in the organization missing some important issues in evaluating its strategy for sales, marketing, and production. For example, opting for the lowest possible production costs, a corporation might outsource that production to factories in China or Bangladesh. However, that lowest cost could mean that conditions in the factory might not be safe for those employed there. Those employees of vendors are stakeholders. If one of those factories should collapse because of the weight of the production equipment in structures not designed to handle manufacturing equipment (See Case 6.6), that worldwide news could

[10] M.E. Clarkson & M. Deck, *The Stakeholder Theory of the Corporation*, PROCEEDINGS OF A WORKSHOP ON THE STAKEHOLDER THEORY OF THE FIRM AND THE MANAGEMENT OF ETHICS IN THE WORKPLACE, U. TORONTO, 9 May, 20–21 1993.

[11] Thomas Donaldson & Lee E. Preston, also at the Toronto Conference, note 10 Paper #37.

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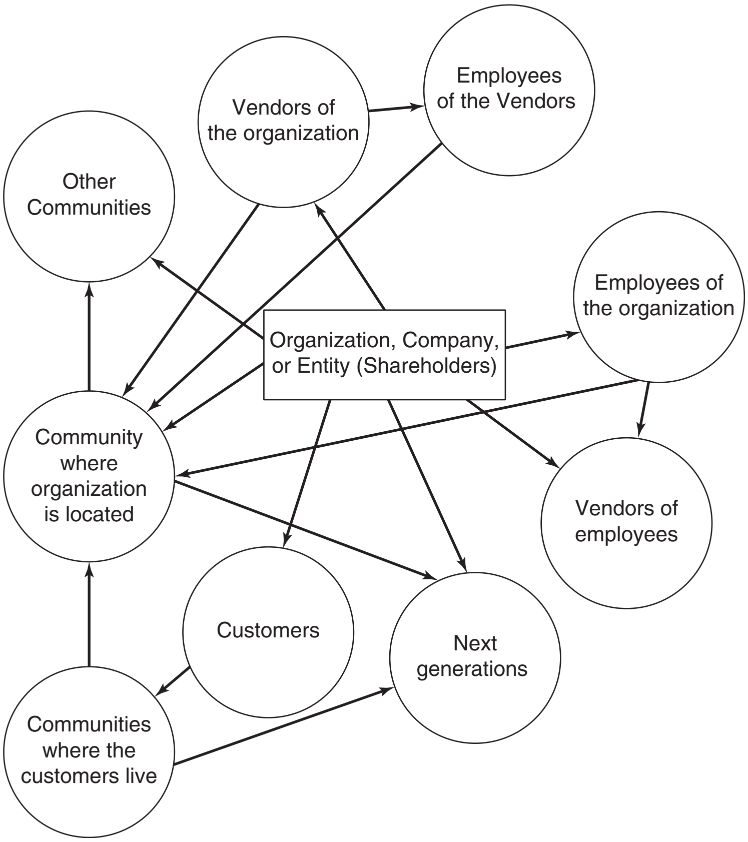
FIGURE 3.1
Stakeholders


Employees
of the Vendors
Vendors of
the organization
Other
Communities
Employees of
the organization
Organization, Company,
or Entity (Shareholders)
Community
where
organization
is located
Vendors of
employees
Customers
Next
generations
Communities
where the
customers live

(and did) result in international outcry and, as a result, the corporation's brand affected by boycotts by customers (also stakeholders). The end result is that the corporation may end up spending far more in recovering from the situation and finding better facilities and companies for outsourcing. In other words, stakeholder theory asks companies to apply the same analysis model used in Unit 1 – who is affected by your decision?

Does Consideration of Stakeholder Interests Benefit Society and Shareholders?

This final question is the heart of stakeholder theory and debate. The readings and cases that follow demonstrate the level of disagreement and additional questions that arise as stakeholder theory is debated. One question is whether it makes sense to give those who do not have a financial interest in the organization the right to impose their views, standards, and priorities on other organizations. Another question that has not been resolved is whose interest is dominant as we consider stakeholders in the decision process. For example, in the case on guns (Case 3.9), the issue of a gun manufacturer settling a lawsuit was a deeply debated one of social responsibility. When the manufacturer opted to settle the suit, its customers boycotted it and the company had to be sold at a loss, thus harming the shareholders and nearly destroying the company.

As you think about the issues of social responsibility, sustainability, economic systems, our moral ecology, and the interests of shareholders and corporations you will discover in this section of the book, use the stakeholder web to anticipate responses and how you would prioritize the interests of stakeholders. Finally, determine whether there is indeed a disagreement here or whether thinking about stakeholders and shareholders together is simply intelligent strategy.

Discussion Questions

1. Give examples of stakeholders and what interests they might have in a company's decisions.
2. Does Milton Friedman see any benefit in considering the interests of employees as a company makes decisions?
3. Explain the web of stakeholders and how the impact of one decision affects others in the web.

Reading 3.3

Business with a Soul: A Reexamination of What Counts in Business Ethics[12]

Jon Entine and Marianne M. Jennings

"Rain-forest chic" is a label coined in the popular business press for the increasingly popular corporate branding strategy of capitalizing on consumer use of environmental issues as a screen for buying decisions. Companies have parleyed this market strategy into product successes. Shampoo bottles, powder blush and toothpaste carry labels that read "no animal testing." Star-Kist markets that its tuna is netted "Dolphin-Free." Rain-forest chic marketing provides a compelling two-for-one sale: buy hair conditioner or ice cream made with nuts from the rainforest and get social justice for free.

Corporate social responsibility has caught the attention of academic researchers. The icons of corporate social responsibility (CSR) are familiar brand names: The Body Shop International cosmetics; Ben & Jerry's Homemade ice cream; Starbucks coffee, Tom's of Maine toothpaste, Working Assets long distance company, Celestial Seasonings teas, and a collection of clothing and sneaker retailers including Esprit, Patagonia and, until the sweatshop controversy is over, Nike. These companies, all of which have engaged in marketing campaigns to promote their social consciousness, represent a coterie of '60s entrepreneurial companies with charismatic founders who have grown niche businesses into multi-national corporations. Their companies and products are associated with the labels "green" and "socially responsible."

These socially responsible companies promote themselves in contrast to companies who are caricatured as corporate desperados such as: Gillette, Dow Chemical, Exxon, every tobacco company, defense contractors, the entire chemical industry and all energy providers (unless perhaps they are a solar company or a wind-power start-up).

Such a simplistic equation of social responsibility obscures the reality that business ethicists have failed to examine closely either what constitutes business ethics or whether these particular firms would qualify as ethical by standards other than those measured by political issues or self-defined parameters. Business and business ethics are much more complex than the breeziness of social responsibility. Understanding the corporate soul requires far more than the shallow categories of the CSR. The soul of a company is more complex than that of an individual.

The consequences of using these trendy standards as a basis for philosophical applications or as a measure for firms' ethics are substantial for the credibility of the academy. Relevant business data [are] ignored; close examination of operations and products is foreclosed in the name of social consciousness. Larger firms whose forward strides have had a greater social, economic or environmental impact are ignored or demonized in the name of this new brand [of] ethics. Companies with a culture of ethics but without

[12] From Jon Entine and Marianne M. Jennings, "Business with a Soul: A Reexamination of What Counts in Business Ethics," 20 *Hamline Journal of Law & Public Policy* 1 (1998).

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tendencies toward self-aggrandizement are sometimes trampled in the marketplace and denigrated in the CSR movement.

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Despite Friedman's adherence to the agency theory, he does, however, outline scenarios in which he believes that social involvement is not only acceptable but also required. Friedman isolates instances when managers should step beyond the constraints of their agency relationship and what the law requires if they can demonstrate that involvement in social issues benefits shareholders. He cites "green marketing" as an example. Friedman once described oil company television ads as "turning his stomach" for they made it seem that the purpose of energy companies was to preserve the environment. However, Friedman adds that he would probably sue oil company executives if they didn't engage in such "nonsense" because oil companies must profess social responsibility to appeal to the public-at-large, remain competitive and ensure profits.

Extending the same reasoning, Friedman supports "green practices" as well as green marketing in limited situations. Ordinarily, Friedman's notion of social responsibility provides that if it is cheaper to pay a fine for releasing effluent into the water surrounding a plant than it is not to pollute or to clean it up, then releasing the effluent is the most responsible action. Friedman advocates the use of taxes or government regulation to control behavior (positive law). However, if an executive can demonstrate that the controversy surrounding the release of the effluents (a) makes it difficult to recruit and retain employees; or (b) offers the prospect of adverse publicity or litigation that diminishes its ability to compete, then voluntary reduction of the effluent, or voluntary clean-up is an appropriate extension of agency authority. If an energy company could mitigate these adverse consequences by modifying environmental practices, then it is compelled to act in its shareholders' best interest by doing so.

Conservative theorist Michael Novak acknowledges that investors have a right to a "reasonable return" but adds new corporate responsibilities, such as to "create new wealth" and "new jobs," guarantee "upward mobility" fairly reward "hard work and talent," promote "progress in the arts and useful sciences" and "diversify the interests of the public." He then adds seven "external responsibilities" including promoting "community" and "dignity," and "protecting the moral ecology of freedom," all of which he believes are crucial to the health of civil society. Novak views business as a moral calling as opposed to being merely a profession.

The notions built into the continuum about business ethics present a Hobbesian choice between a faddish concept of social responsibility such as an opposition to animal testing and classic stakeholder concepts such as responsiveness to investors, customers and employees. For instance, helping the homeless is a noble cause, and certainly one that would place a company at the top of the social responsibility continuum. Few would suggest that a small grocery store with thin profit margins should be judged by whether it feeds the homeless in the town in which it operates. The owners and employees of that store depend upon profit for their livelihood, its customers depend on the store being open, and the community prospers if the store becomes more profitable and expands. By devoting its resources to feeding the homeless, such a grocery store would possibly exacerbate the homeless problem as its employees are no longer employed because the business would become extinct.

[Misinformation clouds the social responsibility measures.]

. . . For years after its introduction in 1990, "Rainforest Crunch" ice cream, the flagship product of Ben & Jerry's, was touted as a successful experiment in the partnering of American business with Amazon preservationists. According to company materials, "Rainforest Crunch" was created in part to help indigenous peoples find an alternative to selling their timber rights to mining and forestry industrialists. [It was a noble impulse but turned out to be little more than a brilliant marketing gimmick. For years, Ben & Jerry's purchased no nuts for its ice cream from rainforest aboriginals; more than 95% of the Brazil nuts it sourced were purchased off commercial exchanges supplied by businesses, not indigenous peoples, in Latin America that now dominate the Brazil nut market].

Moreover, many anthropologists maintain that the harvest has actually contributed to falling nut prices and an increase in the selling off of land rights to industrialists to compensate for the economic short-fall. The Ben & Jerry's program actually exacerbated the very problem it was purported to address. In early 1995, Ben & Jerry's pulled the claims on its Rainforest Crunch label. Although the disastrous details of the harvest are widely known in the activist media and SR business community, Ben & Jerry's has been given a relative pass on the disastrous consequences.

Body Shop International ("BSI") has long been touted as the premier socially responsible business. By its own estimates, BSI was averaging 10,000 positive media mentions a year until 1994. In September of 1994, investigative work by Jon Entine, co-author of this article, and numerous journalists and social researchers, revealed a huge ethical gap between BSI's marketing image and its actual practices. This deception—conscious or not—is pervasive: Roddick stole The Body Shop name and marketing concept, fabricated key elements of the company myth, misrepresented its charitable contributions and fair trade programs and has been beset by employee morale and franchise problems. Moreover, its "natural" products are filled with petrochemical colorings, fragrances, preservatives and base ingredients such as mineral oil and petrolatum. Its cosmetics are considered "low-end products at a premium price" according to a recent article in *Women's Wear Daily* and numerous reviews by cosmetic product experts.

*****

Can a shareholder or customer trust a firm simply because it has adopted a posture of social responsibility? Can a shareholder or customer assume that a firm is less honorable if it states that it is accountable first and foremost to its shareholders? The answer to both questions is "no."

No company is ethically perfect. No company, just as no individual, is without sin or exempt from mistakes. Consequently, the obsession to anoint icons of CSR only interferes with candid evaluations of the soul of a company.

Determining the soul of a company requires those conducting the examination to look beyond ever-changing political issues. CSR has come to promote narrow and contradictory social agendas as opposed to universal measures of integrity. For example, honesty in business dealings is a universal measure of a company's soul. Looking beyond facile symbolism opens up an examination of ethics. There are eight questions that should be answered about a company to determine the character of its soul.

1. Does the company comply with the law?
2. Does the company have a sense of propriety?
3. How honestly do product claims match with reality?
4. How forthcoming is the company with information?
5. How does the company treat its employees?
6. How does the company handle third-party ethics issues?
7. How charitable is the company?
8. How does the company react when faced with negative disclosures?

With this modest proposal is the basis for an objective look at companies.

Discussion Questions

1. Contrast the authors' views with those of Friedman and Freeman.
2. What is the difference between the authors' eight questions and traditional measures of social responsibility?
3. Would the model mean that a tobacco company could be labeled an "honest" company?

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Reading 3.4

Appeasing Stakeholders with Public Relations[13]

This reading provides a different perspective on the stakeholder versus shareholder debate; the author questions its wisdom and precision.

Robert Halfon

The problem in today's era of corporate pseudo-ethics is that the pendulum has shifted too far. From genuine philanthropy "corporate responsibility" has mutated into a dangerous form of political correctness. The enlightened, entrepreneurial philanthropy of old has, through activist agitation, become the burden of today's so-called "corporate responsibility." At least four distinct trends are in evidence here: the rise of single-issue activist groups; the targeting of companies with dealings in specific countries or specific industries; a rise in public sympathy for such actions; and a seal of approval guaranteed by many Western governments today.

Corporations have an obligation to anticipate and deal with these threats. This can be done in a number of ways. First, every important commercial activity should be rigorously assessed for its political risk. This means the risks or threats a business may face (from pressure groups, governments, *et al.)* in undertaking a particular activity. Business needs to inform itself at the highest level of the political environment in which it operates. As one commentator on these matters argues without hesitation:

> The lessons that need to be understood are simple. It does not matter where you are, or how big you are, if you are not prepared, pressure groups have the ability to make your company a member of the endangered species. You cannot respond effectively in six minutes to a campaign that has probably taken six months to organize.... Our first option is to ignore the increasing threat of pressure groups and lose everything. Our second option is to fight back, challenge and probably win. We have the opportunity to deliver results by promoting morality; challenging credibility; setting policy and practices; offering solutions and advice.[14]

Once the political risks are evaluated, then two actions are required: first, for businesses to mount an efficient public relations campaign, arguing the case for corporate capitalism and stressing how their activities are benefiting the national—or global—economy in which they operate. All businesses, forewarned, should be proactive, not reactive. They must be prepared to fight fire with fire and, if necessary, should be prepared to take their case all the way to the courts. Secondly, companies across the spectrum must band together and act in unison to limit the unaccountable, undemocratic and often extra-legal activities of the activist groups they are up against.

Discussion Questions

1. What does Halfon see as the proper tools for handling stakeholder objections?
2. Can you describe a situation in which his tools may not be effective? What are the costs to the company if his tools fail to halt the opposition of stakeholders to a proposed corporate action?

[13] From Robert Halfon, *Corporate Irresponsibility: Is Business Appeasing Anti-business Activists?* (1998), p. 7.

[14] Tony Meehan, "The Art of Media Manipulation," *The Herald*, May 10, 1997.

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Reading 3.5

Conscious Capitalism: Creating a New Paradigm for Business[15]

A Look at a CEO's Views: John Mackey, founder and CEO of Whole Foods

John Mackey, the founder and CEO of Whole Foods, has taken a sort of blended position on the role of business in society. He begins his analysis by asking the purpose of hospitals and schools and concludes that they exist to benefit society. Those who work in hospitals and schools, teachers and doctors, undertake their work for the purposes of benefiting others. Mr. Mackey then concludes with this thought: Why should business be any different from other institutions and those who work in them?

While economists are committed to the view that businesses to exist to maximize profits, Mr. Mackey believes that those who found businesses rarely go into business for the purpose of maximizing profits and that the goal of maximizing profits is a myth. Rather, his experience has shown him that most entrepreneurs create businesses for reasons other than maximizing profits. Their reasons for creating a business could be as simple as a desire to not have to work for someone else. Some business people simply enjoy the challenge of creating and growing a business, with some of them referred to as serial entrepreneurs. Sometimes the act of creation helps business founders with self-esteem or gives them an outlet for their creativity. Often, businesses are formed because the founder wanted to prove something to a parent, teacher, or friend – the business is a way of showing determination or gratitude. Quite often, a business is formed because founders believe that they have a product or service that could make the world a better place. In other words, many begin their businesses with a goal of improving society. Maximizing profits may be, in Mackey's mind, a by-product of the other reasons businesses are created.

Mackey does see that companies can do more good by being profitable and the profitability of business contributes to a healthy economy, something that helps those within a community. In fact, he sees profitability as one constituency of a business, a type of stakeholder in the company. He also realizes that businesses cannot grow without capital and obtaining capital requires that the business operate profitably. However, he believes that great businesses, and businesses that last, are those that are dedicated to "Service to Others." He believes that JetBlue, Southwest Airlines, Wegmans, Nordstrom, REI, The Container Store, and Whole Foods are all examples of successful businesses that live the mantra of "Service to Others."

A company with this mantra does not grow by placing profit maximization at the forefront. Mackey believes that the profits follow when managers optimize the health and well being of employees, customers, and vendors. Focusing on the health and value of the entire interdependent system (like the web of stakeholders in Figure 3.1) ensures that the company will be a dynamic, evolving entity that allows all within that web to grow and develop.

Discussion Questions

1. Explain Mr. Mackey's theory about entrepreneurs and why they go into business.
2. What is Mr. Mackey's concept of interdependent constituencies?

Compare & Contrast

Discuss where Mr. Mackey's view fits with the Friedman and stakeholder theories.

[15] http://www.wholeplanetfoundation.org/files/uploaded/John_Mackey-Conscious_Capitalism.pdf.

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Reading 3.6

Marjorie Kelly and the Divine Right of Capital[16]

Marjorie Kelly challenges the notion that stockholders fund the corporation by pointing out that only the initial shareholders of a corporation actually fund the corporation. When shares change hands subsequently, the company does not actually receive that money from the shareholder. Only when companies sell new shares of stock do they receive money from shareholders. The secondary sales of stock benefit investment houses, brokerage firms, and the stockholders who choose to sell those shares, but companies receive no money from these secondary sales transactions.

In Kelly's view, shareholders contribute very little to justify what she calls companies' extraordinary allegiance to them in their decisions and loyalties. Her view is that the employees are the ones who create value for the corporation. Employees shoulder the burdens and yet are given very little consideration in return for their efforts. Employees' incomes are not determined according to the success of the corporation, but shareholders' returns and dividends are determined by the success of the corporation. Kelly does not see this system as a function of markets but a system of governance that could be changed very easily without affecting the role of corporation in economic systems. Kelly often quotes Lycophron, the ancient Greek philosopher when he was observing an Athenian slave uprising, "The splendor of noble birth is imaginary and its [prerogatives] are based upon mere word."

Because shareholder primacy is a mere structural and superficial system, Kelly believes that it can be changed quite easily. She also sees shareholder primacy as an entitlement and concludes that economists agree that entitlements have no place in a free market economy. Her proposal is to eliminate shareholder primacy and revise the primary responsibility of corporations to one of wider economic distribution of wealth. She notes that of the marketable wealth gain achieved between 1983 through 1998, more than half went to the richest 1 percent.

Kelly would like to place employees as the top priority in corporate responsibility. Employee stakeholders would be the primary responsibility of corporations with shareholders classified as stakeholders along with others in the web of connections. Rather than have employees earn wages, they would share in the profits of the corporation, taking their share before any distributions to shareholders. The current business financial model is:

$$\text{Profits} = \text{Revenues} - \text{Cost}$$

Kelly would change that model to the following

$$\text{Profits} = \text{Revenues} - \text{Employee Income} + \text{Cost of Materials}$$

Under her model, employee income would be a percentage of the profits from the first model. Shareholders' profits would be reduced by a primary distribution of those profits to employees as a cost of doing business. Kelly believes that this system will benefit not only the employees but also provide them with the incentives to do what is best to maximize those profits because of the interest they would hold in maximization. Kelly also notes that her model would solve the stakeholder issue of employee compensation because employees would be entitled to a percentage of the profits that they work to earn for the corporation.

[16] From Marjorie Kelly, *The Divine Right of Capital: Dethroning the Corporate Aristocracy* (2001).

Discussion Questions

1. List the differences in perceptions between Friedman and Kelly about corporations.
2. What distinction does Kelly make about shareholder ownership?

Reading 3.7

Schools of Thought on Social Responsibility[17]

The following excerpt deals with the various schools of thought on social responsibility. These postures can be found across industries and can be used as a framework for analysis of dilemmas.

Ethical Postures, Social Responsibility, and Business Practice

The ethical perspective of a business often sets the tone for its operations and employees' choices. Historically, the philosophical debate over the role of business in society has evolved into four schools of thought on ethical behavior based on the responses to two questions: (1) Whose interest should a corporation serve? and (2) To whom should a corporation be responsive in order to best serve that interest? There are only two answers to these questions—"shareholders only" and "the larger society"—and the combination of those answers defines the school of thought.

Inherence

According to the inherence school of thought, managers answer only to shareholders and act only with shareholders' interests in mind. This type of manager would not become involved in any political or social issues unless it was in the shareholders' best interests to do so, and provided the involvement did not backfire and cost the firm sales. Milton Friedman's philosophy, as previously expressed, is an example of inherence. To illustrate how a business following the inherence school of thought would behave, consider the issue of a proposed increase in residential property taxes for school-funding purposes. A business that subscribes to the inherence school would support a school-tax increase only if the educational issue affected the company's performance and only if such a position did not offend those who opposed the tax increase.

Enlightened Self-interest

According to this school of thought, the manager is responsible to the shareholders but serves them best by being responsive to the larger society. Enlightened self-interest is based on the view that, in the long run, business value is enhanced if business is responsive to the needs of society. In this school, managers are free to speak out on societal issues without the constraint of offending someone, as in inherence. Businesses would anticipate social changes and needs and be early advocates for change. For example, many corporations today have instituted job sharing, child-care facilities, and sick-child care in response to the changing structure of the American family and workforce. This responsiveness to the needs of the larger society should also be beneficial to shareholders because it enables the business to retain a quality workforce.

[17] From *Business: Its Legal, Ethical and Global Environment,* 10th ed., by Marianne M. Jennings, pp. 48–50. Copyright © 2014. Reprinted with permission of South-Western, a division of Cengage Learning.

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The Invisible Hand

The invisible hand school of thought is the opposite of enlightened self-interest. According to this philosophy, business ought to serve the larger society and it does this best when it serves the shareholders only. Such businesses allow government to set the standards and boundaries for appropriate behavior and simply adhere to these governmental constraints as a way of maximizing benefits to their shareholders. They become involved in issues of social responsibility or in political issues only when society lacks sufficient information on an issue to make a decision. Even then, their involvement is limited to presenting data and does not extend to advocating a particular viewpoint or position. This school of thought holds that it is best for society to guide itself and that businesses work best when they serve shareholders within those constraints.

Social Responsibility

In the social responsibility school of thought, the role of business is to serve the larger society, and that is best accomplished by being responsive to the larger society. This view is simply a reflection of the idea that businesses profit by being responsive to society and its needs. A business following this school of thought would advocate full disclosure of product information to consumers in its advertising and would encourage political activism on the part of its managers and employees on all issues, not just those that affect the corporation. These businesses believe that their sense of social responsibility contributes to their long-term success.

Discussion Questions

1. Does Friedman's position blend across categories?
2. Suppose that a piano company was known for use of mahogany wood in its grand pianos. However, increasingly, in Brazil and Peru, the harvesting of those woods is restricted because of programs to preserve the rain forests. What options could the company explore in dealing with this issue? If they voluntarily changed the wood but compromised their customer base and the sound quality, revenues would decrease. Should that choice be an option? How would those in the various schools of thought respond?

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SECTION B

Applying Social Responsibility and Stakeholder Theory

Issues of social responsibility can dominate the press coverage of a corporation and infiltrate its annual meeting through shareholder proposals on social responsibility issues. Now that you have both the decision models for ethical analysis, ethical theory, and the schools of thought on social responsibility, you are ready for analysis. This section provides you with practice in the analysis of ethical issues.

Case 3.8

Skittles, Trayvon Martin, and Social Responsibility

Trayvon Martin was shot and killed in February 2012 near his home in Sanford, Florida. He was on his way back from the store where he had purchased a bag of Skittles and a bottle of iced tea. Because of the death of the unarmed teen, questions regarding racial injustice have surrounded the arrest, prosecution, and acquittal of George Zimmerman, and whether self-defense was involved. The controversial case gripped the nation, and college students and teens began marching in protest, with Skittles bags taped across their mouths. At Spelman College, a historically black women's liberal arts school in Atlanta, the students began selling bags of Skittles in order to raise money for the Martin family.

The result was that Wrigley (and its parent company Mars) experienced unprecedented sales and resulting profits. All of the attention to the brand as well as increased sales produced a backlash. On Twitter and various blogs, there was pressure on Wrigley to take the profits earned to make donations to the Martin family or to organizations that promote racial reconciliation. Some of the sites asked for a boycott of Skittles until the company pledged to reinvest the profits in African American communities. Wrigley released a statement that indicated it was "deeply saddened, respects the family's privacy" and that it would be "inappropriate to get involved or comment further as we would never wish for our actions to be perceived as an attempt of commercial gain following this tragedy."[18]

Discussion Questions

1. How should a company deal with its product becoming a symbol for a tragedy and resulting social protests?
2. Should Wrigley be making donations as was suggested in social media?

[18] Kim Severson, "For Skittles, Death Brings Both Profit and Risk," *New York Times*, March 29, 2012, p. A14.

Case 3.9

Guns, Stock Prices, Safety, Liability, and Social Responsibility

The manufacture and sale of guns continue to be issues of social responsibility. Although the issues surrounding guns are complex, they are emotionally charged. Over the years, there have been a variety of approaches taken to control the production, distribution, and sale of guns. As these efforts are undertaken through legislative, regulatory, and judicial bodies, the NRA has proven to have a formidable presence in the public and legislative debates and a continuing presence in litigation on laws and rules and their constitutionality under the Second Amendment to the U.S. Constitution on the "right to keep and bear arms."

Retail Issues, Guns, and Social Responsibility

Manufacture and Distribution, Guns and Social Responsibility

At one point, one of the principal targets of anti-gun activists was the so-called "Saturday Night Special," a gun that costs about $13 to make and then retails for between $59 and $70. The gun has a long history that traces back to the Jennings family of California, a family that focused on the successful sales of handguns.

Three gun manufacturers in California evolved from the Jennings family. George Jennings founded Raven Arms, Inc., in 1970 and made the Raven .25. George's son, Bruce Jennings, left Raven in 1978 to form Jennings Firearms, Inc., which manufactures another Saturday Night Special, the Jennings .22, which costs $13 to make and retails for $75 to $89.

George's son-in-law, Jim Davis, left Raven in 1982 to start Davis Industries, Inc., which makes a third Saturday Night Special, the Davis .38; this gun costs $15 to make and retails for $95 to $100.

Based on Bureau of Alcohol, Tobacco and Firearms data on handguns sold after 1986, the leading handguns used in crimes are the Davis, the Raven, and the Jennings.

Many criminologists, prosecutors, and gun-sale reform advocates maintain that the availability of cheap weapons escalates crime and killing. Josh Sugarmann of the Violence Policy Center, which studies violence prevention, said of the Saturday Night Specials: "We have a fire burning, and these companies are throwing gasoline on it. These people know what the inner-city gun buyer wants."[19]

Dave Brazeau, the general manager of Raven Arms, responded, "If it wasn't a gun, it would just be something else—a rock, a bow and arrow, or a baseball bat."[20]

Only a few states ban the cheap handguns. Maryland, for example, has banned the Jennings .22 and the Raven .25 as "unreliable as to safety." South Carolina and Illinois have banned the three California companies' brands because the zinc-alloy frames melt at less than 800 degrees.[21]

Smith & Wesson holds the top slot in gun sales, but the three Jennings-related companies together account for 22 percent of all handguns sold and 27 percent of all handguns used in crimes across the country.[22]

[19] Alix M. Freedman, "A Single Family Makes Many of Cheap Pistols That Saturate Cities," *The Wall Street Journal*, February 28, 1992, p. A1.

[20] *Id.*

[21] *Id.*

[22] *Id.*

The Saturday Night Specials are often sold in bulk in states where gun laws are lax and then smuggled to urban areas for sale. An illegal gun dealer in Harlem commented, "Here, where I live, every young kid has a .22 or a .25. It's like their first Pampers."[23]

Congress passed the Brady Bill in 1993, which mandates a five-day waiting period for handgun purchases. A number of states also proposed regulations of Saturday Night Specials. Some note that firecrackers are regulated, but firearms are not. In addition, during this time there was significant litigation around the country against gun manufacturers that sought to recover for the medical costs associated with the victims of gun crimes. All of the handgun manufacturers were named as defendants in the suits. The liability was addressed as a risk in all of the gun companies' public disclosures (for those that were publicly traded companies).

The Smith & Wesson Deal and Social Responsibility

Smith & Wesson, a gun manufacturer, concerned about proposed Massachusetts regulation and the litigation to hold gun manufacturers liable for the injuries to crime victims, was struggling as to how to handle all the potential liability. Additionally, its parent company, Tomkins, P.L.C., a British firm, was trying to sell the 157-year-old Massachusetts company and was not having much luck given the status of the pending litigation.

Tomkins had purchased Smith & Wesson in 1987 for $112.5 million. As a manufacturer of plumbing supplies and lawn mowers, it was unprepared for the litigation and very public controversy surrounding gun manufacturers in the United States. Further, the British attitude toward handguns (they are outlawed in Britain) created considerable controversy for Tomkins at home as it began experiencing protests and boycotts over its ownership.

To find a way out of the situation, Smith & Wesson decided to break rank with its fellow gun manufacturers, and it reached a settlement with the federal government that included substantial restrictions on the production and distribution of handguns. On March 17, 2000, Smith & Wesson signed an agreement with the federal government that provided for a 21-page settlement. Smith & Wesson agreed to change the way its guns are designed, marketed, and distributed. Under the key provisions of the pact, the company agreed to:

- equip all handguns with external safety locks within 60 days;
- equip all pistols with internal locking devices within two years;
- devote 2 percent of its gross revenues to the development of "smart," personalized guns that can only be fired by an authorized user;
- design firearms so that they cannot be readily operated by a child under age six;
- include chamber-load indicators on all pistols within one year; and
- stop producing firearms that accept large-capacity ammunition magazines.

The company also agreed to add a hidden serial number on every gun to make it easier for law enforcement authorities to trace guns used by criminals.

Sales and Distribution

Within six months, Smith & Wesson had to include in the packaging of each firearm sold a warning on risks of guns in the home and information about proper home storage. In addition, the gun maker agreed not to sell firearms that are resistant to fingerprints or that can be readily converted to illegal fully automatic weapons.

[23] *Id.*

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All authorized dealers and distributors of Smith & Wesson's products had to abide by a "code of conduct" to eliminate the sale of firearms to criminals, unauthorized juveniles, or "straw purchasers." Dealers and distributors also had to do the following:

- deny guns to purchasers unless they have completed a background check, even if the check takes longer than the then-current legal standard of three business days;
- make no sales to anyone who has not passed a certified firearms safety course or exam;
- require purchasers of multiple handguns to take only one gun on the day of sale and the rest two weeks later; and
- implement a security plan to prevent gun thefts.

Under the code of conduct, dealers agree not to allow children under 18 access, without an adult, to gun shops or sections of stores where guns are sold.[24]

In exchange for all of these voluntary changes, the federal government had all gun litigation dismissed (approximately thirty such suits were pending).

The Effect of the Settlement

The reaction to the settlement was mixed. Although the British hailed the decision as brilliant and many business ethicists heralded it as a socially responsible decision, Charlton Heston, president of the NRA, said, "Smith & Wesson is a good company and a fine old American name, but they're owned by the Brits. I don't really relish the idea of the Brits telling us how to deal with one part of our Bill of Rights."[25]

There was significant customer backlash, and the CEO of Tomkins, Ed Shultz, received used tea bags in his mail from U.S. customers to remind him of the Boston Tea Party.[26] There was a boycott of Smith & Wesson guns by both customers and retailers, with many retailers refusing to carry Smith & Wesson guns in their inventory.

The result was that Smith & Wesson was forced to close plants in Maine and Massachusetts, and by September of 2000, it was forced to lay off a substantial number of workers.

In May 2001, Tomkins sold Smith & Wesson for $15 million to an Arizona gun lock company, Saf-T-Hammer Lock Corporation of Scottsdale. As part of the sale, Saf-T-Lock got $97 million in assets, including a 660,000-square-foot plant in Springfield, Massachusetts; a production facility in Houlton, Maine; Smith & Wesson patents; trademarks; intellectual property; distribution rights; inventory; equipment; and machine drawings.

The Bush Administration announced in August 2001 that it was not bound by the Smith & Wesson agreement and considered the agreement to be only a "Memorandum of Agreement," but not a binding and final contract. However, by the time the announcement was made, Smith & Wesson's sales had fallen off by one-third, and it had a year-to-date loss of $57 million.[27]

[24] Gary Fields, "For Smith & Wesson, Blanks Instead of a Magic Bullet," *The Wall Street Journal*, August 24, 2000, p. A24; and Paul M. Barrett, Joe Mathews, and Vanessa O'Connell, "Arms Deal," *The Wall Street Journal*, March 21, 2000, p. A1.

[25] Christine W. Westphal and Susan M. Wheeler, "When Ethical Decisions Alienate Stakeholders: Smith & Wesson as a Case Study," paper presented at the Academy of Legal Studies, August 8, 2001, Albuquerque, New Mexico, citing, *The Guardian* (London), August 5, 2000, p. 24.

[26] *Id.*

[27] Tish Durkin, "Good Deeds Can Misfire: Consider a Gunmaker's Tumble," *National Law Journal*, April 28, 2001, p. 1207.

Further Controls When Restrictions Do Not Curb Violence: The 2011–2013 Activities[28]

The issue of the sale of guns reemerged during the period from 2011–2013. There were three mass shootings that gripped the country and resulted in demands for new legislation that had a range of controls, from prohibiting the sale of certain types of guns (semiautomatic rifles), to limiting the number of bullets in magazine rounds to seven bullets, to requiring health-care professionals to report patients who pose dangers to society.

The three shootings began on January 8, 2011, in Tucson, Arizona, when Jared L. Loughner went to a constituency meeting being held by then-Representative Gabrielle Giffords at a shopping center. Mr. Loughner opened fire on those who were waiting in line to see the congresswoman, as well as Representative Giffords and her staff. Six people were killed and 12 were wounded, including Ms. Giffords, who has spent the time since the shooting in hospitals, rehabilitation, and ongoing physical therapy required for the bullet wound to her head. Mr. Loughner, a former community college student who had a history of mental illness, entered a guilty plea and was sentenced to seven consecutive life terms and 140 years.

On July 20, 2012, James Holmes is alleged to have entered an Aurora, Colorado, theater on the night of the premier of *The Dark Knight Rises*, in full tactical gear, and using tear gas, opening fire on the theater patrons, killing 12 and wounding 58 others. He used a 12-gauge shotgun, a semiautomatic rifle, and a Glock handgun. He was arrested and awaits trial.

On December 14, 2012, Adam Lanza, 20, entered the Sandy Hook Elementary School in Newtown, Connecticut, where he fatally shot 20 children and six adults with a rifle, firing 154 rounds. When first responders arrived, Lanza shot himself. Authorities later discovered that Lanza had shot and killed his mother prior to going to the elementary school. Lanza was described as somewhat autistic by his brother and was diagnosed with Asperger syndrome.

These mass shootings and the resulting impact on families and communities resulted in state and federal movements toward more legislation on controlling everything from the types of guns sold, to background checks, to limits on ammunition.

In New York, where the legislature passed what is perhaps the strictest gun control legislation in the country, Governor Cuomo was emotional in his support for limiting the size of a gun magazine to seven rounds, "No one needs 10 bullets to kill a deer!"[29] His response was designed to cut off the dissent coming from the state's hunters who, with their humble approach and clean records, were persuading legislators to understand that there are valid uses for guns. The NRA has always been strong in recruiting its 5 million members in order to have a presence in state and national debates to explain ranchers and hunters who use their guns as a means of protection and obtaining food. Mr. Cuomo's remarks went viral and persuaded even those who had supported hunters to join the battle for gun control.

The Responses to Emotion: The Strength of Constitutional Protections and Rights

The response to the emotional tugs of the tragic events involving guns is measured and focuses on rights and laws, and the emotional tug of personal safety. Wayne La Pierre, the head of the NRA for thirty-five years, told his members that he was "horrified" by

[28] The author is grateful to her son, Samuel Jennings, for his research and assistance in writing this case because of his extensive work on this topic as part of a research paper for his communications course.

[29] You can see Governor Cuomo's speech here. http://www.youtube.com/watch?v=DDokWmha68E.

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the three tragedies but that "These people are out to get us and the Second Amendment, and we're not going to let them."[30] His appeal rallied the membership and turned the battle from emotion to rights.

The NRA does have legal precedent on its side. In *U.S. v. Heller*, 554 U.S. 570 (2008), the U.S. Supreme Court took the gun control debate back to one very simple point grounded in the history of the Second Amendment to the U.S. Constitution. In that case, Dick Heller, a D.C. special police officer, was authorized to carry a handgun while on duty at the Thurgood Marshall Judiciary Building. He applied for a registration certificate for a handgun that he wished to keep at home, but officials in the District of Columbia refused. Mr. Heller filed suit, arguing that the D.C. ban on handguns violated his Second Amendment rights. In his suit, Mr. Heller argued the ban as well as the D.C. requirement that guns be kept nonfunctional unless needed for self-defense were unconstitutional infringements of the Second Amendment, which reads, "A well regulated Militia, being necessary to the security of a free State, the right of the people to keep and bear Arms, shall not be infringed."

Although those who argued the case for the District of Columbia argued that the right applied only to the militia, the Court held that the language "right of the people" meant that the right was an individual one. In addition, in discussing the history of the Second Amendment, the Court noted that, "In the tumultuous decades of the 1760's and 1770's, the Crown began to disarm the inhabitants of the most rebellious areas. That provoked polemical reactions by Americans invoking their rights as Englishmen to keep arms."[31] The court also quoted from the scholars of the founding era and included the following from George Tucker:

> This may be considered as the true palladium of liberty … The right to self defence is the first law of nature: in most governments it has been the study of rulers to confine the right within the narrowest limits possible. Wherever standing armies are kept up, and the right of the people to keep and bear arms is, under any colour or pretext whatsoever, prohibited, liberty, if not already annihilated, is on the brink of destruction."[32]

There was strength in this argument that was appealing for the public discourse – the right is there to protect citizens from the enemy within, or those in power who would seek to take away rights and property. With this historical backdrop, those against gun control were able to gain some support by reminding people why guns in the hands of the people are important for their freedom.

With that backdrop, the Court turned its argument to self-defense and struck down the District of Columbia's ban on handguns, by appealing to safety and individual preference and protection.

> It is no answer to say, as petitioners do, that it is permissible to ban the possession of handguns so long as the possession of other firearms (i.e., long guns) is allowed. It is enough to note, as we have observed, that the American people have considered the handgun to be the quintessential self-defense weapon. There are many reasons that a citizen may prefer a handgun for home defense: It is easier to store in a location that is readily accessible in an emergency; it cannot easily be redirected or wrestled away by an attacker; it is easier to use for those without the upper-body strength to lift and aim a long gun; it can be pointed at a burglar with one hand while the other hand dials the police. Whatever the reason, handguns are the most popular weapon chosen by Americans for self-defense in the home, and a complete prohibition of their use is invalid. [33]

[30] Sheryl Gay Stolberg and Jodi Kantor, "The Gun Man, Sticking to His Cause," *New York Times*, April 14, 2013, p. A1.

[31] 554 U.S. at 594.

[32] 2 Tucker's Blackstone 143 (1789).

[33] 554 U.S. at 630.

The Responses to Emotion: Your Safety

In addition to the freedom and constitutional appeal, those who oppose gun control also cite studies of countries, cities, and states where there is strict gun control and the resulting impact on crime rates. In his book *More Guns, Less Crime*, University of Chicago law professor, John Lott presented the definitive work on the relationship between reduction in crime and the presence of more crimes. One of the popular bumper stickers over the decades of gun control debate reads, "When they outlaw guns, only outlaws will have guns." Professor Lott establishes the truth of the bumper sticker as his book documents the fear criminals have of guns and how armed citizens mean less crime. His compelling stories about elderly widows scaring off criminals from their home bring the emotional tug back to this side of the argument. His statistics on violent robberies in Great Britain (which has among the strictest gun control laws) and Australia (guns were banned there) illustrate that the simple bumper sticker is correct, and the absence of guns in the hands of law-abiding citizens creates a lawless and dangerous society.[34]

The Response: Gun Education and "I am the NRA"

Another response that those who oppose gun control have used is education, with two prongs. The first prong, education, concerns clearing up the confusion about guns, including the irrational fear of assault weapons. In his testimony related to a proposed ban on assault weapons, Professor Lott explained:

> Why do people need a semiautomatic Bushmaster to go out and kill deer? They obviously imply that the weapon must be a military weapon not designed for hunting. But they are simply plain mistaken. It has just been made to look like a military weapon. The semiautomatic Bushmaster functions identically to a small game hunting rifle.[35]

The response was an effective factual one to respond to the emotional testimony of the father of one of the children killed at the Sandy Hook massacre.

Professor Lott has also been effective in his factual responses to President Obama's claims that "40% of guns are purchased without a background check" and that background checks would have "blocked 1.7 million prohibited individuals from buying a gun."[36]

His response was:

> The 40% number is actually 36%, and refers to *transfers*, not sales. It would only be accurate if family inheritances and gifts were reclassified as "purchases."
>
> The 36% number was based on a small survey from 1991 to 1994, most of which came before the Brady Act took effect on Feb. 28 1994, with the act introducing the requirement that all federally-licensed dealers perform checks.
>
> Similarly, the supposedly 1.7 million prohibited individuals prevented from buying a gun make no sense whatsoever. What we have is 1.7 million "initial denials." Again, it is a big difference.

The proposed federal legislation on background checks and other curbs on sales failed to pass the Senate in April 2013. The gun debate became quiet in mid-2013, but emotions and events will bring it to the fore once again.

[34] John Lott, *More Guns, Less Crime*.

[35] John Lott, "The Truth About Assault Weapons Bans and Background Checks," The Fox News Opinion Page, February 28, 2013, http://www.foxnews.com/opinion/2013/02/28/truth-about-assault-weapons-bans-and-background-checks/.

[36] Senate Judiciary Transcript, Hearing on Gun Violence, January 13, 2013, http://www.washingtonpost.com/politics/senate-judiciary-committee-hearing-on-gun-violence-on-jan-30-2013-transcript/2013/01/30/1f172222-6af5-11e2-af53-7b2b2a7510a8_story_4.html.

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Discussion Questions

1. Are gun manufacturers and gun dealers legally and/or ethically responsible for a crime committed by someone to whom they sold a gun?
2. If you were a retailer, would you sell guns? If no retailers sell guns, have consumers lost a fundamental constitutional right?
3. How does the Second Amendment fit into the ethical issues in gun sales and ownership?
4. Consider the following analysis by Professors Christine Westphal and Susan Wheeler about the Smith & Wesson experience, and then evaluate the stakeholder versus shareholder debate in that scenario:

   A number of editorial writers have characterized Smith & Wesson's agreement with the government as an ethical decision that was not necessarily good business, and certainly there is some justification for that position. The agreement might also be seen as a conflict among stakeholders where Smith & Wesson betrayed its customers in order to satisfy the demands of its financiers and community.[37]

   Did Smith & Wesson betray its employees too? Did Smith & Wesson violate trust for selfish ends, as the National Shooting Sports Foundation said?

Case 3.10

The Craigslist Connections: Facilitating Crime

Craigslist, referred to as the world's largest classified advertising, came into the public spotlight after medical school student Philip H. Markoff was charged with the murder of a young woman he contacted and met through classifieds placed on Craigslist. Craigslist was not held responsible for a murder, even though the parties involved were connected through Craigslist personal ads. Unless Craigslist was aware of the danger of the personal ads or individuals posting them, then the company is not responsible for resulting criminal and/or harmful activity. However, in response to a series of criminal issues connected to postings on the site and the negative publicity and investigation, Craigslist removed erotic ads and shifted them to a new category called, "Adult Services," where Craigslist employees do screen for suspicious posts.

Discussion Questions

1. Should Craigslist be responsible for criminal connections made via its listing service?
2. Who are the stakeholders for Craigslist, and did its solution solve the effects those stakeholders experience because of the ads?

Case 3.11

Planned Parenthood Backlash at Companies and Charities

Planned Parenthood is a controversial organization that has an impact on any organization from which it obtains support and also from those organizations that withhold their support.

Dayton-Hudson Corporation is a multistate department store chain. In 1990, its charitable foundation gave $18,000 to Planned Parenthood and other contributions to the Children's Home Society, the Association for the Advancement of Young Women, and the Young Women's Christian Association. It had contributed to Planned Parenthood for twenty-two years.

[37] Christine W. Westphal and Susan M. Wheeler, "When Ethical Decisions Alienate Stakeholders: Smith & Wesson as a Case Study," Paper presented at the Academy of Legal Studies, August 8, 2001, Albuquerque, New Mexico, citing, *The Guardian* (London), August 5, 2000, 24.

Pro-life groups have vocally criticized corporate foundations that support Planned Parenthood and have persuaded JCPenney Company and American Telephone and Telegraph (AT&T) to stop their contributions to the organization. After Pioneer Hi-Bred International's foundation gave $25,000 to Planned Parenthood of Greater Iowa for rural clinics that did not perform abortions, Midwestern farmers began circulating a flyer headlined, "Is Pioneer Hi-Bred Pro-Abortion?" CEO Thomas Urban canceled the donation, saying, "We were blackmailed, but you can't put the core business at risk."[38] When pro-life groups raised their objections with the Dayton-Hudson foundation, the foundation's board decided to halt its contributions to Planned Parenthood.

Pro-choice supporters responded strongly by boycotting Dayton-Hudson stores, writing letters to newspaper editors, and closing charge accounts. Pickets appeared outside Dayton-Hudson stores, and picketers cut up their charge cards for media cameras.

A trustee for the New York City Employees Retirement System, which owned 438,290 Dayton shares, commented, "By antagonizing consumers, they've threatened the value of our investment."[39]

Dayton-Hudson decided to resume its funding of Planned Parenthood, even though pro-life groups announced plans to boycott the company's stores.[40]

The backlash can affect nonprofit organizations as well. The Susan G. Komen Foundation, dedicated to the prevention, diagnosis, and treatment of breast cancer, found itself at the center of a Planned Parenthood controversy when, because of internal foundation rules, the Foundation ended its funding from organizations that are under government investigation. Such a rule is not unusual for charitable foundations. Because Planned Parenthood was, in December 2011, under congressional investigation, the Komen Foundation pulled its $700,000 annual donations to the group. Accusing the Foundation of political motivation, Planned Parenthood vowed a boycott of the Foundation's annual Race for the Cure.

The 2012 Race for the Cure found many cities missing their fundraising goals in this important annual event.[41] Donations waned and the executive director of the Komen Foundation resigned. Members of the Foundation's board resigned as well in protest. The Foundation's contribution to Planned Parenthood was restored.

Discussion Questions

1. Is there any way for a corporation to meet all demands in formulating policies on philanthropic giving?
2. Who are the stakeholders in the Komen/Planned Parenthood confrontation? Who was affected by the actions of Planned Parenthood? What are the impacts of boycotts of philanthropic organizations?
3. Currently, companies that have indicated an interest in conducting, or taken steps to conduct, embryonic stem-cell research have had shareholder proposals objecting to such projects or requesting that the company adopt a policy in advance of shunning such research. The proposals, such as one for the Merck 2004 annual meeting, are often submitted by religious groups that own shares in the company. Do these companies face a different dilemma from that of Dayton-Hudson? What makes companies take such different postures? Is it the action of their managers/executives? Are there customer demographic differences?
4. Some pharmacists have refused to fill prescriptions for RU-486 (the morning-after pill) because of their religious and moral convictions. Some pharmacies have refused to stock RU-486 because

[38] Richard Gibson, "Boycott Drive against Pioneer Hi-Bred Shows Perils of Corporate Philanthropy," *The Wall Street Journal*, June 10, 1992, p. B1.

[39] Kevin Kelly, "Dayton-Hudson Finds There's No Graceful Way to Flip-Flop," *Business Week*, September 24, 1990, p. 50.

[40] Fem Portnoy, "Corporate Giving Creates Tough Decisions, Fragile Balances," *Denver Business Journal*, November 15, 1991, p. 15.

[41] Amy Dockser Marcus and Melanie Grayce West, "Some Komen Races Miss Their Goals," *Wall Street Journal*, March 27, 2012, p. A3.

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of the moral convictions of their staff. How do these companies resolve their postures on right to life, abortion, and choice? What makes some companies shun RU-486, whereas others agree to sell it? Why do some companies terminate pharmacists who refuse to dispense RU-486, and why do other companies accommodate those pharmacists?

Reading 3.12

The Regulatory Cycle, Social Responsibility, Business Strategy, and Equilibrium[42]

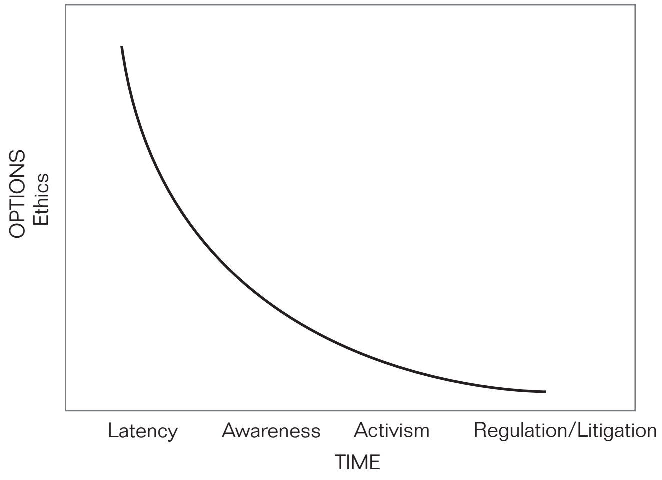
Introduction

Some years ago, when he was serving as the CEO for Motorola, before going on to become Kodak's CEO, George Fisher spoke to a group of our masters students from both engineering and business. One of the questions the students asked, after he had given his thoughts on success in life and business, was "How do you become a leader in business?" His response was that those in business should take an evolving problem in their business unit, their company, their industry, or their community and fix it before the problem was regulated or litigated. He assured the students that business people who voluntarily undertake self-correction are always ahead of the game.

There is a diagram I use to teach students this Fisher principle of leadership that shows how its best execution is found in focusing on ethics. That diagram, based on the political science model developed by Professor James Frierson, appears below (Figure 3.2).

Understanding this cycle, what it represents, what moves it, and how companies and industries should respond is a critical part of the study of ethics in business. The phenomenon of a rapidly moving regulatory force drives home the reality that businesses and industries are always better off self-regulating than waiting for government regulations. A historical study of the cycle phenomenon reveals that regulators, as bureaucratic as they are, can move far more quickly than market forces to solve market frauds,

FIGURE 3.2
Leadership and Ethics: Making Choices before Liability

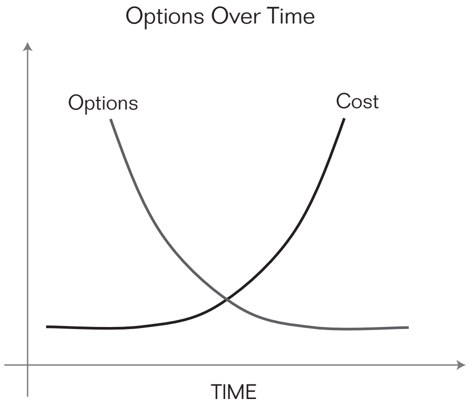


Adapted from James Frierson's "Public Policy Forecasting: A New Approach," *SAM Advanced Management Journal*, Spring 1985, pp. 18–23.

[42] Marianne Jennings. "How Ethics Trump Market Inefficiencies and Thwart the Need for Regulation," *Corporate Finance Review* 10 (2006), pp. 36–41.

FIGURE 3.3

Leadership and Ethics: Making Choices before Liability



abuses, and other perversions that occur when the moral sentiments of markets do not prevail as Adam Smith intended in his assumptions about economic efficiencies.

Every market, consumer, or industry issue that is subject to regulation or litigation began as an ethical issue. Because the law and regulations afforded businesses wide latitude in a particular area, some seized the moment a bit too aggressively. That aggressive seizure of a loophole, without the checks and balances of ethics and market morality, puts companies, industries and individuals at a disadvantage when the inevitable regulation arrives, because their practices have been so foreign to the now mandated morality. The X-axis of the diagram represents time, and the Y-axis represents options for self-regulation. The longer companies and industries wait prior to taking self-corrective action, the less likely their self-correction will be allowed, and the more likely regulators are to impose regulation with often unintended consequences, including additional costs, as illustrated in Figure 3.3 with the addition of a second curve that depicts costs. This diagram depicts the regulatory cycle with an additional line to illustrate the fact that the firm's costs increase the longer the time period for addressing the evolving issues.

Understanding and applying the regulatory cycle is a means of exercising company and industry leadership. Examining issues in light of the cycle provides firms with the opportunity for self-regulation, often a cheaper and more efficient means of curbing the misdeeds that too often occupy loophole areas of markets and industries.

The Stages and Activities of the Regulatory Cycle

Every area that is now the subject of regulation or litigation began at the left side of the regulatory cycle, in the latency stage, with plenty of options for how to handle a gray area. During this phase of the cycle, only those in the industry and perhaps academics and researchers are aware of the evolving issue. For example, the issue of underfunding pensions has been an evolving concern for the past fifteen years. Companies, researchers, and corporate governance experts expressed concerns about the funding, investments, and reporting on pension plans. But the issue remained one of interest only to those in the financial field. It failed to gain traction in daily newspapers such as *USA Today* or in weekly news magazine publications. However, the bankruptcy of United Airlines and its bankruptcy court ruling excusing it from its pension obligations have moved the issue from the latency stage, through the public awareness stage, to activism, or the demand for reform of pension funding and, shortly, new mandates for companies on pension funding. Suddenly the issue of pensions and sudden losses was the cover story for *Time* and *Newsweek*. Consumers and employees were demanding to know "How safe is my pension?"[43]

[43] Marilyn Adams, "'Fundamentally Broken' Pension System In 'Need of a Fix,'" *USA Today*, November 15, 2005, pp. 1B, 2B.

Companies had been able to capitalize on a rather large loophole in pension reporting requirements. When United Airlines (UA) declared bankruptcy, the Federal Pension Benefit Guaranty Corporation discovered that UA's pension was underfunded by 50 percent. The shortage the federal agency will need to supply in order to provide UA employees with their pension benefits is estimated at $8.4 to $10 billion. UA did nothing that violated the law in its pension funding and reporting.[44]

Under a federal pension law enacted in 1974, companies found quite a loophole that enabled them to report better financial results because they were not required to report any pension shortfalls to the Federal Pension Benefit Guaranty Corporation unless their pension funding fell below 50 percent of requirements. The 50 percent figure was, however, a guide for reporting a "state of emergency" in the pension plan and its funding. Under interpretations of the law, most companies declared their plans fully funded so long as they did not dip below 50 percent. United reported a shortfall in 2004 of about $74 million.

The SEC (Securities and Exchange Commission) requires companies to report pension funding shortfalls in their annual reports when pension funding falls below 90 percent. Of the 100 largest pension funds examined by a Department of Labor study in 2003, only six of the plans were truly at the 90 percent funding level, and those six companies had their SEC reports consistent with their Federal Pension Benefit Guaranty Corporation. The audit estimates the shortfall in total private pension plan funding at $450 billion. The Federal Pension Benefit Guarantee Corporation's deficit from paying pensions is now $23.5 billion. With that level of shortfall and media attention, massive reforms came with the passage of the Pension Protection Act of 2006.

The pattern in the regulatory cycle is always the same. Someone finds a loophole in the law, and those in the industry take advantage of that loophole as a strategy for maximizing their returns. History repeats itself when it comes to the regulatory cycle. For example, prior to the savings and loan crisis and collapse of the late 1980s and early 1990s, appraisers were not regulated. The qualifications for an appraiser were limited, and issues such as conflicts of interest (where the appraisers stood to benefit in a transaction if the land value came in at an appropriate level) were not controlled. In an area in which there are few legal guidelines, leeway translates into licentiousness and then abuses that often graduate into fraud. The firms begin by crossing those ethical lines of conflicts of interest or by only asking whether something *can* be done (such as the pension funding and reporting issues), and not whether it *should* be done.

Those basic ethical violations, centering on basic values such as fairness in real estate transactions or honoring the pension commitment made to employees, cause emotional reactions and outrage. Courts and/or legislatures step in to legislate ethics.

What is perhaps so difficult for executives to grasp about the regulatory cycle is that it moves not by data or logic, but rather by emotion and by public perception. Public perception changes through examples and anecdotes.

The U.S. tax deductibility limits on CEO pay, as ill-defined and designed as they were, resulted from public emotion and outcry over executive compensation. There are continuing demands for reforms. Stock option grants are a gently percolating issue to watch as continuing attention and outrage build.[45]

Presently, companies are grappling with the expensive and intense mandates of Sarbanes-Oxley regulations. The statutorily imposed mandates on board structure, conflicts,

[44] Mary Williams Walsh, "Pension Loopholes Helped United Hide its Troubles," *New York Times*, June 7, 2005, pp. C1, C3.

[45] The result was SEC investigation of over 250 companies for backdating in their options grants.

financial reporting, and certification of processes and reports have found many firms with delayed filings and restatements.

Still, one of the benefits of anticipating issues in the latency stage is that a company is then prepared for implementation and may enjoy a period of competitive advantage because it is not distracted by complex regulations and their implementation. Their practices found them in compliance before the law and regulatory mandates existed. Some firms have taken Sarbanes-Oxley (SOX) in stride and found that its provision even provide them with some efficiencies.

How to Seize the Moment and Manage the Cycle

There are businesses that do seize the latency moment. There is little question that the electric utility industry would look a great deal different today if it had not handled the issue of EMF (electromagnetic fields) as effectively and openly as it did.

As we look back over the art of financial reporting, we see a host of ethical issues that went on unmanaged until SOX was passed and mandated. The audit firms themselves are now fully regulated for their complicity in the frauds at WorldCom, Enron, Adelphia, and others. The federal government must authorize them to conduct audits, and the role of the accounting profession in setting ethical standards has been usurped by the government—federal laws now determine what constitutes a conflict of interest on the part of an auditor because the profession had not defined a conflict broadly enough to cover the clearly conflicting interests auditors had with their clients. Officers are now required to pay back bonuses earned because of inflated earnings reports. Ethically there was no other answer but that the company be repaid those bonuses, but too few executives saw the issue, and SOX requires that the officers restore their bonus payments to the company if the numbers have been inflated.

How can a director who is not independent be an effective member of the board audit or compensation committee? The conflict is overwhelming, and even the disclosure of a director's dual role does not cure the conflict. The result of too many abuses of conflicting relationships by too many directors is that federal law now requires independent directors only on the audit and compensation committees of the board. How could the issue have evolved to the point of federal mandates? It got to the point because there were ethical breaches, and the result was a wild ride in terms of both compensation and inaccurate financial reports. When the degree of abuses unfolded, the public became emotional and demanded action. That action came in the form of strict requirements for board structure.

There are ethical issues that are now in the latency stage—that stage where the public is not aware of a problem and no one is filing suit or demanding regulation. What follows is a list of questions to help anticipate the cycle:

- What is the topic of discussion in the industry?
- What concerns are academics and others expressing about the product, its production, and the future?
- Is the company capitalizing on a loophole in the law?
- Has it disclosed what loophole it is using?
- If it has not disclosed the loophole, what are the company's reasons for keeping it close to the vest?
- Are the company's actions fair or do they put someone at risk?
- Are others in the industry doing the same thing?

Discussion Questions

1. Name some issues that you have seen or are seeing moving through the regulatory cycle.
2. How should a business respond when the public is emotionally charged about its practices, its products, or operations?

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Case 3.13

Fannie, Freddie, Wall Street, Main Street, and the Subprime Mortgage Market: Of Moral Hazards

Background on Fannie Mae

Fannie Mae was created as a different sort of business entity, a shareholder-owned corporation with a federal charter. The federal government created Fannie Mae in 1938 during the Roosevelt administration, to increase affordable housing availability and to attract investment into the housing market. The charge to Fannie Mae was to be sure that there was a stable mortgage market with consistent availability of mortgage funds for consumers to purchase homes. Initially, Fannie Mae was federally funded, but in 1968 it was rechartered as a shareholder-owned corporation with the responsibility of obtaining all of its capital from the private market, not the federal government. On its website, Fannie Mae describes its commitment and mission as follows:

- "Expand access to homeownership for first-time home buyers and help raise the minority home-ownership rate with the ultimate goal of closing the homeownership gap entirely;
- Make homeownership and rental housing a success for families at risk of losing their homes;
- Expand the supply of affordable housing where it is needed most, which includes initiatives for workforce housing and supportive housing for the chronically homeless; and
- Transform targeted communities, including urban, rural, and Native American, by channeling all the company's tools and resources and aligning efforts with partners in these areas.

A Model Corporate Citizen

In 2004, *Business Ethics* magazine named Fannie Mae the most ethical company in the United States. It had been in the top ten corporate citizens for several years (number nine in 2000 and number three in 2001 and 2002).[46] Marjorie Kelly, the editor-in-chief of the magazine (see Reading 3.6), described the standards for the award, which was created in 1996, as follows:

> Just what does it mean to be a good corporate citizen today? To our minds, it means simply this: treating a mix of stakeholders well. And by stakeholders, we mean those who have a "stake" in the firm—because they have risked financial, social, human, and knowledge capital in the corporation, or because they are impacted by its activities. While lists of stakeholders can be long, we focus on four groups: employees, customers, stockholders, and the community. Being a good citizen means attending to the company's impact on all these groups.[47]

In 2001, the magazine explained why Fannie Mae was one of the country's top corporate citizens:

> Fannie Mae scores high in the areas of community and diversity, and has been ranked near the top of everyone's "best" list, including Fortune's "Best Companies for Minorities," Working Mother's "Best Companies for Working Mothers," and The American Benefactor's "America's Most Generous Companies." Franklin D. Raines, an African American, is CEO, and there are two women and two minorities among the company's eight senior line executives.[48]

[46] In 2003, Fannie Mae was number 12. *Business Ethics*, March/April 2003.

[47] *Business Ethics*, May/June 2000.

[48] *Business Ethics*, May/June 2001.

In 2002, *Business Ethics* described third-ranked Fannie Mae as follows:

> The purpose of Fannie Mae, a private company with an unusual federal charter, is to spread home ownership among Americans. Its ten-year, $2 trillion program—the American Dream Commitment—aims to increase home ownership rates for minorities, new immigrants, young families, and those in low-income communities.
>
> In 2001, over 51 percent of Fannie Mae's financing went to low- and moderate-income households. "A great deal of our work serves populations that are under-served, typically, and we've shown that it's an imminently bankable proposition," said Barry Zigas, senior vice president in Fannie Mae's National Community Lending Center. "It is our goal to keep expanding our reach to impaired borrowers and to help lower their costs.
>
> "That represents a striking contrast to other financial firms, many of which prey upon rather than help low-income borrowers. To aid the victims of predatory lenders, Fannie Mae allows additional flexibility in underwriting new loans for people trapped in abusive loans, if they could have initially qualified for conventional financing. In January the company committed $31 million to purchasing these type of loans."[49]

The Community Reinvestment Act (CRA) is a federal statute that established a government program to get people who would otherwise not qualify (i.e., no credit history and no down payment) into homes with the goals of helping these folks and thereby revitalizing blighted areas. Banks and lenders were evaluated for their commitment to these loans, and no bank or lender wanted a bad rating.

Simultaneously, the federal government anticipated pushback from lenders who would point out that these were high-risk loans and required greater returns. However, lenders were evaluated for their CRA commitment, which included their creativity in granting the loans. In addition, lenders faced prosecution by the Justice Department for discrimination in lending if their loan portfolios did not include a sufficient number of CRA loans. All the while, Fannie Mae served as the purchaser for these loans, eventually packaging them and selling them as securitized mortgage pools. The CRA loans had borrowers with less equity, higher default rates, and more foreclosures. There was also an exacerbating effect of this false sense of security on the part of the high-risk borrowers about their mortgages. Because these risky borrowers were not really anteing up the actual cost of their homes (and remember, these were folks who had never had a mortgage before, had bad credit histories, and may not have had much in the way of financial literacy), they overextended and overspent in other areas. In short, they were maxed out in all areas because they were lulled into a false sense of financial security with such a low mortgage payment. Because Fannie Mae owned or guaranteed half of the $12 trillion mortgage debt in the United States, any problems with those mortgages could and did lead to a financial crisis for Fannie, the U.S. stock market, and the economy.[50] Then-Federal Reserve Chairman Alan Greenspan warned of the looming problems at Fannie Mae in 2005. He testified before Congress, "The Federal Reserve Board has been unable to find any credible purpose for the huge balance sheets built by Fannie and Freddie other than profit."[51] Others, including St. Louis Federal Reserve Chairman William Poole, warned that the huge debt load rendered Fannie and Freddie insolvent.

The Darker Side of Corporate Citizen Fannie

Even as the mortgage issues were evolving under the radar and Fannie was being recognized for its corporate citizenship, there were issues in Fannie's operations that went undetected for nearly a decade.

[49] *Business Ethics*, May/June 2002.

[50] Julie Creswell, "Long Protected by Washington, Fannie and Freddie Ballooned," *New York Times*, July 13, 2008, p. A7.

[51] *Id.*, at A18.

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Fannie Mae: The Super-Achiever with an EPS Goal

Fannie Mae was a company driven to earnings targets through a compensation system tied to those results. And Fannie Mae had a phenomenal run based on those incentives in terms of its financial performance:

- For more than a decade, Fannie Mae achieved consistent, double-digit growth in earnings.[52]
- In that same decade, Fannie Mae's mortgage portfolio grew by five times, to $895 billion.[53]
- From 2001 to 2004, its profits totaled $24 billion.[54]
- Through 2004, Fannie Mae's shares were trading at over $80.[55]
- Fannie Mae was able to smooth earnings through decisions on the recording of interest costs and used questionable discretion in determining the accounting treatment for buying and selling its mortgage assets. Those decisions allowed executives at the company to smooth earnings growth, with a resulting guaranteed payout to them under the incentive plans.[56]

Those incentive plans were based on earnings per share (EPS) targets that had to be reached in order for the officers to earn their annual bonuses. The incentive plans began in 1995, with a kick-up in 1998 as Franklin Raines, then chairman and CEO, set a goal of doubling the company's EPS from $3.23 to $6.46 in five years.[57] Raines, the former budget director for the Clinton administration, was able to make the EPS goal a part of Fannie Mae's culture. Mr. Raines said, "The future is so bright that I am willing to set a goal that our EPS will double over the next five years."[58] Sampath Rajappa, Fannie Mae's senior vice president of operations risk (akin to the Office of Auditing), gave the following pep talk to his team in 2000, as the EPS goals continued:

> By now every one of you must have a 6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breathe and dream 6.46, you must be obsessed on 6.46. … After all thanks to Frank, we all have a lot of money riding on it…. We must do this with a fiery determination, not on some days, not on most days but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%. Remember Frank has given us an opportunity to earn not just our salaries, benefits, raises … but substantially over and above if we make 6.46.
>
> So it is our moral obligation to give well above our 100% and if we do this, we would have made tangible contributions toward Frank's goals.[59]

For 1998, the size of the annual bonus payout pool was linked to specific EPS targets:

- Earnings per share (EPS) range for 1998 annual incentive plan (AIP) corporate goals
- $3.13, minimum payout; $3.18, target payout; $3.23, maximum payout[60]

[52] James R. Hagerty and John D. McKinnon, "Fannie Mae Board Agrees to Changes It Long Resisted," *Wall Street Journal*, July 28, 2004, p. A1.

[53] *Id.*

[54] Alex Berenson, "Assessing What Will Happen to Fannie Mae," *New York Times*, December 17, 2004, p. C1.

[55] Paul Dwyer, Amy Borrus, and Mara Hovanesian, "Fannie Mae: What's the Damage?" *Fortune*, October 11, 2004, p. 45.

[56] Office of Federal Housing Enterprise Oversight, report, November 15, 2005. Report found at http://www.fhfa.gov/Default.aspx?Page-4. Accessed July 20, 2010. The OFHEO was merged into the federal Finance Housing Agency in 2009 following Fannie Mae's collapse.

[57] Bethany McLean, "The Fall of Fannie Mae," *Fortune*, January 25, 2005, pp. 123, 128.

[58] *Id.*

[59] Office of Federal Housing Enterprise Oversight (OFHEO), *Final Report of the Special Examination of Fannie Mae*, May 2006 (Washington, DC: OFHEO), p. 50 (hereinafter referred to as *OFHEO Final Report*).

[60] OFHEO, Office of Compliance, *Report of Findings to Date: Special Examination of Fannie Mae*, September 17, 2004 (Washington, DC: OFHEO), pp. vii, 149 (hereinafter referred to as *OFHEO Interim Report*).

For Fannie Mae to pay out the maximum amount in incentives in 1998, EPS would have to come in at $3.23. If EPS were below the $3.13 minimum, there would be no incentive payout. The 1998 EPS was $3.2309. The maximum payout goal was met, as the OFHEO report noted, "right down to the penny." The final OFHEO report concluded that the executive team at Fannie Mae determined what number it needed to get to the maximum EPS level and then worked backward to achieve that result. One series of e-mails finds the executives agreeing on what number they were comfortable with as using for the "volatility adjustment."[61]

The following table shows the difference between salary (what would have been paid if the minimum target were not met) and the award under the annual incentive plan (AIP).

1998 Salary and Bonus of Senior Fannie Mae Executives

Officer	Title	Salary	AIP Award/Bonus
James A. Johnson	Chairman and CEO	$966,000	$1,932,000
Franklin D. Raines	Chairman and CEO designate	$526,154	$1,109,589
Lawrence M. Small	President and COO	$783,839	$1,108,259
Jamie Gorelick	Vice chairman	$567,000	$779,625
J. Timothy Howard	Executive vice president (EVP) and CFO	$395,000	$493,750
Robert J. Levin	EVP, housing and community development	$395,000	$493,750

"Right down to the penny" was not a serendipitous achievement. For example, Fannie Mae's gains and losses on risky derivatives were kept off the books by treating them as hedges, a decision that was made without determining whether such treatment qualified under the accounting rules for exemptions from earnings statements. These losses were eventually brought back into earnings with a multibillion impact when these types of improprieties were uncovered in 2005.[62]

Fannie Mae and Volatility

Fannie Mae's policies on amortization, a critical accounting area for a company buying and holding mortgage loans, were developed by the chief financial officer (CFO) with no input from the company's controller. Fannie Mae's amortization policies were not in compliance with GAAP (generally accepted accounting principles).[63] The amortization policies relied on a computer model that would shorten the amortization of the life of a loan in order to peak earnings performance with higher yields. Fascinatingly, the amortization policies were developed because of a mantra within the company of "no more surprises."[64] The philosophy was that in order to attract funding for the mortgage market, there needed to be stability that would attract investors. The officers at the company reasoned that "volatility" was a barrier to accomplishing its goals of a stable and available

[61] *OFHEO Final Report*, p. 51.

[62] *Id.*, p. 45.

[63] Fannie Mae's "Purchase Premium and Discount Amortization Policy," its internal policies on accounting and financial reporting on its loan portfolio, did not comply with GAAP. *OFHEO Interim Report*, pp. vii and 149. The final report was issued in February 2006, with no new surprises or altered conclusions beyond what appeared in this interim report Greg Farrell, "No New Problems in Report on Fannie, *USA Today*, February 24, 2006, p. 1B.

[64] *OFHEO Interim Report*, p. v.

source of mortgage funds for homes. When the computer model was developed, the officers reasoned that they were simply adjusting for what was "arbitrary volatility." However, "arbitrary volatility" turned out to be a difficult-to-grasp concept for those outside Fannie Mae.[65] Further, the volatility measures and adjustments appeared to have a direct correlation with the EPS goals that resulted in the awards to the officers. Even those within Fannie Mae struggled to explain to investigators what was really happening with their adjustments.

In the OFHEO report, an investigator asked Janet Pennewell, Fannie Mae's vice president of resource and planning, "What is arbitrary volatility in earnings?" Ms. Pennewell responded,

> Arbitrary volatility, in our view, was introduced when—I can give you an example of what would cause, in our view, arbitrary volatility. If your constant effective yield was dramatically different between one quarter and the next quarter because of an arbitrary decision you had or view—changing your view of long-term interest rates that caused a dramatic change in the constant effective yield that you were reporting, you could therefore be in a position where you might be booking 300 million of income in one quarter and 200 million of expense in the next quarter, introduced merely by what your assumption about future interest rates was. And to us that was arbitrary volatility because it really just literally because of your view, your expectation of interest rate and the way that you were modeling your premium and discount constant effective yield, you would introduce something into your financial statements that, again, wasn't very reflective of how you really expect that mortgage to perform over its entire expected life, and was not very representative of the fundamental financial performance of the company."[66]

The operative words "to us" appeared to have fueled accounting decisions. But there was an overriding problem with Fannie Mae's reliance on arbitrary volatility. Fannie Mae had fixed-rate mortgages in its portfolio. Market fluctuations on interest rates were irrelevant for most of its portfolio.[67]

Fannie Mae's Accounting

The accounting practices of Fannie Mae were so aggressive that when Raines, lawyers, and others met with the SEC to discuss the agency's demand for a restatement in 2005, the SEC told Raines that Fannie's financial reports were inaccurate in "material respects." When pressed for specifics, Donald Nicolaisen, head of the SEC's accounting division, held up a piece of paper that represented the four corners of what was permissible under GAAP and told Raines, "You weren't even on the page."[68] The OFHEO report on Fannie Mae's accounting practices "paints an ugly picture of a company tottering under the weight of baleful misdeeds that have marked the corporate scandals of the past three years: dishonest accounting, lax internal controls, insufficient capital, and me-first managers who only care that earnings are high enough to get fat bonuses and stock options."[69]

When Franklin Raines and Fannie Mae CFO J. Timothy Howard were removed by the board at the end of 2005, Daniel H. Mudd, the former chief operating officer during the time frame in which the accounting issues arose, was appointed CEO.[70] When

[65] *Id.*

[66] *OFHEO Final Report*, p. 6.

[67] This portion of the discussion was adapted from Marianne M. Jennings, "Fraud Is the Moving Target, Not Corporate Securities Attorneys: The Market Relevance of Firing before Being Fired upon and Not Being 'Shocked, Shocked' That Fraud Is Going On," 46 *Washburn L.J.* 27 (2006).

[68] McLean, "The Fall of Fannie Mae," pp. 123, 138.

[69] *Id.*, p. 45.

[70] Stephen Labaton, "Chief Is Ousted at Fannie Mae under Pressure," *New York Times*, December 22, 2004, p. A1.

congressional hearings were held following the OFHEO report, Mudd testified that he was "as shocked as anyone" about the accounting scandals at the company at which he had served as a senior officer.[71] He added, "I was shocked and stunned," when Senator Chuck Hagel confronted Mudd with "I'm astounded that you would stay with this institution."[72]

There were other issues that exacerbated the accounting decisions at Fannie Mae. Mr. Howard, as CFO, had two functions: to set the targets for Fannie's financial performance and make the calls on the financial reports that determined whether those targets (and hence his incentive pay and bonuses) would be met.[73] In effect, the function of targets and determination of how to meet those targets rested with one officer in the company. The internal control structure at Fannie Mae was weak even by the most lax internal control standards.[74]

In 1998, when Fannie Mae CEO Raines set the EPS goals, the charge spread throughout the company, and the OFHEO report concluded that the result was a culture that "improperly stressed stable earnings growth."[75] Also in 1998, Armando Falcone of the OFHEO issued a warning report that challenged Fannie Mae's accounting and stunning lack of internal controls. The report was buried until the 2004 report, readily dismissed by Fannie Mae executives and members of Congress who were enamored of Fannie's financial performance, as the work of "pencil brains" who did not understand a model that was working.[76]

The Unraveling of the Fannie Mae Mystique

Employees within Fannie Mae did begin to raise questions. In November 2003, a full year before Fannie Mae's issues would become public, Roger Barnes, then an employee in the Controller's Office at the company, left Fannie Mae because of his frustration with the lack of response from the Office of Auditing at Fannie. He had provided a detailed concern about the company's accounting policy that internal audit did not investigate in an appropriate manner.[77] No one at Fannie Mae took any steps to investigate Barnes's warnings about the flaws in the computer models for amortization. Worse, in one instance, Mr. Barnes notified the head of the Office of Auditing that at least one on-top adjustment had been made in order to make Fannie's results meet those that had been forecasted.[78] At the time Barnes raised his concern, Fannie Mae had an Ethics and Compliance Office, but it was housed within the company's litigation division and was headed by a lawyer whose primary responsibility was defending the company against allegations and suits by employees.

When those in charge of the Office of Auditing (Mr. Rajappa, of EPS 6.46 pep talk fame, was the person who handled the allegations and investigation) investigated Barnes's allegations, they were not given access to the necessary information and the investigation was dropped.[79] Many of the officers at Fannie disclosed in interviews that they were aware of the Barnes allegation of an intentional act related to financial reporting,

[71] David S. Hilzenrath and Annys Shin, "Senators Grill Fannie Mae Chief," *Washington Post*, June 16, 2006, p. D2.

[72] Marcie Gordon, "Fannie Mae Execs Face Intense Questioning from Senators," *USA Today*, June 16, 2006, p. 4B.

[73] *Id.*

[74] *Id.*

[75] Stephen Labaton and Rick Dash, "New Report Criticizes Big Lender," *New York Times*, February 24, 2006, pp. C1, C6.

[76] *Id.*, p. 128.

[77] *OFHEO Interim Report,* p. iv.

[78] *OFHEO Interim Report,* p. 75.

[79] *Id.*, p. 78.

but none of them followed up on the issue or required an investigation.[80] Barnes was correct but was ignored, and he left Fannie Mae. He would later be vindicated by the OFHEO report, but the report was not issued until after he had left Fannie Mae.[81] Fannie Mae settled with Barnes before any suit for wrongful termination was filed. In 2002, at about the same time Barnes was raising his concerns internally, the *Wall Street Journal* began raising questions about Fannie Mae's accounting practices.[82] Those concerns were reported and editorialized in that newspaper for two years. No action was taken, however, until the OFEHO interim report was released.

The final OFHEO report noted that Fannie Mae's then-CEO Daniel Mudd listened in 2003 as employees expressed concerns about the company's accounting policies. However, Mr. Mudd took no steps to follow up on either the questions or concerns that the employees had raised in the meeting that also subsequently turned out to accurately reflect the financial reporting missteps and misdeeds at Fannie Mae.[83] The special report done for Fannie Mae's board indicates that the Legal Department at Fannie Mae was aware of the Barnes allegations, but it deferred to internal audit for making any decisions about the merits of the allegations.[84]

The investigation of then – New York Attorney General Eliot Spitzer (Mr. Spitzer became governor in 2007 and resigned in 2008 because of a sex scandal) into insurance companies added an aside to the Fannie Mae scandal and revealed yet another red flag from a Fannie Mae employee. In 2002, Fannie Mae bought a finite-risk policy from Radian Insurance to shift $40 million in income from 2003 to 2004. Radian booked the transaction as a loan, but Fannie called it an insurance policy on its books. In a January 9, 2002, e-mail, Louis Hoyes, Fannie Mae's chief for residential mortgages, wrote about the Radian deal, "I would like to express an extremely strong no vote.… Should we be exposing Fannie Mae to this type of political risk to 'move' $40 million of income? I believe not."[85] No further action was taken on the question raised; the deal went through as planned, and the income was shifted to another year.

The Fallout at Fannie Mae

Fannie Mae paid a $125 million fine to OFHEO for its accounting improprieties.[86] As part of that settlement, Fannie Mae's board agreed to new officers, new systems of internal control, and the presence of outside consultants to monitor the company's progress. The agency concluded that it would take years for Fannie Mae to work through all of the accounting issues and corrective actions needed to prevent similar accounting missteps in the future.[87] Fannie Mae settled charges of accounting issues with the SEC for $400 million.[88] Investigations into the role of third parties and their relationships to Fannie

[80] *Id.*, p. 76. However, the OFHEO investigation reveals inconsistencies in the Office of Auditing's take on the Barnes allegations.

[81] Paul, Weiss, Rifkind, et al., *A Report to the Special Review Committee of the Board of Directors of Fannie Mae*, February 23, 2006, p. 25 (hereinafter referred to as *Board Report*).

[82] "Systemic Political Risk," *Wall Street Journal*, September 30, 2005, p. A10.

[83] Eric Dash, *Regulators Denounce Fannie Mae, New York Times,* May 24, 2006, p. C1. Mr. Mudd said, "I absolutely wish I had handled it differently."

[84] *Board Report,* p. 28.

[85] Dawn Kopecki, "It Looks Like Fannie Had Some Help," *BusinessWeek*, June 12, 2006, pp. 36, 38. *Id.* Radian's general counsel had this comment on the deal: "We have not done anything improper or illegal in this particular case or in any other case"; odd to get that kind of a wide swath from general counsel.

[86] Edward Iwata, "Celebrated CEO Faces Critics," *USA Today*, October 6, 2004, pp. 1B, 2B.

[87] "Fannie Mae Overhaul May Take Years," *New York Times*, June 16, 2006, p. C3.

[88] Elliott Blair Smith, "Fannie Mae to Pay $400 Million Fine," *USA Today*, May 24, 2006, p. 1B.

Mae and "actions and inactions" with them are pending.[89] Former head of the SEC Harvey Pitt commented, "When a company has engaged in wrongful conduct, the inquiry [inevitably turns to] who knew about it, who could have prevented it, who facilitated it."[90]

The head of the OFHEO, upon release of the Fannie Mae report, said of the company's operations, "More than any other case I've seen, it's all there."[91]

When he was serving as the CEO of Fannie Mae as well as the chair of the Business Roundtable, Franklin Raines testified before Congress in March 2002 in favor of passage of Sarbanes-Oxley. The following are excerpts from his testimony, which began with a reference to the tone at the top:

> The success of the American free enterprise system obtains from the merger of corporate responsibility with individual responsibility, and The Business Roundtable believes that responsibility starts at the top.
>
> We understand why the American people are stunned and outraged by the failure of corporate leadership and governance at Enron. It is wholly irresponsible and unacceptable for corporate leaders to say they did not know—or suggest it was not their duty to know—about the operations and activities of their company, particularly when it comes to risks that threaten the fundamental viability of their company.
>
> First, the paramount duty of the board of directors of a public corporation is to select and oversee competent and ethical management to run the company on a day-to-day basis.
>
> Second, it is the responsibility of management to operate the company in a competent and ethical manner. Senior management is expected to know how the company earns its income and what risks the company is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the company.[92]

The final Fannie Mae report was issued in May 2006 with no new surprises or altered conclusions beyond what appeared in the interim report.[93]

Fannie Mae concluded the financial statement questions and issues with, among other things, a $6.3 billion restatement of revenue for the period from 1998 through 2004. Mr. Raines earned $90 million in bonuses for this period. The report also concluded that management had created an "unethical and arrogant culture" with bonus targets that were achieved through the use of cookie jar reserves that "manipulated earnings."[94] OFHEO filed 101 civil charges against Mr. Raines, former Fannie Mae CFO J. Timothy Howard, and former Controller Leanne G. Spencer. The suits asked for the return of $115 million in incentive plan payouts to the three.[95] The suit also asked for $100 million in penalties. The three settled the case by agreeing to pay $31.4 million. Mr. Raines issued the following statement when the case was settled: "While I long ago accepted managerial accountability for any errors committed by subordinates while I was CEO, it is a very different matter to suggest that I was legally culpable in any way. I was not. This settlement is not an acknowledgment of wrongdoing on my part, because I did not

[89] Kopecki, "It Looks Like Fannie Had Some Help," p. 36.

[90] *Id.*

[91] Dwyer, Borrus, and Hovanesian, "Fannie Mae: What's the Damage?" pp. 45, 48.

[92] Statement by Franklin D. Raines, Chairman, Corporate Governance Task Force of the Business Roundtable, before the U.S. House Committee on Financial Services, Washington, D.C., March 20, 2002.

[93] Greg Farrell, "No New Problems in Report on Fannie," *USA Today*, February 24, 2006, p. 1B.

[94] OFHEO, "Report of Findings to Date, Special Examination of Fannie Mae," September 17, 2004, http://www.ofheo.gov. Accessed June 19, 2010.

[95] Eric Dash, "Fannie Mae Ex-Officers Sued by U.S.," *New York Times*, December 19, 2006, pp. C1, C9.

break any laws or rules while leading Fannie Mae. At most, this is an agreement to disagree."[96]

The Evolving Financial Meltdown and the Conflicts

Once the restatement was completed, Fannie Mae returned to increasing its mortgage portfolio. But Fannie also built relationships. Through its foundation, the Fannie Mae Foundation, Fannie (subsequently investigated by the IRS for violating the use of a charitable foundation for political purposes) made donations to charities on the basis of the political contacts they were able to list on their applications for funding.[97] Bruce Marks, the CEO of Neighborhood Assistance Corporation, a recipient of Fannie Foundation funds explained, "Many institutions rely on Fannie Mae and understand that those funds are contingent on public support for its policies. Fannie Mae has intimidated virtually all of them into remaining silent."[98] Donations went to those groups that supported CRA loans, including the annual fundraisers for several congressional groups. In exchange, when regulatory or legislative action was pending that was unfavorable to Fannie, those members of Congress would come out in support of Fannie, what one member of Congress called, "a gorilla that has outgrown its cage."[99] When the SEC wanted to push to have Fannie Mae register its securities as other companies did, at least six members of Congress wrote letters of support for Fannie, and the SEC backed down from its demand.

Fannie's board members also stood to benefit from continuing Fannie's growth and mortgage policies. Lenders, seeking to curry favor with Fannie in having it purchase their mortgages, offered special loan terms to Fannie executives and board members as well as to members of Congress. The following chart lists those loans that were given by Countrywide under a special program that was nicknamed, "FOA," for "Friends of Angelo."[100] Angelo Mozilo was the CEO of Countrywide, a company that collapsed under the weight of its subprime mortgages, nearly all of which were purchased by Fannie Mae.

FOAs at Countrywide

Name/Title	Amount	Rate	Years
Franklin Haines Former CEO Fannie Mae	$982,253 $986,340	5.125% 4.125%	10 10
Jamie Gorelick Vice Chair Fannie Mae	$960,149	5.00%	10
James Johnson Former CEO Fannie Mae	$971,650	3.875%	3
Daniel Mudd COO/CEO Fannie Mae	$2,965,000	4.250%	7

[96] James R. Hagerty, "Fannie Mae Settlement Proves Anticlimactic," *Wall Street Journal*, April 21, 2008, p. A3.

[97] Dawn Kopecki, "Philanthropy, Fannie Mae Style," *BusinessWeek*, April 2, 2007, p. 36.

[98] *Id.*

[99] Julie Creswell, "Long Protected by Washington, Fannie and Freddie Ballooned," *New York Times*, July 13, 2008, p. A7.

[100] Paul Gigot, "The Fannie Mae Gang," *Wall Street Journal*, July 23, 2008, p. A17.

Between 2005 and 2008, Fannie Mae guaranteed $270 billion in risky loans, an amount that was three times the amount of risky loans it had guaranteed in all of its existence (since 1938, when it was created during the Roosevelt administration). The mortgage loans were risky because the income of the borrowers had not been verified; the borrowers had little or no equity in the property; the real level of payments that would be due under the loans did not take effect until three to five years after; and most of the borrowers had little or a poor credit history.

When employees expressed concerns that there were too many mortgages being evaluated, that the computer system was not effective in determining risk, and that Fannie's exposure was too great, Mr. Mudd, then-CEO, instructed them, "Get aggressive on risk-taking or get out of the company."[101] During the years from 2004 to 2006, the company operated without a permanent chief risk officer. When a permanent risk officer was hired in 2006, he advised Mr. Mudd to scale back on risk. Mr. Mudd rebuffed the suggestion because he explained that Congress and shareholders wanted him to take more risks. In September 2008, the federal government had to pay $200 billion in order to restore Fannie to solvency and prevent the quake that would have shaken other firms if Fannie had defaulted on its guarantees.

The Fannie Mae Mortgages—The Ripple Effect and Stakeholder Analysis.

Even with the $200 billion bailout, Fannie was still left as the guarantor on all the subprime mortgages that were now in default. Defaults on those mortgages carried ripple effects. The issues of the subprime market provide a structure for understanding stakeholder analysis. Suppose Bob is a subprime borrower or suppose that Bob misrepresents his qualifications for a mortgage on a loan application. Either way, Bob represents a riskier type of mortgage than those borrowers who have minimum income, down-payment, and verification requirements. Suppose further that Bob defaults—and there is a greater likelihood that Bob will default if he is a subprime borrower or a borrower who has misrepresented his status. Because Bob has defaulted, the lender has to go through foreclosure and take a write-down for a loan gone bad. Those who have purchased bundled mortgages or securities based on bundles of mortgages also have devalued assets, particularly if, in addition to subprime Bob, there are other subprime borrowers such as Betty, Bill, Brent, and others all through the alphabet.

But there is a far more local impact. Bob's home and others are in foreclosure, with the resulting effect of an ill-maintained or unoccupied property in a neighborhood. Other homeowners in the neighborhood are affected by the loss in value generally, as well as by the sale of the homes at foreclosure for what is inevitably a much lower price. All those who live in the area have the value of their homes affected. Lower property values means taxes are lower, with a resulting effect on government services.

In addition, Bob's original lender tightens credit and lending standards, even for those who would have been good credit risks under original standards. There are more homes on the market, which also means lower prices. With more existing homes on the market, construction firms scale back on building, which results in reduced labor forces, which could mean more defaults because of loss of income. Decorators, landscapers, lawn services, and companies that provide services to real estate and construction firms are all affected by these events. There is a ripple through the economy that produces more foreclosures, tighter credit standards, a smaller funds pool, little opportunity for business expansion, and credit markets frozen because of the fear of increased risk.

[101] Charles Duhigg, "Pressured to Take More Risks, Fannie Reached Tipping Point," *New York Times*, October 5, 2008, p. A1.

Walking Away, Refinancing, and Moral Hazards

Ethical analysis looks at this question: How did you get in this situation in the first place? In the words of the not-so-great Bob Dylan, "When you ain't got nothin', you got nothin' to lose." In the words of the great University of Utah–Austin economics professor Stan Liebowitz, "skin in the game" is the single most important factor in determining default on mortgage and—too often after the market collapse—the walk-away. If you have a little down payment and no equity to speak of, you walk when your mortgage is more than your property value—in other words, underwater. Some walked away with arms full—taking everything that moved (or didn't) from their homes, including copper plumbing.

Of the foreclosures in the second half of 2008, only 183,447 resulted from the loss of employment. Other foreclosures? Negative net equity: 283,305; a 3 percent or less down payment: 130,014; low initial interest rate going higher: 60,942; and poor FICO score: 148, 697. So, 624,958 foreclosures for financial folly as compared to 183,447 for loss of employment. The 12 percent of the homes with negative equity are responsible for 47 percent of the foreclosures. Pick-a-Pay re-default rates are 55 percent. If you refinance the mortgage challenged, the default rate is 55 percent on their refinance.

The drop in home values after the market collapse is about 50 percent in Phoenix, Atlanta, and Las Vegas. Detroit has homes for sale for $7,000. Short sales reduce the value of every home in a neighborhood. The presence of so many abandoned properties finds city workers, paid by tax dollars, mowing lawns and doing upkeep on abandoned properties. Vandalized vacant properties attract criminal activity. Baltimore and Detroit are bulldozing areas with high concentrations of walk-away properties.

Discussion Questions

1. Consider the ethics recognition that Fannie Mae received and the reasons given for those awards. Then consider that Fannie Mae was rated by Standard & Poor's on its corporate governance scoring (CGS) system as being a 9, with 10 being the maximum CGS score. Fannie Mae received a 9.3 for its board structure and process.[102] What issues do you see with regard to these outside evaluations of companies that relate to governance and ethics? Is there a difference between social responsibility and ethics? Is there a connection between good governance practices and ethics?
2. List the signals that were missed in Fannie Mae's devolution. Were they missed or ignored? Evaluate the actions of Mr. Barnes and Fannie Mae's response to him.[103]
3. What observations can you make about incentive plans and earnings management? Incentive plans and internal controls?
4. Why was dealing with the volatility not the issue? Why were the changes in the numbers necessary?
5. Evaluate the pep talk of the vice president of risk operations and its effect on Fannie Mae's culture. Are there some ideas for your credo that stem from the conduct and responses of various executives at Fannie Mae? Did Mr. Mudd carry that culture forward in his positions on risk?
6. The theory of moral hazard holds that failure is a necessary part of an economic system. Where would this theory have applied in preventing the demise of Fannie Mae? Be sure to look at all aspects of the case in providing your answer. Now apply the theory of moral hazard to those who walk away from their mortgages. Angelo Mozilo is the former CEO of Countrywide Mortgage, a company that sold all of its mortgages to Fannie Mae and, as noted, was a major lender to Fannie Mae officers and board members. At his deposition in a lawsuit brought against him by a mortgage insurer, he was asked, "After all the foreclosures and ruined lives and lawsuits, do you have any regrets about the way you ran

[102] Standard & Poor's, "Setting the Standard," January 30, 2003, http://www.standardandpoors.com. Accessed April 28, 2010.

[103] Mr. Barnes now travels and addresses ethics, audit, accounting, financial reporting, and internal control issues. Mr. Barnes has been particularly active in working with college students in helping them to sort through the ethical issues in these areas.

Countrywide?" Mr. Mozilo's response about the role of his company in the market collapse was as follows:

> This is a matter of record. The cause of the problems of foreclosures is not created by Countrywide. This is all about an unprecedented, cataclysmic situation, unprecedented in the history of this country. Values in this country dropped 50 percent. This is not caused by any act of Countrywide. It was caused by an event that was unforeseen by anyone, because if anybody foresaw it, you would never have insured it, we would never have originated the loan. And it spread across the world. Any judgment made on a foreclosure—on a loan being made is because values deteriorated.
>
> And for the first time in the history of this country, people decided that they were going to leave their homes because the value of their home was below the mortgage amount. Never in the history of this country did that ever happen, and that could never have been assessed in the risk profile. These people didn't lose their jobs. They didn't lose their health. They didn't lose their marriage. Those are the three factors that cause foreclosure. They left their homes because the values went below the mortgage. That's what caused the problem.
>
> So, I have no regrets about how I—how Countrywide was run. It was a world-class company. So your tirade about foreclosures and lawsuits is nonsensical and insulting. Countrywide did not cause this problem. We made no loans in Greece. We made no loans in Ireland. We made no loans in Portugal. This is a worldwide financial crisis that was totally a shock to the system."[104]

Case 3.14

Cruises, Comfort, and Costs

The Nature of the Cruise Industry

Until the economic crisis of 2008, the cruise industry was the fastest growing portion of the leisure travel industry.[105] In 1999, only three of the thirty-six large cruise ships in operation had been built before 1990. Twenty-five of those ships were put into service after 1995.[106]

During the industry's growth period, the ships were increasing in size and amenities. The *Titanic* was 43,239 tons. Carnival had the first 100,000-ton ship in 1996, and by 2005, the cruise ships were heavier, longer, and more fully loaded with amenities such as swimming pools, regulation basketball and volleyball courts, rock-climbing walls, inline skating tracks, and jogging tracks. Carnival built a new trans-Atlantic ocean liner, the *Queen Mary*, the largest such ship ever built. Royal Caribbean launched a ship with an ice-skating rink and an atrium the length of two football fields.

In the year 2000, there were nearly 7 million U.S. citizens who took a cruise, an increase of 51 percent from 1995, and although there was a slight decline in the post-2008 market collapse, by 2010, the passenger total had reach almost 11 million with 14,300,000 worldwide.[107] There were thirty-eight cruise ships scheduled for delivery between 1999 and 2002, including two for a new ship line the Disney Cruise Lines.

[104] Deposition of Angelo Mozilo in *MBIA Insurance Corporation v. Countrywide Home Loans*, Inc., No. 602825/08, Supreme Court of the State of New York, http://www.mbia.com/investor/publications/073011_AppellateDivisionRuling ReMotiontoDismiss.pdf.

[105] Gene Sloan, "Trips, Crowds and Price: On the Up and Up," *USA Today*, October 22, 1999, 1D.

[106] Brook Hill Snow, "New Ship Preview: Multi-Billion-Dollar Shipbuilding Boom Stretches into the 21st Century," *Cruise Travel*, February 1999, pp. 17 and 21.

[107] Debra D. Burke, "Cruise Lines and Consumers: Troubled Waters," 37 *American Business L.J.* 689 (2000); and "Cruise Ship Industry Statistics," statisticbrain.com, November 27, 2012, http://www.statisticbrain.com/cruise-ship-industry-statistics/.

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There were twenty-six new cruise ships launched in 2010. Occupancy rates aboard the ships average around 91 percent.

Profit margins in the industry are high, with Carnival Cruise's net profits per day averaging about $3 million.[108]

The cruise industry also

- generates 314,000 full-time jobs for U.S. citizens;
- purchased $10, billion of U.S. goods and services;
- made expenditures resulting in $18 billion in total economic impact on the U.S. economy; and
- generated over $9 billion in wages for U.S. employees.

Carnival Cruise Lines, incorporated in Panama, with headquarters in Miami, has earned one-half billion dollars in profits per year on a consistent basis and pays less than 1 percent in taxes. Cruise ship lines pay about $70 million per year in port fees, but those fees are passed on directly to passengers as part of the price of their tickets. Gross profit margins for cruise lines are in the 20–35 percent range, with profit margins hovering between 20 and 29 percent.

Cruise Ships and Company Location

All cruise ships based out of ports in the United States fly foreign country flags because the companies register their ships in other nations. Although nearly 90 percent of cruise ship passengers are U.S. citizens, the cruise lines are incorporated in countries where they can minimize their tax bills, such as Panama and Liberia.

All ocean-going vessels engaged in international commerce must have a country of registry in order to operate in international waters. Accordingly, most countries, including the United States, provide these registration services or flags of registry. Predominant countries offering flags of registry for cruise vessels are the United Kingdom, Liberia, Panama, Norway, Netherlands, Bahamas and the United States. These nations, which provide vessel owners with comprehensive, competitive ship registry services and maritime expertise, are all member states of the International Maritime Organization (IMO). These major flag registries provide maritime expertise and administrative services; require annual safety inspections prior to issuance of a passenger vessel certificate; and utilize recognized classification societies to monitor its vessels' compliance with all international and flag state standards.

The Internal Revenue Service and several states, such as Florida, California, and New York, states with high levels of cruise ship activities in their ports, have undertaken audits of these cruise lines to determine whether they have paid all taxes applicable to their operations in the United States and the states.

Congress has ongoing efforts to fix what has been described as "avoidance" of U.S. taxes because of their foreign incorporation. The issues percolate most intensely when there is an incident with one of the cruise ships (see below for further discussion of these incidents).

Cruise Ship Employees

Workers on many cruise ships work twelve- to fourteen-hour days and are paid $400–$450 per month. The workers are not entitled to U.S. labor and wage protections. U.S. labor laws do not apply to the ships and their crews. The International Labor Organization of the United Nations suggests a workweek limit of seventy hours. Some of the workers do earn around $2,000 per month in tips. They work four to ten months per

[108] Carnival Cruise Lines 10-K, 2012. www.sec.gov.

year and are not covered by medical insurance when they are not working on the ships. Most cruise ship workers are recruited from the Philippines, where average earnings are $1,000 per year.

The International Council of Cruise Lines (ICCL) has issued the following statement on labor practices for the industry:

International Labor Organization (ILO)

> A United Nations agency, the International Labor Organization (ILO) governs international labor and employment practices and sets minimum crewing standards. ICCL member lines work hard to provide a good work environment for their onboard personnel.

Cruise Ship Operations

Cruise ships release effluent into the oceans because the cost of waste disposal for boats with 3,000 passengers can run into the hundreds of thousands per day. The cruise ship industry has taken the position that no country has jurisdiction over them when they are on the high seas. They point to the availability of gambling on the ships once the boats are past the territorial waters mark for the United States and other nations. Of the 111 complaints of cruise ship dumping (including everything from oil to waste) brought in countries outside the United States, enforcement action was taken in only two of the cases. The U.S. Environmental Protection Agency (EPA) has brought enforcement action against companies dumping in U.S. waters. For example, Holland America, a division of Carnival Cruises, pleaded guilty in 1998 to discharging waste into Alaska's Inside Passage and agreed to pay a fine of $2 million.

The industry association, the ICCL,[109] issued the following directive in 2001:

> All ICCL member cruise ship operators will implement the adopted standards, which include the following areas:
>
>> Graywater and blackwater discharge (Types of wastewater produced by ships carrying passengers or crew. "Graywater" is produced by showers, basins and in food preparation. "Blackwater" refers to sewage. On cruise ships, both are treated in accordance with regulatory requirements and beyond that, with industry environmental standards that frequently are more stringent than government regulations.
>>
>> - Hazardous chemical waste such as photo-processing fluid and dry-cleaning chemicals.
>> - Unused and outdated pharmaceuticals.
>> - Used batteries
>> - Burned-out fluorescent and mercury vapor lamps.

Passenger Safety

Medical Safety

During the time the passengers are at sea, there are many health issues that can develop, particular because the average age for cruise passengers is above 50. There is a requirement that all ships have at least one doctor and one nurse; there are no international standards for what constitutes adequate medical care on passenger cruise ships in terms

[109] According to the Center for Responsive Politics, the cruise industry spent $2.9 million on lobbying at the federal level for the 2004 through 2005 time period, $1.9 million more than Walmart spent on lobbying during that same period. ICCL lists the following focuses on its website: Safety, Public Health, Environmental Responsibility, Security, Medical Facilities, Passenger Protection, Legislative Activities.

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of the size of the facilities as well as the number of staff that might be needed for 3,000 passengers. That is, one doctor may be insufficient for 3,000 passengers on a seven-day cruise.

Criminal Activity

There has been a significant increase criminal activity aboard cruise ships. *Time* magazine reported that between 2002 and 2005, twenty-eight persons disappeared while on cruises. Congress has been working to get more transparency about the safety of passengers on cruise ships. In 2010, Congress passed a law requiring cruise lines to report missing passengers, sexual assaults, and other crimes on their ships. Prior to that time, the cruise ships did not always report crimes or disappearances.[110] In 2013, Congress had a bill pending, the Cruise Vessel Safety and Security Act, a law that would require disclosures about the numbers and types of crimes committed on cruises during the year. Although the bill passed, lobbying efforts by the cruise lines resulted in a language change that means the cruise lines are only required to disclose the data for missing persons and alleged crimes that are no longer under investigation by the FBI. The effect of the parameters for disclosure is that the data will not include cases investigated by other entities, cases investigated by the cruise line only, cases under active investigation by the FBI, and cases left open after the FBI files charges. The requirements of the bill are similar to those imposed on colleges and universities in their annual reports on campus safety. The statistics would have to be disclosed to potential passengers on the cruises.

The crime numbers are not large when examined in contrast to crimes in the cities in the United States. However, there are no law enforcement officials aboard cruise ships. Former Congressman Chris Shays, who is known as the congressman for the “hunky honeymooner,” the Connecticut groom who disappeared while on his honeymoon cruise, says that he has come to conclude that “going on a cruise is the perfect way to commit the perfect crime.”[111] However, the ICCL notes that its violent crime rate is fifteen incidents per 100,000 passengers, which makes it thirty times safer than almost all communities in the United States (based on their violent crime rates per population). ICCL says its members vet their employees more carefully than on-shore resorts and that all of their employees must also have a State Department background check in this post–9-11 era.

Passenger Injuries

Passengers who are injured are bringing suit against the companies for their injuries. Several recent examples include a passenger who experienced a back injury in an organized pillow fight, a passenger who was injured while dancing the lindy as part of cruise activities, and a passenger who slipped and fell on a grape left behind from a passenger impersonating Carmen Miranda as part of a skit. Passengers are increasingly using long-arm statutes to require the companies to defend lawsuits in federal district court. Miami seems to be the most common location for such litigation because all major cruise lines have ships and offices there and meet the standards for minimum contacts.[112]

[110] As passenger loads have increased, there have been large numbers of thefts and sexual assaults aboard cruise ships. Litigation in federal district court in Miami resulted in revelations through discovery of a high number of sexual assaults on cruise ships, with few of those reported to local law enforcement authorities. Of those reported to law enforcement officials, 93 percent of the cases are dropped. Intoxication, loss of memory, time lapse, and inconvenience of travel to testify are all factors that contribute to the high rate of failed prosecutions. The Miami lawsuit, against Carnival, produced records during discovery in which it was revealed that members of Carnival Cruise crews had sexually assaulted passengers and fellow crewmembers 62 times over a five-year period.

[111] Julie Rawe, “Crime Rocks the Boats,” *Time,* March 13, 2006, pp. 24–25.

[112] Michael D. Goldhaber, A Ticket to Paradise or a Trip from Hell? *National Law Journal*, March 22, 1999, C1.

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The ICCL has adopted the following mandatory industry safety standards:

- A personal flotation device (PFD) for each infant carried onboard every ICCL member cruise ship. An infant PFD is one that is specifically designed.
- Additional adult lifejackets onboard each cruise ship in excess of the number required by U.S. and international regulations. In general, the number of lifejackets carried will increase by 30–50 percent on all ICCL cruise ships.
- A helicopter pickup area for patient evacuation to a shore-side hospital.

Passenger Contracts

Contract Dispute Issues

One of the active litigation issues that cruise companies faced was that of requiring passengers to return to the location of their cruises in order to recover any damages. For example, Eulala and Russel Shute, through an Arlington, Washington, travel agent, purchased passage for a seven-day cruise on one of Carnival's ships, the *Tropicale*. The Shutes paid the fare to the agent, who forwarded the payment to Carnival's headquarters in Miami, Florida. Carnival then prepared the tickets and sent them to the Shutes in Washington. The face of each ticket, at its left-hand lower corner, contained this admonition:

> 8. It is agreed by and between the passenger and the Carrier that all disputes and matters whatsoever arising under, in connection with or incident to this Contract shall be litigated, if at all, in and before a Court located in the State of Florida, U.S.A., to the exclusion of the Courts of any other state or country.[113]

The Shutes boarded the *Tropicale* in Los Angeles, California. The ship sailed to Puerto Vallarta, Mexico, and then returned to Los Angeles. While the ship was in international waters off the Mexican coast, Eulala Shute was injured when she slipped on a deck mat during a guided tour of the ship's galley. The Shutes filed suit against the petitioner in the U.S. District Court for the Western District of Washington, claiming that Mrs. Shute's injuries had been caused by the negligence of Carnival Cruise Lines and its employees.

Following extended procedural litigation, the U.S. Supreme Court held that cruise lines could decide the location and method for hearing disputes on a contract and that absent some showing of unfairness, the clause would be enforced. Mr. and Mrs. Shute were bound by the contract they signed and could recover only if they went to Florida and filed suit there.

Cruise Quality Issues

If there is any problem with the quality of the passenger's experience, federal law of the United States would apply for U.S. passengers, and there are few remedies afforded under federal law for the following types of issues that have arisen in passenger complaints and some litigation:

- Last-minute changes in the itinerary
- Chronic air-conditioning problem
- Plumbing problems
- Misrepresentation about the port fees being a charge in addition to the cost of the ticket
- Food poisoning
- Lack of cleanliness
- Facilities not as depicted in brochures

[113] *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, at 587–588 (1991).

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During 2012 and 2013, the industry experienced a run of quality issues related to equipment, and the incidents that were widely publicized caused a 17 percent drop in consumer trust in the Carnival brand. In January 2012, the *Costa Concordia* (part of Carnival's fleet) was off the cost of Italy when it struck an island and tipped over. Twenty-five passengers were killed in the accident, and the image of the tilted ship captured worldwide attention as well as legislative action. Congress held hearings on the accident that resulted in consideration of laws regulating the safety, tax, and environmental issues in the cruise industry. The industry responded by noting that the ship tipped over because a captain was trying to "show off" for a woman by steering the ship too close to the shore and asked that Congress not vilify an entire industry because of the actions of "one rogue employee."[114] The cost of righting the ship, the largest such task ever undertaken, was $300 million.[115]

In February 2013, the Carnival ship *Triumph* was crippled by an engine room fire and left 2,758 passengers stranded in the Gulf of Mexico for four days without running water, air conditioning, and toilets. The boat had to be towed to Mobile, Alabama, where lawyers were waiting to sign up the passengers for a class-action lawsuit against the cruise company.

Less than a month later, the Carnival ship *Legend* lost one of its propulsion units, had to skip a stop at Grand Cayman, and limped back to Tampa, Florida. Within days, the Carnival ship *Dream* lost a backup generator. Carnival ended the cruise early, and all 4,300 passengers were flown home.[116] At that time, Carnival canceled twelve trips in order to make repairs to its ships, with the cancellations affecting 30,000 travelers. Carnival gave the travelers a full refund as well as a 25 percent discount on any future Carnival trip they decided to book.[117] Carnival's bookings dropped by double digits, and its cancellations increased by double digits in the weeks following the accidents. However, through aggressive pricing and promotions, Carnival has been able to get the bookings to rebound to a point where analysts call the drop following the incidents a mere "hiccup."[118]

Immediately following the incidents, Carnival scheduled a conference call and disclosed that it expected that both the incidents and the needed repairs to what it called "a slightly older fleet" would affect profits.[119]

Americans with Disabilities Act

Originally, the Americans with Disabilities Act (ADA) did not apply to cruise ships. That is, the cruise lines did not have modify their ships to make accommodations for wheelchairs and other disability-related needs and equipment. Disability activists got involved and through public appeal, as in the following poem, and through litigation have been successful in getting a case to the U.S. Supreme Court, where the court held that the ADA does apply to cruise ships that dock in the United States.

> 'Twas the night before regulations,
> And all through the Land
> Federal agencies were in motion

[114] Bart Jansen, "Lawmakers Examine Cruise Industry Rules," *USA Today*, March 1, 2012, p. 5A. After the ship listed, the captain abandoned the ship and, despite being ordered to return, refused. Eric J. Lyman, "Recording Stirs More Contempt for Captain," *USA Today*, January 18, 2012, p. 5A. The captain had told others that he enjoyed diverting from ship procedures and was hoping that taking the ship close to the island would give the residents of the island a thrill.

[115] Gaia Pianigiani, "Luxury Liner's Removal to Begin Off the Italian Coast," *New York Times*, May 19, 2012, p. A8.

[116] Gene Slogan, "Cruisin' Takes a Bruisin' in Eye of PR Storm," *USA Today*, March 18, 2013, p. 5B.

[117] Gene Sloan, "12 More Carnival Trips Canceled To Allow Fixes," *USA Today*, March 21, 2013, p. 1B.

[118] *Id.*

[119] Maxwell Murphy and Saabira Chaudhuri, "Carnival to Step Up Maintenance After Mishaps," *Wall Street Journal*, March 16–17, 2013, p. B3.

Deciding what barriers should be banned.
Clear standards have been enacted
For buildings, roads, and rail,
That guarantee access
To the disabled, blind, and frail.
For bowling alleys, theaters, theme parks, and spas—
We have rules for construction, renovation, and decals.
But for ships on the sea
Not a word has been spoken
Of how they must proceed
So the law is not broken.

In Spector v. Norwegian Cruise Line, Ltd., 545 U.S. 119 (2005), the court held that cruises ships were places of public accommodation and required ADA compliance, with the caveat that cruise ships need not risk safety and violation of sailing safety standards in order to comply with ADA.

Discussion Questions

1. Make a list of all the ethical issues you see with the cruise line operations.
2. What benefits do the cruise lines gain by not being based in the United States?
3. Why do you think their profit margins are so substantial?
4. Describe Marjorie Kelly's reaction to the wage levels and profit margins of the cruise lines.
5. Why is the ICCL active in self-regulation?
6. What changes could easily be made that would impose additional costs on the cruise lines? If you were an officer in a cruise line company, what voluntary steps would you take and why?

Case 3.15

Ice-T, the *Body Count* Album, and Shareholder Uprisings

Ice-T (Tracy Morrow), a black rap artist signed under the Time Warner label, released an album called *Body Count* in 1992 that contained a controversial song, "Cop Killer." The lyrics included, "I've got my twelve-gauge sawed-off…. I'm 'bout to dust some cops off…. die, pig, die."

The song set off a storm of protest from law enforcement groups. At the annual meeting of Time Warner at the Beverly Wilshire Hotel, 1,100 shareholders as well as police representatives and their spokesman, Charlton Heston, denounced Time Warner executives in a five-hour session on the album and its content. Heston noted that the compact disc had been shipped to radio stations in small replicas of body bags. One police officer said the company had "lost its moral compass, or never had it." Others said that Time Warner seemed to cultivate these types of artists. One shareholder claimed that Time Warner was always "pushing the envelope" with its artists, such as Madonna with her *Sex* book, and its products, such as the film *The Last Temptation of Christ*, which drew large protests from religious groups. Another shareholder pointed out that Gerald Levin, then–Time Warner president, promised a stuttering-awareness group that the cartoon character Porky Pig would be changed after they made far fewer vocal protests.

Levin responded that the album would not be pulled. He defended it as "depicting the despair and anger that hang in the air of every American inner city, not advocating attacks on police." Levin announced Time Warner would sponsor a TV forum for artists, law enforcement officials, and others to discuss such topics as racism and free speech. At the meeting, Levin also announced a four-for-one stock split and a 12 percent increase in Time Warner's dividend.

The protests continued after the meeting. Philadelphia's municipal pension fund decided to sell $1.6 million in Time Warner holdings to protest the Ice-T song. Said Louis J. Campione, a police officer and member of the city's Board of Pensions and Retirement, "It's fine that somebody would express their opinions, but we don't have to support it."

Several CEOs responded to Levin's and Time Warner's support of the song.[120] Roger Salquist, then-CEO of Calgene, Inc., who went on to be a controversial technology liaison at UC Davis, noted,

> I'm outraged. I think the concept of free speech has been perverted. It's anti-American, it's anti-humanity, and there is no excuse for it.
>
> I hope it kills them. It's certainly not something I tolerate, and I find their behavior offensive as a corporation.
>
> If you can increase sales with controversy without harming people, that's one thing. [But Time Warner's decision to support Ice-T] is outside the bounds of what I consider acceptable behavior and decency in this country.

David Geffen, chairman of Geffen Records (now a co-owner with Steven Spielberg and Jeffrey Katzenberg of DreamWorks, the film production company), who refused to release Geto Boys records because of lyrics, said,

> The question is not about business, it is about responsibility. Should someone make money by advocating the murder of policemen? To say that this whole issue is not about profit is silly. It certainly is not about artistic freedom.
>
> If the album were about language, sex, or drugs, there are people on both sides of these issues. But when it comes down to murder, I don't think there is any part of society that approves of it.... I wish [Time Warner] would show some sensitivity by donating the profits to a fund for wounded policemen.

Jerry Greenfield, cofounder of Ben & Jerry's Homemade, Inc., responded that "songs like 'Cop Killer' aren't constructive, but we as a society need to look at what we've created. I don't condone cop killing. [But] to reach a more just and equitable society everyone's voice must be heard."

Neal Fox, then-CEO of A. Sulka & Company (an apparel retailer owned by Luxco Investments), said,

> As a businessperson, my inclination is to say that Time Warner management has to be consistent. Once you've decided to get behind this product and support it, you can't express feelings of censorship. They didn't have recourse.
>
> Also, they are defending flag and country for the industry. If they bend to pressures regarding the material, it opens a Pandora's box for all creative work being done in the entertainment industry.
>
> On a personal basis, I abhor the concept, but on a corporate basis, I understand their reasoning.

John W. Hatsopoulos, then–executive vice president of Thermo Electron Corporation (now president and CEO), had this to say:

> I think the fact that a major U.S. corporation would almost encourage kids to attack the police force is horrible. Time Warner is a huge corporation. That they would encourage something like this for a few bucks.... You know about yelling fire in a crowded theater.

[120] *Wall Street Journal*, Eastern ed. (Staff Produced Copy Only) by Wall Street Journal News Round Up. Copyright 1992 by Dow Jones & Co. Inc. Reproduced with permission of Dow Jones & Co. Inc. in the format textbook via Copyright Clearance Center.

> I was so upset I was looking at [Thermo Electron's] pension plan to see if we owned any Time Warner stock [in order to sell it]. But we don't own any.

Bud Konheim, longstanding CEO of Nicole Miller, Ltd., weighed in with the following:

> I don't think that people in the media can say that advertising influences consumers to buy cars or shirts, and then argue that violence on television or in music has no impact. The idea of media is to influence people's minds, and if you are inciting people to riot, it's very dangerous.
>
> It's also disappointing that they chose to defend themselves. It was a knee-jerk reaction instead of seizing the role to assert moral leadership. They had a great opportunity. Unfortunately, I don't think they will pay for this decision because there is already so much dust in people's eyes.

George Sanborn, then-CEO of Sanborn, Inc., said, "Would you release the album if it said, 'Kill a Jew or bash a fag'? I think we all know what the answer would be. They're doing it to make money."

Marc B. Nathanson, CEO of Falcon Cable Systems Company and a member of the board of directors for the Hollywood Bowl, responded, "If you aren't happy with the product, you don't have to buy it. I might not like what [someone like Ice-T] has to say, but I would vigorously defend his right to express his viewpoint."

Stoney M. Stubbs Jr. chairman of Frozen Food Express Industries, Inc., commented, "The more attention these types of things get, the better the products sell. I don't particularly approve of the way they play on people's emotions, but from a business standpoint [Time Warner is] probably going to make some money off it. They're protecting the people that make them the money. … the artists."[121]

Despite the flap over the album, sales were less than spectacular. It reached number thirty-two on the Billboard Top 200 album chart and sold 300,000 copies.[122]

Levin had defended Time Warner's position:

> In the short run, cutting and running would be the surest way to put this controversy behind us. But, in the long run, it would be a destructive precedent. It would signal to all the artists and journalists that if they wish to be heard, then they must tailor their minds and souls to fit reigning orthodoxies.

Time Warner went on to make a pledge to use the controversy to create a forum for discussion of the issues in order to deal with the tensions that Ice-T's song caused to surface. Time Warner also pledged to continue its commitment to truth and free expression for the sake of the country's future.[123]

By August 1992, protests against the song had grown and sales suffered. Ice-T made the decision himself to withdraw "Cop Killer" from the *Body Count* album. Time Warner asked music stores to exchange the *Body Count* CDs for ones without "Cop Killer." Some store owners refused, saying there were much worse records. Former Geto Boys member Willie D said Ice-T's free speech rights were violated. "We're living in a communist country and everyone's afraid to say it," he said.

Following the flap over the song, the Time Warner board met to establish general company policies to bar distribution of music deemed inappropriate. By February 1993, Time Warner and Ice-T agreed that Ice-T would leave the Time Warner label because of "creative differences." The split came after Time Warner executives objected to Ice-T's

[121] "Time Warner's Ice-T Defense Is Assailed," *Wall Street Journal*, July 23, 1992, pp. B1, B8.

[122] Mark Landler, "Time Warner Seeks a Delicate Balance in Rap Music Furor," *The New York Times*, June 5, 1995, p. 1B.

[123] *Wall Street Journal*, Eastern ed. (Staff Produced Copy Only) by Holman W. Jenkins, Jr. Copyright 1996 by Dow Jones & Co. Inc. Reproduced with permission of Dow Jones & Co. Inc. in the format textbook via Copyright Clearance Center.

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proposed cover for his new album, which showed black men attacking whites. In an ironic twist, Ice-T is now a co-star on the NBC television series *Law and Order: Special Victims Unit* as Detective Odafin "Fin" Tutuola, partner of Richard Belzer's character, Detective John Munch.[124]

In 2004, Ice-T introduced his own line of clothing, a trend among rap music stars. He had been on a six-year hiatus from music because of the death of two of his group members. The drummer, Beatmaster V, died of leukemia, and Mooseman, the bass player, was killed in South Central Los Angeles. Ice-T commented that Mooseman's death was the kind of thing "I rap about every day."[125] The album that followed *Body Count—Violent Demise, Last Days*—was barely heard and rarely sold. Living in New Jersey, the man credited with founding gangsta rap is preparing for a *Body Count II* album, and has offered the following perspective on the first *Body Count* album and where the country is now:

> I wasn't trying to start all that drama with that [*Body Count*] album. On the song "Cop Killer" I was just being honest. I never really reached for controversy. I just said what was on my mind, like I'm saying now.[126]
>
> Since Clinton was in the White House, everybody became very complacent, everybody kicked back. He had sex in the White House, what's there to worry about? But now we got Bush—or son of a Bush—in there, and he's out to control the world. He's trying to be Julius Caesar and so it's time for more music about things. It's time for *Body Count*.

Following the Ice-T issue, Time Warner's board undertook a strategy of steering the company into more family-oriented entertainment. It began its transition with the 1993 release of such movies as *Dennis the Menace, Free Willy*, and *The Secret Garden.*

However, Time Warner's reputation would continue to be a social and political lightning rod. In June 1995, presidential candidate Senator Robert Dole pointed to Time Warner's rap albums and movies as societal problems. Public outcry against Time Warner resulted.

In June 1995, C. DeLores Tucker, then 67 years old, and head of the National Political Congress of Black Women, handed Time Warner Chairman Michael J. Fuchs the following lyrics from a Time Warner label recording:

> Her body's beautiful,
> so I'm thinkin' rape.
> Grabbed the bitch by her mouth,
> slam her down on the couch.
> She begged in a low voice:
> "Please don't kill me."
> slit her throat
> and watch her shake like on TV.[127]
>
> —Geto Boys, "Mind of a Lunatic"

Ms. Tucker told Mr. Fuchs, "Read this out loud. I'll give you $100 to read it." Mr. Fuchs declined.

Mrs. Tucker was joined by William Bennett, a GOP activist and former secretary of education. Mrs. Tucker believes Time Warner is "pimping pornography to children for the almighty dollar. Corporations need to understand: What does it profit a corporation to gain the world but lose its soul? That's the real bottom line."

[124] http://www.nbc.com/lawandorder. Accessed July 12, 2010.

[125] http://www.vh1.com/artists/news/1459713/01272003/ice_t.jhtml. Accessed October 21, 2004.

[126] *Id.*

[127] http://rapgenius.com/Geto-boys-mind-of-a-lunatic-lyrics#lyric.

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In June 1995, following Mrs. Tucker's national campaign, Time Warner fired Doug Morris, the chairman of domestic music operations. By July, Morris and Time Warner were in litigation. Morris had been a defender of gangsta rap music and had acquired the Interscope label that produced albums for the late Tupac Shakur and Snoop Doggy Dogg. Mr. Fuchs said the termination had nothing to do with the rap controversy.

Rap music grew in popularity for about twelve years, but from 2005 to 2006 dropped 21 percent in sales. In 2006, no rap album made it into the top ten albums for the year. Rap is back to its level of a decade ago, which is about 10 percent of total sales in the record industry. About 50 percent of Americans believe that rap/hip-hop is a negative influence in society. Some retail chains, including Walmart, have refused even during the upswing in popularity of rap/hip-hop to carry the gangsta rap albums, and some radio stations have declined to play the songs. The songs cited included the following:

> I'd rather use my gun 'cause I get the money quicker.... got them in the frame—Bang! Bang!... blowing [expletive] to the moon.[128]
>
> —Tupac Shakur, "Strugglin'"

These lyrics contain slang expressions for using an AK-47 machine gun to murder a police officer:

> It's 1-8-7 on a [expletive] cop.... so what the [expletive] does a nigger like you gotta say? Got to take trip to the MIA and serve your ass with a [expletive] AK.[129]
>
> —Snoop Doggy Dogg, "Tha' Shiznit"

Discussion Questions

1. Was Ice-T's song an exercise of artistic freedom or sensationalism for profit?
2. Would you have taken Levin's position?
3. Evaluate the First Amendment argument.
4. Would shareholder objections influence your response to such a controversy?
5. What was Time Warner's purpose in firing Morris? By November 1995, Time Warner's Levin fired Michael Fuchs. What message is there for executives in controversial products?
6. Offer your thoughts on Ice-T's new career and role as a police officer.
7. Rapper Lil Wayne used lyrics from the Rolling Stones' 1965 song "Play With Fire" in his "Playing With Fire" song that was part of his *The Carter III* CD. Abkco Music filed an infringement suit against Lil Wayne for using the lyrics after it had denied him permission. Abkco was going to grant permission to Lil until it read all of the song's lyrics, described as "explicit, sexist, and offensive." The suit was settled in an interesting manner. Abkco, under the terms of the settlement, has required Lil Wayne to remove the song from the CD and from iTunes. The Rolling Stones didn't want the money—they didn't want to be associated with Lil Wayne. Are the Rolling Stones controlling artistic expression? Is this the same right exercised by Time Warner, but the other way?[130]

Compare & Contrast

Reebok had contracted with Rick Ross, Swizz Beatz, and Tyga in order to make marketing inroads into the urban and hip-hop fan markets. The marketing strategy can be effective unless the star who is endorsing the product has a misstep that causes public outcry.

[128] http://www.azlyrics.com/lyrics/2pac/strugglin.html.

[129] http://rapgenius.com/Snoop-dogg-tha-shiznit-lyrics#note-234016.

[130] For more information, see Ethan Smith, "Rapper to Pull Song in Copyright Fight," *Wall Street Journal*, January 30, 2009, p. B8.

Mr. Ross released a new song and video called "U.O.E.N.O," a song that includes the following lyrics:

Put Molly all in her Champagne, she ain't even know it
I took her home and I enjoyed that, she ain't even know it[131]

After the song was released, a new women's rights group, UltraViolet, began a Twitter, YouTube, and phone campaign to Reebok headquarters in Massachusetts, to have Mr. Ross removed as a Reebok spokesperson because of his insensitivity to women and the issue of rape following the use of drugs or alcohol.

Mr. Ross gave several interviews and issued apologies on Twitter, but Reebok terminated his endorsement contract because, as the company explained in a statement, "While we do not believe that Rick Ross condones sexual assault, we are very disappointed he has yet to display an understanding of the seriousness of this issue or an appropriate level of remorse. At this time it is in everybody's best interest for Reebok to end its partnership with Mr. Ross."[132]

The endorsement contract, like others involving celebrities who become embroiled in public controversies or questionable conduct (Kate Moss, Michael Phelps, Tiger Woods, Lance Armstrong), contains a "morals clause." These types of clause vary significantly but provide the company with the opportunity to end the contract (without damages being paid) if the celebrity's conduct results in public backlash. The conduct could be a crime (indictment, charges, investigation, and or conviction), a controversial statement, or, as in this case, the nature or content of a celebrity's performance.

Experts note that one of the distinctions of this particular termination of a celebrity contract is its speed. UltraViolet was very effective in using social media in order to gain traction for its concerns. The Tweets and YouTube video resulted in physical petitions that were delivered to the company. Another result of the intense and active social media campaign was demonstrations outside Reebok headquarters, which then resulted in national and international coverage and the company's rapid decision to end its relationship with the rapper. Mr. Ross had issued an apology, "I don't condone rape. Apologies for the #lyric interpreted as rape." Based on negative feedback, Mr. Ross followed up with yet another Tweet: "Apologies to my many business partners, who would never promote violence against women." That note specifically mentioned Reebok and UltraViolet, but the words chosen were not enough to reflect an understanding of the issue to those who were protesting.

Celebrity endorsements do garner customer attention, but they are not without risk. Carefully drafted contracts, however, provide companies with the legal protection they need when the conduct of celebrity sponsors harms the brand.

Discussion Question

What kinds of conduct would you cover in a morals clause if you were hiring a celebrity to endorse your product?

[131] http://rapgenius.com/Rocko-uoeno-lyrics.

[132] Tanzina Vega and James C. McKinley Jr., "Social Media, Pushing Reebok To Drop a Rapper," *New York Times*, April 13, 2013, p. C1.

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Case 3.16

Athletes and Doping: Costs, Consequences, and Profits[133]

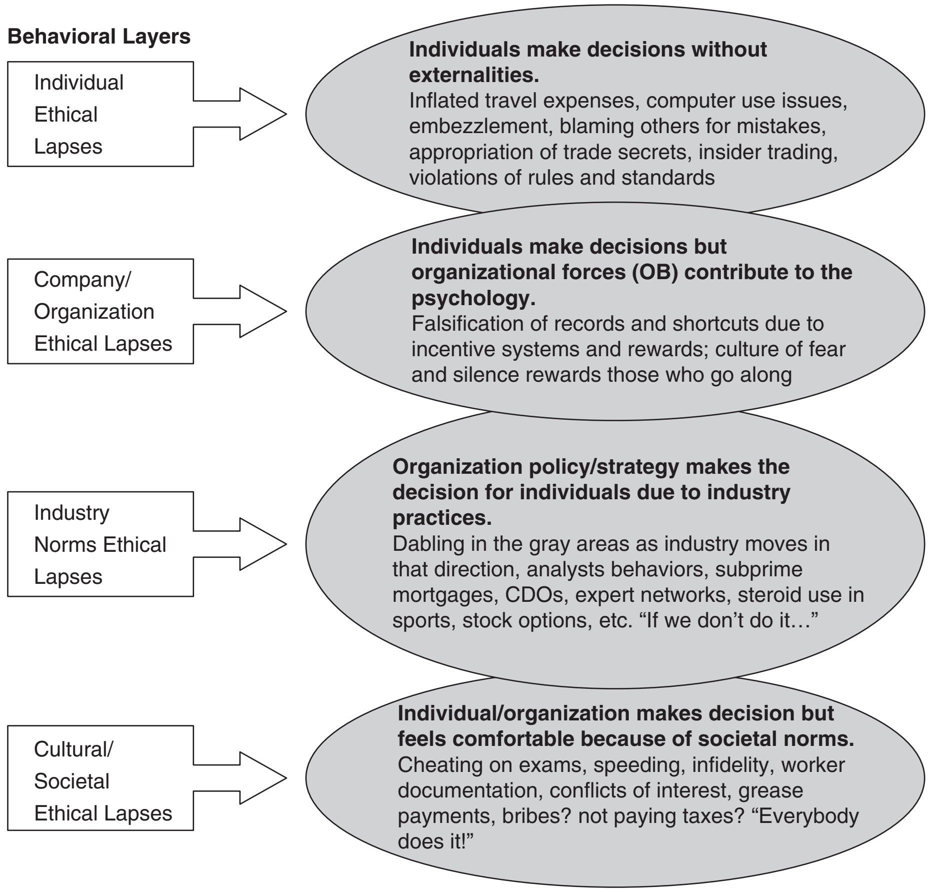
There are four levels of ethical issues, and there are different root causes for these levels. The levels of lapses as well as the prevention tools are depicted in Figure 3.4, followed by discussion and examples.

There is perhaps no better illustration of how these layers work than to explore the issue of the use of performance-enhancing drugs in sports. Figure 3.5 shows how the four layers exist in the use of performance enhancing drugs in sports.

The Individual Ethical Lapses

Individual ethical lapses are those that occupy the time of the bulk of ethics and compliance folks. Some examples include inflated travel expenses; computer use for personal or inappropriate activities; use of company resources for personal reasons (remodeling your

FIGURE 3.4
Behavioral Layers


Behavioral Layers
Individual Ethical Lapses
Individuals make decisions without externalities.
Inflated travel expenses, computer use issues, embezzlement, blaming others for mistakes, appropriation of trade secrets, insider trading, violations of rules and standards
Company/ Organization Ethical Lapses
Individuals make decisions but organizational forces (OB) contribute to the psychology.
Falsification of records and shortcuts due to incentive systems and rewards; culture of fear and silence rewards those who go along
Industry Norms Ethical Lapses
Organization policy/strategy makes the decision for individuals due to industry practices.
Dabling in the gray areas as industry moves in that direction, analysts behaviors, subprime mortgages, CDOs, expert networks, steroid use in sports, stock options, etc. "If we don't do it…"
Cultural/ Societal Ethical Lapses
Individual/organization makes decision but feels comfortable because of societal norms.
Cheating on exams, speeding, infidelity, worker documentation, conflicts of interest, grease payments, bribes? not paying taxes? "Everybody does it!"

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[133] Adapted from Marianne M. Jennings, "Grappling with the Four Levels of Ethical Issues," 15 *Corporate Finance Review* 36 (2010).

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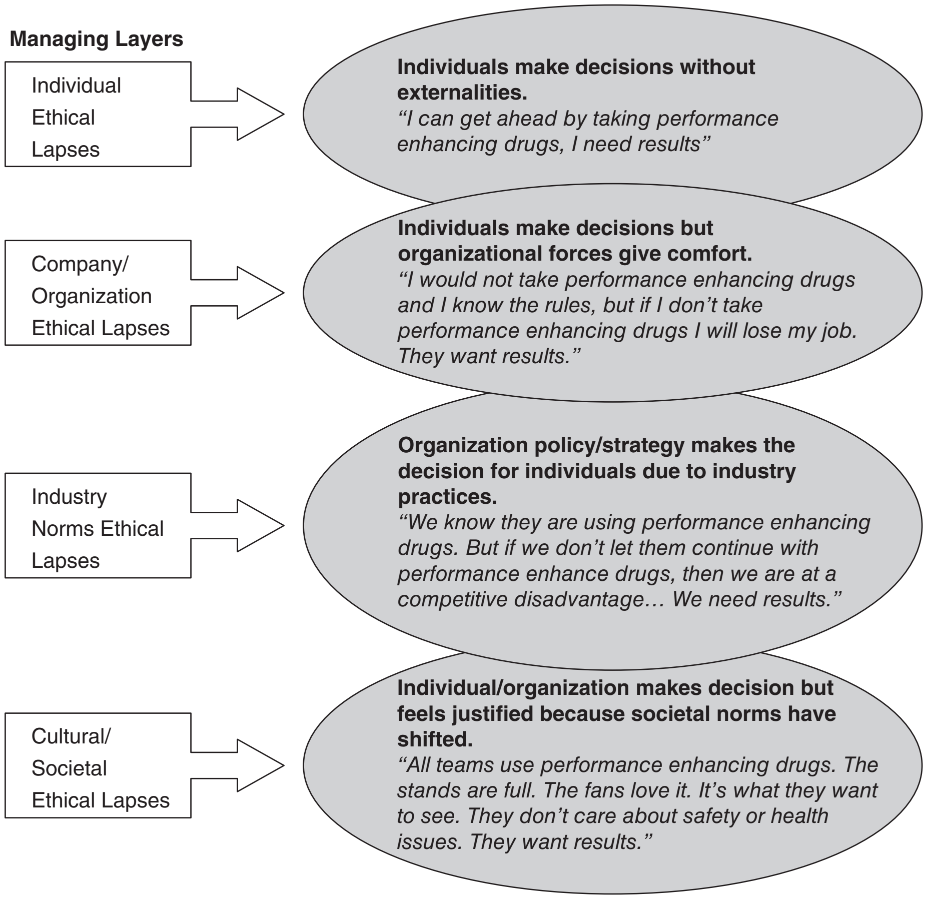
FIGURE 3.5
Managing Layers


Managing Layers
Individual Ethical Lapses
Individuals make decisions without externalities.
"I can get ahead by taking performance enhancing drugs, I need results"
Company/ Organization Ethical Lapses
Individuals make decisions but organizational forces give comfort.
"I would not take performance enhancing drugs and I know the rules, but if I don't take performance enhancing drugs I will lose my job. They want results."
Industry Norms Ethical Lapses
Organization policy/strategy makes the decision for individuals due to industry practices.
"We know they are using performance enhancing drugs. But if we don't let them continue with performance enhance drugs, then we are at a competitive disadvantage… We need results."
Cultural/ Societal Ethical Lapses
Individual/organization makes decision but feels justified because societal norms have shifted.
"All teams use performance enhancing drugs. The stands are full. The fans love it. It's what they want to see. They don't care about safety or health issues. They want results."

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home with company materials or personnel); sexual harassment; falsification of reports or documents (signing off on your annual ethics training when you did not complete it); misrepresenting information to customers, shareholders, and/or creditors; letting someone else take the blame for a mistake you made at work; appropriation of trade secrets from a former employer or competitor; violation of company rules, such as working while impaired; and embezzlement. All of these activities can harm the company in terms of negative publicity, regulatory relationships, litigation, and loss of customers. However, these company harms spring from individual choices.

When an athlete decides to take performance-enhancing drugs, something prohibited within the sport, it is initially a desire on the part of that individual athlete to perform beyond the levels of other team members as well as other athletes on other teams.

The defining characteristic of individual ethical lapses is that the individual makes the choice. There are no externalities that serve to cloud the individual's decision processes. Company and industry practices and pressures are not afoot at this level, as the employees make their decisions. Companies and organizations can also stop these individual actions through discipline. Once the individual is caught embezzling, or in the case of sports, using performance-enhancing drugs, the termination of employment, or the end of the contract in the case of a professional athlete, is the signal to others who are making individual choices that the conduct is not acceptable in the organization. Without enforcement, however, the individual choices ripen into something more.

The Company or Organization Ethical Lapses

These types of lapses are those that employees may commit individually, but the reason for their misstep is not just rooted in a poor choice. There are company externalities that contribute to their choices. For example, once athletes are recognized and rewarded for their use of performance-enhancing drugs, their conduct has taken on a new justification—my company or my team wants me to do this—and the conduct continues, but perhaps at a higher level because the signal has been sent that it is acceptable. Further, the approval brings along individuals at the company who would not have otherwise made the individual choice to use performance-enhancing drugs. However, when they see others being recognized and rewarded, with no punishment or enforcement, they too begin to use because of organizational pressures to compete or reach the same performance results that those using the performance-enhancing drugs are achieving.

A business example helps in understanding how this works. During the 1990s, Bausch & Lomb settled financial reporting issues with the SEC because it had overstated its revenues. In announcing the settlement, Bausch & Lomb emphasized that the SEC found no evidence that top management knew of the overstatement of profits (the amount was a 54 percent overstatement) at the time it was made. However, the SEC's associate director of enforcement said, "That's precisely the point. Here is a company where there was tremendous pressure down the line to make the numbers. The commission's view is that senior management has to be especially vigilant where the pressure to make the numbers creates the risk of improper revenue recognition."[134]

The employees of Bausch & Lomb had some "creative" ways of meeting their numbers in terms of sales goals. For example, the company's Hong Kong unit was faking sales to real customers but then dumping the glasses at discount prices onto gray markets. The contact lens division shipped products that were never ordered to doctors in order to boost sales. Some distributors had up to two years of unordered inventories. The U.S., Latin American, and Asian contact lens divisions also dumped lenses on the gray market, forcing Bausch & Lomb to compete with itself.

However, the mistake that companies and organizations make is in treating these poor choices by employees as belonging to the category of individual ethical lapses. The root cause rests with the organization's drivers. What signals is the organization sending that would lead individuals to believe that their behavior is acceptable here? High praise and recognition for athletes' achievements as they continue to use performance-enhancing drugs will keep them using those drugs and motivate other athletes to do the same.

Another form of company or organizational lapse is one that begins with an individual lapse but ripens into an organizational one because of the reaction. Hire an athlete known to be using performance-enhancing drugs, and that behavior is introduced into the organization. Add compensation factors that reward the behavior, and there are incentives to break the rules. Why did the New Orleans Saints players participate in the bounty program, knowing that it was prohibited in the NFL? The answer is, because they were well compensated.

Industry Norms Ethical Lapses

In this situation, the company or organization has simply followed the industry policies and achieves a great deal of ethical comfort from the assurance, "Everybody does this." When he confessed to having used performance-enhancing drugs in January 2013, Lance Armstrong explained, "I looked up the word 'cheat' in the dictionary and decided it

[134] Mark Maremont, "Judgment Day at Bausch & Lomb," *BusinessWeek*, December 25, 1995, 39; and Floyd Norris, "Bausch & Lomb and SEC Settle Dispute on '93 Profits," *New York Times*, November 18, 1997, p. C2.

didn't apply, given that it meant 'to gain an advantage on a rival or foe.' I didn't view doping that way. I viewed it as a level playing field."[135] In his mind, and at this level, organizations and individuals do things they would not otherwise do because they see what others are doing and feel they are at a disadvantage if they don't do the same. In baseball, the club owners could see what the other teams' players were doing and how well it was working for them, and took no action within their own clubs because they feared their teams would not be play-off competitive. For example, in *American Icon: The Fall of Roger Clemens and the Rise of Steroids in America's Pastime*, the following quote illustrates the industry level of ethical issue:

> Clemens was determined to prove he wasn't fading, and McNamee, having just arrived at the Show, was committed to staying there. So there would be other injections, but with the first one the two men crossed a stark line into territory they would never escape. Clemens became a cheater, and McNamee became his enabler.[136]

The men were responding to the realities of their industry. Another example involves Rafael Palmeiro, a Baltimore Oriole at the time of the congressional hearings on steroid use in major league baseball. He testified, "I have never used steroids. Period. I don't know how to say it any more clearly than that. Never. The reference to me in Mr. Canseco's book is absolutely false."[137] By August 2005, Mr. Palmeiro would be the first big-name player to be suspended under the tougher policies that Commissioner Selig described at the congressional hearings. By the time of the Palmeiro suspension, there had been six other players suspended for testing positive. Mr. Palmeiro was suspended for ten days following a drug test that was positive for the presence of steroids.[138] Several people associated with MLB said that the league was aware of the positive test about one month before the suspension was announced but allowed Mr. Palmeiro to hit, as it were, the milestone of 3,000 hits before suspending him. MLB took out a full-page ad in major newspapers to congratulate Mr. Palmeiro on his achievement, only one of four players in the history of the game to reach 3,000 hits and 500 home runs. He was then suspended.

The introduction to Jose Conseco's book *Juiced* includes the following:

> Because of my truthful revelations I have had to endure attacks on my credibility. I have had to relive parts of my life that I thought had been long since buried and gone. All of these attacks have been spurred on by an organization that holds itself above the law. An organization that chose to exploit its players for the increased revenue that lines its pockets and then sacrifice those same players to protect the web of secrecy that was hidden for so many years. The time has come to end this secrecy and to confront those who refuse to acknowledge their role in encouraging the behavior we are gathered to discuss.
>
> The pressure associated with winning games, pleasing fans, and getting the big contract, led me, and others, to engage in behavior that would produce immediate results.
>
> Why did I take steroids? The answer is simple. Because, myself and others had no choice if we wanted to continue playing. Because MLB did nothing to take it out of the sport.
>
> Baseball owners and the players union have been very much aware of the undeniable that as a nation we will do anything to win. They turned a blind eye to the clear evidence of steroid use in baseball. Why? Because it sold tickets and resurrected a game that had recently suffered a black eye from a player strike.

[135] Jonathan McEvoy, "Career Cheat Still Playing the Game As He Performs Dark Arts for Oprah," The Daily Mail, January 18, 2013, http://www.dailymail.co.uk/sport/othersports/article-2264334/Lance-Armstrong-interview-He-glint-eye-cocky-smirk-Jonathan-McEvoy.html. Last visited October 8, 2013.

[136] Teri Thompson, Nathaniel Vinton, Michael O'Keeffe, and Christian Red (2009).

[137] http://reform.house.gov/GovReform/Hearings/EventSingle.aspx?EventID=1637. Accessed April 26, 2013.

[138] Bill Pennington, "Baseball Bans Longtime Star for Steroid Use," *New York Times*, August 2, 2005, p. A1.

In answer to a question, Mr. Canseco said, "It was as acceptable in the late '80s and the mid-'90s as a cup of coffee."[139]

We cannot fix this layer of ethical breaches without recognizing the pervasive nature of the industry's acceptance. No matter how effective the individual or company ethical lapse prevention tools have been, this level of ethical lapse will, once again, trump the efforts at those other levels. Those in the position to make strategic decisions about the companies' products, services, and directions miss the ethical implications of what everyone is doing because they have accepted the flawed reasoning of this relativistic ethical standard. Prevention here occurs at higher levels in the company and does require deeper analysis and longer term strategies.[140]

Cultural and Societal Ethical Shifts

There is always a little bit of pushback when folks view the latest stats on cheating by our high school and college students. There is a dismissiveness, to wit, "They are not cheating more; they are just more honest about it!" or "Don't you think it's the Internet? We just find out about these things more?" "It was more of a disgrace back then, so we didn't talk about it!" "Every generation thinks the next generation is worse!" However, the Inspector General for the Justice Department issued a report in September 2010 that concluded that FBI agents and some supervisors were cheating on their surveillance tests, that is, the tests that determined whether the agents knew the law regarding what they can and cannot do to initiate surveillance and how it is to be conducted.

Over the past year we have uncovered cheating rings on the GMAT exams as well as the exams for the certification of physicians for internal medicine specialization. The American Board of Internal Medicine (ABIM) has taken some sort of disciplinary action against 140 doctors who cheated on their ABIM certification exams. In a lawsuit that the ABIM had filed previously against Arora Board Review, a company that does exam review courses for certification, the discovery process yielded information that proved to be more damaging for the docs than for Arora. The documents in the now-settled case included e-mails and other correspondence from the doctors to Arora, which revealed that the docs knew many of the questions and, indeed, followed up by sending along memorized test questions from their own certification exams to Arora in order to help those awaiting taking the exam.[141]

In the world of sports, baseball attendance was never higher than when the players such as Barry Bonds, Mark McGwire, and Roger Clements were using performance-enhancing drugs. Lance Armstrong built a fortune, a foundation, and a place in history with his Tour de France victories. Never had a cyclist created so much attention for cycling.

Is There Any Answer for the Societal Shift?

Yes, and it is the simple understanding that "everyone is not cheating." While playing one of the Q school rounds at Houston's Deerwood Country Club in mid-November 2008, Hayes chipped his ball onto the green and placed a marker. After finishing the hole, he realized that he had used a different ball. He called himself on it and took a

[139] http://reform.house.gov/GovReform/Hearings/EventSingle.aspx?EventID=1637. Accessed April 26, 2013.

[140] Former Senator George Mitchell was hired by MLB in 2006 to conduct an investigation into MLB. However, the choice was not without its problems because Mr. Mitchell serves on the board of directors for the Boston Red Sox. Nonetheless, one of the conclusions Mr. Mitchell reached was this: "What we should have done a long time ago was stand up, players, ownership, everybody, and say, 'We made a mistake.'" Bob Nightengale, "Giambi Set to Cooperate with Mitchell," *USA Today*, June 22, 2007, p. 1C.

[141] *ABIM v. Arora Board Review*, (E.D. Pa), January 5, 2010. The lawsuit was settled.

two-stroke penalty. Later Mr. Hayes realized that the ball he had used was not one that was PGA approved. He had some Titlelist prototypes in his bag that he had been testing for the company. He had used a newfangled, unapproved ball. To call or not to call PGA officials? Disqualification versus six figures in earnings several times over? Mr. Hayes notified PGA officials. He said, "I pretty much knew at that point that I was going to be disqualified." It was a mistake, and Mr. Hayes doesn't know how the prototypes remained in his bag. Players generally make certain that they eliminate those issues before the round.

Mr. Hayes put a year of his career on the line to be honest. Being in the Top 25, the rank the Q school gives a player can mean about $1 million in earnings. Being disqualified from the Q means Mr. Hayes, at his rank, is looking at fewer tournaments and about a $300,000 loss in earnings. Mr. Hayes took full responsibility and held himself accountable, and all when no one would have known. The PGA, to its credit, made sure the story got out there to remind us that the higher road is a possibility.

Another fix is the realization that "everyone" doing something means that standards slip.

The fact that the cheating scandals seem to always be with us is not a justification for abandoning the goal of upholding educational standards. If those who are hired or who are seeking professional qualification are required to demonstrate mastery of knowledge and skills, then the burden shifts back to them for knowledge acquisition. There is no benefit in dishonesty used to earn grades if effective testing awaits prior to entry into the workforce or the profession. For example, an engineering graduate may be able to find ways to obtain questions, answers, and intelligence on exams. However, a practical exam that requires application of knowledge in the field remains an effective screen for which there is no alternative, easier path. A utility executive bemoans the fact that recent engineering hires do not seem to have the knowledge base necessary for understanding a power plant's functional interaction. A controller worries that a recent finance graduate seems unable to compute something as simple as APR. These skills are easily tested in the workplace, using a simple problem that requires response in real time. The facile reliance on the multiple-choice test has netted the scandals described earlier. A return to the apprenticeship form of examination circumvents the shifted norm on cheating. However, such an approach also serves to tell us what we need to know: Is this individual qualified?

The fixes for the layers require something more than fingers of blame pointed at individuals. The question to be asked is "Why would they think that what they did was acceptable in this company? In this industry? In our society? The question turns the issue back around to all of us for introspection and perhaps as well for response and action to do our part to restore ethical values in all the layers.

Discussion Questions

1. When Congress held the baseball steroid hearings, those in attendance included the parents of young baseball players who had taken their lives after using steroids in order to remain competitive in high school and college baseball. Explain why young players and their parents are stakeholders.
2. Commissioner Selig offered the following in his testimony:

   I should also say a word about our players. For some time now the majority of our great and talented athletes have deeply—and rightly—resented two things. They have resented being put at a competitive disadvantage by their refusal to jeopardize their health and the integrity of the game by using illegal and dangerous substances. And they have deeply—and rightly—resented the fact that they live under a cloud of suspicion that taints their achievements on the field.

   Using his statement, explain how unethical behavior hurts those who comply with the rules. Apply these same principles to academic dishonesty.

3. When he was inducted into Baseball's Hall of Fame in 2005, Ryne Sandberg said, "I didn't play the game right because I saw a reward at the end of the tunnel. I played the game right because that's what you're supposed to do."[142]

   Mark McGwire was eligible for the Hall of Fame in 2007. Barry Bonds broke Hank Aaron's home-run record in 2007, but did so before he was indicted for perjury. The debate over their induction into the Hall of Fame continues. *Sports Illustrated* has noted that Barry Bonds could end up "in baseball purgatory with Pete Rose."[143] What lessons about ethics do the McGwire and Bonds outcomes and controversy provide?
4. In August 2012, the Justice Department and MLB began a joint investigation of San Francisco Giants All-Star outfielder Melky Cabrera for possible use of synthetic testosterone. Jeff Novitsky, a criminal investigative agent for the FDA, who was the lead investigator in the BALCO scandal that brought the 2006 players' use of steroids to light, headed up the investigation. They found that Mr. Cabrera had developed a website to sell a nonexistent product with the idea of establishing that he inadvertently took the synthetic testosterone.[144] However, Mr. Cabrera was given a fifty-game suspension and a raise for the following year of play.[145] What messages did the team and MLB send with the investigation and sanctions? What layers are we dealing with now? The players' union has said that it wants the game clean. What role can the union play in keeping the game clean? Is the union a stakeholder?

Case 3.17

Back Treatments and Meningitis in an Under-the-Radar Industry

The New England Compounding Center (NECC) was the epicenter of a nationwide outbreak of meningitis that has resulted in fifteen deaths. The NECC produced a painkilling steroid for use in back treatments. The company's steroid doses contained fungal meningitis that resulted in hundreds of patients becoming sick, with the total increasing by day, and a resulting recall by the company of all of its products.

NECC is part of a nationwide network of smaller firms that mix together existing drugs to produce treatments such as the steroid injections that are at the heart of the controversy. Compounding companies such as NECC operate in a gray area. They are not subject to FDA direct supervision because they are not pharmaceutical firms. Rather, they are regulated as pharmacists under state laws. However, they do ship their products across state lines. The effect of their operation in this regulatory "demilitarized zone" is that they are regulated as if they were pharmacies dispensing drugs, when they are more like pharmaceuticals that produce drugs. The result is what the *Wall Street Journal* refers to as a "shadow industry."[146]

Since 1996, when David Kessler was head of the FDA, Congress has attempted federal regulation of compounding companies because of fears that the production processes in compounding "could result in serious adverse effects, including death."[147] Those were Mr. Kessler's words as he tried to carry forward some additional federal regulation over compounding labs as early as 1996. The compounding companies spent $1.1 million on lobbying in 2007 to stop a bipartisan bill that would have given the FDA some authority over the labs.

[142] "Sandberg, Boggs Relish Hall of Fame Induction Day," *USA Today*, August 1, 2005, p. 1C.

[143] Tom Verducci, "The Consequences," *Sports Illustrated*, March 13, 2006, p. 53.

[144] Bob Nightengale, "MLB, Justice Team in Testosterone Probe," *USA Today*, August 20, 2012, p. 1C.

[145] Bob Nightengale, "Baseball Union Targets Drug Cheaters," *USA Today*, March 4, 2013, p. 1C.

[146] Thomas M. Burton, James V. Grimaldi, and Timothy W. Martin, "Pharmacies Fought Controls," *Wall Street Journal*, October 15, 2012, p. A6.

[147] *Id.*

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The New England Compounding Center employees have offered examples of shortcuts that managers encouraged even if safety was compromised. For example, a pilot project at the company substituted quality control workers for pharmacists to conduct preliminary checks on drug content and proper settings on pumps for IV bags. There were mistakes, such as the time the company almost shipped a drug at twice its potency level, a mistake that resulted from overtime work in an effort to meet production. There were potency errors that state regulators caught over the years, but employees maintain that the goal was always to keep the production line going. One employee quoted the management mantra: "This line is worth more than all your lives combined, so don't stop it."[148]

Other "rounded corners" have emerged as regulators, news organizations, and plaintiffs' lawyers have combed through the NECC records. They have discovered that NECC was shipping drugs without waiting the necessary fourteen days for the lab tests on potency to be processed. The records also show that drugs were shipped without the names of specific patients, a requirement under state laws. Buyers would just fax in the names of the patients later so that there was no delay in booking sales or having the drugs on hand. Interestingly, one buyer for a hospital in Nevada pushed back when a NECC salesperson tried to encourage the fax-the-names-later approach, with the simple reminder, "I'm on the pharmacy board in Nevada, and that won't fly here."[149]

Since the time of the discovery of the defective steroids at the lab, government agencies and legislators have been active in closing the regulatory no-mans land in which compounding labs existed. The U.S. Senate has held hearings as to why the FDA took no action with regard to the labs and whether new legislation is necessary in order to bring the labs under federal regulation.[150] The FDA has explained that even with a warrant, labs often challenged its jurisdiction over them. That jurisdictional issue will be the focus of any new federal laws that would enable the FDA to inspect and regulate the compounding labs. Massachusetts has already passed what will be the strongest regulation of compounding labs of any state in the country. The new law requires stringent licensing procedures for the labs and extensive record keeping on production and shipment of compounded products.[151]

Discussion Questions

1. Explain how and when the regulatory cycle worked here.
2. What happens to those labs in this area that were following good practices and were not responsible for the problems caused by one lab?
3. How does ethical leadership apply in an industry?

[148] Sabrina Tavernise and Andrew Pollack, "Workers Cite Safety Fears at Drug Firm," *New York Times*, October 13, 2012, p. A1.

[149] *Id.*

[150] Andrew Pollack, "Checks Find Unsafe Practices At Compounding Pharmacies," *New York Times*, April 13, 2013, p. A12.

[151] Abby Goodnough and Denise Grady, "Massachusetts Plans Stricter Control of Compounding Pharmacies," *New York Times*, January 5, 2013, p. A9.

SECTION C

Social Responsibility and Sustainability

Reading 3.18

The New Environmentalism[152]

Richard MacLean[153] and Marianne M. Jennings

Boston Harbor doesn't smell. Annual Earth Day celebrations seem hushed in comparison to the first in 1970. Love Canal is but a reference in Oliver Stone films. Could we have achieved a different kind of "silent spring"? If all is quiet on the environmental front, why did Generation Xers, dressed as sea turtles, link with labor unions and the eco-friendly from forty-two nations to protest the WTO meeting in Seattle? That odd combination of "Birkenstocks" and Teamsters should give any CEO pause, but the sheer weirdness and senseless properly damage make Seattle easy to dismiss. It is a mistake to do so. Environmental issues are afoot in the same quiet fashion as Rachel Carson's first efforts.

The environmental movement of thirty years ago got its legs because the public was galvanized into action when pollution was in their backyards. Today's environmental issues are not conspicuous. Greenpeace learns there is PVC in Barbie and its pressure on Mattel, Inc., turns her into vegetable-based plastic. Although issues, like the fish population of the North Atlantic, may not be visible or even of concern to many, the activists have widened their sights and now have honed skills. The nature of international trade and the wonder of Internet communication for organizing movements make the stakes on emerging environmental issues higher than they were when landfills and effluents were the causes du jour.

Most companies are not prepared to respond because their environmental efforts are outmoded. They remain myopically focused on regulatory compliance and fail to take this generation's environmental focus seriously. Further, environmental professionals have witnessed a decade of cutbacks and consolidations in their ranks after two decades of staff growth. Today's environmental managers face a tough job market, mounting family obligations, and retirement looming on the horizon—if only they can make it. They concentrate on working the internal and external bureaucracies.

A "green arthritis" has infected the business world. Environmental managers who once put forward a "Save the Planet" mantra that comforted the general public, now use "Don't rock the boat" as a motto. These once creative leaders nowadays put a positive spin on company performance in an annual report on recycled paper and assure their management that all necessary systems are in place and regulatory compliance is improving.

[152] From "Green Arthritis: The Stagnation of Environmental Strategy," white paper. Reprinted with the permission of the authors.

[153] Richard MacLean is the owner of Competitive Environment, Inc., and a former corporate environmental manager with General Electric and Arizona Public Service.

But beneath, there is a powerful undertow that requires the same aggressive management these specialists brought to the *Silent Spring* backlash. Fortunately, there is a cure for green arthritis.

CEOs, not the environmental staff, should lead the way in this new environmental frontier, recognizing that threats may actually be opportunities. CEOs can be lulled into a sense of false security on environmental issues. In fact, what may be under control are only the procedural, regulatory compliance, and public relations aspects of environmental matters, not the strategic ones. Reliance on environmental management systems such as ISO 14000 or traditional compliance audits rarely reveals anything new.

ISO 14000 illustrates both the best and worst of environmental management. At its best, the ISO standard is a step-by-step guide to environmental management. At its worse, it substitutes a bureaucratic, one-size-fits-all process for strategic thinking. The questions raised by executive management must go beyond "Did we get our facilities ISO registered?" to assurances that these processes provide the degree of environmental assurance stakeholders expect.

Additionally, companies have signed on to a number of voluntary government, industry, and NGO initiatives to improve their images as environmentally responsible. Are they true responses? Do they just buy time? Will they survive close scrutiny?

Companies would never dream of substituting a process devised by a standard-setting organization for their unique strategic-planning or market-forecasting methodology. Yet, their environmental vision consists of handing over their destiny to a bureaucratic stamp of approval. The challenge is to make these processes robust in order to address the protests while serving shareholders.

Such enlightened self-interest often requires unconventional voluntary actions to thwart costly controls and public relations disasters. DuPont faced one of the first global environmental issues and voluntarily phased out chlorofluorocarbons (CFCs). It could have continued the fight in the courts. Instead, DuPont made a brilliant strategic choice that was also environmentally friendly—it moved into fluorochemicals, a market as rewarding as CFCs, but safer and all without the protests.

"Under control" is not an adequate response. These environmental issues must be managed, not handled with so-called green wash that costs companies credibility. For example, initial studies on EMFs, indicating an association between overhead electrical wires and childhood leukemia, presented an environmentalist's and trial lawyer's dream, complete with the Paul Brodeur series in the *New Yorker* on electric utilities killing small children. The electric utility industry could have handled the issue or managed the issue. Handling the issue means questioning the studies, sneering a bit, and doing the usual lobbying for liability exemptions. Managing the issue is sponsoring highly credible, peer-reviewed studies, educating the public about the issue, and placing overhead lines prudently while the data are being collected. The result of the management path has been the death of EMF fear and litigation. Had utilities handled this issue as Dow Corning handled silicone, a case in which a company was a victim of junk science, the industry would be in the process of settling class action lawsuits today.

There is also need for an overall strategy of managing information about the environment that goes far beyond the typical public relations responses. Gen Xers, out in full force in Seattle, bring their issues, those of the new environmental movement, straight from their schools. Michael Sanera's *Facts Not Fear* analyzed K–12 texts and found children learning well beyond global warming. They are taught the evils of capitalism and given unequivocal information that the world is overpopulated, that fossil fuel use is an imperialistic U.S. problem, and that any pesticide is a human killer. Teachers have students involved in letter-writing campaigns to CEOs on everything from animal testing to genetic engineering. Part of a comprehensive environmental strategy requires understanding this influential grass roots environmental educational movement.

Environmental issues remain a very powerful wild card. Vegetarian Barbie is but one small sign of what lies ahead, and the arthritically green will not be ready. The battles have become very political and very fierce.

Discussion Questions

1. Who should be responsible for environmental issues and programs in a company, and why?
2. What is the difference between the environmental issues of thirty years ago and today's issues?
3. Explain the examples of proactive behavior given and why there was business benefit in those decisions and actions.

Case 3.19

GM, the Volt, and Halted Sales and Production

Spending hundreds of millions of dollars, GM developed the Volt, a battery-powered car that the company hoped would change the perception of the company, largely formulated through its SUV sales. The Volt runs on a lithium-ion battery and has a small gasoline engine that takes over should the battery run low. The Volt was the passion of former GM Vice Chairman Bob Lutz, and he had projected large volume sales for the car.

However, the car's price was $41,000, offset by a $7,500 rebate from the federal government, was still a big obstacle for consumers despite state benefits for car buyers such as the ability to travel in HOV lanes even when traveling alone in your Volt. The car also had a rough rollout because of delivery delays and shortages as well as a very short range of travel when compared with the Toyota Prius. A serious accident that involved a Volt catching fire after a relatively minor collision almost cast the Volt into Edsel territory. GM did redesign the car after the accident to strengthen it, but GM rolled out its new Cruze at the same time, a car that gets 42 mpg and sold for about one-half the price of a Volt.

When the car was released for sale in 2011, its sales for the year finished at 7,700, well short of the 10,000 projected. By February 2012, GM had sold less than 1,699 cars, dealers were flush with inventory, and sales were declining. As one analyst explained, "Consumer demand is just not that strong for these vehicles."[154]

As a result, GM halted production of the Volt and shut down its Hamtramck, Michigan, plant, resulting in the layoff of 1,300 workers. GM reduced the price of the Volt, hoping for a sales boost. GM sold 23,461 Volts in 2012, and Volt sales were up 8.4 percent in the first quarter of 2013; but GM acknowledged that, despite expensive ad campaigns, "Drivers are only marginally aware of electric vehicles" and that the projected sales figure of 1 million sales by 2015 was not attainable.[155]

Discussion Questions

1. Who are the stakeholders in the Volt?
2. What role does consumer preference play in environmentally sustainable products?
3. Where do the GM shareholders fit in the problems with the Volts?

[154] Sharon Terlep, "GM to Idle Chevy Volt Output As Sales Slow," *Wall Street Journal*, February 3–4, 2012, p. A1.

[155] General Motors, Inc. 10-K, 2013, www.sec.gov.

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Case 3.20

Buying Local: The Safety Issues in Farmers' Markets

"Farmers' markets are great…. One day they're going to kill some people, though."[156] Galen Weston, the Chairman of Loblaw, the Canadian grocer, offered this assessment in his speech at the 2012 Canadian Food Summit. Mr. Weston's speech was the beginning of a year of concern and proposed and promulgated regulations related to the sale of fresh produce. Exempt from federal, state, and local regulation, the local produce market has been growing because of the ease of entry and lower costs of regulatory compliance. The Centers for Disease Control and Prevention concluded in 2013 that produce such as fruits and vegetables accounted for 46 percent of the 4,589 food-borne illness outbreaks linked to a specific commodity between 1998 and 2008.[157] At the top of the list were leafy greens. A 2013 similar FDA analysis found that leafy produce resulted in 131 outbreaks (including Salmonella, E. coli, Hepatitis A, and Cyclospora) between 1996 and 2010 that resulted in 14,000 illnesses and thirty-four deaths. In the summer of 2012, the Salmonella-infected cantaloupes from a farm in Indiana affected all growers and caused all melon growers to experienced significant losses because of one farm's shoddy operations.

Farmers' markets have gained popularity in the past decade because of a sustainability movement to buying locally, a practice touted as reducing dependence on oil because the transportation of produce is not necessary. Support for local, small farmers was seen as a step toward local sustainability. However, the small farmers and their marketplaces have escaped regulation and inspection. In some states, the extent of regulation is making sure that the farmers at the local farmers' market are indeed local, and not misrepresenting their local status. Also, regulators check to be sure that the food was grown locally and that local farmers have not imported it from elsewhere. In California, the regulations just require that the produce be kept six inches above the ground.[158]

As a result, Congress passed the Food Safety Modernization Act (FSMA), called the most sweeping safety reforms in seventy years.[159] The FSMA imposes growing standards, packing requirements, inspection procedures, and record-keeping requirements through administrative rules designed to track food from farm to table so that the outbreaks can be reduced, tracked, and, hopefully, prevented. However, the law exempts from federal standards and regulations any farms with less than $500,000 in food sales for the past year, a threshold that results in an exemption for 80 percent of the farms. As a result the farmers' markets will not be subject to the new food safety standards, and larger farms and produce sellers will have price increases because of the compliance standards the FSMA imposes.

Discussion Questions

1. Explain the stakeholders in the farmers' market movement, and discuss the risks associated with this sustainability movement.
2. If you were a small farmer who was exempt from the FSMA, would you voluntarily comply with FSMA standards? Explain your answer.
3. How will the FMSA affect the sale of produce?

[156] In "Quoted," Bloomberg's BusinessWeek, February 13–19, 2012, p. 5.

[157] "Attribution of Foodborne Illness, 1998–2008," Centers for Disease Control, March 2013, http://www.cdc.gov/foodborneburden/attribution-1998-2008.html.

[158] Cookson Beecher, "Fresh Produce at Farmers Markets Exempt from New Food Safety Regs," *Food Safety News*, January 30, 2013. http://www.foodsafetynews.com/2013/01/fresh-produce-at-farmers-markets-exempt-from-new-food-safety-regs/#.UXmur5Pn9D8.

[159] A primer on the Act can be found at www.fda.gov. http://www.fda.gov/Food/GuidanceRegulation/FSMA/ucm249243.htm.

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Case 3.21

Biofuels and Food Shortages in Guatemala

Biofuels were developed as an alternative to the use of oil and the dangers of its carbon footprint. Biofuels are made from corn, and the production of cars that run on biofuels has been mandated in Europe and the United States. However, there has been an unanticipated effect. The demand for corn has driven corn prices higher, particularly in poorer nations. For example, in Guatemala, the price of eight tortillas was one quetzal (about 15 cents USD) in 2010. Today, one quetzal will buy just three tortillas. The price of eggs has tripled because chickens feed on corn, and the cost of the feed is passed along in the price of eggs.

More than prices are affected. Individual farmers are unable to grow crops because large farmers have taken over the land, and these individual farmers are found planting their crops on medians in the highways because, as they explain, "There is no other land, and I have to feed my family."[160] The same farmer's children, ages 4 and 6, appear to be victims of chronic malnutrition.

The same shortages of land and spike in food prices can be found in Asia, Africa, and Latin America. Guatemala's experience is worse because, as one expert notes, the small Central American country is hit from demands for biofuels from both sides of the Atlantic—the United States and Europe.

Meanwhile the renewable fuel standard in the United States requires increasing volumes of biofuel per year, and Europe has a 10 percent mandate of biofuels by 2020. The demand for corn will increase. The corn demand in Guatemala has resulted in 60,000 jobs, but the large number of poor are not beneficiaries of the jobs and the result is increasing poverty. Even before the biofuel demands on corn crops, the poor spent two-thirds of their income on food. With the spike in prices, their food budgets are now consuming all of their income. Pantaleon Sugar Holdings, Guatemala's largest sugar producer has experienced annual sales growth of 30 percent. Labor unions in Guatemala have been appealing to European politicians regarding their biofuel standards because of the resulting increase in world hunger.

Discussion Questions

1. Discuss the meaning of this statement within the context of the biofuel movement and the impact on countries such as Guatemala: "Good intentions don't always produce good results."
2. Explain the stakeholders in the biofuels movement. Does sustainability increase poverty?

Case 3.22

The Dictator's Wife in Louboutin Shoes Featured in *Vogue* Magazine

In March 2011, *Vogue* magazine ran a 3,000-word story, complete with full-page color photographs of Syria's first lady, Asma al-Assad, wife of Syria's leader, Bashar al-Assad. *Vogue* writer Joan Juliet referred to Mrs. Assad as "glamorous, young, and very chic," the "freshest and most magnetic of first ladies," and ogled over the "flash of red soles" on her shoes (the trademark of Christian Louboutin $800–$1,200 shoes). Mrs. Assad described

[160] Elisabeth Rosenthal, "As Biofuel Demand Grows, So Do Guatemala's Hunger Pangs," *New York Times*, January 6, 2013, p. A6.

her role as one of convincing 6 million Syrians "under eighteen … to engage in 'active citizenship.'"[161]

The timing of fashion trends may have been slightly off because the "eastern Diana's" husband began a crackdown on the rebellious Syrians who reached a breaking point on tyranny with their realization that 20,000 Syrians have been killed in the civil war in Hama.[162] The result of their rebellion has been a bloody crackdown by Mr. Assad and the killing of 9,000 Syrians, the threat of the use of weapons of mass destruction, and a well-documented shopping spree by Mrs. Assad as the rebellion rages on.

Within weeks, the 3,200 words were pulled from *Vogue*'s website. The only copy available on the Internet ("A Rose in the Desert") is on a website called President Assad.com and that is dedicated to presenting flattering information about the President and his family.[163] One of the more ironic quotes in the article is: "The household is run on wildly democratic principles. 'We all vote on what we want, and where,' she [Mrs. Assad] says. The chandelier over the dining table is made of cut-up comic books. 'They outvoted us three to two on that.'"[164] Ms. Buck, the author of the article, said in an interview with NPR she was "horrified" to be near the Assads and suspected that the children were not their real children but plants used for security purposes.[165] Her biggest regret was the title of the article, which she assured she had nothing to do with, "A Rose in the Desert."

The United Nations released a video in 2012 pleading with Mrs. Assad to end the bloodshed in Syria with pictures of dead and injured Syrian children.

Discussion Questions

1. Who were the stakeholders in *Vogue's* decision to run the flattering profile?
2. Through a spokesperson, *Vogue* editor Anna Wintour defended the decision to publish the piece as "a way of opening a window into this world a little bit."[166] Did the article serve that function?
3. Why was the story scrubbed from the Internet following the outbreak of the rebellion in Syria?

Case 3.23

Herman Miller and Its Rain Forest Chairs

In March 1990, Bill Foley, research manager for Herman Miller, Inc., began a routine evaluation of new woods to use in the firm's signature piece—the $2,277 (the 1990 cost) Eames chair. The Eames chair is a distinctive office chair with a rosewood exterior finish and a leather seat, and was sold in the Sharper Image's stores and catalog.

At that time, the chair was made of two species of trees: rosewood and Honduran mahogany. Foley realized that Miller's use of the tropical hardwoods was helping destroy rain forests. Foley banned the use of the woods in the chairs once existing supplies were exhausted. The Eames chair would no longer have its traditional rosewood finish.

[161] Maura Judkis, "Asma al-Assad: The Fashionable Face of Tyranny," *Washington Post*, February 29, 2012, http://www.washingtonpost.com/blogs/blogpost/post/asma-al-assad-the-fashionable-face-of-tyranny/2012/02/29/gIQAT0zfiR_blog.html.

[162] Bari Weiss and David Feith, "The Dictator's Wife Wears Louboutins," *Wall Street Journal*, March 7, 2011, p. A15.

[163] http://www.presidentassad.net/ASMA_AL_ASSAD/Asma_Al_Assad_News_2011/Asma_Assad_Vogue_February_2011.htm (as accessed in original research). The website comes and goes.

[164] *Id.*

[165] Paul Farhi, "Vogue's Flattering Article on Syria's First Lady Is Scrubbed From Web," *Washington Post*, April 25, 2012, http://www.washingtonpost.com/lifestyle/style/vogue-profile-on-assads-wife-disappears/2012/04/25/gIQAgMWthT_story.html.

[166] Max Fisher, "The Only Remaining Online Copy of Vogue's Asma al-Assad Profile," *The Atlantic*, January 3, 2012, http://www.theatlantic.com/international/archive/2012/01/the-only-remaining-online-copy-of-vogues-asma-al-assad-profile/250753/.

Foley's decision prompted former CEO Richard H. Ruch to react: "That's going to kill that [chair]."[167] Effects on sales could not be quantified.

Herman Miller, based in Zeeland, Michigan, and founded in 1923 by D. J. DePree, a devout Baptist, manufactures office furniture and partitions. The corporation follows a participatory-management tradition and takes environmentally friendly actions. The vice president of the Michigan Audubon Society noted that Miller has cut the trash it hauls to landfills by 90 percent since 1982: "Herman Miller has been doing a super job."[168]

Herman Miller built an $11 million waste-to-energy heating and cooling plant. The plant saves $750,000 per year in fuel and landfill costs. In 1991, the company found a buyer for the 800,000 pounds of scrap fabric it had been dumping in landfills. A North Carolina firm shreds it for insulation for automobile roof linings and dashboards. Selling the scrap fabric saves Miller $50,000 per year in dumping fees.

Herman Miller employees once used 800,000 styrofoam cups a year. But in 1991, the company passed out 5,000 mugs to its employees and banished styrofoam. The mugs carry the following admonition: "On spaceship earth there are no passengers … only crew." Styrofoam in packaging was also reduced 70 percent for a cost savings of $ 1.4 million.

Herman Miller also spent $800,000 for two incinerators that burn 98 percent of the toxic solvents that escape from booths where wood is stained and varnished. These furnaces exceeded the 1990 Clean Air Act requirements. It was likely that the incinerators would be obsolete within three years, when nontoxic products became available for staining and finishing wood, but having the furnaces was "ethically correct," former CEO Ruch said in response to questions from the board of directors.[169]

Herman Miller keeps pursuing environmentally safe processes, including finding a use for its sawdust byproduct. However, for the fiscal year ended May 31, 1991, its net profit had fallen 70 percent, from 1990 to $14 million on total sales of $878 million.

In 1992, Herman Miller's board hired J. Kermit Campbell as CEO. Mr. Campbell continued in the Ruch tradition and wrote essays for employees on risk taking and for managers on "staying out of the way." From 1992 to 1995, sales growth at Herman Miller was explosive, but as one analyst described it, "Expenses exploded." Despite sales growth during this time, profits dropped 89 percent to a mere $4.3 million.

Miller's board, concerned about Campbell's lack of expedience, announced Campbell's resignation and began an aggressive program of downsizing. Between May and July 1995, 130 jobs were eliminated. Also in 1995, sales dropped from $879 to $804 million. The board promoted Michael Volkema, then 39 and head of Miller's file cabinet division, to CEO.[170]

Volkema refocused Herman Miller's name with a line of well-made, lower-priced office furniture, using a strategy and division called SQA (simple, quick, and affordable). The dealers for SQA work with customers to configure office furniture plans, and Miller ships all the pieces ordered in less than two weeks.

Revenues in 1997 were $200 million, with record earnings of $78 million. In 1998, Miller acquired dealerships around the country and downsized from its then 1,500 employees.[171]

[167] David Woodruff, "Herman Miller: How Green Is My Factory?" *Business Week*, September 16, 1991, pp. 54–55.

[168] *Id.*

[169] *Id.*

[170] Susan Chandler, "An Empty Chair at Herman Miller," *BusinessWeek*, July 24, 1996, p. 44.

[171] Bruce Upjohn, "A Touch of Schizophrenia," *Forbes*, July 7, 1997, pp. 57–59.

Volkema notes that staying too long with an "outdated strategy and marketing" nearly cost the company. By 1999, Herman Miller was giving Steelcase, the country's number one office furniture manufacturer, stiff competition, as it were, with its Aeron chair. The Aeron chair, which comes in hundreds of versions, has lumbar adjustments, varying types of arms, different upholstery colors, and a mesh back Its price is $765 to $1,190, and it is said to be capitalizing on its "Austin Powers-like" look. The chair has thirty-five patents and is the result of $35 million in R&D expenditures and cooperation with researchers at Michigan State, the University of Vermont, and Cornell who specialize in ergonomics. The seat features a sort of spine imprimatur. That is, the chair almost conforms to its user's spine.[172]

Since 2002, Herman Miller has been named one of the "Sustainable Business 20," which is a list of the top twenty stocks of companies with strong environmental initiatives as well as good financial performance. The list is compiled by *Progressive Investor*, a publication of SustainableBusiness.com. In announcing the list, http://www.sustainable business.com said, "Our goal is to create a list that showcases public companies that, over the past year, have made substantial progress in either greening their internal operations or growing a business based on an important green technology."[173] For the past nine years, Herman Miller has been named to the Dow Jones Sustainability World Index, and for six years has received a perfect score on the Human Rights Index, a measure of treatment of employees in factories located in other countries.

For the fiscal year ended June 30, 2010, Herman Miller's earnings had declined 19 percent. It is working to expand its product base to include home furnishing. Despite the earnings setback, Herman Miller continued its focus on sustainability. One of its corporate goals is zero pounds of waste by 2020. Known as its "Perfect Vision" strategy, the company had pledged also to have zero emissions, zero hazardous waste, zero landfill, zero process water use, and 100 percent green energy use. Currently the company is at 27 percent renewable energy use for its offices and production.

Despite the earnings struggles, the recognition the company receives is remarkable. The company consistently appears in CRO magazine's "100 Best Corporate Citizens" and has been named twenty-four times by *Fortune* magazine as one of the United States's "Most Admired" companies as well as one of the "Top 100 Companies to Work For" for a decade. In 2008, it was consistently ranked as one of the top twenty safest companies in the United States because of its low workplace injury rate for its employees.

By 2011, the earnings picture had changed. Herman's Miller's NASDAQ listing found its shares climbing due to its acquisitions of fabric companies and its expansion into furniture for health care facilities and home furnishings. Despite a sagging economy, Herman Miller's sales were up 11 percent for the first quarter of 2013, something attributed to the company's strong international presence. Experts attribute its strong international sales to its reputation for sustainable products and operations. Herman Miller has changed significantly since its 1968 invention of the office cubicle, a design that has now fallen out of favor. Its evolution into new fields, new products, and sustainability has resulted in increasing sales and profits. Herman Miller's recruiting page includes the following:[174]

> You can make a salary making furniture. Or you can make a difference. Or you can work at Herman Miller and make both. Speak up, solve problems, lead others, and be an owner. All while giving back to the community and caring for a better world. Join us and make your mark.

[172] Terril Yue Jones, "Sit on It," *Forbes*, July 5, 1999, 53–54.

[173] "Sustainable Business 20," *Progressive Investor*, July 17, 2007, http://www.sustainablebusiness.com.

[174] www.hermanmiller.com—look under employment opportunities.

Speak Up

People who speak up and share ideas make for a strong business. Embracing good ideas and sharing the rewards with everyone is one way we stand apart.

Solve Problems

We use design to do that. You don't have to be a "designer" to make things better—for customers, for the communities we do business in, and for a better world.

Lead

Envision the future and help others reach their potential. Sometimes you'll lead and other times follow. We believe everyone does both, depending on the problem to be solved.

Own

At Herman Miller everyone can be a shareholder. But more so, you'll be a stakeholder, because we're all challenged to design solutions and make decisions that improve our community, our business, and our world.

Discussion Questions

1. Evaluate Foley's decision on changing the Eames chair woods. Consider the moral standards at issue for various stakeholders.
2. Is it troublesome that Miller's profits were off when Foley made the decision?
3. Is Herman Miller bluffing with "green marketing"? Would Albert Carr (Reading 2.3) support Herman Miller's actions for different reasons?
4. Why would Herman Miller decide to buy equipment that exceeded the 1990 Clean Air Act standards when it would not be needed in three years?
5. In 2010, sales earnings were down for the company, but Herman Miller retained its sustainability focus. Despite advice from shareholders and experts, the company refused to cut costs by eliminating some of its green programs. Did the sustainability focus help the company with its sales and profits?

SECTION D

Government as a Stakeholder

Case 3.24

Solyndra: Bankruptcy of Solar Resources

Solyndra is a solar-cell factory located in California. Begun in 2005, Solyndra was perceived as a high-risk firm because its product design was that of creating cylindrical solar cells. The market has relied on conventional photovoltaic (PV) cells that we are familiar with in solar panels. However, Solyndra was able to garner $1 billion in private equity because its sales pitch was that its design did not require the use of silicon, something required for PV design that was very expensive.

Unfortunately, the price of silicon began to drop rapidly at about the time Solyndra was up and running. The result was that Chinese solar cell and panel manufacturers were able to flood the market with their products. In 1995, Chinese companies held 6 percent of the international market for PV cells. By 2011, those same companies held 54 percent of the market share. Solyndra acknowledged the market share issues to investors in 2010 and also disclosed that it cost more to produce its cells than it could sell them for in the market because of the cheaper PV products.[175] The product design would not sell unless and until silicon prices went up.

However, that information about production costs and pricing was not disclosed to the federal government, which gave Solyndra a $535 million loan guarantee as part of the 2009 economic stimulus package. The loan guarantee for Solyndra was critical because it was no longer able to raise private funds, as the market was aware of the cost and pricing issues.

Following the boost from the federal government in March 2009, Solyndra was able to obtain loans, but its cash burn rate was so high that by December 2010, it was low on cash and had violated the loan covenants then in place. Although Rockport Capital and other investors in the company agreed to infuse $75 million in loans, the company was forced to declare bankruptcy in September 2011. Two days after its declaration of bankruptcy, the FBI raided the company's headquarters and the homes of its top management to obtain records as part of an investigation into the company's loans, the federal guarantee, misrepresentations to the Department of Energy, the use of the funds, and whether the loan guarantee had been simply an effort to get investors repaid.[176]

Following the bankruptcy material information about the interrelationships of the company with federal officials came to light. Rockport Capital, one of Solyndra's largest investors has a seat on the U.S. Navy's panel that helps the federal government find emerging technologies. Kevin Kopczynski, a principal in Rockport, who fills the Rockport seat on the Navy panel, recommended Solyndra for Navy contracts. While Mr. Kopczynski did disclose Rockport's interest in Solyndra in his discussion with the Navy about the company, he did not disclose Solyndra's financial condition at the time of his recommendation, even though he was aware of such as a Solyndra board member.[177]

[175] Paul Keegan, "What's Behind the Solar Scandal?" *Fortune*, October 17, 2011, pp. 35–36.

[176] Deborah Solomon, "Solyndra Came Close To Landing Navy Deal," *Wall Street Journal*, October 14, 2011, p. A1.

[177] *Id.*

Navy rules require disclosure of interests in companies when the Navy is considering doing business with those companies, but do not require the panel member who has disclosed the conflict to disclose anything further about that company. The deal with the Navy would have gone through if the Navy had not discovered that Solyndra was planning to declare bankruptcy. The George Kaiser Family Foundation is another large investor in Solyndra, and Mr. Kaiser was a major donor to President Obama's 2008 presidential campaign. This relationship created political controversy following the Solyndra bankruptcy.

E-mails showed that Steven J. Spinner, a senior member of the Department of Energy's loan guarantee oversight office, had significant e-mail contact with the White House in urging that the Solyndra loan guarantee be moved along quickly. However, Mr. Spinner had promised to recuse himself from the loan guarantee approval because Spinner's wife was a partner in a law firm that represented Solyndra.

During the approval process, several Department of Energy officials raised concerns about Solyndra's financial viability and also voiced questions about company investors getting first position for repayment under the terms of the government's guarantee. They felt that the loan guarantee should not be subordinate to any other investors or creditors. Some believed that Department of Energy regulations required that the government have first position.[178] However, under the terms of the agreement, the investors in Solyndra were given first position. With the government standing liable as a guarantor and Solyndra having no assets, the $535 million will be paid to the Solyndra investors.

Discussion Questions

1. Make a list of the ethical issues you see in the negotiations for the federal guarantee as well as the Navy contract.
2. Did the good intentions of the government in investing in renewable energy have unintended consequences? Explain the consequences.
3. In 2008, Congress passed a bill authorizing $16 billion in loans to companies that were developing fuel-efficient vehicles. The money has yet to be disbursed because many believe that the firestorm of controversy that erupted over the bankruptcy of Solyndra. The failed company accompanied by the fact that one of the major investors in Solyndra was a fundraiser for President Obama has stalled the loan program.[179] Explain the group of stakeholders that you see after reading about Solyndra's impact. What does this experience teach business about its accountability?

Case 3.25

Stanford University and Government Payment for Research

Included in government research grants to universities are indirect cost payments designed to compensate for the researchers' use of the schools' facilities.

Stanford University received approximately $240 million in federal research funds annually. About $75 million went to actual research, and Stanford billed the federal government $85 million, or 20 percent of its operating budget, for its overhead.[180] The rest of the research funds went toward employee benefits. An audit of Stanford's research program in 1990 by U.S. Navy accountant Paul Biddle revealed that the school billed the government $3,000 for a cedar-lined closet in president Donald Kennedy's home (Hoover House), $2,000 for flowers, $2,500 for refurbishing a grand piano, $7,000 for

[178] Eric Lipton and John M. Broder, "E-Mail Shows Official Pushed Solyndra Loan," *New York Times*, October 8, 2011, p. A1.

[179] Bill Vlasic and Matthew J. Wald, "Feeling Solyndra's Chill," *New York Times*, March 13, 2012, p. B1.

[180] Colleen Cordes, "Universities Review Overhead Charges; Some Alter Policies on President's Home," *Chronicle of Higher Education*, April 3, 1991, p. A1.

bed sheets and table linens, $4,000 for a reception for trustees following Kennedy's 1987 wedding, and $184,000 for depreciation for a seventy-two-foot yacht as part of the indirect costs for federally funded research.[181]

In response to the audit, Stanford withdrew requests for reimbursement totaling $1.35 million as unallowable and inappropriate costs. Stanford's federal funds were cut by $18 million per year.[182]

Kennedy issued the following statements as the funding crisis evolved:

> **December 18, 1990:** What was intended as government policy to build the capacity of universities through reimbursement of indirect costs leads to payments that are all too easily misunderstood.
>
> Therefore, we will be reexamining our policies in an effort to avoid any confusion that might result.
>
> At the same time, it is important to recognize that the items currently questioned, taken together, have an insignificant impact on Stanford's indirect-cost rate....
>
> Moreover, Stanford routinely charges the government less than our full indirect costs precisely to allow for errors and disallowances.
>
> —From a university statement

> **January 14, 1991:** We certainly ought to prune anything that isn't allowable—there isn't any question about that. But we're extending that examination to things that, although we believe are perfectly allowable, don't strike people as reasonable.
>
> I don't care whether it's flowers, or dinners and receptions, or whether it's washing the table linen after it's been used, or buying an antique here or there, or refinishing a piano when its finish gets crappy, or repairing a closet and refinishing it—all those are investments in a university facility that serves a whole array of functions.
>
> —From an interview with the Stanford Daily

> **January 23, 1991:** Because acute public attention on these items threatens to overshadow the more important and fundamental issue of the support of federally sponsored research, Stanford is voluntarily withdrawing all general administration costs for operation of Hoover House claimed for the fiscal years since 1981. For those same years, we are also voluntarily withdrawing all such costs claimed for the operations of two other university-owned facilities.
>
> —From a university statement

> **February 19, 1991:** I am troubled by costs that are perfectly appropriate as university expenditures and lawful under the government rules but I believe ought not be charged to the taxpayer. I should have been more alert to this policy issue, and I should have insisted on more intensive review of these transactions.
>
> —From remarks to alumni

> **March 23, 1991:** Our obligation is not to do all the law permits, but to do what is right. Technical legality is not the guiding principle. Even in matters as arcane as government cost accounting, we must figure out what is appropriate and act accordingly. Over the years, we have not hesitated to reject numerous lawful and attractive business proposals, gifts, and even federal grants because they came with conditions we thought would be inappropriate for Stanford. Yet, with respect to indirect-cost recovery, we pursued what was permissible under the rules, without applying our customary standard of what is proper....

[181] Maria Shao, "The Cracks in Stanford's Ivory Tower," *BusinessWeek*, March 11, 1991, 64–65.

[182] Gary McWilliams, "Less Gas for the Bunsen Burners," *BusinessWeek*, May 20, 1991, 124–126; and Courtney Leatherman, "Stanford's Shift in Direction," *Chronicle of Higher Education*, September 7, 1994, p. A29.

> The expenses for Hoover House—antique furniture, flowers, cedar closets—should have been excluded, and they weren't. That the amounts involved were relatively small is fortunate, but it doesn't excuse us. In our testimony before the subcommittee I did deal with this issue, but I obviously wasn't clear enough. I explained that we were removing Hoover House and some similar accounts from the cost pools that drew indirect-cost recovery because they plainly included inappropriate items. What came out in the papers was that Stanford removed the costs because it was forced to, not because it was wrong.... That is not so. To repeat, the allocation of these expenses to indirect-cost pools is inappropriate, regardless of its propriety under the law.
>
> —From remarks to alumni[183]

By July 1991, Kennedy announced his resignation, effective August 1992, stating, "It is very difficult … for a person identified with a problem to be a spokesman for its solution."[184] Gerhard Casper, who was hired as Stanford's new president, said, "I just want this to remain one of the great universities in the world. I ask that we question what we are doing every day." Kennedy remains at Stanford, teaching biology.[185]

Stanford's donations declined that year; 1999 was the first time it saw an uptick in its donations since the time of this government overhead issue.[186]

Ultimately, Stanford settled with the federal government for $1.3 million, a small percentage of the $185 million of alleged overcharges that appeared in Biddle's report. The federal government also concluded that there was no fraud by Stanford. Biddle filed suit, seeking recovery of the statutory whistleblower fee of 10 percent for finding the submitted costs that the government ultimately recovered from Stanford. His suit was dismissed.

Discussion Questions

1. Did Kennedy's ethics evolve during the crisis? Contrast his March 23, 1991, ethical posture with his December 18, 1990, assessment.
2. Is legal behavior always ethical behavior?
3. Do Casper's remarks reflect an ethical formula for Stanford's operations?
4. List all of the stakeholders in this situation.
5. In a 2000 interview for an internal Stanford publication, Kennedy offered the following when asked about research and cost issues as he assumed the editorship of *Science:*

> One of the factors in the explosive growth of Stanford during the '60s and continuing into the '70s and '80s was the availability of federal funding for research. The policy behind that support was always that the government benefited from basic research because it eventually produced findings that could be converted to human service in one way or another and so the government continually built that capacity and built that capacity in universities. Its policy was that it would pay the full cost of research, including not only the direct cost that could be associated with particular programs but the indirect costs that had to be made by the university in order to stay in the business of doing sponsored research.
>
> Over time, the percentage of all research funding that was allocated to indirect cost grew. And it grew to a point in the late '80s and early '90s when it seemed to many people, some in Congress and some on this faculty, that it was an unacceptably large percentage and we recognized that though, probably not soon enough, made some efforts to constrain it, but in fact it was high enough to trouble people and it was calculated, the indirect costs were calculated on the basis on a pool accounting mechanism no one in the public understood and indeed few people on the faculty understood. And when Congressman

[183] Karen Grassmuch, "What Happened at Stanford: Key Mistakes at Crucial Times in a Battle with the Government over Research Costs," *Chronicle of Higher Education*, May 15, 1991, p. A26.

[184] "Embattled Stanford President to Quit," *Mesa Tribune*, July 30, 1991, p. A6.

[185] Associated Press, "Stanford's Chief Resigns over Billing Controversy," *Arizona Republic*, July 30, 1991, p. A8.

[186] Leatherman, "Stanford's Shift in Direction," p. A29.

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> Dingell decided to make that the subject of a very high profile Congressional investigation and made Stanford the subject of it, we had a very, very bad time. We took a beating. It was sufficiently bad that after the hearings and during the summer of 1991, it became clear to me that there was so much faculty concern about the ruckus and whether Stanford would continue to be a target for this kind of thing that I decided that if you're part of a problem, you can't be part of a solution and so I resigned. I think that steadied things down considerably. It wasn't any fun to do that. It was not any fun to take a certain amount of newspaper abuse in connection with it. Stanford's recovered nicely. We're still not paid the indirect cost rate I think we are entitled to under articulated government policies, but the sequelae to the whole furor, I think, made it plain to everybody that Stanford hadn't engaged in any wrongdoing.
>
> I think there were a few people in other institutions who got caught up in the problem later when it was revealed that they had engaged in exactly the same practices we had who did a little finger pointing and said "Well, Stanford was pushing the envelope." But in fact we weren't. Our indirect cost rate was high but it was in a cluster of other high rates, two or three or four other institutions which were comparable or within three or four percentage points. So you can't make the case that we were doing stuff that others weren't also doing.[187]

List the rationalizations you see in this statement. Does he think Stanford did anything unethical?

Case 3.26

Minority-Owned Businesses and Reality

Federal, state, and local government agencies have special bidding priority and criteria for businesses that are owned by minorities or women when they are evaluating proposals for their contracts. As a result, many husbands have listed their wives as shareholders and/or officers in their companies even though their wives do not work in their businesses or invest any funds in their companies. Others have named their businesses in a way that gives the impression that they are minority-owned businesses.

Discussion Questions

1. Is this conduct legal? Is it ethical?
2. Explain who the stakeholders are who are affected by the use of these structure changes.
3. What was the purpose of the special bidding priority?
4. Why do you think the businesspeople find ways around the bidding priority rules?
5. Is this another situation of unanticipated consequences of good intentions?

Case 3.27

Prosecutorial Misconduct: Ends Justifying Means?

Senator Stevens and the Remodeling

The U.S. Justice Department announced that it was dropping all charges against convicted former Alaska U.S. Senator, the late Ted Stevens. U.S. Attorney General Eric Holder announced that his office had uncovered prosecutorial misconduct in that lawyers for the federal government had failed to disclose notes from a witness interview

[187] http://becoming.stanford.edu/interview/donaldkennedy.html. Accessed July 10, 2010.

that included exculpatory evidence that would have cast doubt on Mr. Stevens' criminal intent.

Mr. Stevens had originally been convicted of making false statements on his federally mandated disclosure statements about gifts. The government alleged he failed to disclose significant gifts he received from federal contractors that were related to the remodeling of his home in Alaska. Mr. Holder's decision was the end of the case. Mr. Stevens was nearly reelected to the Senate despite having been convicted of criminal charges just a week before the November 2008 election. He lost the election by just over 3,000 votes. Following the loss, he returned to private life in Alaska. Sadly, Mr. Stevens died in a plane crash in the rugged mountain area 350 miles south of Anchorage, Alaska, on August 9, 2010.

When Mr. Holder made his announcement of the withdrawal of the charges in April 2009, he also announced that there would be a Justice Department investigation into the conduct of the lawyers involved in the case. In the hearing held in federal court to grant the Justice Department's motion to dismiss the charges, the federal district court judge ordered an investigation into the conduct of the prosecutors. That report, issued in 2011, concluded that the prosecution of the late Senator Stevens was "permeated by the systematic concealment of significant exculpatory evidence which would have independently corroborated his defense and his testimony and seriously damaged the testimony and credibility of the government's key witness."[188] The report also concluded that there was "significant, widespread, and at time intentional misconduct" by the prosecutors."[189] The 525-page report refers to "astonishing misstatements" by prosecutors as well as their failure to reveal the history of witnesses, including the fact that one of their witnesses had tried to obtain a false affidavit from a child prostitute in order to protect himself from prosecution. The prosecutors felt that the information would undermine his credibility and withheld it from Senator Stevens' lawyers. One of the prosecutors allowed a witness, who was a contractor who worked on the Stevens Alaska home, to give false testimony: that he had paid for the improvements to Senator Stevens' home when, in fact, Senator Stevens had written to the contractor/witness twice asking for a bill for the work on his home.[190]

Discussion Questions

1. What are the ethical duties of lawyers? Of prosecutors?
2. What are the rules of discovery for criminal and civil cases?
3. Mr. Nicholas Marsh, one of the prosecutors under investigation for the Stevens evidence issue, committed suicide in September 2010. Is there a credo moment for lawyers here?
4. Following the court report on misconduct, all of the lawyers involved had been working and continued to work in the Justice Department? Mr. Holder said that he has required additional training for the lawyers. Are there any ethical issues in having the prosecutors found to engage in misconduct still working there? In answering this question, think about this statement from a *Wall Street Journal* editorial on the prosecutors' conduct, "Americans hand prosecutors an awesome power—the power to destroy fortunes and futures, and in this case to reallocate national political power. We are seeing a pattern of abuse of this power in order to win big cases. [P]rosecutors [should] remember that their job is to do justice and not simply beat the defense team."[191]

[188] Jim Morhard, "Are Prosecutors Above the Law," *Wall Street Journal*, December 3–4, 2011, p. A15.

[189] *Id.*

[190] Brad Heath and Kevin Johnson, "Evidence Hidden in Sen. Stevens' Corruption Case," *USA Today*, March 16, 2012, p. 2A.

[191] "Department of Injustice" (editorial, no author listed), *Wall Street Journal*, March 17–18, 2012, p. A14.

The Duke Lacrosse Team and the Prosecutor

In the wee hours of the morning (between March 13 and 14, 2006), two women who were hired as dancers went to a party being held by the Duke lacrosse team to perform. One of the women later (or early, depending on how one defines the wee hours) went to the police station in Durham to report being sexually assaulted by three of the Duke players.

By March 16, 2006, the police searched the house where the party was held and conducted with the accuser a photo ID session with pictures of the twenty-four lacrosse players. She was unable to identify her assailants but could identify several young men who were at the party. At a later photo lineup of twelve more team members, she was unable to identify any of them as either assailants or team members who were at the party.

On March 23, 2006, all forty-six members of the Duke team reported to the Durham police to give DNA samples. Within days, Mr. Michael B. Nifong, the district attorney for Durham, held the first of many press conferences on the case. Mr. Nifong said that the young men on the team were engaging in a "conspiracy of silence," but that the physical evidence in the case would be strong and conclusive.

The photo lineups continued, but the accuser had great difficulty, including identifying one of the young men on the team; she explained that whoever he was, he had a moustache at the time of the assault. The officers knew that the young man who was identified had never had a moustache. Lawyers and police officers agree that the photo lineup process used by the Durham police for all of the sessions with the accuser violated not only Durham police rules but also standard procedures for such lineups. For example, one requirement is that the photos include photos of those who would not be associated with the crime scene, the alleged victim, or, in this case, the team. The photos shown consisted only of the Duke team members.

The response of the Duke community was swift and severe. Eighty-eight faculty members at Duke University took out a full-page newspaper ad condemning the white male, college athletics, and racism. Duke's president, on April 4, 2006, canceled the lacrosse team's season. Duke President Richard Brodhead called the events the team was involved in "sickening and repulsive."[192] The accuser was an African American woman, and the players on the lacrosse team were white males. Reverend Jesse Jackson had taken a strong position in the case and offered the young woman a scholarship. Commentators referred to the case as a volatile one that was a mix of race, sex, and class.[193]

On April 10, 2006, the prosecutor's office (Mr. Nifong's office) received the results of the DNA analysis. None of the results linked any of the team members to the accuser. However, despite the difficulties with the lineups, Mr. Nifong stated at a public forum on April 11, 2006, that the accuser had identified at least one of the team members and that he was not concerned about the absence of DNA linkage.

On April 17, 2006, the grand jury returned indictments against Reade Seligmann and Collin Finnerty for rape, sexual assault, and kidnapping. Mr. Seligmann's lawyer was rebuffed when he offered evidence of his client's whereabouts at the time of the alleged assault, including time stamps from his use of an ATM, a credit card at a fast-food restaurant, and his punch-in at his campus housing.

May 2, 2006, was the primary election in Durham, and Mr. Nifong emerged as the victor for the Democratic Party, winning the opportunity to run for reelection. Another team member, David F. Evans, was indicted on May 12, 2006, because there was a

[192] Eddie Timanus and Tim Peeler, "Duke Lacrosse Coach Resigns; School Cancels Season," *USA Today*, April 7, 2006, p. 1C.

[193] Duff Wilson, "Prosecutor in Duke Case Is Stripped of Law License," *New York Times*, June 17, 2007, p. A16.

possible match between his DNA and some DNA found on the artificial fingernail of the victim that had been found under a trash can at the house where the party was held.

National attention on the case became a daily thing, with national news programs and talk shows focusing on the accuser, the team, and Duke. Mr. Seligmann, a graduating senior, had his job offer from Goldman Sachs revoked because of his indictment. As a result of the continuing news conferences and circus-like atmosphere, a judge ordered the parties to abide by a gag order as of July 17, 2006. As a result, a relative quiet settled over the case, with the exception of Mr. Nifong handily winning reelection on November 7, 2006.

At one of many pretrial hearings on various motions, Brian W. Meehan, a director of a DNA lab that performed the analysis of the players' DNA, admitted on December 6, 2006, that Mr. Nifong did not note in the documents turned over to defense lawyers that the DNA of a number of different men had been found on the accuser's clothing, body, and underwear. The accuser had been a stripper for a number of years. In fact, Reverend Jackson's motto for the case, one in which he offered personal assistance for the young woman, had been "Don't strip. Scholarship." Mr. Meehan referred to the omission as an intentional one that he and Mr. Nifong had agreed to in advance of the report's release. On cross-examination at the hearing, Mr. Meehan admitted that he violated his own laboratory's processes and procedures in not turning over all of the exculpatory evidence.

By December 22, 2006, the accuser admitted that she could not be sure what had really happened, and as a result, Mr. Nifong dropped the rape charges but continued with the prosecution of the kidnapping and assault charges.

National attention was back on the case, despite the gag order, and on December 26, 2006, the North Carolina State bar filed prosecutorial misconduct charges against Mr. Nifong. When the charges were filed, which included making "inflammatory remarks" about the case, Mr. Nifong withdrew from the case on January 13, 2007, and asked North Carolina's Attorney General's Office to assume responsibility for the case.

As the North Carolina attorney general began its review of the case, the North Carolina State bar added charges to its complaint against Mr. Nifong, including a charge that he withheld evidence from defense lawyers in the case.

On April 11, 2007, the North Carolina attorney general not only dropped all the remaining charges against the three young men but also announced that the young men were innocent of any of the charges. The young men were issued an apology on behalf of the state. They have since settled a lawsuit they brought against Duke University for an amount that remains undisclosed.

On June 15, 2007, Mr. Nifong announced his resignation as district attorney for Durham at his state bar hearing on the charges. However, the ethics panel for the state bar hearing was unmoved and, forty minutes after the evidence was presented, issued its decision of disbarment. The panel noted that there was no other remedy that was appropriate because this was "a clear case of prosecutorial misconduct" that involved "dishonesty, fraud, deceit, and misrepresentation."[194]

On May 30, 2007, a Duke alum of the class of 1957 ran a full-page ad in several national newspapers, including *USA Today*, that had the following headline: "For a team very few people stood by, how about a standing ovation?"[195]

[194] "The Mills of Justice Grind Slow," *National Review*, July 9, 2007, p. 10.

[195] *USA Today*, May 30, 2007, p. 5A.

Discussion Questions

1. Why do you think a seasoned prosecutor and lawyer like Mr. Nifong was not more forthright with the evidence and findings in the lacrosse case? In referring to Nifong's conduct, a retired Durham police officer said, "It makes me think it's because of the upcoming election."[196] Are there some credo lessons in this conduct?
2. What insights can you offer about prosecutorial responsibility?
3. What insights can you offer for young people and college parties in the wee hours?

Compare & Contrast

What lessons are there for the Duke faculty, president, and university because of what happened here? Professor Lee D. Baker was one of the eighty-eight scholars who have since met to discuss a possible apology or retraction of their ad.

During their discussion the professors concluded two things: (1) they disagreed on whether they regretted their actions as well as the definition of "regret"; and (2) that they had not rushed to judgment in the case, but simply making it clear that the students were facing a sexists and racist campus and country.[197]

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[196] Oren Donnell, "Duke Case Prosecutor's Media Whirl Raises Eyebrows," *USA Today*, May 2, 2006, p. 2A.

[197] Christina Asquith, "Duke Professors Reject Calls to Apologize," *Diverse*, January 17, 2007, http://www.diverseeducation.com/artman/publish/article_6902.shtml. Accessed July 10, 2010.

Ethics and Company Culture

UNIT FOUR

The conscience that is dark with shame for his own deeds or for another's, may well, indeed, feel harshness in your words;

Nevertheless, do not resort to lies, let what you write reveal all you have seen, and let those men who itch scratch where it hurts.

Though when your words are taken in at first they may taste bitter, but once well-digested they will become a vital nutrient.

—Dante, *Paradiso*
Canto XVII, 124–132

What is the right thing to do and that it what we are going to do. Imagine that the pope and the head of the Securities and Exchange Commission are in the same room when you make decisions."[1]

—Jamie Dimon, CEO of J.P. Morgan Chase, following a $6 billion loss on risky trades that resulted in criminal indictments against Chase employees.

At times, individuals who have become part of a larger organization feel that their personal values are in conflict with those of the organization. The types of ethical dilemmas that arise between an individual and his or her company include conflicts of interests and issues of honesty, fairness, and loyalty. Rogue employees do happen, but it is possible that good apples turn rogue (rotten) in a bad barrel. Sometimes employees make poor ethical choices because their personal temptations are too great, and they cross those lines established in personal and individual ethics in Units 1 and 2. Other ethical lapses happen because of company practices. Bonus and incentive plans will get results from employees, but those results may be achieved as a result of crossing a few ethical lines and violating the credo here and there. Then, there are the industry practices. When your entire industry is engaged in subprime lending, are you not hurting your customers if you also do not write subprime loans despite the impact of those loans on the markets and the economy? This unit looks at all three of these sources of pressure that contribute to ethical missteps: personal, company, and industry.

[1] Dan Fitzpatrick, "Dimon, Showing Old Swagger, Ponders Wake of the 'Whale,'" *Wall Street Journal*, June 12–13, 2013, p. C2.

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SECTION A

Temptation at Work for Individual Gain and That Credo

No one wakes up one day and thinks, “You know what would be good? A gigantic fraud! I believe I will create a gigantic fraud and make money that way.” We ease ourselves into fraud. No one wakes up one day and says, “I believe I will go to work and embezzle $100,000.” We begin by using the postage meter or copier for personal reasons and work up to the $100,000, perhaps even taking it in small increments in order to adjust the comfort level experienced with such conduct. One of the tasks we have in studying, understanding, and living ethics in business is drawing lines for ourselves on what we will not do and then honoring the lines we have chosen. If we start moving the lines, we can find ourselves in complete violation of the standards and absolutes we have set for ourselves, and we got there incrementally. The following concise and insightful reading provides pithy insight into this process of moving the line.

Reading 4.1

The Moving Line

George Lefcoe, a renowned USC law professor and expert in real property, zoning, and development and, for a time, a commissioner of the Los Angeles County Regional Planning Commission, offered the following thoughts on his retirement and the seduction of public office:[2]

> I really missed the cards from engineers I never met, the wine and cheese from development companies I never heard of and the honey baked ham from, of all places, Forest Lawn Cemetery, even though the company was never an applicant before the commission when I was there.
>
> My first Christmas as a commissioner—when I received the ham—I tried to return it, though for the record, I did not, since no one at Forest Lawn seemed authorized to accept the ham, apparently not even for burial. My guess is that not one of the many public servants who received the ham had ever tried to return it.
>
> When I received another ham the next Christmas, I gave it to a worthy charity. The next year, some worthy friends were having a party so I gave it to them. The next year I had a party and we enjoyed the ham.
>
> In the fifth year, about the tenth of December, I began wondering, where is my ham?

Discussion Questions

1. What was Professor Lefcoe’s absolute line?
2. How did he cross it? As you review his gradual slippage, be sure to think about your credo and personal lines that Unit 1 encouraged you to develop. Think about this question: How did he go from an absolute standard of accepting

[2] From George Lefcoe, quoted in “Notable, Quotable,” *Wall Street Journal*, December 18, 1998, p. A14.

nothing—indeed, returning the gifts—to expecting the gifts?

3. As you think about Professor Lefcoe, rely on this metaphor. When you buy a new car, think about your initial feelings on food and beverages in the car—perhaps only bottled water at first. Then you move into the brown beverages. Then food enters the new car. Then red punch, sundaes, and ketchup. How did we evolve to a position that is the exact opposite of our original absolute line? In answering this question about the line, consider the following reading.

Reading 4.2

Not All Employees Are Equal When It Comes to Moral Development[3]

The experts in organizational behavior tell us that when it comes to incentive plans not all employees are created equal. That is, their literature says to tailor those incentive plans individually because what motivates one employee may be a ho-hum for another. For example, those who have just entered the work force will probably jump at an extra $10,000 per year even though the promotion and salary bump will require longer hours. More seasoned employees or employees with family demands might respond, "No thanks. I'd rather have the time at home." Some employees want flexibility while others just want the cash. Some employees work for benefits while others just want the benefits of work. Good managers respond with appropriate incentives for these different types of employees.

So it is with employees and their moral development. They are not all created equal. Ethics training may be enough for one type. Ethics training for others may be water off a duck's back. The need to begin a process of evaluating employees for their moral development came to mind in the final days of October 2009. Galleon, [at that time] one of the country's largest hedge funds, was a longstanding beneficiary of inside information from employees, traders, brokers, and others. This inside information was then used to create the legendary and unusually consistent returns for which Galleon was famous. Identified in the Galleon-related indictments is the notorious "Tipper A." The tipper is the one providing the inside information, i.e., stock tips, to the tippees, the outsiders who use the inside information to position themselves for market gains in advance of the information's public disclosure.

Who is Tipper A? Roomy Khan. Yes, right out of a Grisham novel comes a character named Roomy Khan, a former Intel employee who, ironically, was under house arrest for six months in 2002 for passing along proprietary inside information about Intel to those who then profited in the market. Mind you, Roomy Khan does not pass along inside info out of the goodness of her heart or a profound belief in the market's need for asymmetrical information. Roomy Khan had to pay back her gains as part of the 2002 case. One cannot help but wonder: Why would someone who has already experienced legal difficulties return to the same behaviors? More relevantly for ethics and compliance officers, why would a publicly traded company hire someone who has a history of passing along inside information? Most importantly, why would any company that hired Roomy Khan not keep a close watch on her activities? And keeping an eye on any stock trades that seem to occur in advance of public announcements would also be a good idea. Ethics training will not have much effect on our Roomy Khans because there is a different psychology at work in her behavior. Understanding that different employees require different compliance techniques is a concept in its infancy stages of development and application. But there is a framework to consider.

[3] Marianne M. Jennings, "Not All Employees Are Equal When It Comes to Moral Development," *New Perspectives: Journal of the Association of Healthcare Auditors*, March 2010, p. 19.

Years of study and interaction with organizations and their employees have yielded the following categories of employees when it comes to moral development. Herewith is a list with a brief explanation and an example. Understanding the categories helps organizations to decide what can and should be done about our merry moral categories

- Morally clueless. These folks do not seem to be aware of rules. They function in their own world and have little or no sensitivity to the impact of their conduct on others or even the impropriety of that conduct. The character George Costanza in the *Seinfeld* series was a classic example. In one episode, Mr. Costanza was caught in the act of having an affair with a member of the janitorial staff on the desk of a colleague. When caught his response was, "What? Is there something wrong with this? Who knew?"
- Morally superior/moral egotist. The moral egotist believes that the rules are for others who are less gifted. Rules were developed for the plodders, not the stars. During the era of the dot-com boom, we had many morally superior characters. For example, Sanjay Kumar, the former CEO of Computer Associates often explained his creative accounting on his company's results as follows, "Standard accounting rules [are] not the best way to measure [CA's] results because it had changed to a new business model offering its clients more flexibility."[4] Dullards follow rules. Moral egotists soar. At least until they run into the SEC. Mr. Kumar is doing 12 years for securities fraud. Computer Associates became known as the company whose earnings were reported on the basis of a new calendar innovation: the 35-day months. With super-star docs and researchers, we often see the moral egotist syndrome. They cannot be bothered with all the regulation and the concerns about conflicts of interest. Moral egotists believe it is impossible for them to experience a conflict of interest because they can process influences better than others who must follow such rules.
- Inherently moral. Ah, the ethics officer's dream. These are the folks who, if you put them in a room and said, "Don't move from this chair," would not move from the chair, with or without a surveillance camera observing them. They will always do the right thing because they have a strong moral code that they live. Mother Teresa comes to mind. In the secular world there is Ed Begley, Jr. He not only worries about the environment but everything from his house to his mode of transportation demonstrates commitment to his concerns. No hypocrisy among the inherently moral—only commitment to values and a life that reflects those values.
- Amoral technician. This character makes no determinations about right or wrong. The amoral technician does not violate rules. The amoral technician simply finds out what the rules are, what the law is, and then functions within those parameters, right down to the line/wire. They work, and often game, the system with personal feelings and ethics being irrelevant. Andrew Fastow was an amoral technician, brilliant in his use of FASB and accounting loopholes and absolutely unaffected by the impact this loophole approach had on those who had invested in his company.
- Moral schizophrenic. This type of moral development means that the employee has one set of ethics at work and another in personal life, and vice versa, one set of ethics in personal life and another at work. The NBA referee Tim Donaghey who was betting on NBA games even as he called them was known in his personal life for a phenomenal summer basketball camp for children with developmental disabilities and issues. The moral schizophrenic is capable of saying, "Okay, so I threw a few NBA games for gambling. But look what I did with the money!" Donaghey entered a guilty plea and did 15 months.
- Moral procrastinator/postponer. This category of employee is fully aware of ethical issues and the rules and laws but has made a conscious decision to worry about the "ethics stuff' and morality at some time in the future. That time in the future is after they have made enough money. Andrew Carnegie is the classic example. Mr. Carnegie made a fortune as an industrialist, an industrialist with some moments in labor management that saw fatalities. Mr. Carnegie gave his fortune away. If you have been in a public library in the United States you were a beneficiary of his noblesse oblige. But it was an oblige born of postponing ethics until a time when the income was not in jeopardy.
- Moral compartmentalizer or rationalizer. You hear these phrases from the moral compartmentalizer. "Everybody does this." "That's the way we have always done things." "I only do this in certain situations." "I would never allow my kids to do this." This is the Willy Loman syndrome: A man has to sell, sell, sell, no matter what. Ethics apply sometimes, but when you are involved in sales, those lines do have to bend just a bit.
- Morally desensitized. These are the souls who should provide the motivation for working on ethical culture. These employees were once keenly aware of ethical lines and issues but have been beaten down in their objections and have given up raising those concerns. They cope with the cognitive dissonance in their value

[4] Alex Berenson, "Computer Associates Officials Stand By Their Accounting Methods," *New York Times*, May 1, 2001, C1, C7.

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system by no longer being affected by them. Indeed, they may just join in on the unethical festivities. During the Watergate scandal in the Nixon administration, Charles Colson was a classic example of a morally desensitized soul. He was an experienced and respected lawyer, but because no one was making any headway in stopping the cascading consequences of the Watergate burglary, he just joined in with the group and found himself in prison. Until the time of his death, Mr. Colson took the lessons of his experience and used them to help business people. However, he has also founded a program that focuses on teaching inmates about morality and faith.

- Morally detached. Herein is another group that should find us striving to improve organizational culture. The morally detached are still acutely aware of ethical issues but the rules of the sandbox have worn them down so that they simply go along in a depressed manner. They will not join in, but they do stop objecting. These folks are sometimes called the morally disengaged or the morally disillusioned. The former ethics officer and associate counsel at Hewlett-Packard at the time of the board's great pretexting plan (i.e., the company using private investigators to spy on board members) fell into this category. He was worried about the pretexting, asked security about the pretexting, and inquired as to whether they were crossing legal lines. However, he was unable to make any headway because the directive was coming from the very top of the company. He simply distanced himself from the activities. He did not participate, but he also did not leave nor report the conduct.
- Moral chameleon. This frightening character adapts to ethics of those he/she is working with at the time. One's ethics depend. Those ethics can change depending upon which industry you are in and which company has hired you. They adapt as high schoolers do with their cliques. If one group is making fun of the math club and they are in that group, they join in on the math ridicule. For example, in the Marsh McLennan collusion case, one broker was worried about the issue of price fixing. He prefaced his note expressing his concerns with, "I'm not some goody two-shoes…." He wanted his colleagues to know he was one of them even though he was worried about their practices. A recent Ford truck ad was a moral chameleon's dream, if they are part of the pick-up driving group. The ad boasted about the trucks, "Made by the guys we used to cheat off in high school."
- Moral sycophant. Present far too often in organizations, this character adopts the ethics of those who are in charge. They will be whatever kind of sycophant the leaders want them to be. In October 2009, the *New York Times* ran a lengthy story about the former employees in Lehman and their involvement in the largely worthless mortgage instrument markets. "I was just following orders," was the common explanation. One brave broker also added, "I have blood on my hands."[5] But, as all sycophants explain, and ethical issues aside, he too was just following orders.

Discussion Questions

1. Are you able to place yourself in any of these categories? Why? Give the circumstances that led to your response and behavior.
2. Think of the individuals involved in the cases you have studied so far, and develop a chart that categorizes their behavior according to these types of moral development.

[5] Louise Story and Landon Thomas Jr., "Tales From Lehman's Crypt," *New York Times*, September 9, 2009, SB, p. 1.

SECTION B

The Organizational Behavior Factors

Reading 4.3

Why Corporations Can’t Control Chicanery[6]

Saul Gellerman

Recent corporate scandals prove that the lessons of previous scandals have not yet been learned. Management still blames rogue employees, and pundits still blame business schools. Most companies would rather not touch the real cause: pressures that push management to test the boundaries of the permissible. As a result, some executives are inevitably confronted with more temptation to do the wrong thing, and more opportunity to do it, than they can resist. Policies that assume everyone will nobly rise above that combination are unrealistic. The best defense lies in painful structural changes that minimize both the temptation and the opportunity to loot the company and defraud investors. It happens, on average, about every 12 years: Someone who works for a big company gets caught cooking the books. In a smaller company, the same offense might not be newsworthy. But if the company is well-known, the media—whose job, after all, is to sniff out headlines—react swiftly. Swarms of reporters descend on the company, with prosecutors and politicians not far behind. In a matter of hours, another of corporate America’s household names is all over Page One, mired in a messy, potentially damaging scandal.

Management usually defines its predicament as being primarily a problem in public relations, and calls in the damage-control experts. And right there—in diagnosing the problem as a mere crisis in reputation, rather than the inevitable result of the way they do business—the seeds of yet another corporate disaster, due to sprout in about another 12 years, are sown. It will probably strike a different company, but that makes it all the more dangerous, because the next corporate victim will be blind to the lesson not learned by the first one. The next big scandal, in other words, could strike any big company.

Short-Term Effects

Next, top executives, taking their cue from the wily police chief played by Claude Raines in Casablanca, proclaim themselves to be “shocked, shocked!” at the unauthorized misconduct of a few rogue employees—who promptly become ex-employees. Public relations consultants then prescribe massive doses of good works, such as well-publicized sponsorships of socially beneficial programs (prenatal health care? adult literacy?), to associate the company’s name in the public’s mind with doing the right thing—conspicuously. Thanks to the public’s notoriously short memory, the whole unpleasant episode is soon forgotten.

[6] *Business Horizons,* May–June 2001, pp. 17–22.

Today's horrendous scandal inevitably becomes tomorrow's stale news—unless, that is, the prosecutors or the regulators strike pay dirt during the discovery phase of their investigation, and if the company's attorneys can't head them off. That could cause the company to implode, which is what happened to financial giants E. F. Hutton and Drexel Burnham about a dozen years ago. Their current counterparts include the once-mighty Arthur Andersen and WorldCom.

Convictions are, of course, the ultimate PR disaster. Firms do not want to do business with a demonstrably crooked company, if only because their own stockholders would surely question their sanity for even thinking of it. Avoiding corporate destruction is the best reason for companies to rein in the chicanery of their own employees. But as that continuing 12-year cycle indicates, their track record is not very good. There are three reasons for that. First, management is ambivalent about really clamping down on the kinds of mischief that can get a company into serious trouble. Second, when they do try to get a handle on it, they are likely to use ineffective methods. Third, they are likely to shrink from the kinds of drastic structural changes that could halt these abuses altogether.

Managerial Ambivalence

A corporation's executives are caught between avoiding the sanctions of the authorities and the displeasure of the stock market. They are forever in the gray zone between maximizing profits and risking the incursions of inquisitive reporters and ambitious prosecutors. (Rudy Giuliani, be it remembered, made his reputation by sending Michael Milken to jail.)

Executives are also in competition with those of other companies, whose profit performance becomes the standard by which their own is judged. They are thus constantly pushed toward the fuzzy, indistinct line that separates barely acceptable practices from those that are intolerable. It should not be surprising, then, that they send mixed messages to the middle managers who make the company's day-to-day, tactical decisions.

I once attended a management meeting of a company that had to walk a fine line between competitiveness and a looming antitrust injunction. A top executive, addressing an audience of middle managers, pounded the lectern for emphasis as he shouted at the top of his lungs, "We want our competitors to survive!" To which he added, in a clearly audible stage whisper, "barely." He was, I think, expressing the essence of the dilemma in which executives find themselves: to go as far as they dare in a lucrative but dangerous direction without ever quite going too far. You can bet that when the Enron scandal hit the headlines, many a corporation ordered an immediate review of its own accounting practices and put any questionable tactics on hold. How much document-shredding went on in companies that were not (at least not then) the targets of investigation is a fascinating but unanswerable question.

This much is certain: When executives send mixed messages, their subordinates are left to decipher their real meaning. The usual translation is: "If the rewards are not enough to motivate you, we don't need you. Just do whatever you have to do to make your numbers. And remember, anyone stupid enough to get caught will be hung out to dry."

Of course, hardly anyone is foolish enough to say such things for the record. But all that executives really have to do is hint to their subordinates that the race will be won by the most audacious among them, rather than by the most deliberate, and then leave them to draw the necessary inferences. So it should not be surprising when subordinates decide that lifting debts from the balance sheet and stashing them somewhere else, or masking ordinary expenses as long-term investments, is what their bosses really had in mind. Most executives are likely to welcome the results such tactics bring, and do not condemn them until someone outside the company finds out, or until an insider blows the whistle. For all these reasons, executives tend to approach internal reforms with mixed feelings. For many of them—perhaps most—the bottom line is their highest priority, especially if their own compensation is tied to it. That makes them reluctant to give up a tactic that has already worked to their advantage. But from a longer-range perspective, any given quarter's bottom line is a secondary goal. The primary goal, always, is corporate survival. In the long run, you can make a lot more money from a steadily profitable company that is still in business than from a spectacularly profitable company that lost the confidence of its customers and is now deservedly defunct.

Ineffective Methods I: Preaching Ethics

When executives undertake to prevent future scandals, they usually seek to prevent "misunderstandings" of their policy guidance. The most common way of doing this is to provide employees with a written "Code of Ethics," most of which states boldly, but imprecisely, that the highest standards of decency, honesty, and fairness are demanded of everyone at all times, and that deviations from those standards will not be tolerated. The main problem with these codes is that they are seldom referred to after the hoopla with which they are introduced has died down. For all practical purposes, they are forgotten after a few months simply for lack of emphasis.

Recognizing the inadequacy of trying to control behavior by merely distributing documents, many companies have gone one step further by bringing in consultants to provide ethics training. Usually these are academics with credentials in philosophy who have "majored," so to speak, in the study of ethics. Their objective is to arm employees with analytical methods that enable them to discern where a line can be drawn between right and wrong. These consultants illustrate their message with case examples of how easily one can be tempted, or deceived, into taking the wrong turn when making what appears on the surface to be an ordinary business decision. But these courses usually amount to little more than highly sophisticated Sunday School lessons.

There is no question but that an intelligent student will come out of them with an intellectual grasp of ethical principles and how they apply to on-the-job decision making. That such an understanding will beget ethical behavior on the job—especially when the actual challenge occurs long after the course has ended, under heavy pressure for results, in the presence of dangled temptation, and in a culture that stresses winning at all costs-is at best dubious.

Giving the right answer to an ethical problem in a classroom, and applying that same answer in the heat of battle, are two very different things. Unless a way can be found to make what are usually near-instantaneous, gut-level decisions in an atmosphere of classroom-like serenity, under the benign guidance of a professor who has your best interests at heart (as distinct from a demanding boss who will not take "no" for an answer), providing employees with formal training in ethics will be an exercise in futility.

Training does not get at the root of the problem, which is not a lack of ethical intent or ethical wisdom, but rather the circumstances in which most critical managerial decisions are made. Thus, a student may in fact be conversant with such advanced ethical concepts as the Categorical Imperative of Immanuel Kant, or the Utilitarianism of Jeremy Bentham, but will either completely forget them at the moment of decision or discard them as irrelevant when that decision must be made under fire. Knowing full well that what you contemplate doing is wrong is not, alas, an effective deterrent when the rewards of wrongdoing are extravagant, the risks of being found out seem remote, and the consequences of not doing what your superiors seem to want can be devastating to your career.

Ineffective Methods II: Excluding Unethical Employees

Another popular but equally ineffective method used by companies that want to avoid potentially dangerous scandals is to try to prevent unscrupulous people from getting into positions in which they could harm the company. Psychologists are brought in to try to weed out executive candidates who seem overly predisposed to cutting corners or bending rules. The psychologists attempt to peer, as it were, into the innermost psyches of candidates for high-level positions, usually by administering various tests, studying their life histories, and/or interviewing people who have known them well at various stages of their lives.

To authorize such screening requires a great deal more faith in the predictive powers of psychological methods than their record would justify. Many executives are aware of that but reason that in the event of another failure they can always say they did all they could to prevent it. Psychologists operate on the (correct) assumption that some people are more likely than others to simply brush rules aside and let the consequences be damned. If individuals carrying that trait can be screened out before they acquire the power to make fateful decisions, the company will be spared the disastrous consequences of their rashness. (The flip side of that screening is that you also eliminate people of uncommon initiative.) The psychologists survey candidates for jobs in which critical decisions can be made, hoping to ensure that only men and women of probity, wisdom, and self-restraint get to make the really big ones.

In practice, there are two severe problems with this approach, either of which is enough to invalidate it. The first concerns its feasibility: Can executive crooks actually be weeded out before they do irreparable harm? The second concerns the realism of its underlying premise: Is corporate misconduct actually the work of just a few "bad apples"—that is, a handful of incorrigibly unscrupulous executives? When you dig down into the details, the feasibility question turns out to be tougher than it may appear at first. There are not just one but two types of potential offenders whom the psychologists have to detect.

First, there are those for whom self-serving, irresponsible acts are a way of life. Clinically, these people are usually diagnosed as psychopaths. Fortunately for society, they are relatively rare. Fortunately for employers, most of them quickly acquire the kinds of records that human resource departments routinely screen out. But their very scarcity makes hunting for them among the employees of a big company rather like hunting for a few needles in an enormous haystack. There may not be any of them there in the first place; and if there are, their disdain for rules is likely to be blatantly obvious without tests. The second target for the psychologists are people whose morals are not especially rigid and who might not be above doing the wrong thing if they encountered sufficiently permissive conditions. This group is likely to be quite large. The practical problem they present is that excluding them from positions of power would probably make a majority of employees, virtually all of whom are innocent, the targets of discrimination. Many a capable, promising, and heretofore honorable employee would be ruled ineligible for higher-level posts if the absence of a stern, steely character were considered a disqualification. Among the remaining few—those whose characters were deemed "impervious" to temptation (the quotation marks are unavoidable)—it might be difficult to find those who were also sufficiently imaginative and decisive to handle executive responsibilities. The practical result is that management has little choice but to take its chances on executive candidates who might, under the wrong circumstances, present risks of wrongdoing. Then there is the question of whether psychologists can actually make all those distinctions accurately and reliably. The long answer requires at least a semester in a good psychology program, because of the inherent difficulty in trying to demonstrate such things incontrovertibly. The short answer is: Probably not.

The Origins of Unethical Conduct

The sad truth seems to be that when it pays to do the wrong thing, someone will. Singling out that "someone" in advance is, for the reasons just discussed, at best impractical and at worst improbable. Many employees—possibly even most—will resist the temptation, but in a large enough group, someone will give in. And it only takes one aggressive risk-taker, or a few, to ease a company onto the initially lucrative but inevitably slippery slope that leads, all too readily, to its own destruction. Why do they do it? What motivates people who usually have a lot to lose (in most cases, a career that was off to an excellent start) to risk everything on a fast buck? Every corporate scoundrel probably had his own set of motives. But the one common denominator that influenced all of them is that they did it because they could. The opportunity was there, and they seized it. Had there been no opportunity, they would still be what they were before the fatal temptation presented itself: highly regarded, promising employees with a great future and perfectly clean records.

In other words, whether one's behavior is going to be ethical or unethical is, to a large extent, situational. It is not the result of an inadequate understanding of ethics, or of fault lines within one's character, but of being in the wrong place at the wrong time. A wise sociologist once observed, "The main reason there aren't more affairs is that there aren't more opportunities." The same can be said of resorting to creative accounting, of bribing employees to put their own interests above those of clients, even of defrauding widows and orphans. Opportunity, not ignorance or inherent evil, is the culprit. If that thought strikes you as too cynical, answer this question for yourself: Suppose you are out of town, alone, in a city where you know no one and no one knows you. You enter a taxi cab, and as it rushes off toward your destination you notice beside you, on the back seat, the wallet of a previous passenger. It is stuffed with hundred-dollar bills. What will you do? Obviously, there will be some kind of identification in that wallet, so what you should do is contact its owner and arrange to return the wallet and its contents to him. But the question I am asking is not what you should do, but what you *would* do. If you returned the wallet, many would applaud your honesty. Yet many others would call you a fool. (After all, they might note, those would be tax-free dollars.) The only way to get a definitive answer to the question would be to put you in a taxi in a strange city, with no one but yourself in a position to see what actually happened. Absent that ultimate test, all of us have a right to be at least somewhat skeptical about what each of the rest of us would do. And if that is the case, it should not be surprising if circumstances that management deliberately creates, or knowingly tolerates, can lead people with previously unblemished records to reach for those fast bucks. Exalted ideas about human nature have no place in a realistic plan to control employee misconduct. To achieve that goal, you have to start with the following assumptions: that everyone (with no exceptions) is at least potentially dishonest; that temptation and opportunity are the two main contributors to potential dishonesty; and that the best way to keep everyone honest is to eliminate, or at least severely restrict, both of them.

Bad Apples or Bad Barrels?

An old saying has it that a few bad apples, if not removed, can spoil all the other apples in the barrel. That is the principle underlying the attempt to screen out unreliable managers before they rise too high in the hierarchy. But the attempt itself is probably futile. To pursue the analogy, the problem is not with the apples (that is, the individual executives themselves) but rather with the barrel (the system of constraints and licenses in which they operate). John C. Coffee, Jr., a professor at the Columbia Law School, dealt with exactly that problem in analyzing the reasons why auditors at Enron and elsewhere acquiesced in their clients' attempts at "earnings management." During the 1990s, he noted, the costs to auditors of doing that went down, while the benefits went up: The costs declined because in several decisions the Supreme Court made it harder to sue accountants, while Congress passed legislation that, among other things, reduced their maximum liability…. In any profession, but especially for custodians of the public trust, advocacy and objectivity cannot be safely combined. (Coffee 2002)

In other words, the government, not just greedy executives, had a hand in this. Constraints designed to dissuade accountants from colluding with clients to misrepresent their earnings, or at least to present them in an extremely optimistic light, had eroded because of decisions taken by both the judicial and legislative branches. Risks that had been thought foolish under prior rules now seemed worth thinking about. Inevitably, someone experimented with tactics that had previously been discouraged, just to see what would happen. And when nothing happened, others followed suit. Soon, methods that might once have been considered unthinkable became, instead, the norm.

The Need for Structural Change

Bigger fines and stricter enforcement of existing rules are not the answer. That is because so many minds are virtually programmed to seek ways around restrictions on personal freedom—especially when it pays to evade them. Ingenuity always wins out over regulation. Instead, the way to keep all those perfectly clean records as clean as ever lies in structural changes that remove either the incentive to misbehave or the opportunity to do so, or (preferably) both. Of course, such changes come with a price tag attached.

The solutions suggested here are hardly panaceas. They cannot make any of these problems disappear altogether, and they certainly are not painless. But the present sorry situation of American business demands challenges to the kinds of established thinking that got us into this mess. Four areas seem especially ripe for structural change: boards of directors, organization structure, executive pay, and the auditor-client relationship.

Boards of Directors

In theory, boards are the shareholder's (and the public's) last line of defense against managerial chicanery. In practice, they have been overly acquiescent and (in too many cases) insufficiently inquisitive about what is really going on in the companies they allegedly govern. For both reasons, boards have come under fire from critics who see them as too chummy with, and therefore too easily conned by, management….

But another issue regarding board performance, though at least as important as the "inside vs. outside" question, has received less attention: the board's competence to carry out its duties. Some boards appear to have been asleep at the switch while great harm was being done to their companies. Enron's board, for example, got into an unseemly finger-pointing contest with management once the extent of the firm's accounting shenanigans began to emerge. Do boards consist chiefly of semi-informed, easily satisfied figureheads capable of presiding over a company but not actively steering it? I doubt that. But to the extent that there may be any truth at all in that stereotype, it is probably because directors are simply playing the role they have been given to play. Keeping their hands off, leaving the heavy lifting to management, and being satisfied with only a general overview of how the company is achieving its reported results is what is commonly expected of them. Nevertheless, we must ask whether it is indeed possible for anyone to bear the ultimate responsibility for a company's fortunes with such a loose grip on its reins.

Another issue that has not received enough attention is the fact that board members (with the frequent exception of the chairman) serve on only a part-time basis. Outside directors, of whom so much more is now expected than before, usually have full-time jobs elsewhere and necessarily treat their directorships as secondary responsibilities. If boards are to do what they are supposed to do—control their firms, rather than merely preside over them—they will have to become the antithesis of what they have been. And if we are to have active, hands-on, fully informed boards of directors, a majority of them will have to serve full-time. They will also have to be given the authority of a military inspector-general: the right to go anywhere, ask any question of anyone, and apply appropriate sanctions to whoever attempts to conceal information from them. Will management like this? Of course not. Will relationships between such a board and its management become tense and adversarial? Possibly. But are these prices worth paying to put the representatives of the owners actually in charge of their company? That is a question on which reasonable people may differ. For myself, I suggest that fewer scandals, and fewer bear markets prolonged and worsened by shareholder disgust, would make all that discomfort well worth it in the end.

Organization Structure

Organizations with built-in conflicts of interest have tried to enjoy the best of both worlds by erecting so-called "Chinese Walls" (prohibited contacts or discussions) in order to separate employees who could collaborate too easily in ways that could compromise the firm's integrity. The most striking recent example of an unsuccessful attempt to prevent corruption by merely forbidding it was Merrill Lynch.

Investment bankers realized that having securities analysts under the same roof with them could be a huge competitive advantage when seeking corporate underwriting accounts. So the "wall" was breeched by giving analysts a financial stake in obtaining underwriting business, simply by inducing them to add some undeserved luster to their evaluations of the prospective client's company.

Trying to repair the wall by punishing those who have breached it or by increasing the penalties for those who try it in the future are probably futile, simply because the incentive is still there. The problem at Merrill Lynch was not the villainy of a few investment bankers, or the willing collaboration of a few financial analysts, but rather the common corporate roof over both of them. Their ready access to each other made the deception of the company's brokerage clients possible, and perhaps even inevitable. The only way to eliminate both the incentive and the opportunity for this kind of gambit is to spin off one of the two units into a separately owned and managed company. Of course, that would also eliminate opportunities for perfectly legitimate synergy. Like the executive who wanted his competitors to survive (barely), brokerages that are also investment bankers have to walk a fine line between maximizing their profits and risking the loss of their reputation. It would be a hard choice, because in all probability the sum of the profits generated by two totally separated units would be less than those produced by those same units under a single but perpetually endangered corporate ownership.

Executive Pay

Some CEOs and other high-level executives have been grossly overpaid, at the ultimate expense of the companies' shareholders. During the stock market boom of the late 1990s, this attracted little comment because everyone else was prospering too. But when stock prices fell early in the new century, questions arose about whether the earnings of the 1990s that had pumped up those prices were real—and complacency over executive pay quickly changed to outrage…. The real issue is not the pay package itself but the basis on which it is calculated, usually a fiscal year. But as we have learned to our sorrow, earnings often have to be recalculated long after they were first officially announced, and fiscal "skeletons" sometimes don't emerge from wherever they were buried until years afterward. In other words, the problem is not so much in the size of the pay package as in the payment schedule. The only way for the directors of a big company to be reasonably certain that the performance on which an executive's pay is based has been accurately measured is to let enough time pass between its initial calculation and the actual transfer of funds. That means sequestering the incentive component of an executive's pay for several years, and then paying it out gradually over a period of several more years. Boards might even consider attaching strings to those payouts, in the form of mandatory reimbursement, in the event subsequent discoveries make those initial reports questionable. Until those initially reported earnings are no longer uncertain, these executives can live on their salaries (an arrangement that most non-executives would consider neither cruel nor unusual). Will CEOs and other beneficiaries of lucrative pay packages like this? Of course not. But it will give them an incentive to see to it that there are no hidden accounting tricks, errors, or omissions in the reports they pass on to their boards. And if a board has to stiffen its spine to face down a CEO who finds these restrictions too onerous, that is exactly what their shareholders have a right to expect of them.

Auditors and the Audited

The incentive for external auditors to collaborate with a client's attempts to present its financial reports in the most favorable light is to keep the client's auditing business. In the past, there was often an even bigger incentive: to keep the client's consulting business. But even if—as now seems likely—auditing firms have to get out of the consulting business, the temptation for auditors to please the people they are paid to police will still be there.

The problem is not that corporate accountants (or their boss, the chief financial officer) are inherently dishonest. Instead, the problem lies in the structure of their relationship with their auditors. The auditors are hirelings whom the company can dispense with as it pleases and simply replace with other auditors. The effect is that the company is expected to police itself, which places both the temptation and the opportunity to coerce the auditors squarely in the hands of the client's financial staff. It should not be surprising that some people on that staff, realizing how much power they have, decide to exercise it.

The solution is term limits for auditors. They should contract with their clients to prowl through their books for a fixed number of years, with no options for renewal. Since there is no point in trying to hold on to a client you are going to lose anyway, auditors would have no incentive to bend over backwards to please the client. They could then return to the at least quasi-adversarial relationship that their respective roles require of them. All of the changes prescribed here are strong medicine. They won't taste good, and they probably won't go down easily. But boards and management must recognize that the likely alternative is yet another round of scandals, possibly even worse than this one, perhaps a dozen or so years down the road. Sooner or later, the public and its elected representatives will declare that enough is enough and force changes like these (or even tougher ones) down the throats of both guilty and innocent companies. It would be much better for all concerned if companies undertook the necessary reforms by themselves, now, without waiting for that.

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Discussion Questions

1. What relationships would need to be restructured in order to prevent some of the problems with financial reports? How should they be restructured?

2. Why does the author conclude that ethics training is not effective? Would it be dangerous to not have ethics training for employees?
3. How would the author restructure compensation packages?
4. Refer to Case 2.11, and discuss the compensation changes made at Goldman following the market collapse in 2008.

Case 4.4

Swiping Oreos at Work: Is It a Big Deal?

Penny Winters was a 63-year-old maintenance worker at the Portage, Indiana, Walmart store. The surveillance cameras caught Ms. Winters eating Oreos that she had not paid for during her evening shift at the store. When asked why she did it, Ms. Winters explained that she did not have the money to buy the cookies. She earned $11.40 per hour (the usual Walmart pay is $8.87 per hour), but her son had been in a motorcycle accident and was unable to work, thus making her the sole wage earner in her home.

Ms. Winters also confessed that she had been taking Oreos, gum, deli sandwiches, chocolate, and potato chips for more than eight years, with four of the years being at a Walmart in Tucson, Arizona, where Ms. Winters originally lived.[7] She confessed to taking one to two items per week during her shift. She indicated that she began eating Oreos that were open and near cash registers because she assumed that they could not be sold and would just be thrown away. However, when the opened packages were not available, she would simply remove the food from the shelves and then take it into the break room where she would eat it. The result was, because junk food costs add up over eight years, that Ms. Winters was charged with felony theft. She has come to be known as the "Oreo Grandma."

Discussion Questions

1. Explain the gradual drift of Ms. Winters, and discuss her justification for the drift.
2. Some have suggested that Walmart should not prosecute Ms. Winters because of her circumstances. Walmart loses $3 billion per year to employee theft of merchandise. Are there stakeholders involved in this decision?
3. The police report indicates that Ms. Winters has never had any legal charges filed against her. Police could not locate any parking tickets or moving violations in Indiana or Arizona. Explain what happened that would cause Ms. Winters to take the food.

Reading 4.5

The Effects of Compensation Systems: Incentives, Bonuses, Pay, and Ethics[8]

How are the mighty fallen![9] As we watch financial firms and businesses fold in near domino fashion, we find ourselves wondering what we did or could now do differently that has or will serve to distinguish us from the fallen. Dropping international markets and collapsing businesses do wear on the nerves when the casualties continue over months-long periods. But in the dark of this financial storm, there are some very clear and simple perspectives and ideas that could serve us well. Amidst the fog of misdeeds

[7] The information was taken from the Portage Police Department report, found at http://www.thesmokinggun.com/file/oreo-cookie-bust.

[8] Adapted from an article by Marianne M. Jennings in *Corporate Finance Review* 13(4):37–40 (2009).

[9] In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act took effect. It imposes new requirements on compensation committees and pay consultants.

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and missteps, there are concepts of ethical culture and sound governance to be considered and applied. Threats that could cause further collapses continue to abound, and the reality of additional and costly regulation looms, but there is still time for some self-correction. Herewith, a few suggestions related to perception that could help to avert looming heavy-handed regulatory and legislative controls that could impede our progress out of the economic slump.

Suspend Your Compensation Plans, and Revisit Your Incentive and Compensation Formulas and Processes

American International Group (AIG), granted a bailout from the U.S. government, had, as of the end of October 2008, $619 million in bonuses scheduled to be paid to its executives and former CEO. The year 2008 was not a good one for AIG; it was headed into bankruptcy until Treasury Secretary Henry Paulson agreed to provide a capital infusion. The attorney general of New York has extracted an agreement from the company to suspend those payments. The agreement provided that taxpayers had made an involuntary investment in AIG, the company clearly did not, by any measure, perform in a manner that warranted bonuses for its executives, and that there must be different compensation rules when taxpayers are in charge as involuntary stakeholders.

Companies tend to see these compensation packages as contracts between them and their executives and, despite any economic crunch or crash the company experiences, those contracts must be honored. Board members maintain that by paying the compensation packages negotiated, they are simply averting the litigation that would result if the executives' package were suspended. Keeping one's promise is a noble and normative thing to do, but those firms that are beneficiaries of government noblesse oblige should process the contract argument with the following nuances: (1) They have a new set of bosses/board members in the form of taxpayers; (2) if there had been no government support, their firms would not still be standing and, ergo, would be subject to pay recovery limitations of bankruptcy priorities on wages; and (3) there is a great deal of emotional micromanagement of all companies because of increasing job losses (i.e., no income). In short, exceptional times call for exceptions to those contractual bonds and perceived moral obligations on compensation packages.

For those companies not grappling with their new federal investment partners there are still unresolved compensation issues. Government-mandated limitations on executive compensation have been floating about since the Clinton era limitation of tax deductibility of executive compensation over $1 million. The unintended consequences to that good-intentions limitation was the stock option compensation formula, with the resulting abuses there that led to over 200 companies being investigated, the conviction of one CEO, a host of board compensation committee reforms, and new procedures limiting, eliminating, or controlling option grants. The level of executive compensation remains a lightning-rod issue that now experiences heightened attention because of the economic turmoil. The U.S. House of Representatives' Committee on Oversight and Government Reform has issued document requests related to and held hearings on executive compensation.[10]

Companies have two choices on compensation packages: (1) They can opt to self-regulate; or (2) they can wait for new regulation to place limitations that could produce further unintended consequences as they add additional compliance costs. The reforms are already percolating to the surface in the form of shareholder proposals. For the

[10] The hearings were held in December 2007. The full committee report on the hearing can be found at http://oversight.house.gov/documents.

shareholder season in 2007, about 10 percent of the shareholder proposals that required shareholder approval for executive compensation passed. Additional government reform [continues with Dodd-Frank mandating shareholder votes on executive compensation packages. The votes must occur every two years, and while nonbinding, some companies, through shareholder proposals have adopted a binding shareholder approval vote on an annual basis.]

There is one additional issue that has been addressed by about half of the S&P companies. That issue is disclosure of the full relationship between the company and the company's pay consultants. Many of the consulting firms providing companies opinions on the structure and soundness of the companies' executive pay structure are actually retained by those same companies to provide the frameworks for and elements of that pay structure. The House Committee found that 113 of the top Fortune 250 firms had pay consultants[11] that played dual roles for those companies. The average compensation for consulting services for the compensation firms for their work on structuring pay packages was $2.3 million; the average fees for the compensation firms' work on certifying the soundness of the formulas for the compensation and incentives was $220,000. The report also found that two-thirds of the companies with these extensive relationships with their pay consultants did not disclose the extent of those relationships.

In other words, pay consulting firms are doing what audit firms were doing pre-Enron. The same firms who are offering their imprimatur for the soundness of the companies' practices are the ones that designed those practices. Here, however, the disparity between the consulting services and the certification services is more along the lines of 10:1 as opposed to the audit firms, which were about split evenly between consulting and audit fees. We realized post-Enron that it takes a fairly strong-willed firm that designed a company's internal controls to turn around and say that those internal controls are no good. So it is with pay structure design and pay structure soundness. Those functions must now be performed by separate firms. Presently, the compensation conflicts are where the audit conflicts were pre-Enron. The law requires that companies disclose only the identity of the firm that provides the opinion on the soundness of the companies' compensation packages and formulas. The companies need not disclose the extent of their additional consulting relationships with the certifying firm.

If I were in charge at a company, I would work on the following areas of executive compensation:

1. Establish better relationships with shareholder groups that have reform proposals:[12] Disclose the extent of the company's relationships with pay consultants. Questions arise as to whether the companies that do not disclose these consulting arrangements are in compliance with SEC rules on executive compensation consultant disclosures. The SEC rule provides that there must be disclosure of "any role of compensation consultants in determining or recommending the amount or form of executive and director compensation."[13] The SEC has also offered interpretive guidance that requires companies to disclose all consultants that played a role in determining pay.[14] The Conference Board offers the following suggestion:

   > When the compensation committee uses information and services from outside consultants, it must ensure that consultants are independent of management and provide objective, neutral advice to the

[11] In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act took effect. It imposes new requirements on compensation committees and pay consultants.

[12] Two activist groups that received an open forum in Congress were Institute for Policy Studies and United for a Fair Economy. Their research can be found at: Executive Excess 2007. The Staggering Social Cost of U.S. Business Leadership (August 2007). Also see faireconomy.com. Accessed September, 2010.

[13] SEC, Final Rules on Executive Compensation and Related Party Disclosures, Items 402 (b) and 407 (e) of Regulation S-K (August 29, 2006).

[14] SEC, Staff Interpretation: Item 407 of Regulation S-K—Corporate Governance (March 13, 2007).

> committee.... The economics of the consultants' engagement for services is very important as an insight into independence. Any imbalance in fees generated by management versus fees generated on behalf of the committee should receive intense scrutiny;[15]

2. Consider bifurcation of the design and certification functions of pay consultants;
3. Check with compensation consulting firms to see what checks and balances they have implemented internally to guard against potential conflicts and independence;[16] and
4. Consider bold reforms in compensation packages, looking at issues such as upper limitations, pay relationship limitations (limits on pay of executives as compared to employee salaries),[17] kill clauses (events in which no bonuses will be paid), and limits on or elimination of perks (see following).

Plenty of goodwill is out there for companies that undertake bold reforms in the area of executive compensation.

Check Your Perks and Retreats

In October 2008, AIG spent $443,000, including $23,000 for spa treatments, at a California St. Regis resort where top-performers attended a retreat within one week of the government's rescue loan of $85 billion to the mismanaged firm. This conduct is akin to that of the friend who orders steak and lobster just after borrowing rent money from you.

An insurance company clearly needs to reward those agents who sold, sold, sold. But at a time when economic angst is at a peak, surpassed only by the level of anger in the taxpayers, who were picking up the tab, taking a pass on the annual spa extravaganza for the agents might be a good idea.

AIG was in the news in November when it hosted another retreat for independent advisors at a swank Arizona resort. Explanations to the press were that this event was educational; the advisors needed to know about AIG products. When the press attention continued, the company canceled the scheduled appearance of former Steelers player Terry Bradshaw. Some experts noted the costs to the company if the event is canceled and the loss of loyalty and goodwill that are built by such events. However, in these times of corporate resentment, companies cannot speak legalese to those who see extravagance. These times call for heightened sensitivity to public perception of corporate spending that could be eliminated or curbed.

Now is the time for all good managers to come to the aid of their companies by issuing general edicts on perks. Once again, there is goodwill for the taking for companies that voluntarily cut back during this era of angst, cutbacks, job losses, and poor earnings results. The following suggestions would be a way to accomplish these self-restraints with full cooperation of employees who might be affected.

[15] The Conference Board, The Evolving Relationship Between Compensation Committees and Consultants, 6, 15 (January 2006). Also see http://www.conference-board.org/ectf. Accessed September, 2010.

[16] Some of the executive compensation consulting firms have voluntarily implemented internal rotation and independence policies akin to those audit firms use, that is, senior consultants must rotate out from account after five years and/or another senior consultant must review the work of the consultant that works with the company. On the other hand, some of the executive compensation firms have internal documents that reflect the desire of the firm to "cross-sell" companies on a wide variety of services the firms provide. Their goal is more business.

[17] This emotionally charged issue was highlighted in the congressional hearings and its reports, and continues to be a draw in terms of attracting public attention as well as activism. Below is an excerpt from the report:

> Dramatic increases in executive compensation have widened the gulf between CEO pay and the pay of the average worker. In 1980, CEOs in the United States were paid 40 times the average worker. In 2006, the average Fortune 250 CEO was paid over 600 times the average worker. While CEO pay has soared, employees at the bottom of the pay scale have seen their real wages decline. In real terms, the value of the new federal minimum wage, $5.85 per hour, is 13% below its value a decade ago.

- Bring employees into the loop, and ask for their ideas on how to cut costs without cutting jobs.
- Ask for ideas from all areas of the company and all employees. In one company, employees suggested that in lieu of the company holiday party, all employees simply participate in a Saturday community cleanup event that was sponsored by a group that has been a part of one employee's life for nearly twenty years.
- Set the tone by cutting expenses at the top. Private jet travel, auto allowances, and private car services are a few of the executive expenses being voluntarily cut as a way of setting an example for employees.

Culture is symbolic. Companies are in need of cultures that reflect an economy that is struggling. These small steps can provide the credibility businesses need to steer through the regulatory hearings and mazes of proposed controls that have resulted from perceived excess in everything from pay to perks to risk. There are many free marketers and Friedman disciples among us who are able to make the intellectually sound argument that the market will remedy excesses and that pay decisions are best left to the companies with the oversight of shareholders who are free to participate through their votes or vote through their departure from the companies that are not performing but are rewarding managers nonetheless. In theory they are correct. However, economic theory must operate within the reality of human emotion. Human emotion is controlling the markets these days. Perception is everything. Taking control of those negative perceptions, even when logic supplies an explanation, creates goodwill and results in trust. These voluntary actions must be simple and symbolic, along the lines of those provided here. With trust restored, we may be able to find our way out of the teetering economy so susceptible to perceptions of breach.

Discussion Questions

1. Develop a chart that shows the distinctions between prevalent compensation packages and the new approaches suggested. Study the Dodd-Frank Wall Street Reform and Consumer Protection Act for mandates on compensation and the board's role.
2. Refer to Case 2.11, and discuss the changes Goldman has made in its compensation packages and why and what additional changes could help the company.
3. What does the piece discuss about Friedman versus human emotion?

Reading 4.6

A Primer on Accounting Issues and Ethics and Earnings Management[18]

When Arthur Levitt was the chairman of the Securities Exchange Commission (SEC), he gave a speech at New York University (NYU) that became known as the "Numbers Game" speech. He spoke about companies and their efforts to use earnings management, a process in which they use accounting rules and financial manipulations to meet goals or make their earnings seem smooth. Mr. Levitt said, "Too many corporate managers, auditors, and analysts are participants in the game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation…. Managing may be giving way to manipulation; integrity may be losing out to illusion."[19]

Earnings management has been business practice for so long, so often, and by so many that many businesspeople no longer see it as an ethical issue, but an accepted business practice. *Fortune* magazine has even offered a feature piece on the how-to's and the

[18] Adapted from an article by Marianne M. Jennings in *Corporate Finance Review* 3(5):39–41 (March/April 1999). Reprinted from *Corporate Finance Review* by RIA, 395 Hudson Street, New York, NY 10014.

[19] Arthur Levitt, Chairman, Securities and Exchange Commission, "The Numbers Game," speech, NYU Center for Law and Business, New York, September 28, 1998.

importance of doing it. It remains an unassailable proposition, based on the financial research, that a firm's stock price attains a quality of stability through earnings management. However, the financial issues in the decision to manage earnings are but one block in the decision tree. In focusing on that one block, firms are losing sight of the impact such activities have on employees, employees' conduct, and eventually on the company and its shareholders.

Issues on financial reporting and earnings management are at the heart of market transparency and trust. Understanding the issue of earnings management is important as you begin to study the cases involving companies that used this process, perhaps to an extreme. What is earnings management? How is it done? How effective is it? How do accountants and managers perceive it from an ethical perspective?

The Tactics in Earnings Management

Earnings management consists of actions by managers used to increase or decrease current reported earnings so as to create a favorable picture for either short- or long-term economic profitability. Sometimes managers want to make earnings as low as possible so that the next quarter, particularly if they are new managers, the numbers look terrific, and it seems as if it is all due to their new management decisions. Earnings management consists of activities by managers to meet or exceed earnings projections in order to increase the company's stock value.

You can pick up just about any company's annual report and see how important consistent and increasing earnings are. Tenneco's 1994 annual report provides this explanation in the management discussion section: "All of our strategic actions are guided by and measured against this goal of delivering consistently high increases in earnings over the long term." Eli Lilly noted it had thirty-three years of earnings without a break. Bank of America's annual report notes, "Increasing earnings per share was our most important objective for the year."[20]

The methods for managing earnings are varied and limited only by manager creativity within the fluid accounting rules. The common physical techniques that have been around since commerce began are as follows:

- Write down inventory.
- Write up inventory product development for profit target.
- Record supplies or next year's expenses ahead of schedule.
- Delay invoices.
- Sell excess assets.
- Defer expenditures.

However, in his NYU speech, Chairman Levitt noted five more transactional and sophisticated methods for earnings management.

1. Large-charge restructuring
2. Creative acquisition accounting
3. Cookie jar reserves
4. Materiality
5. Revenue recognition

Yet another accounting issue, not noted by Mr. Levitt, percolates throughout the financial collapses and misstatements of companies.

[20] Bank of America's woes, post-2008, with its ill-fated acquisition of Merrill Lynch, have resulted in a new CEO and a struggle for earnings.

6. EBITDA (earnings before interest taxes, depreciation, and amortization) and non-GAAP (GAAP is an acronym for generally accepted accounting principles) financial reporting.[21]

In the following sections, you can find an explanation of each of these accounting issues that present both ethical and legal questions and provide the squishy areas too many companies have used to ultimately mislead investors, creditors, and the markets about their true financial status.

Large-Charge Restructuring

This type of earnings management helps clean up the balance sheet (often referred to as the "big bath"). A company acquiring another company takes large expenses for the acquisition because, during the next quarter, its new and effective management and control, without those added expenses, makes things look so much better. Often referred to as *spring loading*, this technique was part of Tyco's acquisition accounting. The strategy here is to toss in as many expenses as possible in the quarter of the acquisition. Even bills not due and charges not accrued are plowed in, with the idea of showing a real dog of a performer at the time of the acquisition. Management looks positively brilliant by the next quarter, when the expenses are minimal. Indeed, the next quarter, with its low expenses, may afford the opportunity for some cookie jar reserves (see following) to be set aside for future dry periods of revenues or increased expenses.

Creative Acquisition Accounting

This method, also employed by WorldCom and Tyco and other companies that went on buying binges in the 1990s, is an acceleration of expenses as well. The acquisition price is designated as "in-process" research. The tendency for managers is to overstate the restructuring charges and toss the extra charges, over and above actual charges, into reserves, sometimes referred to as the *cookie jar*.[22] For example, a company makes an acquisition and books $2 billion for restructuring charges. Its earnings picture for that year is painted to look quite awful.[23] However, the actual costs of the restructuring are spread out over the time it takes for the company to restructure, which is actually two to three years, and some of the charges booked may not ever be incurred.[24] The charges taken are often called *soft charges* or *anticipated costs*, and can include items such as training, new hires, computer consulting, and so forth. It is possible that those services may be necessary, but it is literally a guess as to whether they will be needed and an even bigger guess as to how much they will cost. However, the hit to earnings has already been taken all at once, with the resulting rosier picture of earnings growth in subsequent years. Also, although not entirely properly so, managers have been known to use these in a future year of not-so-great earnings to create a smoother pattern of earnings and earnings growth for investors.[25] Indeed, the reserves have been used to simply meet previously announced earnings targets.[26] So, taking the example further, if the actual

[21] A seventh issue was the tactic of shipping debt off the books to decrease the leverage ratios. Lehman Brothers did so by shipping off its debt equity just before quarterly earnings and then buying it back at a loss. The appearance of low leverage enabled Lehman to take on more debt, something that eventually resulted in its bankruptcy. See Reading 4.20 for more information on the Lehman tactic.

[22] Geoffrey Colvin, "Scandal Outrage, Part III," *Fortune*, October 28, 2002, p. 56.

[23] "Firms' Stress on 'Operating Earnings' Muddies Efforts to Value Stocks," *Wall Street Journal*, August 21, 2001, pp. A1, A8.

[24] Carol J. Loomis, "Lies, Damned Lies and Managed Earnings: The Crackdown Is Here," *Fortune*, August 2, 1999, pp. 75, 84.

[25] *Id.*, pp. 74, 84.

[26] Louis Uchitelle, "Corporate Profits Are Tasty, but Artificially Flavored," *New York Times*, March 28, 1999, p. BU4.

charges are $1.5 billion, then the company has $500 million in reserves to feed into earnings in order to demonstrate growth in earnings where there may not be actual growth or to create the appearance of a smooth and upward trend.

For example, in an acquisition, there will be costs associated with merging computer systems. When one airline buys another, the two reservations systems must be merged. Some mergers of computer systems have been done with relative ease and little in the way of either labor costs or consulting fees. However, the acquiring airline has taken a charge, anticipating a large cost of this merger. Its numbers look low for the quarter and year of the charge. The next quarter and year, however, look dramatically improved. The acquiring airline gains value because of this performance and likely double-digit growth in earnings. The market responds with increased share value. That increased value is not grounded in real performance; changing markets; or superior skill, foresight, and industry on the part of the airline. Rather, the simple manipulation of the timing on reporting expenses yields results. The hit to earnings in one fell swoop means the financial reports do not reflect the airline's expenses and evolving challenges. The hit to earnings may not be real, and certainly we cannot know whether the anticipated costs and expenses actually occur. Again, future earnings look better, and the door is open again for cookie jar reserves.

Cookie Jar Reserves

This technique uses unrealistic assumptions to estimate sales returns, loan losses, or warranty costs. These losses are stashed away because, as the argument goes, this is an expense that cannot be tied to one specific quarter or year (and there has been much in the way of interpretation as to what types of expenses fit into this category). Companies then allocate these reserves as they deem appropriate for purposes of smoothing out earnings. They dip into the reserves when earnings are good to take the hit and then also use the reserves when earnings are low, to explain away performance issues. The discretionary dip is the key element of the cookie jar. You dip in as needed.

Materiality

Companies avoid recording certain items because, they reason, they are too small to worry about. They are, as the accounting profession calls them, *immaterial.* The problem is that hundreds of immaterial items can and do add up to make material amounts on a single financial statement. Also, these decisions on whether items are material versus immaterial, and to report or not to report certain things, seem to create a psychology in managers that finds them always avoiding reporting bad news or trying to find ways around disclosure. An example comes from Sunbeam, Inc., a maker of home appliances such as electric blankets, the Oster line of blenders, mixers, can openers, and electric skillets. Sunbeam carried a rather large inventory of parts it needed for the repair of these appliances when they came back while under warranty. Sunbeam used a warehouse owned by EPI Printers to store the parts, which were then shipped out as needed. Sunbeam proposed selling the parts to EPI for $11 million and then booking an $8 million profit. However, EPI was not game for the transaction because its appraisal of the parts came in at only $2 million. To overcome the EPI objection, Sunbeam let EPI enter into an agreement to agree at the end of 1997. The "agreement to agree" would have EPI buy the parts for $11 million, which Sunbeam would then book as a sale with the resulting profit. However, the agreement to agree allowed EPI to back out of the deal in January 1998. The deal was booked, the revenue recognized, Sunbeam's share price went up, and all was well. And all without EPI ever spending a dime.

Arthur Andersen served as the outside auditor for Sunbeam during this time, and its managing partner, Phillip E. Harlow, did raise some questions about the EPI deal and didn't particularly care for the Sunbeam executives' responses. Mr. Harlow asked the executives to restate earnings reflecting changes he deemed necessary. Management refused, but Mr. Harlow and Arthur Andersen certified the Sunbeam financials anyway.

Mr. Harlow reasoned that he did not see the change as "material," something that Sunbeam executives were required to restate prior to his certification. For example, under accounting rules, the "agreement to agree" with EPI, although nothing more than a sham transaction, was not "material" with regard to its amount in relation to Sunbeam's level of income. However, Mr. Harlow had defined *materiality* only in the sense of percentage of income. Although the amount was immaterial, the transaction itself spoke volumes about management integrity as well as the struggle within Sunbeam to meet earnings projections. Both of those pieces of information are material to investors and creditors. The nondisclosure of the sham transaction meant that the true financial, strategic, and ethical situation in Sunbeam was not revealed through the financial statements intended to give a full and accurate picture of where a company stands.

Further, if one added together the total number of items that were deemed immaterial individually in the Sunbeam situation, the amount of those items (items that the SEC eventually challenged as improper accounting) totaled 16 percent of Sunbeam's profits for 1997.

There is no question that Sunbeam, Mr. Harlow, and Andersen were correct in their handling on the Sunbeam issues, if we measure from a strict application of accounting rules. As the certification reads, Sunbeam's financial statements "present fairly, in all material respects, the financial position of, in conformity with generally accepted accounting principles."

In fact, Mr. Harlow hired PricewaterhouseCoopers to go over Sunbeam's books and his (Harlow's) judgment calls, and those auditors from another firm agreed independently that Mr. Harlow certified "materially accurate financial statements."[27] However, the real issues in materiality are not the technical application of accounting rules. Rather, the issues surround the question of intent in using the materiality trump card.

The amounts involved in many of the noted Sunbeam improprieties were not "material" in a percentage-of-income sense. The problem is that an individual auditor's definition of *materiality* is the cornerstone of a certified audit. All an auditor does is certify that the financial statements "conform with generally accepted accounting principles."

There is no definition of *materiality* for the accounting profession. Research shows that most auditors use a rule of thumb of 5 to 10 percent as a threshold level of disclosure, such as 5 percent of net income or 10 percent of assets or vice versa.[28] They may also use a fixed dollar amount or an index of time and trouble in relation to the amount in question.[29]

However, it is clear just from the amount of regulatory action, shareholder litigation, and judicial definitions that the standard for materiality employed by auditors is not the same as the standard other groups would use in deciding which information should be disclosed. Called the *expectations gap*, this phenomenon means that auditor certification and executive disclosure are at odds from the expectations of investors and creditors.

[27] Andersen has settled the suit brought against it by shareholders for $110 million. Floyd Norris, "S.E.C. Accuses Former Sunbeam Official of Fraud," *New York Times*, May 16, 2001, pp. A1, C2.

[28] Marianne M. Jennings, Philip M. Reckers, and Daniel C. Kneer, "A Source of Insecurity: A Discussion and an Empirical Examination of Standards of Disclosure and Levels of Materiality in Financial Statements," 10 *J. Corp. L.* 639 (1985).

[29] Jeffries, "Materiality as Defined by the Courts," 51 *CPA J.* 13 (1981).

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They expect more disclosure even as the technical application of accounting rules allows for less disclosure.

As a company establishes its ethical standards for materiality and disclosure, it should adopt the following questions as a framework for resolution:

- What historically has happened in cases in which these types of items are not disclosed? In our company? In other companies?
- What are the financial implications if this item is not disclosed now?
- What are our motivations for not disclosing this item?[30]
- What are our motivations for booking this item in this way?
- What are our motivations for not booking this item?
- How do we expect this issue to be resolved?
- Are our expectations consistent with the actions we are taking vis-à-vis disclosure?
- If I were a shareholder on the outside, would this be the kind of information I would want to know?

Revenue Recognition

These are the operational tools of earnings management, noted earlier in this discussion. Some examples include *channel stuffing,* or shipping inventory before orders are placed. Sales are recognized as final and booked as revenue before delivery or final acceptance, sometimes without the buyer even knowing. The financial reporting issues at Krispy Kreme Doughnuts resulted from this ploy of reflecting sales of franchise items to franchises without those franchises actually having ordered those items.

More recently, Hewlett-Packard hit an embarrassing snag after it paid $11.1 billion for the software firm Autonomy. Shortly after the acquisition, the accounting and earnings spool of Autonomy began to unwind. Autonomy pushed the envelope on earnings reports and booking revenue, even under the more liberal British standards. For example, Autonomy made a $9 million software sale to VMS Information but agreed to buy $13 million in licenses for data from VMS as part of the deal. The $9 million was booked as revenue, but the $13 million was booked as a marketing expense, making the deal look like a lucrative sale.[31] A more diabolical HP discovery is that Autonomy used the old Global Crossing "round trip" accounting trick in which buyer and seller buy and sell something from each other at an inflated price. Sales numbers look great, but no cash or other form of payment actually ever takes place.

The other tools related to revenue recognition can be broken down into categories. Operations earnings management would involve delaying or accelerating research and development expenses (R&D), maintenance costs, or the booking of sales (channel stuffing). Finance earnings management is the early retirement of debt. Investment earnings management consists of sales of securities or fixed assets. Accountings earnings management could include the selection of accounting methods (straight-line vs. accelerated depreciation), inventory valuation (last in, first out [LIFO], or first in, first out [FIFO]), and the use of reserves (the cookie jar).

EBITDA and Non-GAAP Financial Reporting

Earnings management does hit those roadblocks of the application of accounting rules and their interpretation. So, rather than risk the wrath of the SEC and the litigation of shareholders and creditors, managers began using a different sort of financial statement.

[30] In thinking about this question, the words of outgoing SEC Chairman Arthur Levitt are instructive: "In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called nonevents simply don't matter." *Id.*

[31] Ironically, VMS declared bankruptcy owing over $6 million to Autonomy. Ben Worthen, Paul Sonne, and Justice Scheck, "Long Before H-P Deal, Autonomy's Red Flags," *Wall Street Journal*, November 27, 2012, p. A1.

Sanjay Kumar, the former CEO of Computer Associates, once said that "standard accounting rules [are] not the best way to measure Computer Associate's results because it had changed to a new business model offering its clients more flexibility."[32]

The "pro forma" financial statement, with all the assumptions and favorable earnings management techniques, was born. Also known as *non-GAAP measures*, this is accounting that does not comply with "Generally Accepted Accounting Principles," the rules established by the American Institute of Certified Public Accountants (AICPA), developed through its work with the SEC, scholars, and practitioners as they debate that elusive question of "Are these financials fair?"

Non-GAAP measures of financial performance can be enormously helpful and insightful in assessing the true financial condition and performance of a company. However, non-GAAP measures can also be used in a way that obfuscates or even conceals the true financial condition and performance of a company.

The Types of Non-GAAP Measurements and Their Use

EBIT (earnings before interest and taxes) and EBITDA (earnings before interest taxes, depreciation, and amortization) are not as much accounting tools as financial analysis tools. They were developed because of concerns on the part of those who evaluated financial performance and worth that the rigidity of GAAP necessarily resulted in the omission of information that was relevant for determining the true value of a company and the richness of its earnings. EBIT and EBITDA were means of factoring out the oranges so that the apples of real earnings growth in a company could be determined.

Although the dot-coms and other firms of the new economy are often viewed as those that popularized EBITDA as the measure of valuation for companies, its origins actually go back to the time of Michael Milken and the junk bond era of the 1980s. The takeovers of the Milken era, with their characteristics of very little cash, were actually accomplished through the magic of the EBITDA measurement. If an acquirer could reflect an EBITDA of just $100 million per year, that amount was sufficient to attract investors for purposes of acquisition of up to a $1 billion company. Milken, in effect, leveraged EBITDA numbers to structure takeovers.[33] However, the EBITDA figures that Milken used did not include the long-term capital expenditures and principal repayments that were, in effect, assumed to be postponed and postponable, thus allowing a portrayal of a company that could see itself through to a state of profitability. Factoring out expenses such as the cost of equipment replacement meant that earnings growth was reflected at a substantially higher rate. Investors were thus lulled into a sense of exponential earnings growth at the acquired company, not realizing the balloon type of investment that would be required when equipment replacement became inevitable.

EBITDA, for some companies, is perhaps the only forthright way to actually reflect the value of a company. A company dependent on equipment, with its resulting replacement costs, has its earnings growth and value distorted through the use of EBITDA because investors should have the cost of replacement reflected in the numbers. Depreciation is the means whereby that cost is reflected in GAAP measurements. If an equipment-heavy company, such as a manufacturer, has the same EBITDA as a service company, with only minimal equipment investment because of its focus on human resources, then EBITDA is a misleading measure. For example, Sunbeam, the small appliance manufacturer, clearly a company in which replacement of manufacturing equipment is a significant cost, was a proponent and user of EBITDA. Firms in different

[32] Alex Berenson, "Computer Associates Officials Stand by Their Accounting Methods," *New York Times*, May 1, 2001, p. C1, C7.

[33] Herb Greenberg, "Alphabet Dupe: Why EBITDA Falls Short," *Fortune*, July 10, 2000, p. 240.

industries cannot be compared accurately using only EBITDA numbers because the nature of their business attaches significance to those numbers. GAAP measures that include depreciation provide a better means for cross-comparison, with the financial statement user able to note the depreciation component and make independent judgments about the quality of earnings.

The use of these non-GAAP measures in creating pro forma numbers is also particularly useful to investors and analysts when a company changes an accounting practice. For example, when a company switches its inventory evaluation method from LIFO to FIFO, the ability to present to financial statement users the contrast between what the company's performance would have been under the previous accounting practices versus the new methods shows users the real performance versus performance that includes the new methodology.

The original intent in pro forma numbers was a desire on the part of the accounting profession to offer more information and a better view of the financial health of a company. That intent was particularly justified in those cases in which a company has undergone a change in accounting practice that affects income in perhaps a substantial way but would actually have little impact if prior treatments had continued. The booking of options as an expense is an example. The change in the rule is important, but investors and users of financial statements will want to know what income would have looked like under the old methodology so that they are better able to track trends in real performance. However, these original good intentions in the use of pro forma reports changed. Pro forma became the accepted metric, with the pro forma results often manipulated with the idea of meeting earnings expectations, or the practice of earnings management.

Warren Buffett described resorting to non-GAAP methods as a means of "manufacturing desired 'earnings.'"[34] However, among academicians and analysts there was substantial disagreement about whether EBITDA and other non-GAAP measures were meaningful forms of valuation.[35] In 2000, prior to the dot-com bubble bursting, Moody's analyst Pamela Stump created a furor by releasing her twenty-four-page examination of EBITDA in which she concluded that its use was excessive and that it was no substitute for full and complete financial analysis.[36] Former SEC Chief Accountant Lynn Turner was more harsh in his assessment of the pervasive use of EBITDA, calling such usage a means of lulling the "investing public into a trance with imaginary numbers, just as if they had gone to the movies. Little did they know that the theater was burning the entire time."[37] An example of EBITDA in action can be found in the WorldCom case (see Case 4.15).

As early as 1973, the SEC had issued its cautionary advice on the use of pro forma financial statements.[38] Nonetheless, the use of non-GAAP measures continued and expanded, and the accounting profession offered its imprimatur and certification for pro forma releases. By 2001, 57 percent of publicly traded companies used pro forma numbers along with GAAP numbers in their financial reports, whereas 43 percent used only GAAP numbers.[39] For the years 1997 to 1999, Adelphia, the company that

[34] Uchitelle, "Corporate Profits Are Tasty, but Artificially Flavored," p. BU4.

[35] *Id.* In his 2000 annual report to shareholders, Mr. Buffett wrote, "References to EBITDA make us shudder." Elizabeth McDonald, "The EBITDA Folly," *Forbes*, March 17, 2003, http://www.forbes.com.

[36] Greenberg, "Alphabet Dupe," 240.

[37] MacDonald, "The EBITDA Folly," *supra* note 393 at p. 3.

[38] Securities and Exchange Commission, Accounting Series Release No. 142, Release No. 33-5337, March 15 (Washington, DC: Securities and Exchange Commission, 1973); and Securities and Exchange Commission, Cautionary Advice regarding the Use of "Pro Forma" Financial Information, Release No. 33-8039 (Washington, DC: Securities and Exchange Commission, n.d.).

[39] Thomas J. Phillips Jr., Michael S. Luehlfing, and Cynthia Waller Vallario, "Hazy Reporting," *Journal of Accountancy* (August 2002), http://www.aicpa.org/pubs/jofa/aug2002/phillips (original publication URL).

collapsed in 2002 and has had two of its officers convicted and sentenced, included on the cover of its annual report charts that reflected its EBITDA growth. Geoffrey Colvin of *Fortune* has said that EBITDA stands for "Earnings Because I Tricked the Dumb Auditor."

Following the passage of Sarbanes-Oxley, the SEC defined both EBIT and EBITDA as non-GAAP measures of financial performance.[40] Although both can be offered in financial reports, the SEC requires a joint appearance of the two measures of financial performance.[41] The critical portion of those new rules is that the non-GAAP measures must be accompanied by GAAP measures.[42] These new regulations and appropriate uses of non-GAAP measures are so complex that the SEC has been forced to post responses to the thirty-three most frequently asked questions (FAQs) it has received on non-GAAP financial measures.[43]

Some of those FAQs have produced the following clear rule interpretations from the SEC:

- Companies should never use a non-GAAP financial measure in an attempt to smooth earnings.
- All public disclosures are covered by Regulation G (the rule that requires the presentation of GAAP and non-GAAP measures together).
- The fact that analysts find the non-GAAP measures useful is not sufficient justification for their presentation.

Non-GAAP measures make sense in certain circumstances, when their use is, in fact, necessary to provide the financial statement user with a full and fair picture of the company's financial health.

A Follow-Up to Levitt: Ethical Issues in Financial Reporting, Earnings Management, and Accounting

How Effective Is Earnings Management?

Earnings management is effective in increasing shareholder value. A consistent pattern of earnings increases results in higher price-to-earnings ratios. That ratio is larger the longer the series of consistent earnings. Firms that break patterns of consistent earnings experience an average 14 percent decline in stock returns for the year in which the earnings pattern is broken. However, the discovery of earnings manipulation at a company results in a stock price drop of 9 percent. In short, there appears to be a net upside for engaging in earnings management.

In addition to the shareholder value argument, there are other drivers that make earnings management such a treacherous area for managers and employees. Executive and even employee compensation contracts may provide dramatic incentives for managing

[40] 15 C.F.R. § 244.1101(a)(1). The rule provides, "A non-GAAP financial measure is a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that: (i) excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer or (ii) Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented." Non-GAAP measures do not include ratios.

[41] SEC Release No. 34-47226, "Conditions for Use of Non-GAAP Financial Measures," 17 C.F.R. §§ 228, 229, 244, and 259 (Washington, DC: Securities and Exchange Commission, n.d.).

[42] Running parallel to the SEC changes is a project by the Financial Accounting Standards Board (FASB) called *Financial Reporting by Business Enterprises*. The purpose of the project is to focus on how key performance measures are presented and the calculation of those measures. The project will also address the general issues of whether current accounting standards and their rigidity prevent the release of full and accurate portrayals of the financial health of a company.

[43] The FAQs on non-GAAP measures can be found at the Securities and Exchange Commission website, http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.

earnings. Bausch & Lomb, Sears, and Cendant are all examples of companies whose managers manipulated earnings because of incentive systems and goals that brought the managers personal benefits. Incentives for earnings management can also come from sources other than compensation incentives for executives. Covenants in debt contracts, pending proxy contests, pending union negotiations, pending external financing proposals, and pending matters in political or regulatory processes can all be motivational factors for earnings management. Many managers use earnings management as a strategic tool to have an impact on pending matters.

The Ethics of Earnings Management

The question that fails to arise in the context of management decisions on managing earnings is whether the practices are ethical. Managers and accountants comply with the technical rules, but technical compliance may not result in financial statements that are a full and fair picture of how the company is doing financially. In a system dependent upon reliable (known as *transparent*) financial information, the practice of earnings management conceals relevant information. Research shows that firms that engage in earnings management are more likely to have boards with no independence and eventually higher costs of capital.

The new approach to accounting rules and earnings management focuses on the ethical notion of balance: If you were the investor instead of the manager, what information about earnings management would you want disclosed? If you were on the outside looking in, how would you feel about the decision to book extra expenses this year in order to even out earnings in a year not so stellar? In short, when all the complications of LIFO, FIFO, EBITDA, and spring loading are discussed, we are left with the simple notions of ethical analysis provided in Unit 1, from the categorical imperative to the Blanchard-Peale and Nash questions of "How would I feel if I were on the other side?" When involved in complex situations, reducing the complexities to their simplest terms gives you the common denominator of those basic tests and analysis methods for all ethical issues.

For example, in evaluating the use of non-GAAP measures, the following questions prove helpful: Why is this measure important for the company? Why do we choose to rely on it? What insight does this measure give that is not afforded by traditional GAAP methods? Does this method of reporting mislead users of financial statements? How reliable is this measure? Is it based on models, or is it simply theory?

In addition to the examination of intent these questions require, those who prepare and audit financial statements should also consider the amount of discussion and analysis that is necessary in order for them to offer a fair explanation on their decisions to use alternative reporting metrics.

An example provides a look at the wide-swath interpretations that these alternative metrics can cut as financial reports are prepared. A company has the following financials:

- Operating revenues: $1 million
- Nonrecurring, nonoperating gain: $300,000
- Nonrecurring, nonoperating loss: $800,000
- Operating expenses of $600,000

The questions are as follows: What are the company's earnings? What earnings number should be released to the press? The GAAP answer is that the company has experienced a $100,000 loss. The EBITDA answer is that the company has $400,000 profit because $400,000 does indeed reflect the operating profit. However, some EBITDA proponents would conclude that there was $700,000 in profit because they would eliminate the nonrecurring loss but recognize the nonrecurring gain. WorldCom (see Case 4.15, for example, using its strategy discussed earlier, would have reclassified the operating expenses (inappropriate under GAAP) as nonrecurring and would have boosted its non-GAAP pro forma even beyond the $700,000.[44]

The ultimate ethical question in all financial reporting and accounting practices is "Do these numbers provide fair insight into the true financial health and performance of the company?" Further, the example given illustrates that numbers alone, even if concluded to be fair, may not be sufficient because only MD&A can provide a full and complete picture of what the non-GAAP measures mean, why they were used, and how they should be interpreted. The juxtaposition of GAAP and non-GAAP measures, now mandated by law, has also been a critical component to the effective use of both sets of numbers. The presentation of both provides checks and balances for the excesses in financial reporting during the 1990s as the non-GAAP measures became the standard for financial reports.

Discussion Questions

1. Describe the risks in earnings management.
2. What are the motivations for moving around expenses and revenues in quarters and years?
3. Don't shareholders benefit by earnings management? Who is really harmed by earnings management?
4. Put earnings management into one of the ethical categories you have learned.
5. Make up a headline description of earnings management.
6. How do you respond to a CFO who says, "Everybody does earnings management. If I don't do it, I am at a disadvantage."

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Case 4.7

Law School Application Consultants

There was a time when undergraduate students paid for preparation courses for the LSAT. That practice evolved to hiring a one-on-one tutor to coach them on the LSAT. Law schools had no difficulty with students seeking help for exam preparation. However, admissions committees are balking at the use of admissions consultants. Law school admission consultants earn up to $300 per hour helping undergraduate students put together their applications for admission. The consultants work on everything from making an arrest seem palatable, and even sometimes noble, to sprucing up that personal essay. Admissions

[44] Modified from an example given in Phillips, Luehlfing, and Vallario, "Hazy Reporting."

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officers from law school say that they are seeing the same essays being submitted, just under different names and to different undergraduate institutions. The personal essay that is a cookie cutter essay means the application goes into the rejection pile.

However, some consultants say that they merely work with the applicants to "encourage self-examination" so that they can write a better essay.[45] Some law school faculty members say that the consultants have created a cottage industry for "angst-ridden" students. Colleges and universities say that the consulting industry arose because there just are not enough advisers to help students with graduate school applications.

One consultant explains his company's services this way: You can hire a trainer to help you work out, but it does no good to have the trainer work out for you. You need to do the application and writing—the goal of the consultant is advice and coaching.

Discussion Questions

1. Some students pay $800 to consultants for their applications. What happens to those students who simply cannot afford consultants?
2. Is this really deception or is it simply, like earnings management, a way of presenting a better picture for those who evaluate your ability and performance to date?
3. Was there a gradual evolution to the consultant? Are there lines to be drawn in using a consultant? Is it different if your parents, an academic adviser at your school, or a friend helps you with your essay?
4. Are the consultants taking advantage of students who are nervous about their futures?

Case 4.8

The Daiquiri Concession and Ferragamo Shoes and the County Supervisors

Government officials are not immune from temptation. County supervisors, mayors, commissioners and their staffs from Georgia to Nevada and back to Alabama have had difficulties resisting gifts.

The Clark County, Nevada, Commissioner with an Entrepreneurial Bent

Yvonne Atkinson Gates, once the chairperson of the Clark County, Nevada, Commission, an elected office, also operated her own daiquiri business. Many of the new and expanding hotels in Clark County, where Las Vegas is located, have retail space available for shops and restaurants. Ms. Atkinson Gates, as a commissioner, made decisions on whether proposed hotels and expansions would be approved.

Ms. Atkinson Gates approached executives from five casinos about leasing space for her daiquiri franchises. Ms. Atkinson Gates acknowledged the contacts but stated that they "were made in passing and cannot be considered solicitations."[46] She acknowledged actually seeking an arrangement with MGM Grand Resorts.

Sheldon Adelson, the then-chairperson of Las Vegas Sands, Inc., said, "I was shocked, absolutely shocked that Yvonne would come to me directly. I felt she was pressuring me to agree. And when I didn't, I think she went out of her way to vote against my project."[47] Adelson wanted to build a Sands Venetian Mall, but his proposal was not approved by the commission.

[45] Leigh Jones, "Students Seek Edge in Law School Quest," *National Law Journal*, May 22, 2006, p. A1.

[46] Susan Green, "Official Defines Role in Venture," *Las Vegas Review Journal*, October 4, 1997, pp. 1A, 2A.

[47] Susan Green, "Official Sought Casino Leases," *Las Vegas Review Journal*, October 3, 1997, pp. 1A, 2A.

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Upon its investigation of the matter, the Nevada State Ethics Commission found that Ms. Atkinson Gates had violated Nevada's rules of ethics for elected officials in her conduct with businesspeople regarding her daiquiri business. The Ethics Commission ruled by a five-to-one vote that she had used her position to obtain business concessions. She resigned as a Clark County Commissioner in early 2007; she did not complete her term that was slated to run until 2009. Despite the ethics reprimand, she had served as a commissioner for fourteen years. She was a superdelegate to the 2008 Democratic National Convention.

Jefferson County, Birmingham, Alabama: The Sewer Project, and the Clothing and Ferragamo Shoes

Jefferson County, where Birmingham is located, needed a new sewer system. However, the government needed to raise the money for the repairs and reconstruction through bond offerings. Many a Wall Street firm was interested in putting together the bond deals for the sewer, and they came to Birmingham courting the mayor and various commissioners. For example, the mayor was rewarded with Mary Miller Buckelew, a county commissioner who was sentenced to three years probation following her guilty plea to charges of corruption, conspiracy, and bribery in connection with the bonds and the sewer project. On one trip to New York, paid for by a bond firm courting the project, she picked out a Salvatore Ferragamo bag and shoes, worth $1,500, which the bond firm paid for, along with a $1,400 spa treatment on the same trip. Birmingham Mayor Larry Langford was charged with 101 counts of bribery, fraud, money laundering, and conspiracy and was convicted of 60 counts and sentenced to fifteen years in prison. At his trial, sales clerks from Salvatore Ferragamo, Rolex, and Ermenegildo Zegna testified that Mr. Langford obtained suits, watches, and other clothes that were paid for with a credit card by the manager of one of the bond firms that helped to do the bond offerings for the sewer system.

At the sentencing of the mayor and Ms. Buckelew, an FBI agent explained, "Politicians should hear the message loud and clear. There is no acceptable level of corruption and there is no place for corruption in our political system."[48]

The original cost estimates for the sewer system were $250 million. By the time all the bond issues were done, the cost had ballooned to $3 billion. By 2011, the city of Birmingham declared bankruptcy because it was no longer able to meet its bond repayment schedule.

Discussion Questions

1. Is there a common thread in the two situations of personal gain? What is different about the Gates scenario and those of the Birmingham officials?
2. Why are the trappings of success so important to some people and not others?
3. How do you think the gifts from bond firms to elected officials began?
4. What is the impact of corruption and bribery on governments and citizens?

[48] "Former Jefferson County Commissioner Sentenced for Obstruction of Justice," FBI Press Release, November 12, 2009, http://www.fbi.gov/birmingham/press-releases/2009/bh111209.htm.

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SECTION C

The Psychological and Behavior Factors

Sometimes individuals make poor ethical choices, for example, when a public official accepts a bribe. However, sometimes the organization enables and drives individuals to make certain decisions. For example, if an employee of a hedge fund is rewarded because he brings in inside information, he will keep seeking inside information despite the fact that it is illegal. This section of the unit covers the layers of ethical issues—sometimes individuals make decisions not because of misguided personal ethical compasses, but because of signals, rewards, and perhaps fear, given by the organization.

Reading 4.9

The Layers of Ethical Issues: Individual, Organization, Industry, and Society[49]

A recurring theme has emerged over the past few years in classroom discussions and management training about cases that involve subprime lending, CDOs, hedge funds, and the exotic instruments that have not always served companies or markets well. This question inevitably comes out: "What happens if everyone is doing something that you don't do that ends up costing you in terms of performance?" After thirty-seven years of teaching ethics, I had a surprising epiphany. All ethical issues are not created equal when it comes to root cause. When studying causation factors for ethical lapses, four levels of ethical issues emerge. Because the root causes for these levels differ, tools for prevention must also be different. The levels of lapses as well as the prevention tools are depicted in Figure 4.1, followed by discussion and examples.

The Individual Ethical Lapses

Individual ethical lapses are those that occupy the bulk of ethics and compliance folks' time. Some examples include inflated travel expenses, computer use for personal or inappropriate activities, use of company resources for personal reasons (remodeling your home with company materials or personnel), sexual harassment, falsification of reports or documents (signing off on your annual ethics training when you did not complete it), misrepresenting information to customers, shareholders, and/or creditors, letting someone else take the blame for a mistake you made at work, appropriation of trade secrets from a former employer or competitor, violation of company rules such as working while impaired, and embezzlement. All of these activities can harm the company in terms of negative publicity, regulatory relationships, litigation, and loss of customers. However, these company harms spring from individual choices.

Some examples that received the resulting negative publicity include the resignation/termination of former Hewlett-Packard CEO, Mark Hurd. Public reports and company

[49] Adapted from Marianne M. Jennings, "Grappling with the Four Levels of Ethical Issues," *Corporate Finance Review*, 15(3):36–44 (2010).

statements indicate that Mr. Hurd had an "inappropriate relationship" with a marketing vendor and misled the company on his expense reimbursement requests in order to conceal the extent of the relationship.[50] Regardless of whom one believes and who found what and when, there is an issue of poor judgment. Poor judgment is, however, an individual decision in this case because the company had very clear rules that governed these types of behaviors. The HP code prohibited any actions by employees that would reflect negatively on the company and also was clear on the submission of inaccurate information on reimbursement requests.

The defining characteristic of individual ethical lapses is that the individual makes the choice. There are no externalities that serve to cloud the individual's decision processes. Company and industry practices and pressures are not afoot at this level as the employees made their decisions. Because of this defining characteristic of individual action, the prevention tools deal with targeting the individual.

Prevention Tool One for Individual Ethical Lapses: Screening

Screening is one tool for preventing individual missteps. Neither proven nor perfect, this tool employs various psychological and security exams to detect individual tendencies to engage in behavior such as taking things that don't belong to you. Retailers have the most well developed screens for their potential employees. However, there are some other more casual methods that other organizations can use in the interview process to offer insights into the ethical character of the applicant. One question that has proven effective in screening is asking applicants to describe an ethical dilemma that they have faced personally or professionally and how they handled the dilemma. If an applicant cannot describe an ethical dilemma, the employer has obtained some great insight. Sometimes applicants provide examples that are not really ethical dilemmas such as HR types of issues on performance reviews and employee feedback. They feel a situation was not handled correctly and they are perhaps correct in their assessment. However, those organizational behavior issues are not a matter of ethics but manners.

Prevention Tool Two for Individual Ethical Lapses: Internal Controls and Audits

As forensic auditors teach us, embezzlement has its origins in opportunity and need. The need is difficult to prevent but the opportunity can be limited. SOX Section 404 has resulted in the continual re-evaluation of the adequacy of internal controls. There is some value in what is often viewed as an added expense. Each time one of our so-called "rogue traders" such as Nick Leeson at Barings Bank, Joseph Jett at Kidder Peabody, or Jérôme Kerviel at Société Générale engage in risky trading practices that destroy or quite nearly bankrupt a company we do learn something new about internal controls or the importance of staying ever-vigilant in upholding the rules. Mr. Hurd's conduct was discovered when there was an audit of expense reports of senior officers. With Mr. Kerviel's conduct, a clear principle that emerged was a basic one in banking: every employee must take vacation for two weeks for when they do not take these extended time periods away they have the opportunity for records alterations. No vacations signals that the time has come to start checking on their accounts and activities. Mr. Kerviel was taking only a day here and there because he needed to be hands-on daily to prevent the discovery of his overrides of his account balances on the computer. Prevention is often simply strict adherence to the basics of internal controls and forensic signals.

[50] Ben Worthen and Joann S. Lublin, "At Oracle, Hurd Lands In," *Wall Street Journal*, September 9, 2010, p. B1.

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Prevention Tool Three for Individual Ethical Lapses: Training

There are some employees who need instruction and reminders of the do's and don't while at work. At a power plant, two consultants who were not really known to plant employees watched as a carpenter who earned $90,000 per year stopped at the supply desk and pocketed a package of double-A batteries for home use. An audit revealed that such little "heists" were apparently a way of life. Training serves to provide employees with examples as well as information on consequences. Fear works in organizations as well as it works in parenting. The understanding that "it is not worth my job" is an important training message.

Prevention Tool Four for Individual Ethical Lapses: Personal Commitment

This tool goes beyond the training to ask employees to embrace a set of values that are then used as part of the identity of the organization. The Viad Corporation adopted a commitment principle of "Always honest." The company then used that theme in its communications with vendors, customers, and regulators as part of its identity and brand. The use of the phrase in training and with employees was universal and also part of a strategy to have them commit to the culture of a company that was always honest.

The Company or Organization Ethical Lapses

These types of lapses are those that employees may commit individually but the reason for their misstep is not just rooted in a poor choice. There are company externalities that contribute to their choices. For example, during the 1990s, Bausch & Lomb settled financial reporting issues with the SEC because it had overstated its revenues. In announcing the settlement, Bausch & Lomb emphasized that the SEC found no evidence that top management knew of the overstatement of profits (the amount was a 54% overstatement) at the time it was made. However, the SEC's associate director of enforcement said, "That's precisely the point. Here is a company where there was tremendous pressure down the line to make the numbers. The commission's view is that senior management has to be especially vigilant where the pressure to make the numbers creates the risk of improper revenue recognition."[51]

The employees of Bausch & Lomb had some "creative" ways of meeting their numbers in terms of sales goals. "Creative" translates to unethical choices that were to the point of illogical. The term coined for these activities is often "loading dock fraud," or the kinds of overstatements of earnings that result from physical transfers of goods. For example, the company's Hong Kong unit was faking sales to real customers but then dumping the glasses at discount prices onto gray markets. The contact lens division shipped products that were never ordered to doctors in order to boost sales. Some distributors had up to two years of unordered inventories. The U.S., Latin American, and Asian contact lens divisions also dumped lenses on the gray market, forcing Bausch & Lomb to compete with itself.

However, the mistake that companies make is in treating these poor choices by employees as falling to the category of individual ethical lapses. They then use the prevention tools for category one lapses when what the company is experiencing is a category two lapse. The root cause rests with the organizational drivers. "Here's your number" was the common direction managers gave to sales personnel and even accountants within the company. When "the number" was not made, they were confronted with this question: "Do you want me to go back to the analysts and tell them we can't make

[51] Mark Maremont, "Judgment Day at Bausch & Lomb," *BusinessWeek*, December 25, 1995, 39; and Floyd Norris, "Bausch & Lomb and SEC Settle Dispute on '93 Profits," *New York Times*, November 18, 1997, p. C2.

the numbers?"[52] One division manager, expecting a shortfall, said he was told to make the numbers but "don't do anything stupid." The manager said, "I'd walk away saying, 'I'd be stupid not to make the numbers.'" Another manager said that in order to meet targets, they did 70 percent of their shipments in the last three days of the month.[53] Managers lived in fear of what they called "red ball day." *Red ball day* was the end of the calendar quarter, so named because a red sticky dot was placed on the calendar. As red ball day approached, credit was extended to customers who shouldn't have had credit; credit terms went beyond what was healthy and normal for receivables; and deep discounts abounded. One employee described panic-stricken managers doing whatever it took to meet the number for red ball day.

Another form of company/organizational lapse is one that begins with an individual lapse but ripens into an organizational one because of the reaction. For example, an employee at a competitor could be applying for a new job. That employee might offer, as was the case with Boeing's troubles related to the hiring of a Lockheed-Martin employee, to bring along proprietary information. If Boeing turns down the offer and the employee, the lapse remains an individual one. If, however, Boeing hires the Lockheed-Martin employee and encourages the bring-along and then uses them, the issue becomes a company/organization lapse. The question becomes why would a manager agree to go along with the conduct proposed by an individual? The answer lies in the signals, pressures, and incentives present in the hiring company.

All could be well with the prevention tools on category one lapses but employees will still engage in these behaviors because the organization rewards those who get results, however achieved, and punishes those who do not. The prevention tools are different and require modification of company policies.

Prevention Tool One for Company/Organization Lapses: Alignment of Management Goals with Compensation

Companies provide all the trappings of an ethical culture in addressing the individual level of ethical lapses. Those types of checklists and dashboard measures are reportable, carry physical evidence, and produce numbers results, that is, 97 percent of all employees completed the company's online ethics training. But, if the compensation system is not properly aligned with both goals and values, the prevention tools for the individual level will not be as effective as when they run in parallel with company/organization prevention tools. If employees perceive hypocrisy between the messages to them about ethics and the types of behaviors engaged in by employees who are then rewarded, there are several ill effects. The employees develop resentment, something that affects productivity. In addition, employees' sense of justice and equity is violated and they undertake unilateral actions to align espoused values with rewards. An employee who does not earn a bonus or is passed over for a promotion because he or she did not engage in the behaviors outlined in the "loading dock fraud" scenarios may resort to embezzlement and feel perfectly justified in doing so because the theft is a means of achieving justice. The failure to fix company/organizational ethical lapses undermines efforts to address individual lapses.

Managers need to examine the pay, bonus, and incentive structure in place. It remains an unassailable proposition that incentive plans work to motivate employees and achieve goals. However, how those goals are achieved must also be addressed as part of the plan so that company values and rewards are in alignment. Recently, a federal court ruled against Wells Fargo in a suit brought by customers for a Wells accounting practice on its overdraft charges for its debit cards. The policy was one of biggest charge, first posted

[52] Mark Maremont, "Blind Ambition," *BusinessWeek*, October 23, 1995, pp. 78–92.

[53] Maremont, "Blind Ambition," pp. 78–92.

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(BCFP), and the judge ordered Wells to pay $203 million to consumers.[54] The effect of the practice was to allow the collection of several fees. For example, if the customer's account held $200 and the debit card was used for withdrawals of $30, $10, $5, and $250, taking out the $30, $10, and $5 charges first would result in only one overdraft fee. However, taking the $250 withdrawal first would net the bank 4 overdraft fees of $35 each. Following BCFP increased the debit card overdraft fees. The federal judge in the case explained the criticality of the overdraft revenues:

> Overdraft fees are the second-largest source of revenue for Wells Fargo's consumer deposits group, the division of the bank dedicated to providing customers with checking accounts, savings accounts, and debit cards. The revenue generated from these fees has been massive. In California alone, Wells Fargo assessed over $1.4 billion in overdraft penalties between 2005 and 2007. Only spread income-money the bank generated using deposited funds-produced more revenue.[55]

Rewards for managers were based on those fees. Managers had found a clever way to increase revenue through overdraft fees and they were rewarded under incentive plans based on funds brought into the bank. However, a federal judge found the practice to be unfair and deceptive and ordered the repayment of the fees to the customers and ordered the repayment. The incentive plans emphasized numbers results but failed to place in juxtaposition the values of the bank in always being fair and forthright with customers in terms of account structure and fees. Wells is appealing the decision.

Performance and incentive plans not encased in the company values will result in ethical lapses that might not otherwise occur without the drivers those plans produce. Alignment helps employees understand that results are important but not at the expense of the values exhorted in the individual lapses prevention tools.

Prevention Tool Two for Company/Organization Lapses: Enforcement

A company discovered that a top performer in sales had been able to circumvent the firewall and tap into a competitor's website and obtain proprietary information that he was then able to use in order to obtain new customers. Hence, his top performer status was achieved. He was rewarded for the sales results he had achieved and the company was prepared to look the other way. There was hesitation on the enforcement action.

Without enforcement, employees ignore the admonitions about behavior and perform according to the standards set by management action. One executive notes, "It does not matter what you said. It is what they heard." Lack of enforcement is what employees hear over all the individual prevention tools of training and values. Lack of enforcement trumps the prevention steps with individual lapses.

Prevention Tool Three for Company/Organization Lapses: Leaders' Behavior

In writing a report when he was serving as inspector general for the Department of Interior, Earl Devany disclosed and recommended the following when he discovered ethical lapses by the leaders of that department, "For many people, it's good to see senior officers are disciplined like others. There is a perception that senior folks have a way around the regulations. Short of a crime, anything goes at the highest level of the Department of Interior. Ethics failures on the part of senior department officials—taking the form of appearances of impropriety, favoritism and bias—have been routinely dismissed with a promise of not to do it again."[56] Mr. Devaney appeared before congress to explain

[54] *Gutierrez v. Wells Fargo*, 730 F.Supp.2d 1080 (N.D.Cal. 2010).

[55] 730 F.Supp.2d 1080 (N.D.Cal.); Affirmed, 704 F.3d 712 (9th Cir. 2012).

[56] Testimony of the Honorable Earl E. Devaney, Inspector General for the Department of the Interior before the Committee on Government Reform, U.S. House of Representatives, May 5, 2004, http://www.doioig.gov/images/stories/pdf/050504Testimony%20of%20Earl%20E.%20Devaney.pdf

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his findings because the leaders failed to understand and act upon the serious findings in his report.

Often referred to as "the tone at the top," the piece that is often missing is the realization by company and organizational leaders that they are indeed the top, and their behavior and decisions constitute the tone. Translating the importance of leaders' examples and conducts is relatively easy to do with some simple pieces of advice: The rules apply to everyone. A leader who stops to self-enforce the company's or organization's rules against himself gains the respect of employees even as he moves them along to ethical choices. A CEO stopped accepting reimbursement for meals when he was on the road. He submitted his expenses for transportation and lodging but explained, "I have to eat anyway." He does not expect employees to not seek reimbursement for their meals on the road, but he is showing that he is careful about travel expenses and appreciates that it is not his money and that he owes a fiduciary duty to those who do provide the money by their investments for the company. Leaders need to be ever vigilant in their conduct, choices, and decisions in order to curb company and organizational lapses.

Industry Norms Ethical Lapses

In response to the federal court decision on its overdraft fees, a Wells Fargo spokesperson, in explaining the bank's appeal of the decision, offered, "Many banks process customers' transactions in high-to-low order because it gives priority to larger transactions such as mortgage, rent, or car payments."[57] The spokesperson is absolutely correct; Wells was the defendant in a class action suit, but other banks were following the same accounting processes for overdraft fees. In this situation, the company or organization has simply followed the industry policies and achieves a great deal of ethical comfort from the assurance, "Everybody does this." However, such an approach deprives the company or organization of analysis of the implications and long-term costs of the practice, however pervasive.

Other examples of accepted industry practices that later proved problematic for industries as well as the general state of the economy included the substantial increase in subprime loans in the 2003–2006 period, the development and sale of mortgage-backed securities without verification of the quality of the mortgage pools, and, pre-Enron, the undertaking of both audit and consulting functions by accounting firms. These behaviors were all widely practiced and generally accepted. In fact, those who did not follow these practices were perceived to be at a competitive disadvantage.

No matter how effective the individual or company ethical lapse prevention tools have been, this level of ethical lapse will, once again, trump the efforts at those other levels. Those in the position to make strategic decisions about the companies' products, services, and directions miss the ethical implications of what everyone is doing because they have accepted the flawed reasoning of this relativistic ethical standard. Prevention here occurs at higher levels in the company and does require deeper analysis and longer term strategies.

Prevention Tool One for Industry Lapses: Strategic Reviews and Planning

This prevention tool requires managers to look at revenues and ask how the numbers are arrived at and the sources of the revenues. Wells Fargo was absolutely accurate in its assessment that it was not the only bank following the BCFP accounting practice. However, there were other banks in the industry that had taken a strategic look at the

[57] Joel Rosenblatt and Karen Guillo, "Wells Fargo Must Pay Consumers $203 Million in Overdraft Case," Bloomberg News, August 11, 2010, http://www.bloomberg.com/news/2010-08-11/wells-fargo-should-pay-203-million-in-overdraft-fees-lawsuit-judge-rules.html.

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practice and changed course. In March 2010, Bank of America announced that it was changing its overdraft policy so that when customers were going to cause an overdraft in their account, the transaction would be declined until the customer agreed to pay the fee. In response to customers who said don't charge me $40 for a $5 cup of coffee, the bank offered the warning solution, something that resulted in a drop in fees and a resulting hits to revenue estimated at "tens of millions."[58] Federal rules changes requiring such a warning were looming, but Bank of America made a strategic choice to change its behaviors in a way that differentiated it from its competition and allowed it to have the processes in place prior to regulation taking effect.

The "everybody does it" is a lagging strategy that is fraught with ethical risk of accepting the industry standard as an acceptable ethical standard. Preventing a fall into the industry ethical lapses requires strategic review and leadership in strategy changes, not a ride of the "everyone" wave until the regulatory halt.

Prevention Tool Two for Industry Lapses: Political and Self-Regulatory Activism

This prevention tool finds the leader who has made voluntary changes to correct the "everybody does it" on an industry-wide level. For example, the cruise-line industry, the nuclear power industry, the chemical industry, and others have all established self-regulatory bodies that set safety and reporting standards for members that impose higher requirements than the law and serve to distinguish the members because of the trust the affiliation builds. This form of self-regulation also serves to isolate the organizations with questionable practices that could result in government controls that may be expensive, but not effective in solving the problems. Those who know the industry best are equipped to address its ethical issues in an effective and preemptive manner.

Cultural and Societal Ethical Shifts

There is always a little bit of pushback when folks view the latest stats on cheating by our high school and college students. There is a dismissiveness, to wit, "They are not cheating more; they are just more honest about it!" or "Don't you think it's the Internet? We just find out about these things more?" "It was more of a disgrace back then, so we didn't talk about it!" "Every generation thinks the next generation is worse!" However, the Inspector General for the Justice Department issued a report in September 2010 that concluded that FBI agents and some supervisors were cheating on their surveillance tests, that is, the tests that determined whether the agents knew the law regarding what they can and cannot do to initiate surveillance and how it is to be conducted. Over the past year we have uncovered cheating rings on the GMAT exams as well as the exams for the certification of physicians for internal medicine specialization. The American Board of Internal Medicine (ABIM) has taken some sort of disciplinary action against 140 doctors who cheated on their ABIM certification exams. In a lawsuit that the ABIM had filed previously against Arora Board Review, a company that does exam review courses for certification, the discovery process yielded information that proved to be more damaging for the docs than for Arora. The documents in the now-settled case included e-mails and other correspondence from the doctors to Arora, which revealed that the docs knew many of the questions and, indeed, followed up by sending along memorized test questions from their own certification exams to Arora in order to help those awaiting taking the exam.[59]

[58] Andrew Martin, "Bank of America to End Debit Overdraft Fees," *New York Times*, March 10, 2010, p. B1.

[59] *ABIM v. Arora Board Review*, (E.D. Pa), January 5, 2010.

The shift is real, and the prevention tools at the individual, company or organization, and industry levels will not curb these shifts because the controlling perception of individuals, companies, and industries is that their behaviors are now the norm. When the norm has shifted, the steps of training, commitment, alignment, and strategy are of little help because the societal acceptance level has changed.

However, that the acceptance level has changed does not equate to no danger here. Law enforcement left in the hands of those who do not know the boundaries for surveillance opens the door to undermining of the rule of law. Medicine practiced by those who have not attained the knowledge competency levels for diagnosis and treatment carries a self-explanatory risk. Projects undertaken and supervised by engineers who do not have the requisite skills result in structures with flaws and safety issues. In other words, societal shifts in ethical norms are inherently dangerous. They can be addressed with two prevention tools that require business activism at levels beyond the company and industry, but can certainly be undertaken with industry cooperation.

Prevention Tool One for Cultural/Societal Ethical Shifts: Philanthropy

This prevention tool finds companies and organizations committed to improvement of the formulation of character in young people. Companies and industries need not reinvent the wheel but can contribute to organizations that are working toward bringing the norm back to original position. For example, the Josephson Institute specializes in the training of teachers who can then use their acquired skills to inculcate the concept that "character counts" in students. At schools where this program is used, data indicate that the campuses are safer; an atmosphere of respect between and among students and teachers takes hold; and there is a better focus on education. The program has decades of achievement behind it and is a means for shifting the societal norm back to its starting point of civility.

Recognizing employees, students, and citizens who "do the right thing" gets their stories out there and reawakens the importance of ethics in personal and professional lives. J. P. Hayes was playing the Q school (pro golf's qualifying school, a series of games in which players compete for the top twenty-five slots, a position that allows them to enter most PGA tournaments without qualifying). While playing one of the Q school rounds at Houston's Deerwood Country Club in mid-November 2008, Hayes chipped his ball onto the green and placed a marker. After finishing the hole, he realized that he had used a different ball. He called himself on it, and he took a two-stroke penalty. Oh, but there's more. Later Mr. Hayes realized that the ball he had used was not one that was PGA approved. He had some Titlelist prototypes in his bag that he had been testing for the company. He had used a newfangled, unapproved ball. To call or not to call PGA officials? Disqualification versus six-figures in earnings several times over? Mr. Hayes notified PGA officials. He said, "I pretty much knew at that point that I was going to be disqualified." It was a mistake, and Mr. Hayes doesn't know how the prototypes remained in his bag. Players generally make certain that they eliminate those issues before the round.

Mr. Hayes put a year of his career on the line to be honest. Being in the Top 25, the rank the Q school gives you, means about $1 million in earnings. Being disqualified from the Q means Mr. Hayes, at his rank, is looking at fewer tournaments and about $300,000 in earnings. Mr. Hayes took full responsibility and held himself accountable, and all when no one would have known. The PGA, to its credit, made sure the story got out there to remind us that the higher road is a possibility.

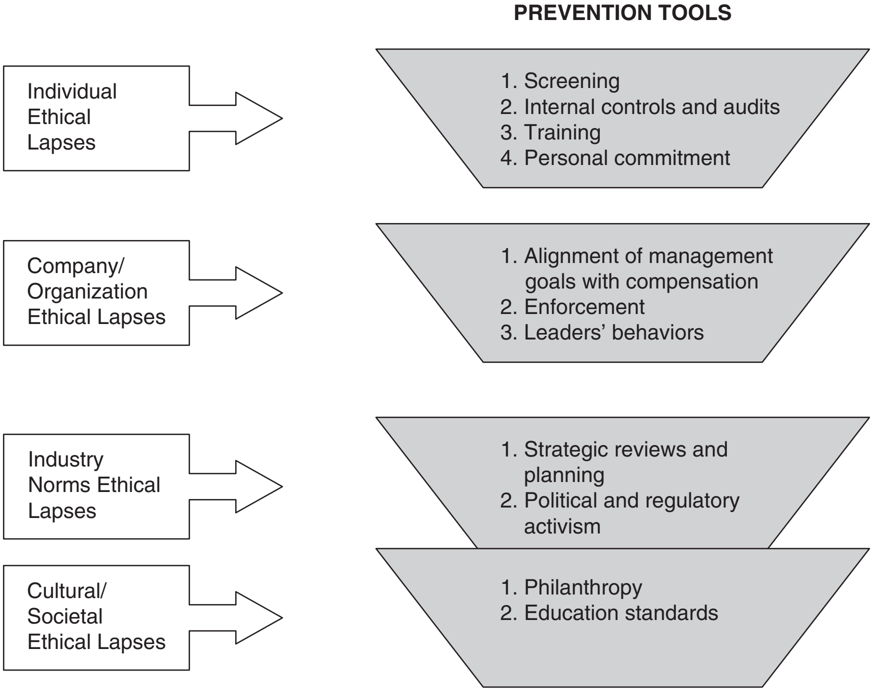
Prevention Tool Two for Cultural/Societal Ethical Shifts: Educational Standards

The fact that the cheating scandals seem to always be with us is not a justification for abandoning the goal of upholding educational standards. If those who are hired or who are seeking professional qualification are required to demonstrate mastery of knowledge and skills, then the burden shifts back to them for knowledge acquisition. There is no benefit in dishonesty used to earn grades if effective testing awaits prior to entry into the workforce or the profession. For example, an engineering graduate may be able to find ways to obtain questions, answers, and intelligence on exams. However, a practical exam that requires application of knowledge in the field remains an effective screen for which there is no alternative, easier path. A utility executive bemoans the fact that recent engineering hires do not seem to have the knowledge base necessary for understanding a power plant's functional interaction. A controller worries that a recent finance graduate seems unable to compute something as simple as APR. These skills are easily tested in the workplace, using a simple problem that requires response in real time. The facile reliance on the multiple-choice test has netted the scandals described earlier. A return to the apprenticeship form of examination circumvents the shifted norm on cheating. However, such an approach also serves to tell us what we need to know: Is this individual qualified?

Thoughts in Conclusion

Addressing ethical lapses has been a one-size-fits-all-approach that centers on the tools in preventing individual ethical lapses. However, the types of ethical lapses and their root causes are much more complex than those tools. The complexity, however, should not be a barrier to entry into those other layers of prevention tools that can be effective in addressing the root causes even as they shift our norms in a way that changes our behaviors, standards, and strategies.

FIGURE 4.1 Levels of Ethical Lapses


PREVENTION TOOLS
Individual Ethical Lapses
1. Screening
2. Internal controls and audits
3. Training
4. Personal commitment
Company/ Organization Ethical Lapses
1. Alignment of management goals with compensation
2. Enforcement
3. Leaders' behaviors
Industry Norms Ethical Lapses
1. Strategic reviews and planning
2. Political and regulatory activism
Cultural/ Societal Ethical Lapses
1. Philanthropy
2. Education standards

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Discussion Questions

1. Using what you have learned from the reading, describe the use of steroids in professional baseball, and determine how the practice became so pervasive in the industry.
2. Explain what must be fixed at the company level that is different from the fixes for individual ethical lapses.
3. Provide a list of other examples of peer pressure that result in industry-level choices.
4. Refer back to Unit I to classify the cases there according to their layer type of ethical issue.

Case 4.10

Rogues: Bad Apples or Bad Barrel: Jett and Kidder, Leeson and Barings Bank, Kerviel and Société General, the London Whale and Chase, Kweku Adoboli and UBS, and LIBOR Rates for Profit[60]

There is no such thing as a rogue trader. So I wrote in 1996 in analyzing the Nick Leeson/Joseph Jett losses and characterizations. Joseph Jett was the then–32-year-old bond trader who found an accounting loophole/computer internal control flaw and was able to fabricate nearly half a billion in sales for his bond division at the now-defunct Kidder Peabody, with, of course, the accompanying bonuses for him. Since the time of Jett, the pattern of the so-called rogue has repeated so many times that the question that perhaps needs to be asked is, "How do we keep missing these wildcards in organizations?" In the following sections, you have a chance to study the so-called rogues, but with a new approach. Are they really rogues or did their organizations contribute to their behaviors that cost their companies billions?

Joseph Jett and Kidder Peabody

Joseph Jett earned his Harvard master's degree in business administration in 1987.[61] Dismissed from his first post-degree job at CS First Boston, he then worked for Morgan Stanley but was laid off in the post-1980s Wall Street cutbacks. Despite his lack of experience in government securities, Jett was hired in 1991 by Kidder Peabody & Company to work in the government bonds section of its fixed-income department.

At the time Jett was hired, the Kidder fixed-income department was headed by Edward A. Cerullo, an exceptionally bright, hands-off manager who emphasized profits and was credited with turning Kidder around following the late-1980s insider trading scandals. Some fixed-income traders so feared telling Cerullo of losses that they underreported their profits at certain times so that they would have reserves to cover any future losses.

At the time of Cerullo's tenure and Jett's employment, Kidder Peabody was owned by General Electric (GE), which had purchased it in 1986 for $602 million. To establish Kidder as a Wall Street force, GE poured $1 billion into the firm and had begun to see a return only from 1991 to 1994.

[60] Adapted from Marianne M. Jennings, "There's No Such Thing as a Rogue Trader," *Corporate Finance Review* 12(6): 40–46 (2008).

[61] Because of a balance on his tuition bill, he did not receive his degree until 1994. In June 1994, he paid the balance due on his tuition, and Harvard processed his degree.

Jett's initial performance in the bonds section was poor: he lost money. Fellow traders recalled Jett's first months on the job as demonstrating his lack of knowledge; some questioned whether Jett should have been hired at all. Even when Jett began earning profits, his reputation remained mediocre. "I don't think he knew the market. He made mistakes a rookie would make," said a former Kidder trader who worked in the 750-member fixed-income section with Jett.

Hugh Bush, a trader at Kidder, raised questions when he examined Jett's trades. In April 1992, Bush accused Jett of "mismarking" or misrecording trading positions, an illegal practice. Bush's allegations were never investigated, and he was fired within a month.

In 1991, Linda LaPrade sued Kidder, claiming that she was terminated as a vice president when she brought illegal trading to the attention of Cerullo. She also claimed she was told to increase allotments from government agency security issuers by "any means necessary."

During this same period, Jett's profits bulged to 20 percent of the fixed-income group's total, and he was made head of the government bond department. Jett's profits, however, did not exist. Jett had taken advantage of an accounting loophole at Kidder that enabled him to earn a $9 million bonus for 1993 alone. The fictitious profits were posted through an accounting system that separated out the interest portion of the bond. Jett captured the profit on the "strip" (the interest portion of the bond) before it was reconstituted or turned back into the original bond. Kidder's system recognized profits on the date that the reconstituted bond was entered into the system. The result was that over two and a half years, Jett generated $350 million in fictitious profits. When auditors uncovered the scheme in April 1994, GE had to take a $210 million write-off in its second quarter. On April 17, 1994, Jett was fired; his bonus and accounts were frozen; and the SEC began an investigation.

Nick Leeson and Barings Bank

There was also Nick Leeson, the fund manager who, through his leveraged derivative investments, brought down Barings Bank, the bank that financed the Napoleonic wars. In 1995, Leeson racked up a $1.4 billion loss for Barings with a bad bet on the yen. The then–28-year-old Leeson did four years in a German prison. Leeson was the toast of Singapore for his remarkable performance in managing the bank's currency portfolio and risk.

Mr. Leeson entered a guilty plea, survived colon cancer, and was released after serving half of his sentence, about four years. He now commands $9,800, or £5,000, per speech. He also does ads and received $100,000 for an appearance before a group of Dutch bankers. In his speech, he holds Barings partially responsible for its failure to stop him and its willingness to rely on what he calls "the bluster" of a young trader. Mr. Leeson was not formally educated and had worked his way up from the trading desks of the bank. He had left school at age 18 but landed the trading desk job in 1985 in London when the British economy was on the upswing. He began at Barings as a clerk in 1989, again at the time the market was booming. By 1991, he was earning more than $1 million per year.

Currently, he lives in Ireland, where he is working for a debt restructuring firm.[62] He also has written a book about his experiences and has been released from his agreement to surrender a portion of his earnings to the government as a fine and an attempt at repaying the losses experienced by the now-defunct Barings Bank.[63]

Robert Citron and Orange County

About the same time as the Leeson-Barings debacle, Robert Citron, a government funds manager in Orange County, had positioned the county in risky derivatives and got it all

[62] David Enrich and Max Colchester, "'Rogue Trader' In Comeback," *Wall Street Journal*, April 9, 2013, p. C2.

[63] Eamon Quinn, "Ex-Trader Tells Story As a Warning," *New York Times*, December 26, 2006, p. C1.

wrong. On December 6, 1994, Orange County, California, filed for bankruptcy protection.[64] The chairman of the Orange County Board of Supervisors said the step was necessary to prevent local agencies from withdrawing their funds from the county's investment fund of $7.5 billion, which might force a fire sale of the fund's assets.[65]

The investment pool had substantial holdings in risky financial instruments known as derivatives that would provide returns only if interest rates continued to fall. For a time, the strategy was effective. Orange County had an 8.5 percent return on its money, whereas the state investment pool in California had only a 4.7 percent return. However, interest rates rose, and Orange County had large debts from borrowing to invest in derivatives. As a result, the county could not pay its creditors, and its investment pool lost $2.5 billion. The investments had been masterminded by County Treasurer Robert Citron.

Twelve different brokerage houses were left with loans to Orange County that were repaid.[66] The announcement of the county's bankruptcy caused the stock market to plunge fifty points. Hiring was frozen in the county, and many people with disabilities whose funds were in the Orange County investment pool could not withdraw their money because of the bankruptcy.[67] Mr. Citron and others entered pleas to various charges. Mr. Citron spent a year in prison and was famously known for his statement at the California Senate hearings on the losses in the county: "I must humbly say. I was not as sophisticated a treasurer as I thought I was."[68]

Mr. Citron was a frugal man who wore discount suits, ate a lunch of soup at the local Elks Club, never failed to go to his office to work on weekends, and invested his own funds in savings accounts and tax-free funds.[69] He was never accused of acting for personal gain—he even consulted a psychic as he saw the county's investments dwindling to see what he could do to save the funds. One of the many analyses of why Mr. Citron did what he did concluded that it was "hubris" and "ambition," the drive for recognition among government treasurers that fueled the missteps.[70]

A report by the California state Bureau of Audits concluded as follows:

> The Orange County (county) treasurer is responsible for receiving and keeping safe all funds belonging to the county and other monies deposited with the treasurer. However, we found that the former treasurer pursued an investment strategy that violated the basic principles of prudent investing, which are safety, liquidity, and yield, in that order. In fact, his investment strategies were diametrically opposed to these principles. The former treasurer's investments were unsafe, highly risky, and extremely volatile, and they lacked the liquidity needed to meet the portfolio's objectives. Further, he sacrificed safety and liquidity in a failed strategy to capture higher yields.[71] The former treasurer did this by leveraging the portfolio more than 2.7 times and purchasing highly volatile inverse floaters and other structured securities that comprised more than 40 percent of his investments.[72]

[64] "Orange County Seeks Protection under Bankruptcy Law," *Mesa Tribune*, December 7, 1994, p. A7; Karen Donovan, "Chapter 9: The Next Page," *National Law Journal*, December 26, 1994, p. A6; Sallie Hofmeister, "In Rare Move, California County Files for Bankruptcy Protection," *The New York Times*, December 7, 1994, pp. C1, C5.

[65] Del Jones, "County Seeks Bankruptcy Protection," *USA Today*, December 7, 1994, pp. 1C, 2C.

[66] "Orange County Fallout Hits Stocks," *Arizona Republic*, December 8, 1994, p. C3.

[67] "As Orange County Investments Flop, Kids' Money Is Frozen," *Mesa Tribune*, December 10, 1994, p. A9.

[68] Douglas Martin, "Robert Citron, 87, Culprit in California Fraud," *New York Times*, January 19, 2013, p. B1.

[69] Interestingly, Mr. Citron's father was a homeopathic physician who treated W. C. Fields successfully for his alcoholism. However, his father had to file suit against Mr. Fields to collect his fees for the treatment. Citron's father won the case.

[70] Sarah Lubman & John Emshwiller, "Before the Fall: How Citron's Hubris and Ambition Helped Cause Orange County Investment Debacle," *Wall Street Journal*, January 18, 1995, p. A1.

[71] *David J. Lynch, "How Golden Touch Turned into Crisis,"* USA Today, *December 23, 1994, p. 1B.*

[72] *Id.*

Jerome Kerviel and Société General

Now, enter Jerome Kerviel, in 2008, at the ripe old age of 31. With this, former Société Generale's racked up $7.09 billion in losses. Kerviel was convicted of breach of trust, forgery, and unauthorized computer use; he was sentenced to three years in prison, starting in 2010, and ordered to repay Société General $6.71 billion.

The defense presented by Kerviel's lawyers consisted of showing that the bank turned a blind eye to his trades as long as he was making money. In other words, Mr. Kerviel's lawyer focused on organizational factors that he argued forced Kerviel to make the bad trades and conceal losses from the bank. In fact, the bank paid $4 million in fines to French banking authorities for the lack of appropriate internal controls.[73] His lawyer noted, "He did what he was paid to do—speculate."[74] From 2005 through 2008, Mr. Kerviel evaded detection on his one-way bets that were hidden through fictitious trades. He was also able to evade detection because he knew the internal controls systems and operations employees so well. When he was questioned about trade anomalies, he promised operations backroom employees champagne, and fabricated e-mails to back up nonexistent trades. Mr. Kerviel argued at his trial that his behavior should have been a red flag for the bank, but it was not, and, as a result, he was able to continue his risky trades. However, the judge in his case concluded, "The absence of proper supervision on the part of the bank should not have been interpreted as a tacit green light to engage in wild speculation."[75] Mr. Kerviel became something of a hero in France because he came from humble roots (his father was a metalwork teacher and his mother a hairdresser), went to a lesser university for his degree, and yet was able to dupe his bosses, many of whom were graduates of the top business schools.[76]

Mr. Kerviel made about €100,000 per year at the bank following a promotion into Delta One from the bank's audit department. Mr. Kerviel had been hired there after earning his business degree from a small college in Lyon. There was a sense of insecurity that Mr. Kerviel revealed in interviews with French investigators: "I was held in lower regard than the others because of my educational and professional background."[77] He was given a bit of a backroom position in internal audit. However, Mr. Kerviel gained significant information about the banks processes, procedures, and internal controls while in the audit department. The result was that he could take and use that knowledge for evasive purposes once he became a trader. He was apparently able to cover up his large trades and losses by placing fake trades on the bank's books to cover his exposure as well as the size of his transactions. One expert said that Mr. Kerviel was able to elude the bank's sophisticated control system in a very simple manner. He said, "Société Générale got caught just like someone who would have installed a highly sophisticated alarm … and gets robbed because he forgot to shut the window."[78] Mr. Kerviel's former dean at the University of Lyon said, "It's a little like becoming a thief with training in locksmithing. If you're good at being a locksmith, then to steal is easier."[79]

[73] David Gauthier-Villars, "Rogue French Trader Sentenced to 3 Years," *Wall Street Journal*, October 6, 2010, p. C1.

[74] *Id.*

[75] *Id.*

[76] Nicola Clark, "Ex-Trader Gets 3 Years in France," *New York Times*, October 6, 2010, p. B1.

[77] David Gauthier-Villars and Stacy Meichtry, "Kerviel Felt Out of His League," *Wall Street Journal*, January 31, 2008, pp. C1, C2.

[78] David Gauthier-Villars and Carrick Mollenkamp, "The Loss Where No One Looked," *Wall Street Journal*, January 28, 2008, pp. C1, C 3.

[79] Doreen Carvajal and Caroline Brothers, "'Rogue Trader' Is Remembered As Mr. Average," *New York Times*, January 26, 2008, pp. A1, A6.

Painfully shy, Mr. Kerviel dressed very well and lived in a studio apartment in Neuilly, a wealthy suburb of Paris. He kept to himself at work, worked long hours, and took only four days of vacation in 2007. The typical vacation in France is six weeks. A typical red flag in audits, particularly in banks, is the nonvacationing employee; an employee who does not want his books examined will never be gone for more than a day or so.

He was questioned about his trades several times by his supervisors at the bank, but he was able to create fabricated e-mails from his alleged trading partners in order to convince his supervisors that the trades and profits were real. He also used the log-ins and passwords of his colleagues to post trades from their accounts in order to cover his losses. When all else failed when he was questioned about his trades, he would simply say that he had made a mistake. Supervisors seemed willing to accept that explanation. Mr. Kerviel has also noted that he is being singled out as a scapegoat. He does not deny that what he did was wrong, but he does note that there are others at the bank who have done and are doing the same thing. "I am taking my share of responsibility, but I will not be the scapegoat."[80] He also added, "I cannot believe that my superiors did not realize the amount I was risking. It is impossible to generate such profits with small positions. That's what leads me to say that while I was [in the black], my supervisors closed their eyes on the methods I was using and the volumes I was trading."[81] In fact, German-Swiss futures exchanges alerted Société Générale in November 2007 about unusual positions in Mr. Kerviel's accounts, but the bank took no action. French bank authorities believe that Société Générale relied too much on computerized risk assessment programs instead of a larger picture and personal context. In short, one French regulator noted, the bank missed "the human factors."[82] A Société Générale executive said, "While our derivatives business was going 130 miles an hour, risk control was only going 80."[83] In March and April of 2007, Mr. Kerviel's supervisors spotted some problems in his long and short positions and told him to straighten out his trades and books, but they took no further action.

The police zeroed in on Mr. Kerviel's unusual volume of cell phone and text messaging traffic as part of their investigation. In one text message, broker Moussa Bakir wrote to Mr. Kerviel, "You did not do anything illegal in the sense of the law."[84]

Mr. Kerviel described, in forty-eight hours of questioning upon his initial arrest, his evolution as a daring trader. He began with small trades that went unnoticed and simply continued to grow them in number and size. With each uncovered trade, he became more emboldened. He told authorities that he wanted to get a bonus of €300,000 and that he wanted to be known around the bank as "a financial genius."[85] In fact, he had succeeded in meeting the numbers needed for the bonus and was expecting the €300,000 for 2007. However, when the fake trades were unwound, there was clearly

[80] Nicola Clark, "Trader Points to Bank's Faults," *New York Times*, February 6, 2008, p. C3.

[81] David Gauthier-Villars and Stacy Meichtry, "Kerviel Felt Out of His League," *Wall Street Journal*, January 31, 2008, pp. C1, C2.

[82] Kara Scannell and David Gauthier-Villars, "SEC Probes French Bank," *Wall Street Journal*, February 5, 2008, p. A3.

[83] Nelson B. Schwartz and Katrin Bennhold, "A Trader's Secrets, A Bank's Missteps," *New York Times*, February 5, 2008, pp. C1, C8.

[84] David Gauthier-Villars, "Police Explore Whether French Trader Acted Alone," *Wall Street Journal*, February 9–10, 2008, p. B1.

[85] Doreen Carvajal and James Kanter, "A Quest for Glory and a Bonus Ends in Disgrace," *New York Times*, January 29, 2008, pp. C1, C10.

going to be no bonus. Mr. Kerviel also told authorities that if the bank had just waited "a little while," he could have lessened the losses.[86]

Banking authorities complained publicly about how the young trader eluded bank controls.[87] The bank chairman sent a letter to bank customers and said, "Société Générale has been the victim of a serious internal fraud committed by an imprudent employee."[88]

Mr. Kerviel's aunt tells a different story about her nephew. "He is a boy who is serious, honest, and hardworking and is incapable of doing anything wrong."[89] She insists that her nephew was manipulated by the authorities and that the authorities should be looking at the actions of the officers and managers at the bank.

Kweku Adoboli and the UBS Losses

Kweku Adoboli, 31, was a young trader for UBS who lived in a $1,570 per week apartment located in an upscale London neighborhood adjacent to Brick Lane. Mr. Adoboli was known in the area for his lively parties. He was known at his office at UBS for five years of work in Delta One products, including exchange-traded funds (ETFs). The first two years apparently went well for Mr. Adoboli, but something went wrong in 2008, and Mr. Adoboli is alleged to have used fake trades to cover his increasing losses. At the time of his arrest, UBS put the estimate of those losses at $2.3 billion.

Mr. Adoboli transferred to the trading desk from an area in which he would have gained information about their banks' internal controls. Mr. Adoboli knew, from his experience in operations, that some trades do not require confirmation. In order to cover his losses, Mr. Adoboli took phantom positions in ETFs as a way to match gains and losses. If the trades had actually been entered in UBS's computers via confirmation requirements, then his losses would have been obvious, and he could not have eluded detection for nearly three years. UBS had no rule that prevented operations employees from moving to trading/client-facing positions. UBS's risk revamping focused on preventing concentrations of securities into one class or type, a response to the significant 2008 losses related to the mortgage-backed instruments that caused significant losses at all banks.[90]

UBS, Libor, and the "Rain Man"

UBS's troubles did not end in 2010. By the end of 2012, the bank was grappling with charges that one of its star traders, 33-year-old Tom Alexander William Hayes, who had generated $260 million in revenues over a three-year period through aggressive bets on interest rates, was at the center of a conspiracy to rig the LIBOR rate (the London Interbank Offered Rate—a rate that allows financial institutions to determine their costs for borrowing money and known as an important cog in the financial transactions world). Mr. Hayes was referred to as "highly valued" at UBS.[91] He was also called "Rain Man" by his colleagues at work because he was brainy and socially awkward.[92]

[86] *Id.*

[87] David Gauthier-Villars, "Tax Twist in the Trading Scandal," *Wall Street Journal*, February 7, 2008, pp. C1, C3.

[88] *Id.* at A9.

[89] *Id.*

[90] Dana Cimilluca, Deborah Ball, and Carrick Mollenkamp, "UBS Raises Tally on Losses," *Wall Street Journal*, September 19, 2011, p. C1.

[91] Jean Eaglesham and Evan Perez, "U.S. Charges Star Trader," *Wall Street Journal*, December 20, 2012, p. A19.

[92] David Enrich, "Rate-Rig Spotlight Falls on 'Rain Man,'" *Wall Street Journal*, February 18, 2013, p. A1.

Mr. Hayes's e-mails included statements such as, "I live and die by these Libors, even dream about them."[93] There were also over 800 e-mails from him to those who set the rates, asking them to put the rates at certain levels that would permit his positions to enjoy gains or avoid deeper losses. For example, Mr. Hayes communicated with Roger Darin, a 41-year-old UBS employee who helped make decisions on the submissions UBS made to the Libor panel that then determined the rates. His e-mails included pleas for help such as, "Really need high [six-month] rates till Thursday."[94] Another Hayes e-mail included the following, "I need you to keep it as low as possible … if you do that … I'll pay you, you know, 50,000 dollars, 100,000 dollars … whatever you want … I'm a man of my word."[95] Interestingly, the *Wall Street Journal*, ran an article on May 29, 2008, that raised questions about its study and that expressed concern about the validity and accuracy of Libor rates because of unexplained volatility.[96]

UBS settled criminal charges and paid a total of $1.5 billion in fines to U.S. and other governments.[97] In hearings on the rate rigging, UBS officials admitted that weaknesses in their internal controls and processes allowed the rigging to start and continue without detection.[98] In fact, in 2009, Citigroup tried to hire Mr. Hayes away from UBS with a $5,000,000 offer. Those at UBS fought to keep him there with a matching offer by explaining to leadership that Mr. Hayes had "strong connections with Libor setters in London."[99] Mr. Hayes was hired away by Citigroup but then was fired after Citigroup was required to pay a fine for rate rigging. Early on in his career, Mr. Hayes had raised questions about his sitting next to those who set rates for the bank, wondering if that close contact was appropriate. He concluded that he thought it was "weird, but that's how they did it."[100]

The "London Whale" and Chase Losses

In March 2013, the U.S. Senate Permanent Subcommittee on Investigations released its report on its investigation into J.P. Morgan Chase & Co.'s $6 billion loss (give or take a billion or so depending on what unfolds) attributed to the so-called "London whale" trades in May 2012.[101] The "London Whale" was the nickname given to Bruno Iksil, a derivatives trader in Chase's London office, before the news of the derivative losses broke by. The media, unable to pinpoint identity, developed the nickname based on market concerns about the large trades participants were witnessing.[102] On the other side of the pond, Wall Street media referred to the trader as "Voldemort."

[93] Jean Eaglesham and Evan Perez, "U.S. Charges Star Trader," *Wall Street Journal*, December 20, 2012, p. A19.

[94] *Id.*

[95] David Enrich and Jean Eaglesham, "UBS Admits Rigging Rates in 'Epic' Plot," *Wall Street Journal*, December 20, 2012, p. A1.

[96] Carrick Mollenkamp and Mark Whitehouse, "Study Casts Doubt on Key Rate," *Wall Street Journal*, May 29, 2008, p. C1.

[97] Ben Protess, "Leniency Denied, UBS Unit Admits Guilt in Rate Case," *New York Times*, December 20, 2012, p. A1.

[98] Max Colchester and Margot Patrick, "RBS Notes Control Failings," *Wall Street Journal*, February 12–13, 2013, p. C3.

[99] David Enrich, "Rate-Rig Spotlight Falls on 'Rain Man,'" *Wall Street Journal*, February 18, 2013, p. A1.

[100] *Id.*

[101] The London Whale was identified as Bruno Iksil, a French national who was a trader in Chase's London Office. "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," United States Senate Permanent Subcommittee on Investigations, Majority and Minority Report (hereinafter referred to as Senate Report), March 15, 2013, p. 25.

[102] Dan Fitzpatrick, Gregory Zuckerman, and Scott Peterson, "'Whale' Sounded an Alarm on Bets," *Wall Street Journal*, February 1, 2013, p. C1.

Before the $6.3 billion loss, there were questions emerging within Chase about the trading activities. The bank's own risk gauges predicted a $6.3 billion loss from the London positions in February 2012. However, a risk manager dismissed the prediction as "garbage" and no action was taken.[103] Losses from the Chief Investment Office (CIO), which was spun off as a separate unit in 2005, amounted to $719 million for the first quarter of 2012. At that point, the head of CIO, Ina Drew, sent orders for the traders to "put phones down" and stop trading.[104] Her warning was not heeded. Instead, in March 2012, the CIO changed its valuation practices in order to avoid having to report the losses. The result was that the losses were kept in the $600 to $700 million range, a range deemed to be immaterial for financial reporting disclosures. During the first quarter of 2012, senior executives of Chase were notified that the CIO had exceeded its limits for risk in all five measurement categories. Jamie Dimon, Chairman and CEO of Chase, was told of the breach of the five metrics, but no action was taken. There was no review undertaken, and many within CIO mocked the metrics.

In March 2012, when a senior executive questioned the valuations, the issues were still not discussed in the bank's SEC disclosures because $600 to $700 million was not a material amount for the bank. Those disclosures were eventually made in reports issued in June 2012 when Chase restated its earnings, not because, executives explained, the amount was material, but because the London personnel had not acted in "good faith" in changing the valuation methodology, and therefore, those valuations had to be changed.[105]

During the Whale trading periods, Chase did disclose the changes in its valuation and risk models to regulators, but no regulators followed through to inquire about the changes. For February and March of 2012, Chase did not send key performance data of the CIO to regulators, but no regulator followed up to request the missing data. Generally, a missing report will trigger an investigation by the Office of Comptroller of the Currency (OCC), one of the bank's regulators. For example, the CIO (Ina Drew) had not, in five years of the bank's operation of the synthetic credit portfolio (SCP) operation, "detailed the purpose or working of the SCP … even though regulations state that, in connection with calculating its risk-based capital requirements, a bank 'must have clearly defined trading and hedging strategies for its trading positions' and each hedging strategy 'must articulate for each portfolio of trading positions the level of market risk the bank is willing to accept and must detail the instruments, techniques, and strategies the bank will use to hedge the risk of the portfolio.'"[106]

By early April 2012, in advance of the May 2012 losses by the Whale, the financial press was asking questions about the "huge trades" that were roiling the credit markets. When confronted with questions about the Whale and Chase's role in the "huge trades," Mr. Dimon called the speculation about losses a "tempest in a teapot."[107] Following the press questions, regulators requested information from Chase. That information was not forthcoming.

During this time period staff members in London were concerned about what was happening with the trades in London. Their observation that the "Whale" had not left

[103] Senate Report, p. 1.

[104] Senate Report, p. 4.

[105] Senate Report, p. 6.

[106] Senate Report, p. 39.

[107] When criminal indictments were later issued in connection with "the Whale's" activities, the U.S. attorney in Manhattan said, "This was not a tempest in a teapot but rather a perfect storm of individual misconduct and inadequate internal controls." Ben Protess and Jessica Silver-Greenberg, "Charges Against 2 Traders Fault JPMPrgan for Lack of Oversight," *New York Times*, August 15, 2013, p. A1.

his desk for three days and was still in the same clothes was an automatic trigger of a questioning attitude in the banking industry. The office staff took their questions, however, only so far because of the pride Chase employees took in having Mr. Dimon as their leader. Mr. Dimon was the one banking icon who had escaped the 2008 destruction and missteps. And Mr. Iksil had a swagger that even showed up on his LinkedIn profile, "Champion of kick it," "Walking over water," and "humble."[108] Little was known about his private life, except that he commuted to his London office from Paris and worked at home on Fridays.

The Chase compensation system rewarded the traders and their leaders for their performance, something that motivated risk taking. Mr. Iksil's compensation during the last few years before the losses at the London desk totaled $100 million. The Senate report concluded, "The compensation history for key employees with responsibility for SCP trading suggests that the bank rewarded them for financial gain and risk taking more than for effective risk management."[109] Chase's own task force, convened after the losses, has recommended significant changes in the compensation system so that losses do not reduce compensation and are acceptable when they are a "consequence of achieving bank priorities."[110]

The task force noted that no one, including Ms. Drew, had communicated to the SCP personnel that proper compensation was possible if losses came from achieving bank objectives. Missing data from a bank is a red flag in and of itself. A bank ignoring repeated requests for missing reports is another red flag. Couple these issues with the same bank reporting that it is changing its risk and valuation models and you reach the Senate Report's conclusion.

The U.S. Senate Report concluded the following about the Chase "London Whale" experience:

> The JPMorgan Chase whale trades provide a startling and instructive case history of how synthetic credit derivatives have become a multi-billion dollar source of risk within the U.S. banking system. They also demonstrate how inadequate derivative valuation practices enabled traders to hide substantial losses for months at a time; lax hedging practices obscured whether derivatives were being used to offset risk or take risk; risk limit breaches were routinely disregarded; risk evaluation models were manipulated to downplay risk; inadequate regulatory oversight was too easily dodged or stonewalled; and derivative trading and financial results were misrepresented to investors, regulators, policymakers, and the taxpaying public who, when banks lose big, may be required to finance multi-billion-dollar bailouts.

Mr. Dimon confided to his wife just before the news of the losses became public, "I missed something bad."[111]

The following chart offers a summary and comparison of the rogue traders.

[108] Joe Coscarelli, "Who Is the London Whale? Meet JPMorgan's 'Humble' Trader Bruno Iksil," *New York Magazine*, May 11, 2012, http://nymag.com/daily/intelligencer/2012/05/jpmorgan-london-whale-bruno-iskil-2-billion-loss.html.

[109] Senate Report, p. 57. Compensation in the London office for traders and their managers was in the millions, and all were given outstanding performance reviews for their performances up through 2009 (p. 59). Those in the London office were compensated so well that their pay had to be reviewed by the Operating Committee of the Board and Mr. Dimon. Fear was a motivator in the risk and reward system. "In a March 23, 2012, e-mail, after a day of large losses, Bruno Iksil wrote: 'I am going to be hauled over the coals…. [Y]ou don't lose 500 M[illion] without consequences.'" Senate Report, p. 59.

[110] Senate Report, p. 60.

[111] Monica Langley, "Inside J.P. Morgan's Blunder," *Wall Street Journal*, May 18, 2012, p. A1.

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The Patterns of Rogue Traders

	Joseph Jett	Nick Leeson	Jérôme Kerviel	Kweku Adoboli	The London Whale	Libor Traders—The Rain Man
Financial institution	Kidder Peabody	Barings Bank	Société Générale	UBS	Chase	UBS
Age (at time of trades)	32	28	31	28–31	44	33
Market instruments	Bonds	Derivatives	Derivatives (Delta desk)	Derivatives (Delta Desk)	Derivatives (Delta desk)	Derivatives (Delta desk)
Amount of loss	$0.5 billion	$1.4 billion	$7.09 billion	$2.3 billion	$6.4 billion	Billions in profits
Length of deficit trades	3 years	3 years	2 years	3 years	1 year	4 years
Preliminary inquiries prior to collapses with no action taken	Yes; audit questions	Yes—suspicion mounted steadily	Yes—several inquiries	Yes—questions about amount of profits	Yes—notice from back-room employees; risk levels changed	Yes—notice of Libor connections surfaced when Hayes job offers came in from other banks; he questioned whether he should be working next to rate-setters; Citigroup fired him after regulators sanctioned the bank for fixing rates
Transfer from other areas of the firm	No (new hire for bond desk)	Yes (transferred to Singapore after denial of trading license in U.K.)	Yes (internal controls)	Yes (supporting operations)	No, but weak governance on policy changes	No, but weak internal controls admitted by UBS
Key revenue area for company/bank	Yes	Yes	Yes	Yes	Yes	Yes

(*Continued*)

The Patterns of Rogue Traders (Continued)

	Joseph Jett	Nick Leeson	Jérôme Kerviel	Kweku Adoboli	The London Whale	Libor Traders—The Rain Man
Rewarded and recognized for performance	Yes	Yes	Yes	Yes	Yes	Yes
Visible wealthy lifestyle	Yes	Yes	Yes	Yes	Yes	Yes
High desire for success/underlying insecurity	Yes (his third job)	Yes (no formal education)	Yes (second-tier university education)	Yes (longstanding desire for success)	Yes (LinkedIn post on "walking above the water"	Yes
Weak internal controls	Yes	Yes	Yes	Yes	Yes—waived risk standards	Yes—ready access to those who submitted data for rates
Tools used	Fake entries	Excessive risk and trade amounts	Fake entries	Fake entries	Concealed levels of mounting losses through altered risk controls and changed definitions	Fake data on rates
Fate of company/bank	Kidder sold at a loss	Barings collapsed	Paid fines to French governing body; had to restore public trust	$1 billion fine; Major management changes at UBS; slowed recovery from 2008 losses; stock down 11%	$6 billion loss; mgt. shake-up; Chair/CEO Dimon fought with shareholders to retain positions	$1.5 billion in fines; $2 billion loss for settlement of litigation related to rates
Personal fate	Civil fines	4 years in prison	Serving 3 years in prison	Charges pending	Terminated and charges pending	Terminated and investigation pending

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Discussion Questions

1. Listen any common threads you see in behaviors of these traders other than those noted in the chart.
2. Describe what the organizations could have done that might have prevented the conduct of the rogues.
3. Warren Buffett described a necessary combination for people who are involved in investing, "Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."[112] What does Mr. Buffett mean by his statement, and how does it apply to rogue traders and their organizations? How would you develop the necessary temperament he describes?

Compare & Contrast

Explain what is different about Robert Citron.

Case 4.11

FINOVA and the Loan Write-Off

The FINOVA Group, Inc., was formed as a commercial finance firm in 1992. It was created as a spin-off from the Greyhound Financial Corporation (GFC). GFC underwent a complete restructuring at that time and other spin-offs included the Dial Corporation.

FINOVA, headquartered in Phoenix, Arizona, quickly became a Wall Street darling. Its growth was ferocious. By 1993, its loan portfolio was over $1 billion both through its own loans as well as the acquisition of U.S. Bancorp Financial, Ambassador Factors, and TriCon Capital. In 1994, FINOVA had a successful $226 million stock offering. By 1995, its loan portfolio was $4.3 billion. Standard & Poors rated the company's senior debt as *A,* and Duff & Phelps upgraded its rating to *A* in 1995 when FINOVA issued $115 million in convertible preferred shares and its portfolio reached $6 billion. FINOVA's income went from $30.3 million in 1991 to $117 million by 1996 to $13.12 billion in 1999. *Forbes* named FINOVA to its Platinum 400 list of the fastest-growing and most profitable companies in January 2000.

FINOVA was consistently named as one of the top companies to work for in the United States (it debuted as number twelve on the list published by *Fortune* magazine in 1998 and subsequent years). Its benefits included an on-site gym for employee workouts and tuition for the children of FINOVA employees (up to $3,000 per child) who attended any one of the three Arizona state universities under what FINOVA called the "Future Leaders Grant Program."[113] FINOVA also had generous bonus and incentive plans tied to the stock price of the company. *Fortune* magazine described the 500 stock options each employee is given when hired, the free on-site massages every Friday, concierge services, and unlimited time off with pay for volunteer work as a "breathtaking array of benefits."[114]

The name *FINOVA* was chosen as a combination of "financial" and "innovators." However, some with language training pointed out that FINOVA is a Celtic term that means "pig with lipstick." FINOVA took pride in its strategic distinction from other finance companies. It was able to borrow cheaply and then make loans to businesses at a premium. Its borrowers were those who were too small, too new, or too much in debt

[112] Dan Fitzpatrick, Jean Eaglesham, and Devlin Barrett, "Two Charged in 'London Whale' Case," *Wall Street Journal*, August 15, 2013, p. C1.

[113] Dawn Gilbertson, "Finova's Perks Winning Notice," *Arizona Republic*, December 22, 1998, pp. E1, E9.

[114] "The 100 Best Companies to Work For," *Fortune*, January 11, 1999, p. 122.

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to qualify at banks.[115] Its 1997 annual report included the following language from FINOVA's CEO and chairman of the board, Sam Eichenfield:

> FINOVA is, today, one of America's largest independent commercial finance companies. We concentrate on serving midsize business—companies with annual sales of $10 million to $300 million—with arguably the industry's broadest array of financing products and services. The goals we set forth in our first Annual Report were to:
>
> - grow our income by no less than 10 percent per year;
> - provide our shareholders with an overall return greater than that of the S&P 500;
> - preserve and enhance the quality of our loan portfolios;
> - continue enjoying improved credit ratings
>
> We have met those goals and, because they remain equally valid today, we intend to continue meeting or surpassing them in the future. Many observers comment on FINOVA's thoughtfulness and discipline and, indeed, FINOVA prides itself on its focus.

FINOVA also had a reputation for its generous giving in the community. Again, from its 1997 annual report:

> FINOVA believes that it has a responsibility to support the communities in which its people live and work. Only by doing so can we help guarantee the future health and vitality of our clients and prospects, and only by doing so can we assure ourselves of our continuing ability to attract the best people.
>
> Over the years, not only have FINOVA and its people contributed monetarily to a broad range of charitable, educational and cultural causes, but FINOVA people have contributed their time and energy to a variety of volunteer efforts.
>
> In 1996, FINOVA contributed more than $1.5 million and thousands of volunteer hours to educate and develop youth, house the homeless, feed the hungry, elevate the arts, and support many other deserving causes around the country.

FINOVA's ascent continued in the years following the 1997 report. Its stock price climbed above $50 per share, and management continued to emphasize reaching the income goals and the goals for portfolio growth. Throughout the company, many spoke of the unwritten goal of reaching a stock price of $60 per share. That climb in stock price was rewarded. The stock traded in the $50 range for most of 1998 and 1999, reaching a high of $54.50 in July 1999.

At the end of 1998, FINOVA reported that Mr. Eichenfield's compensation for the year was $6.5 million, the highest for any CEO of firms headquartered in Phoenix. More than half of the compensation consisted of bonuses. Mr. Eichenfield and his wife purchased a S3 million home in nearby Paradise Valley shortly after the year-end announcement in 1998 of his compensation.[116] Mr. Eichenfield was named the 1999 Fabulous Phoenician by *Phoenix Magazine*, which included the following description:

> A true mensch in every sense of the word, Sam casually says, "I do what I can," referring to the community for which he has done so much. While he maintains a modest air on the outside, Sam admits, "I take a lot of pride in having created a lot of opportunity for a lot of people." As long as Sam is head of FINOVA and lives in this community, we're sure there will be many more people who will benefit from his kindness and his generosity.[117]

It was sometime during the period from 1996 through 1998 that issues regarding financial reporting arose within the company. FINOVA had a decentralized management structure that created autonomous units. There were at least sixteen different finance

[115] Riva D. Atlas, "Caught in a Credit Squeeze," *New York Times*, November 2, 2000, pp. C1, C21

[116] "Finova Chief Splurges on $3 Million Mansion," *Arizona Republic*, January 23, 1998, pp. E1, E7.

[117] Phoenix Magazine, 1999.

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divisions, such as Commercial Equipment Finance, Commercial Real Estate Finance, Corporate Finance, Factoring Services, Franchise Finance, Government Finance, Healthcare Finance, Inventory Finance, Transportation Finance, and Rediscount Finance. Each of these units had its own manager, credit manager, and financial manager. In many cases, the failure of one unit to meet prescribed goals resulted in another unit making up for that shortcoming through some changes in that unit's numbers that they would report for the consolidated financial statements of FINOVA.

The Resort Finance division was a particularly high-risk segment of the company. Resort Finance was the term used to describe what were time-share interests that FINOVA was financing.[118] Time-share financing is a particularly risky form of financing because lenders are loaning money to borrowers who live in France for property located in the Bahamas that has been built by a company from the Netherlands and is managed by a firm with its headquarters in Britain. The confluence of laws, jurisdiction, and rights makes it nearly impossible to collect should the borrowers default. And the default rate is high because time-sharing interests are a luxury item that are the first payments to be dropped when households experience a drop in income because of illness or the loss of a job.

Resort Finance would prove to be a particularly weak spot in the company and an area in which questions about FINOVA's financial reporting would arise. For example, FINOVA had a time-share property loan for a recreational vehicle (RV) park in Arkansas that had a golf course and restaurant. The idea, when first acted on in 1992, was that folks could pay for a place to park their RV in beautiful Arkansas for a week or two in a time-share RV resort. When the loan was made in 1992, the property had a book value of $800,000. At the time of the default in 1995, the property was worth $500,000. FINOVA took back the property but did not write down the loan. It did, however, continue to report the loan as an earning asset even as it capitalized the expenses it incurred to maintain the golf course and restaurant. By 1997, FINOVA was carrying the Arkansas time-share resort on its books as a $5.5 million earning asset. One manager remarked, "You couldn't sell all of Arkansas and get $5.5 million and we were carrying a bad loan at that amount."[119]

Because of its lending strategies, FINOVA had higher risk in virtually all of its lending divisions. For example, it was highly invested in high-tech companies because they fit the category of too new and too risky for banks.

However, FINOVA edged into the *Fortune* 1000 and built new company headquarters in Scottsdale, Arizona, as part of a revitalization project there. Its headquarters housed 380 employees, cost $50 million to construct, and was located just north of the tiny Scottsdale Fashion Square shopping mall. FINOVA had about 1,000 other employees at offices around the world.

In the first quarter of 1999, FINOVA again caught national attention for the cover of its annual report that would soon be released. The cover featured a robot, but the head of the robot had an underlying wheel that readers could rotate. There were six heads to the robot, all photos of FINOVA employees. The torso of the robot was a safe, and the arms and legs were made of symbols of the various industries in which FINOVA had lending interests. "When you have innovators in your name, you can't do a generic annual report," was the description from a FINOVA PR spokesman.[120]

However, the buzz over the annual report cover was small compared to what happened when the cover, printed ten weeks in advance of the content, was to be coupled with the numbers inside the report. FINOVA announced that its annual report would be delayed. It was unclear what was happening until its long-standing auditors, Deloitte and

[118] Interviews with Jeff Dangremond, former finance/portfolio manager, FINOVA, 1996–2000.

[119] *Id.*

[120] "Cover of Finova's '98 Report Turns Heads," *Arizona Republic*, April 9, 1999, p. E1.

Touche, were fired. Mr. Eichenfield explained that FINOVA fired its auditors because they had waited so long to discuss their concerns and issues with management. He indicated that he felt they should have raised the issues much earlier than on the eve of the release of the numbers.[121]

FINOVA then hired Ernst & Young, but when the annual report was finally released the company also announced that it would be restating earnings for the year. The price of the company's stock began to decline. FINOVA worked diligently to restore credibility, with its officers noting that the auditors' disagreements with management's numbers were often because the company was too conservative in its accounting and that there were counterbalances for decisions on aggressive versus conservative accounting practices.[122] However, with a shift in economic conditions and the end of the high-tech market run, the asset quality of FINOVA's portfolio was deteriorating. FINOVA's acquisition of the Fremont Financial Group of California for $765 million only increased investors' concerns about the direction of the company and the quality of its management. By the end of 1999, its stock price had dipped to $34 per share.

In early 2000, when it was again time for the release of the annual report, there was to be another announcement about FINOVA's financial position. FINOVA announced that it was writing down a $70 million loan to a California computer manufacturer. Ernst & Young refused to certify the financial statements until the write-off was taken and the resulting shake-up followed.[123] At the same time as the announcement of the write-off, the FINOVA board announced Sam Eichenfield's retirement with a compensation package of $10 million.[124]

FINOVA had to take an $80 million hit, or $0.74 per share, in one day to cover the loan write-off of $70 million plus the compensation package. FINOVA's stock, which had dipped to $32 per share when the 1998 issues on the annual report delay first surfaced, dropped to $19.88 in one day of heavy trading. The 38 percent dip in stock value was the largest for any stock that day on the New York Stock Exchange, March 27, 2000.[125] As analysts noted, there was a downward spiral because the trust had been breached in 1998; confidence was not regained, and this latest write-off and its delay served to shake investor confidence. Two rating agencies immediately lowered FINOVA's credit ratings, and the costs of its funds jumped dramatically.[126]

Shareholder lawsuits began in May 2000, with several alleging that the $70 million loan had been in default eight months earlier but that, because of bonus and compensation packages tied to the share price, the officers and managers opted not to write the loan off in order to maximize their compensation packages, which were computed at the end of December before the write-off was taken.

Also during May 2000, Credit Suisse First Boston, hired to aid the company strategically, announced that FINOVA had lost a $500 million line of credit from banks. Such a loss was seen as mandating the sale of the company because commercial loan companies must have $1 in a credit line as backup for every $1 in commercial paper. FINOVA's stock fell to $12.62 on May 9, 2000.[127] Analysts noted that FINOVA's aggressive growth strategy placed it in a particularly vulnerable situation because, as credit lines dried up, it

[121] Dawn Gilbertson, "Finova Record Smudged," *Arizona Republic*, April 18, 1999, pp. D1, D2.

[122] Max Jarman, "Finova Group's Stock Sinks," *Arizona Republic*, December 10, 1999, pp. E1, E2.

[123] Anne Brady, "Shareholders Sue Finova Executives," *Mesa Tribune*, May 20, 2000, p. B1.

[124] Dawn Gilbertson, "Surprises at Finova," *Arizona Republic*, March 28, 2000, pp. B1, B9.

[125] *Id.*

[126] Rhonda L. Rundle, "Finova Retains Credit Suisse Unit to Assess Operations," *Wall Street Journal*, May 10, 2000, p. A12.

[127] Donna Hogan, "Finova Finances May Force Sale," *Mesa Tribune*, May 9, 2000, pp. B1, B2.

had more exposure on its large loan portfolios. Further, the nature of those portfolios was such that its default rate was higher than other commercial lenders. Analysts valued its loan portfolio at $0.58 on the dollar.[128]

By early 2001, FINOVA was reporting that it had lost $1 billion for the year.[129] It declared Chapter 11 bankruptcy on March 7, 2001. Its default on its bond debt was the largest since the Great Depression. Its bankruptcy was then the eighth largest in history, with Enron displacing it in fall 2001 (Case 4.22) and WorldCom then displacing Enron (see Case 4.15) (now number 3). Now ranking number one is Lehman Brothers. Its stock price fell to $1.64 per share on April 2, 2001. The stock would fall to $0.88 per share until Warren Buffett's Berkshire Hathaway Company and Leucadia National Corporation made a buyout proposal for FINOVA, which caused the stock to jump to $2.13 in March 2001.[130] Berkshire Hathaway owns $1.4 billion of FINOVA's debt, including $300 million in bank debt and $1.1 billion in public bonds.

GE Capital and Goldman Sachs then countered the Buffett offer, but the bankruptcy court approved the Buffett offer.[131] However, pursuant to its rights under the agreement, the Buffett team backed out of the purchase. Berkshire Hathaway did purchase 25 percent of FINOVA's shares, and FINOVA was able to restructure itself in Chapter 11 bankruptcy. FINOVA emerged from Chapter 11 in 2001, but in November 2006, the company's board of directors voted to liquidate the company. The business was officially closed on December 4, 2006. The company's 10-K report for 2006 indicates that it will not be able to repay its note holders and that all of its assets have been pledged to existing creditors. All of the company offices, except one located in Scottsdale, Arizona, have been closed, with the resulting reduction in force of nearly all employees. The offices in Scottsdale have been moved from the opulent headquarters on Scottsdale Road, and the building FINOVA built is now occupied by a number of companies and professional offices. Its stock reached a high price of $0.12 per share during 2006, with a low price of $0.06. Its Chapter 11 bankruptcy ended in December 2009.

Discussion Questions

1. Why do you think the officers and managers waited until the auditors required it to write off the $70 million loan? Given FINOVA's fate and its free-fall in stock price to a final price of $0.12, what issues did the executives miss in analyzing the decision to write down or not write down the loan? Whose interests were served by the decision?
2. Do you think the incentive plans had any effect on the reported earnings? Why or why not?
3. Was FINOVA so generous with its perks for employees that there was a resulting loyalty that was blinding the employees to the real financial condition of the company and the financial reporting issues? Would these perks have had an effect on you if you worked for FINOVA?
4. Was FINOVA forthcoming about the level of risk in its business?

Compare & Contrast

The FINOVA employees are gone or have been laid off. What impression do you think their time at FINOVA makes as prospective employers read their résumés? Do you see any lines for your credo in the experience of these young businesspeople at a young company?

[128] Riva D. Atlas, "Caught in a Credit Squeeze," *New York Times*, November 2, 2000, pp. C1, C21.

[129] Max Jarman, "Finova Posts $1 Billion Loss," *Arizona Republic*, April 3, 2001, p. D1.

[130] Paul M. Sherer and Devon Spurgeon, "Finova Agrees to a Bailout by Berkshire and Leucadia," *Wall Street Journal*, February 28, 2001, pp. C1, C18.

[131] Edward Gately, "Bankruptcy Court OKs Finova Plan," *Mesa Tribune*, August 11, 2001, p. B1.

Case 4.12

Inflating SAT Scores for Rankings and Bonuses

Since 2005, Claremont McKenna, ranked number nine on *U.S. News & World Report*'s best liberal arts colleges in the country, has been lopping on a few points here and there to its entering students' average SAT score before reporting those numbers to *U.S. News & World* report and rating organizations such as the Princeton Review. For example, in 2010, its combined median score was reported as 1,410, rather than its actual 1,400. And its seventy-fifth percentile was reported at 1,510, when it was, in reality, 1,480.

Claremont McKenna's vice president and dean of admissions has been removed from the college website. President Pamela B. Gann explained the problem and concluded, "As an institution of higher education with a deep and consistent commitment to the integrity of our academic activities, and particularly, our reporting of institutional data, we take this situation very seriously."[132]

The rankings and ratings organizations did not reflect as much outrage. Robert Franek of the Princeton Review noted, "That is a pretty mild difference in a point score. That said, 10 points, 20 points to a student that isn't getting that score on the SAT could be an important distinction," and "I feel like so many schools have a very clear obligation to college-bound students to report this information honestly."[133] Although the points added seemed immaterial, the manipulations veiled the reality that the critical reading scores for the 2011 class were the lowest since 2007, and the mean math score had been boosted by 28 points.

Discussion Questions

1. What is troubling about Mr. Franek's reflections on adding points to test scores?
2. Why do you think the dean of admissions added on the points?
3. Explain how the role of rankings would influence behaviors among employees at colleges and universities.

Case 4.13

Hiding the Slip-Up on Oil Lease Accounting: Interior Motives

In 1998, the Department of the Interior began an incentive plan for oil companies that permitted the companies to waive the 12.5 percent royalty generally paid to the U.S. government for oil leases on federal land. The idea behind the waiver was that oil companies would then have additional cash for purposes of drilling for more oil. However, the waiver was to stop if oil rose above $34 per barrel. When the leases with the oil companies were signed, Department of the Interior officials had neglected to put in the $34 per barrel cap. The leases ran for ten to fifteen years. Officials at the department discovered the omission in 1999, but did not reveal their mistake and just let the leases run without the cap. When the Office of the Inspector General audit began looking at the leases, an employee within the department, who was later given a bonus, forged and backdated documents to try and dupe auditors into believing that the lease caps were in place. With oil topping $34 per barrel by 2002, and over 1,100 oil leases, the federal

[132] Daniel E. Slotnik and Richard Pérez-Peña, "College Says It Exaggerated SAT Figures For Ratings," *New York Times*, January 31, 2012, p. A12.

[133] *Id.*

government lost billions in royalty fees by the time the *New York Times* discovered the misstep in the contracts.

Discussion Questions

1. Was the failure to collect the correct lease fees simply a mistake, an oversight?
2. Evaluate the conduct of the government official who developed the idea for forging and backdating documents to cover the oil lease oversight. Would a credo have helped? Why do employees believe that they can conceal information from an auditor or, in this case as well, the public?
3. Should the oil companies pay the amounts that would have been due had the clause been in the lease? Why or why not?

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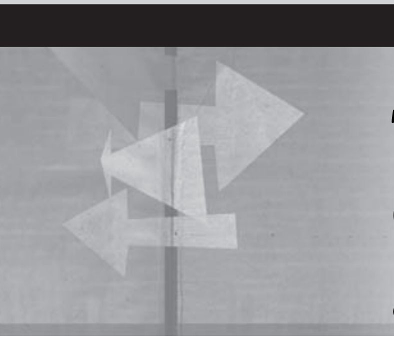
SECTION **D**



The Structural Factors: Governance, Example, and Leadership

This section deals with those who are in charge—company and organizational leadership and their boards. In many situations, these individuals, however unwittingly directed or motivated the conduct or prevented employees from raising concerns that would have ended the legal and ethical violations.

Reading 4.14

Re: A Primer on Sarbanes-Oxley and Dodd-Frank[134]

The introduction to SOX, as it has come to be known, gives the following purpose: "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."

The new portions of the law appear at 15 U.S.C. § 7201. However, because many of the provisions amend the Securities Exchange Act of 1934, which begins at 78 U.S.C. § 1 *et seq.,* many of the provisions can be found there.

Part I: The Creation of the Public Company Accounting Oversight Board

This section of SOX established a quasi-governmental entity called the Public Company Accounting Oversight Board (PCAOB, but called "Peek-a-Boo") under the direction of the SEC to (1) oversee the audit of public companies covered by the federal securities laws (the 1933 and 1934 Acts); (2) establish audit report standards and rules; and (3) investigate, inspect, and enforce compliance through both the registration and regulation of public accounting firms.

Under this section of SOX, companies that conduct audits of companies covered under federal securities laws must register with PCAOB. With this registration control, PCAOB is given the power to discipline public accounting firms, including the ability to impose sanctions such as prohibitions on conducting future audits. PCAOB's powers related to intentional conduct or repeated negligent conduct by audit firms when they are doing company audits and financial certifications. PCAOB's power to regulate was upheld in *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 130 S.Ct. 3138 (2010). Under the Dodd–Frank changes, PCAOB will also have authority to regulate the auditors of broker/dealer firms.

The SEC is now responsible for determining what are or are not "generally accepted" accounting principles for purposes of complying with securities laws. SOX also directs the SEC to study and adopt a system of principles-based accountings.

[134] Adapted from the House and Senate summary of the Sarbanes–Oxley Act of 2002 that appeared on the Senate website in August 2002.

Part II: Auditor Independence

This portion of SOX is a bit of a statutory code of ethics for public accounting firms. Accounting firms that audit publicly traded companies cannot also perform the following consulting services for the companies for which they conduct audits:

1. Bookkeeping and other services related to the accounting records or financial statements of the audit client
2. Design and implementation of financial information systems
3. Appraisal and valuation services, fairness opinions, and contribution-in-kind reports
4. Actuarial services
5. Internal audit outsourcing services
6. Management functions and human resources
7. Broker or dealer, investment adviser, and investment banking services
8. Legal services and expert services unrelated to the audit

Another conflicts prohibition is that the audit firm cannot audit, for one year, a company that has one of its former employees as a member of senior management. For example, if a partner from PwC is hired by Xena Corporation as its controller or CFO, PwC cannot be the auditor (for SEC purposes) for Xena for one year. At least one year must elapse between the hire date of the former partner and the start of the audit if PwC is to conduct the audit.

Procedural requirements in this section include rotating the audit partner for the accounting firm every five years. Also, the auditor must report directly to the audit committee of the company.

Part III: Corporate Responsibility

This section of SOX deals with the audit committees of publicly traded companies and makes these committees responsible for the hiring, compensation, and oversight of the public accounting firm responsible for conducting the company's audits and certifying its financial statements. All the members of the audit committee must be members of the company's board of directors, and must be independent. *Independent* is defined by the SEC to require that the director be an outside board member (not an officer), not have been an officer for a period of time (if retired from the company), not have close relatives working in management in the company, and not have contractual or consulting ties to the company. The SEC and companies have developed complex checklists to help directors determine whether they meet the standards for independence for purposes of qualifying audit committee membership.

In addition to these structural changes in audit committees, this portion of SOX is also the officer certification section. The company's CEO and CFO are required to certify the financial statements the company files with the SEC as being fair in their representation of the company's financial condition and accurate "in all material respects." CFOs and CEOs forfeit any bonuses and compensation that were received based on financial reports that subsequently had to be restated because they were not materially accurate or fair in their disclosures.

The SEC is given the authority to ban those who violate securities laws from serving as an officer or director of a publicly traded company if the SEC can prove that they are unfit to serve. The standard under the statute is "substantial unfitness." For example, Al Dunlap, the former CEO of Sunbeam, settled SEC charges that he oversaw an accounting fraud on its barbecue sales program, by a fine and agreeing to never serve as an officer or director of a publicly traded company. One final section in Part III was passed in response to activity at Enron in the months leading up to its collapse. At Enron, the officers were busily selling off their shares during a time when employees were prohibited from selling shares in their pension plans. Officers, such as Jeffrey Skilling and Clifford Baxter walked away with the cash from selling at the stock's high point, whereas employees, because of the blackout period, were left to simply watch as Enron's stock lost virtually all of its value.

During the so-called "blackout periods" on pension plans, those times when owners of the plans cannot trade in the company stock, officers of the company are also subject to the blackout periods. The penalty for violating this prohibition on stock dealing is that the officers must return any profits from blackout period trading to the company. This requirement to return the profits exists even when the trading was not intentional.

Part IV: Enhanced Financial Disclosures

This section of SOX is the accounting section. Congress directed the SEC to do something about accounting practices for off-balance sheet transactions, including special purpose entities and relationships that while immaterial in amount may have a material effect upon the financial status of the company. For example, a spin-off company that concealed $2 million in company debt is not a material amount. But if the spin-off company is involved in leveraged transactions (as was the case with Enron) and the company has agreed to serve as a guarantor to investors in the spin-off for those leveraged amounts, then the spin-off can have a material effect. The SEC changed the rules for off–balance sheet transactions quite substantially to require companies to show the economics of such off–balance sheet transactions in a transparent fashion. Lehman Brothers' bankruptcy revealed another debt spin-off strategy that company used to hide its obligations and those types of spin-offs must also be disclosed.

A second portion of Part IV gets right to the heart of pro forma and EBITDA. Companies must use generally accepted accounting principles (GAAP) and non-GAAP, side by side.

A third segment of Part IV deals again with officers. Corporations can no longer make personal loans to corporate executives. The only exception is when the company is in the business of making loans, that is, GE executives are permitted to use GE Capital as long as they have the same types of loans that are available to the general public. Another officer requirement shortens the time for them to disclose transactions in the company's shares. Prior to SOX, executives simply had to disclose transactions within ten days from the end of the month in which the transactions occurred. The disclosure period now is within two business days of the transaction.

As a result of the activities that led to these statutory revisions, SOX also requires companies to develop a separate code of ethics for senior financial officers, one that applies to the principal financial officer, comptroller, and/or principal accounting officer. Interestingly, Enron had just such a separate code of ethics. However, the board waived its provisions to allow former CFO Andrew Fastow to have the off-the-book transactions.

Internal Controls Certification: SOX 404

Referred to fondly now as just "404," a final portion of SOX requires companies to include an internal control report and assessment as part of the 10-K annual reports. A public accounting firm that issues the audit report must also certify and report on the state of the company's internal controls.

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Although the audit committee provisions are covered in a different section, Part IV does mandate that every audit committee have at least one member who is a financial expert. The SEC has already established rules for who qualifies as a financial expert and companies' annual reports identify the financial expert and give the background.

Title V: Analyst Conflicts of Interest

The issue of analysts and their conflicts was one that contributed to the failure of the markets to heed the warning signals at Enron, WorldCom, and also contributed to the 2008 market collapse. The SEC now regulates

1. prepublication clearance or approval of research reports by investment bankers;
2. supervision, compensation, and evaluation of securities analysts by investment bankers;
3. retaliation against a securities analyst by an investment banker because of an unfavorable research report that may adversely affect an investment banker's relationship or a broker's or dealer's relationship with the company that is discussed in the report;
4. separating securities analysts from pressure or oversight by investment bankers in a way that might potentially create bias; and
5. developing rules on disclosure by securities analysts and broker/dealers of specified conflicts of interest.

Under Dodd–Frank, the SEC has been directed to further study analysts' relationships and roles in financial markets, and is authorized to promulgate additional rules on conflicts.

Title VIII: Corporate and Criminal Fraud Accountability

This section of SOX expanded and clarified the criminal law portions of securities law by creating new crimes, increasing penalties on existing crimes, and elaborating on the elements required to prove already existing crimes. Also known as the Corporate and Criminal Fraud Accountability Act of 2002, this section theoretically made proving corporate financial crimes a bit easier.

This section amended federal bankruptcy law to make fines, profits, and penalties that result from violation of federal securities laws a nondischargeable debt in bankruptcy. Also, if common-law fraud is involved in the sale of securities, any judgment owed as a result of the fraud is also a nondischargeable bankruptcy debt.

This section also extended the time for bringing a civil lawsuit for securities fraud to not later than the earlier of (1) five years after the date of the alleged violation or (2) two years after its discovery.

Finally, this section prohibits retaliation against employees in publicly traded companies who assist in an investigation of possible federal violations or file or participate in a shareholder suit for fraud against the company. The protections for whistleblowers are expanded under Dodd–Frank to provide for their recovery of 10–30 percent of any fines the company must pay.

Title IX: White-Collar Criminal Penalty Enhancements

This section gives the SEC the authority to freeze bonus, incentive, and other payoffs to corporate officers during an ongoing investigation. The SEC has the authority to banish violating officers and directors from the securities markets as well as from working at a publicly traded company in the future. Auditors must keep their work papers for five years, and the penalties for destruction of documents was increased.

Case 4.15

WorldCom: The Little Company That Couldn't After All[135]

For a time it seemed as if the little long-distance telephone company headquartered in Hattiesburg, Mississippi, would show the world how to run a telecommunications giant. But dreams turned to dust and credits turned to debits, and WorldCom would be limited to showing the world that you cannot stretch accounting rules and hope to survive.

WorldCom: From Coffee Shop Founding to Merger Giant

It was 1983 when Bernard J. (aka "Bernie") Ebbers founded Long Distance Discount Service (LDDS), a discount long-distance telephone company.[136] Local legend has it that Mr. Ebbers, a former junior high school basketball coach from Edmonton, Alberta, launched the plan for what would become a multibillion-dollar, international company in a diner at a Days Inn in Hattiesburg, Mississippi.[137] The telephone industry in the United States was about to be deregulated, and a new industry, telecommunications, would be born. Because competitors to the once-formidable Ma Bell, long the nation's dominant phone company, would now be welcome, Mr. Ebbers and a group of small investors saw an opportunity. They followed a basic economic model in developing their company: buy wholesale and sell retail, but cheaper than the other retailers. Their strategy was to buy long-distance phone network access wholesale from AT&T and other long-distance giants and then resell it to consumers at a discount. They were about to undercut long-distance carriers in their own markets, using their own lines. There was enough money even in the planned lower margins to make money for LDDS.[138]

By 1985, Mr. Ebbers was growing weary of the new telephone venture because LDDS was in constant need of cash infusions, and the thirteen-unit budget motel chain Mr. Ebbers owned was the source of the cash. Following another coffee shop meeting, Mr. Ebbers agreed to take over the management of the company.[139] Mr. Ebbers's strategy upon his ascent to management was different from and bolder than just running a Mississippi phone company. Mr. Ebbers envisioned an international phone company and undertook to grow the company through acquisition. One business writer has described the next phase of LDDS as a fifteen-year juggernaut of mergers.[140] LDDS began regionally, and Ebbers acquired phone companies in four neighboring states. Ebbers also expanded the core business of LDDS from cheaper long distance by expanding into local service and data interchange.

By the time LDDS went public in 1989, it was offering telephone services throughout eleven Southern states and had taken on a new name, WorldCom.[141] By 1998, WorldCom had merged sixty-four times, including mergers with MFS Communications,

[135] Adapted with permission from Marianne M. Jennings, "The Yeehaw Factor," 3 *Wyoming Law Review* 387 (2003).

[136] Seth Schiesel and Simon Romero, "WorldCom: Out of Obscurity to under Inquiry," *New York Times*, March 13, 2002, pp. C1, C4; and Susan Pulliam, Jared Sandberg, and Dan Morse, "Prosecutors Gain Key Witness in Criminal Probe of WorldCom," *Wall Street Journal*, July 3, 2002, pp. A1, A6.

[137] Kurt Eichenwald, "For WorldCom, Acquisitions Were behind Its Rise and Fall," *New York Times*, August 8, 2002, p. A1; and Schiesel and Romero, "WorldCom."

[138] Barnaby J. Feder, "An Abrupt Departure Is Seen as a Harbinger," *New York Times*, May 1, 2002, p. C1.

[139] *Id.*

[140] Kurt Eichenwald and Simon Romero, "Inquiry Finds Effort at Delay at WorldCom," *New York Times*, July 4, 2002, p. C1.

[141] Feder, "An Abrupt Departure Is Seen as a Harbinger," p. C1. The company went public on NASDAQ.

Metromedia, and Resurgens Communications Group.[142] World Corn's sixty-fifth merger was its biggest acquisition. WorldCom made a $37 billion offer to purchase MCI in a bidding war with British Telecommunications and GTE.[143] British Telecom had begun the bidding in 1997 with $19 billion, and in a bidding process that enjoyed daily international coverage, the bidding just kept going until Mr. Ebbers offered Bert C. Roberts Jr., the CEO of MCI, the additional perk of making him chair of the newly merged WorldCom-MCI, to be known as WorldCom. WorldCom won the bidding and completed what was at that time the largest merger in history.[144] WorldCom was on a Wall Street roll, a darling of investors and investment banking firms. It was able to acquire CompuServe and ANS Communications before its merger feast ended in 2000. The ending came abruptly when the Justice Department nixed WorldCom's proposed merger with Sprint, citing a resulting lack of competition in long-distance telecommunications if the $129 billion merger were approved.[145]

Despite the Justice Department's rejection of this merger proposal, WorldCom had grown to 61,800 employees, with revenues of $35.18 billion. The bulk of its revenues came from commercial telecommunications services, including data, voice, Internet, and international services, with the second largest source of revenue being the consumer services division.[146]

Mr. Ebbers was a Wall Street favorite. One analyst described Mr. Ebbers's meetings with Wall Street analysts as "prayer meetings" in which no one asked any questions or challenged any numbers.[147] Few analysts ever questioned Mr. Ebbers or WorldCom's nearly impossible financial performance.[148] Mr. Ebbers made it clear to Wall Street as well as WorldCom's employees that his goals rested in the financial end of the business, not in its fundamentals. He reiterated his lack of interest in operations, billing, and customer service and his obsession with not just being the number-one telecommunications company but also being the best on Wall Street. Mr. Ebbers described his business strategy succinctly in 1997: "Our goal is not to capture market share or be global. Our goal is to be the No. 1 stock on Wall Street."[149] In a report commissioned by the bankruptcy court on the company's downfall, former U.S. Attorney General Dick Thornburgh referred to WorldCom as a "culture of greed."[150]

WorldCom's revenues went from $950 million in 1992 to $4.5 billion by 1996.[151] Mr. Ebbers always promised more and better in each annual report.[152]

The WorldCom era on Wall Street has been likened by those who were competing with the company to being in a race with an athlete who is later discovered to be using

[142] Eichenwald, "For WorldCom, Acquisitions Were Behind Its Rise and Fall," p. B1. The MFS merger alone carried a $12 billion price tag; Eichenwald, p. B4.

[143] Feder, "An Abrupt Departure Is Seen as a Harbinger," p. C1.

[144] Schiesel and Romero, "WorldCom," pp. C1, C4.

[145] Rebecca Blumenstein and Jared Sandberg, "WorldCom CEO Quits amid Probe of Firm's Finances," *Wall Street Journal*, April 30, 2002, pp. A1, A9.

[146] Feder, "An Abrupt Departure Is Seen as a Harbinger," pp. C1, C2. The annual reports for 2000 and 2001 could be found at http://www.worldcom.com. Presently, go to http://www.sec.gov and look up "WorldCom" in the Edgar database. The financial statements in those reports have been restated many times, with a resulting impact of about $9 billion less in revenue than originally reported.

[147] Feder, "An Abrupt Departure Is Seen as a Harbinger," pp. C1, C2.

[148] *Id.*

[149] *Id.*

[150] Andrew Backover, "Report Slams Culture at WorldCom," *USA Today*, November 5, 2002, p. 1B.

[151] These numbers were all computed using the company's annual reports, found under "Investor Relations" at http://www.worldcom.com. Go to http://www.sec.gov and the Edgar database, and plug in "WorldCom" under "Company Name." The numbers were computed using "Selected Financial Data," as called out in each of the annual reports.

[152] In 1998, Mr. Ebbers said that if WorldCom just grew with the market, it would meet its earnings targets.

steroids. In fact, at AT&T, Michael Keith, the head of the business services division, was replaced after just nine months on the job because he could not match World Corn's profit margins. When Mr. Keith told C. Michael Armstrong, CEO of AT&T, that those margins were just not possible, he was removed from his position.[153] William T. Esrey, the CEO of Sprint, said, "Our performance did not quite compare and we were blaming ourselves. We didn't understand what we were doing wrong. We were like, 'What are we missing here?'"[154]

Bernie and His Empire

WorldCom's rollicking Wall Street ride was at least partially enabled by Mr. Ebbers's personality and charisma. He was flamboyant, a 6-foot, 4-inch man who tended toward cowboy boots and blue jeans. Mr. Ebbers's charm worked as well in Jackson, Mississippi, as it did with investment bankers and analysts.[155] He was a "native boy" who was making good. Mr. Ebbers was a 1957 graduate of Mississippi College, located in Clinton, Mississippi, about thirty minutes away from Jackson, Mississippi, where Mr. Ebbers built the headquarters for WorldCom.[156] Even as the company stock was falling, few who lived in Mississippi who had invested in WorldCom would let go of their stock because of an abiding faith in Ebbers.[157] Mr. Ebbers's story was a rags-to-riches one of a Canadian high school basketball player winning a scholarship to a small Mississippi college and then growing an international megabusiness.[158]

Mr. Ebbers's personal life did take some twists and turns. He divorced his wife of twenty-seven years while WorldCom was at its peak and married, in 1998, an executive from WorldCom's Clinton, Mississippi, headquarters who was nearly thirty years his junior. Jack Grubman, the cheerleader analyst for WorldCom who worked at Salomon Brothers, attended the wedding and expensed the trip to Salomon Brothers.[159]

Mr. Ebbers's business acumen with his personal investments presented some problems. He was very good at buying businesses, but not so good at managing them. Most outsiders believed he overpaid for his investments, and he was so distant in day-to-day management that employees referred to him as "the bank," meaning that they could simply turn to him for cash for those things they desired or when they did not operate at a profit or were just plain short of cash.[160] Still, with the value of his WorldCom holdings alone, by 1999 Mr. Ebbers had a net worth of $1.4 billion, earning him the rank of 174 among the richest Americans. Mr. Ebbers owned a minor-league hockey team (the Mississippi Indoor Bandits), a trucking company, Canada's largest ranch (500,000 acres, 20,000 head of Hereford cattle, a fly-fishing resort, and a general store), an all-terrain cycle ATC dealership, a lumberyard, one plantation, two farms, and forest properties equivalent in acreage to half of Rhode Island.[161]

[153] Schiesel, "Trying to Catch WorldCom's Mirage," *New York Times*, June 30, 2002, p. BU1.

[154] *Id.* Sprint has had its own financial difficulties.

[155] Chris Woodyard, "Pressure to Perform Felt as Problems Hit," *USA Today*, July 1, 2002, p. 3A.

[156] *Id.*

[157] *Id.*

[158] Daniel Henninger, "Bye-Bye Bernie Drops the Curtain on the 1990s," *Wall Street Journal*, May 3, 2002, p. A10.

[159] Jayne O'Donnell, "Ebbers Acts as if Nothing Is Amiss," *USA Today*, September 18, 2002, pp. 1B, 2B; and Jessica Sommar, "Here Comes the Bribe: Grubman Expensed Trip to Ebbers' Wedding," *New York Post*, August 30, 2002, p. 39.

[160] Jayne O'Donnell and Andrew Backover, "Ebbers High-Risk Act Came Crashing Down on Him," *USA Today*, December 12, 2002, p. 1B.

[161] Susan Pulliam, Deborah Solomon, and Carrick Mollenkamp, "Former WorldCom CEO Built an Empire on Mountain of Debt," *Wall Street Journal*, December 31, 2002, p. A1.

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Mr. Ebbers found himself heavily in debt with his personal investments, and in need of cash, he used his infallible charm in one more venue, that of his board of directors.[162] Mr. Ebbers was able to persuade the board to allow WorldCom to extend loans in excess of $415 million to him, with the money supposedly to be used to rescue his failing businesses.[163] The problem with the loans, among many others, was that the stock Mr. Ebbers used as security was also the stock he had pledged to WorldCom's creditors in order to obtain financing for the company.[164] The result was that WorldCom's directors were taking a subordinated security interest in stock that had already been pledged, placing it well at the end of the line in terms of creditors, and both the creditors and the board were assuming that the value of the WorldCom stock would remain at an equal or higher level.[165] Although the board's loans to Mr. Ebbers put WorldCom at risk of losing $415 million, the control of the company was actually at greater risk because Mr. Ebbers had pledged about $1 billion in WorldCom stock in total to his creditors as security for loans.[166] Further, if the price of the stock declined and Mr. Ebbers did not meet margin calls, his creditors would be forced to sell the shares. Mr. Ebbers owned 27 million shares of WorldCom stock, and the sale of such large blocks of shares would have had a devastating impact on the price of WorldCom's stock.[167]

Despite all the loans and issues with his personal investments, Mr. Ebbers was a generous philanthropist with his own money as well as with WorldCom's. Clinton Mayor Rosemary Aultman called WorldCom "a wonderful corporate citizen."[168] Ebbers served on the Board of Trustees for Mississippi College and raised $500 million for a fund drive there, more money than had ever been raised by the small college. Interns and graduates from the college worked at WorldCom.

The Burst Bubble and Accounting Myths

Once the Justice Department refused to approve the final proposed merger with Sprint, WorldCom came unraveled. The unraveling had many contributing factors, one of which was the burst in the dot-com bubble and the resulting decline in the need for broadband, Internet access, and all the growth associated with the telecommunications industry.[169] The cuts in the telecom industry began in 2000 and were industry-wide. Between 2000 and 2001, Lucent reduced its employment from 106,000 to 77,000; Verizon went from 263,000 to 247,000; and there was a 52.8 percent decline in employment overall in the telecom industry from 2000 to 2002, cuts that exceeded those in any other industry.[170] When the economy took a general downturn in 2002, WorldCom could no longer sustain what had been phenomenal revenue growth. However, WorldCom's phenomenal revenue growth had not been a function of business acumen. The burst bubble would bring collapses in other industries and regulatory scrutiny of revenues and accounting practices in all industries.

[162] Jared Sandberg and Susan Pulliam, "Report by WorldCom Examiner Finds New Fraudulent Activities," *Wall Street Journal*, November 5, 2002, pp. A1, A11.

[163] Deborah Solomon and Jared Sandberg, "WorldCom's False Profits Climb," *Wall Street Journal*, November 6, 2002, p. A3.

[164] Jared Sandberg, Deborah Solomon, and Nicole Harris, "WorldCom Investigations Shift Focus to Ousted CEO Ebbers," *Wall Street Journal*, July 1, 2002, pp. A1, A8.

[165] Kurt Eichenwald, "Corporate Loans Used Personally, Report Discloses," *New York Times*, November 5, 2002, p. C1.

[166] Sandberg and Pulliam, "Report by WorldCom Examiner Finds New Fraudulent Activities," p. A1.

[167] *Id.*

[168] As noted earlier, Chris Woodyard, "Pressure to Perform Felt as Problems Hit," *USA Today,* July 1, 2002, p. 3A.

[169] Louis Uchitelle, "Job Cuts Take Heavy Toll on Telecom Industry," *New York Times*, June 29, 2002, p. B1.

[170] *Id.*

When Enron collapsed, the SEC, under pressure from Congress, state regulators, and investors, announced, in March 2002, investigations into the financial statements of many companies. WorldCom and Qwest, two of the country's telecommunications giants, were among the SEC's targets.[171] The SEC listed the areas to be examined at WorldCom: charges against earnings, sales commissions, accounting policies for goodwill, loans to officers or directors, integration of computer systems between WorldCom and MCI, and the company's earnings estimates.[172] The SEC inquiry was referred to as a "cloud of uncertainty" over WorldCom.[173] The announcement of the SEC investigation caused a drop of $8.39 in WorldCom's share price, a 7 percent drop.[174] WorldCom had done so well for so long that many analysts expressed doubt that the SEC would find any improprieties. One noted, "I don't think they are going to find anything that they can prosecute. But you may have people try to rewrite the accounting rules so they are not so loose."[175]

At the time that the SEC announced its investigation, Cynthia Cooper, head of WorldCom's internal audit group, was just beginning her internal investigation of the rampant allegations and rumors of creative and not-so-creative accounting practices within the company.[176] With the pressure of the external regulatory investigation and WorldCom's voluntary disclosure that it had loaned Mr. Ebbers the $415 million, WorldCom came to be called "Worldron" by its own employees.[177]

The Acquisitions, Expenses, and Reserves

WorldCom's acquisition strategy required that there always be a bigger and better merger if the company's numbers were going to continue their double-digit growth.[178] If the mergers stopped, so also did the benefits of the accounting rules WorldCom was using to its advantage in booking the mergers.[179]

The pace of the mergers was so frenetic, and the accounting and financials so different because of interim mergers, that even the most sophisticated analysts had trouble keeping up with the books.[180] WorldCom also benefited from the market bubble of the dot-com era, one in which investors suspended intellectual inquiry about these phenomenal performers.[181]

Accounting Professor Mike Willenborg comments on this lax attitude about the confusion and inexplicable numbers during this market era: "You wonder where some of the skepticism was."[182] It almost seemed as if the more confusing the investment, the better the investment. As late as February 2002, analysts were reassuring themselves that all

[171] Andrew Backover, "WorldCom, Qwest Face SEC Scrutiny," *USA Today*, March 12, 2002, p. 1B; and Andrew Backover, "'Cloud of Uncertainty' Rains on WorldCom," *USA Today*, March 13, 2002, p. 3B.

[172] Backover, "'Cloud of Uncertainty' Rains on WorldCom."

[173] *Id.*

[174] *Id.*

[175] *Id.*

[176] Susan Pulliam and Deborah Solomon, "How Three Unlikely Sleuths Discovered Fraud at WorldCom," *Wall Street Journal*, October 30, 2002, p. A1.

[177] Andrew Backover, "Questions on Ebbers Loans May Aid Probes," *USA Today*, November 6, 2002, p. 3B.

[178] Andy Kessler, "Bernie Bites the Dust," *Wall Street Journal*, May 1, 2002, p. A18.

[179] Shawn Tully, "Don't Get Burned," *Fortune*, February 18, 2002, pp. 89, 90.

[180] David Rynecki, "Articles of Faith: How Investors Got Taken in by the False Profits," *Fortune*, April 2, 2001, p. 76.

[181] *Id.* Securities Exchange Commissioner Cynthia Glassman described the market phenomenon in a speech she gave to the American Society of Corporate Secretaries on September 27, 2002; see http://www.sec.gov/news/speech. Accessed June 30, 2010.

[182] "'Going Concerns': Did Accountants Fail to Flag Problems at Dot-Com Casualties?" *Wall Street Journal*, February 8, 2001, pp. C1, C2.

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would be well with WorldCom, and one analyst was on the record as telling clients that the rumor swirls surrounding WorldCom would die down.[183] Indeed, the more confusing, the higher the rate of return and even greater the stock price.[184] WorldCom's stock reached $64.50 per share in June 1999, but was at $0.83 on June 26, 2002, following the announcement of the company's accounting reversals.[185]

WorldCom's fancy merger accounting was not unusual, nor is there any allegation that its methods violated accounting rules. The fancy merger accounting goes like this: a company acquires another (as WorldCom did sixty-five times) and is permitted to take a restructuring charge against earnings, the infamous "one-time charge."[186] The restructuring charge is a management determination, and there are professional disagreements among accountants, auditors, and managers as to how much these charges should be.

Scott Sullivan, the CFO of WorldCom, was able to employ reserves to keep WorldCom going for two years after the merger with Sprint failed in 2000.[187] Because there were no further mergers, the company's phenomenal earnings record would have ended in 2000 had it not been for WorldCom's rather sizeable reserves.[188] One expert estimates the WorldCom's reserves could have been as high as $10 billion.[189]

The Capitalization of Ordinary Expenses

As WorldCom's executive team grappled with what it believed to be strategic issues that needed attention, Ms. Cooper and her team were working nights and weekends to determine how extensive the accounting issues were. By early June 2002, Ms. Cooper went to WorldCom's CFO, Scott Sullivan, with questions about the booking of operating expenses as capital expenses. When Mr. Sullivan was not as forthcoming as she expected, Ms. Cooper became more concerned. Mr. Sullivan was the most respected person in the company, but Ms. Cooper felt that he seemed hostile, and "when someone is hostile, my instinct is to find out."[190] Mr. Sullivan told Ms. Cooper that he was planning a "write down" in the second quarter if she could just hold off on the investigation.[191]

Ms. Cooper did not feel she could hold off any further on the investigation. She and her internal audit team uncovered layers of accounting issues. With the merger reserves quickly eaten away, Mr. Sullivan had to find a means for maintaining earnings levels, including the expected growth. Although the precise timing for the new accounting strategy remains unclear,[192] most experts agree that at least by the first quarter of 2001, Mr. Sullivan and staff embarked on an accounting strategy that would keep WorldCom

[183] E. S. Browning, "Burst Bubbles Often Expose Cooked Books and Trigger SEC Probes, Bankruptcy Filings," *Wall Street Journal*, February 11, 2002, pp. C1, C4.

[184] Matt Krantz, "There's Just No Accounting for Teaching Earnings," *USA Today*, June 20, 2001, p. 1B.

[185] Robin Sidel, "Some Untimely Analyst Advice on WorldCom Raises Eyebrows," *Wall Street Journal*, June 27, 2002, p. A12.

[186] Lee Clifford, "Is Your Stock Addicted to Write-Offs?" *Fortune*, April 2, 2001, p. 166.

[187] Geoffrey Colvin, "Scandal Outrage, Part III," *Fortune*, October 28, 2002, p. 56.

[188] The reserves and some other creative accounting were often done without the executives in charge knowing that their division's accounting figures were being changed because the changes were made from headquarters.

[189] Henny Sender, "Call Up the Reserves: WorldCom's Disclosure Is Warning for Investors," *Wall Street Journal*, July 3, 2002, pp. C1, C3.

[190] Amanda Ripley, "The Night Detective," *Time*, December 30, 2002–January 6, 2003, pp. 45, 47.

[191] Kurt Eichenwald and Simon Romero, "Inquiry Finds Effort at Delay at WorldCom," *New York Times*, July 4, 2002, p. C1.

[192] Disclosures near the end of 2002 put the date at 1999. Stephanie N. Meta, "WorldCom's Latest Headache," *Fortune*, November 25, 2002, pp. 34, 35.

afloat but was not in compliance with GAAP.[193] According to his guilty plea and those filed by others working in WorldCom's financial areas, Mr. Sullivan and colleagues were taking ordinary expenses and booking them as capital expenditures so as to boost earnings.[194]

For example, in 2001, WorldCom had $3.1 billion in long-distance charges.[195] Long-distance wholesale charges are the expenses of a long-distance phone service retailer. The $3.1 billion should have been booked as an operating expense. However, $3.1 billion booked as an expense would have ended the earnings streak of WorldCom with a loss for 2001. So, Mr. Sullivan and his staff charged the $3.1 billion as a capital expense and planned to amortize this amount over ten years, a far lesser hit to earnings. The difference was that WorldCom, by capitalizing the operating expenses, showed net income of $1.38 billion for 2001, its previously announced target.[196]

However, ordinary and capital expenses require receipts and invoices for the property. The accounting lapse began unwinding when Gene Morse, a member of WorldCom's internal audit group, found $500 million in computer expenses but could not find any documentation or invoices.[197] Mr. Sullivan had demanded that employees keep line costs at 42 percent; anything beyond that was just shifted to capital expenditures.[198] The result was that staff members spun numbers out of whole cloth, but costs were kept down even as profits were pumped artificially high. The initial disclosure of the $3.85 billion sent shock waves through the business world,[199] but before the year was out, that number would rise to $9 billion.[200]

Other Accounting Issues

An investigation and report commissioned by the WorldCom board and completed by former Attorney General Richard Thornburgh indicates that accounting issues extended into the reporting of revenues, not just expenses.[201] Mr. Thornburgh's report, partially excised at the time of its release in deference to the Justice Department investigation, reveals that there were eventually two sets of books prepared for David Myers and Mr. Sullivan by Buford Yates. Mr. Myers was the controller of WorldCom, and Mr. Yates was the head of general accounting. Mr. Myers also held a senior vice president's position at WorldCom and was well liked by the other officers and the staff. Described as a World-Com "cheerleader" by coworkers, Myers was referred to around the company as "Mr. GQ" because he dressed so fashionably.[202] Mr. Yates prepared two charts for Mr. Myers and Mr. Sullivan, with one chart offering the real revenues and the other chart showing the revenue numbers WorldCom needed to post in order to make the numbers the company had given to Wall Street analysts.[203]

Because of WorldCom's international organization and worldwide offices, those at the corporate level were able to use computer access to these offices' financial records and

[193] "Big Lapse in Auditing Is Puzzling Some Accountants and Other Experts," *New York Times*, June 28, 2002, p. C4.

[194] Jared Sandberg, Deborah Solomon, and Rebecca Blumenstein, "Inside WorldCom's Unearthing of a Vast Accounting Scandal," *Wall Street Journal*, June 27, 2002, p. A1.

[195] *Id.*

[196] Sandberg, Solomon, and Harris, "WorldCom Investigations Shift Focus to Ousted CEO Ebbers," pp. A1, A8.

[197] Pulliam and Solomon, "How Three Unlikely Sleuths Discovered Fraud at WorldCom," p. A1.

[198] Sandberg, Solomon, and Blumenstein, "Inside WorldCom's Unearthing of a Vast Accounting Scandal," p. A8.

[199] WorldCom's initial $3.8 billion was six times the Enron restatement of earnings. Jared Sandberg, Deborah Solomon, and Rebecca Blumenstein, *Id.*, p. A1.

[200] Kurt Eichenwald and Seth Schiesel, "SEC Files New Charges on WorldCom," *New York Times*, November 6, 2002, pp. C1, C2.

[201] Sandberg and Pulliam, "Report by WorldCom Examiner Finds New Fraudulent Activities," p. A1.

[202] Jim Hopkins, "CFOs Join Their Bosses on the Hot Seat," *USA Today*, July 16, 2002, p. 3B.

[203] Andrew Backover, "Trouble May Have Started in November 2000," *USA Today*, July 1, 2002, p. 3A.

thereby change the company's final financial statements. For example, Steven Brabbs, a WorldCom executive who was based in London and who was the director of international finance and control, raised the question of the accounting changes, which had affected his division, to David Myers. Mr. Brabbs discovered, after his division's books had been closed, that $33.6 million in line costs had been dropped from his books through a journal entry.[204] Unable to find support or explanation for the entry, Mr. Brabbs raised the question of documentation to Mr. Myers. When he had no response, he suggested that perhaps Arthur Andersen should be consulted to determine the propriety of the changes.[205] Mr. Brabbs also raised his concerns in a meeting with other internal financial executives at WorldCom. Following the meeting, Mr. Myers expressed anger at him for so doing.[206]

When the next quarter financials were due, Mr. Brabbs received instructions to make these transfers at his level rather than having them done by journal entry at the corporate level. Because he was still uncomfortable with the process but could get no response from headquarters, he established an entity and placed the costs in there. He felt his solution at least kept his books for the international division clean.[207] He continued to raise the question about the accounting propriety, but the only response he ever received was that it was being done as a "Scott Sullivan directive."[208]

Congressional documents verify that many within the company who were concerned about the accounting changes approached Mr. Myers from as far back as July 2000, but he apparently disregarded them and went forward with the accounting changes anyway.[209] Rep. Billy Tauzin described the congressional findings related to the culture of fear and pressure as follows: "The bottom line is people inside this company were trying to tell its leaders you can't do what you want to do, and these leaders were telling them they had to."[210] When Steven Brabbs continued to raise his concerns about the accounting practices at WorldCom, and even with Arthur Andersen, he received an e-mail from David Myers ordering him to "not have any more meetings with AA for any reason."[211] Although the accounting issues continued to concern employees, it would be some time before they would percolate to the board level.

It was clear that those involved were aware that they were violating accounting principles.[212] An e-mail sent on July 25, 2000, from Buford Yates, director of general accounting, to David Myers, controller, reflected his doubts about changing the operating expense of purchased wire capacity to a capital expense, "I might be narrow-minded, but I can't see a logical path for capitalizing excess capacity."[213] Mr. Yates sent an e-mail to Scott Sullivan that read, "David and I have reviewed and discussed your logic of capitalizing excess capacity and can find no support within the current accounting guidelines

[204] Kurt Eichenwald, "Auditing Woes at WorldCom Were Noted Two Years Ago," *New York Times*, July 15, 2002, pp. C1, C9.

[205] *Id.*, p. C9.

[206] *Id.*

[207] *Id.*

[208] *Id.*

[209] *Id.*

[210] Jayne O'Donnell and Andrew Backover, "WorldCom's Bad Math May Date Back to 1999," *USA Today*, July 16, 2002, p. 1B.

[211] Jessica Sommar, "E-Mail Blackmail: WorldCom Memo Threatened Conscience-Stricken Exec," *New York Post*, August 27, 2002, p. 27.

[212] A 2001 survey of CFOs indicated that 17 percent of CFOs at public corporations feel pressure from their CEOs to misrepresent financial results. Hopkins, "CFOs Join Their Bosses on the Hot Seat," p. 3B.

[213] Kevin Maney, Andrew Backover, and Paul Davidson, "Prosecutors Target World Com's Ex-CFO," *USA Today*, August 29, 2002, pp. 1B, 2B.

that would allow for this accounting treatment."[214] Mr. Myers admitted to investigators that "this approach had no basis in accounting principles."[215] Nonetheless, the change from operating expenses to capitalization went forward, with Betty Vinson and Troy Normand, employees in accounting, making the adjustments in the books per orders from Mr. Myers.[216] Ms. Vinson and Mr. Normand were both fired, and Mr. Yates resigned shortly after he was indicted.

Before making the decision on the accounting changes, neither Mr. Myers nor Mr. Sullivan consulted with WorldCom's outside auditor, Arthur Andersen.[217] The criminal complaint in Mr. Myers's case, and the one to which he entered a guilty plea, included the following description of the role of financial pressures in their decisions and accounting practices: "Sullivan and Myers decided to work backward, picking the earnings numbers that they knew the analysts expected to see, and then forcing WorldCom's financials to match those numbers."[218]

Mr. Sullivan had assumed the helm of WorldCom's finances as CFO in 1994, at age 32.[219] The joke around the WorldCom offices when Mr. Sullivan assumed the CFO slot was that he was "barely shaving."[220] Arriving at WorldCom in 1992 through its merger with Advanced Telecommunications, where he had been since 1987, Mr. Sullivan and Mr. Ebbers became inseparable in the mergers and deals they put together over the next eight years.[221] He earned the nickname *whiz kid*, and whereas Mr. Ebbers was the showman for WorldCom, Mr. Sullivan was the detail person. Mr. Ebbers frequently answered questions from analysts and others with "We'll have to ask Scott."[222]

Mr. Ebbers praised Mr. Sullivan publicly and saw to it that he was well compensated for his efforts.[223] Mr. Ebbers rewarded Mr. Sullivan with both compensation and titles. In addition to his role as CFO, he served as the secretary for the board.[224] When Mr. Sullivan was appointed to the WorldCom board at age 34, in 1996, the company press release included this quote from Mr. Ebbers: "Over the years WorldCom, Inc., has benefited immensely from the outstanding array of talent and business acumen of our Board of Directors, and Scott Sullivan will be an excellent addition to that group. He brings to the table a proven background of expertise and dedication to the Company."[225]

[214] *Id.*, p. 2B.

[215] Eichenwald, "2 Ex-Officials at WorldCom Are Charged in Huge Fraud," *New York Times*, August 2, 2002, pp. A1, C5.

[216] Kevin Maney, Andrew Backover, and Paul Davidson, "Prosecutors Target WorldCom's Ex-CFO," *USA Today,* August 29, 2002, pp. 1B, 2B. See also Simon Romero and Jonathan D. Glater, "Wider WorldCom Case Is Called Likely," *New York Times*, September 5, 2002, p. C9, for background given on titles of employees noted.

[217] Eichenwald, "2 Ex-Officials at WorldCom Are Charged in Huge Fraud," *New York Times*, August 2, 2002, pp. A1, C5.

[218] *Id.* Yochi J. Dreazen, Shawn Young, and Carrick Mollenkamp, "WorldCom Probers Say Sullivan Implicates Ebbers," *Wall Street Journal*, July 12, 2002, p. A3; and Andrew Backover and Paul Davidson, "WorldCom Grilling Turns Up No Definitive Answers," *USA Today,* July 9, 2002, pp. 1B, 2B.

[219] Shawn Young and Evan Perez, "Wall Street Thought Highly of WorldCom's Finance Chief," *Wall Street Journal*, June 27, 2002, pp. B1, B3.

[220] *Id.*

[221] Barnaby J. Feder and David Leonhardt, "From Low Profile to No Profile," *New York Times*, June 27, 2002, p. C1.

[222] *Id.*

[223] *Id.*, p. C6. Sullivan still lives with his wife, who has chronic health problems, in a home in Florida that is valued at $178,000, but they were in the process of constructing a home in the Boca Raton, Florida, area at a cost estimated to be $10 million, with the lot costing $2.45 million. Because of the unlimited homestead exemption in Florida, many financially troubled executives have retained significant assets while still discharging debts in bankruptcy.

[224] WorldCom, WorldCom Proxy Statement, April 22, 2002, http://www.sec.gov. Accessed June 30, 2010.

[225] "WorldCom, Inc. Appoints New Board Member," press release, March 12, 1996. http://www.worldcom.com. Accessed January 22, 2003.

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According to WorldCom proxy statements, Mr. Sullivan's compensation was as follows: 1997, $500,000 salary and $3.5 million bonus; 1998, $500,000 salary and $2 million bonus; 1999, $600,000 salary and $2.76 million bonus; 2000, $700,000 salary and $10 million bonus; and for 2001, Mr. Sullivan earned a salary of $700,000 and a bonus of $10 million. These figures do not include the stock options, which for the years from 1997 to 2001 totaled $1.5 million, $900,000, $900,000, $619,140, and $928,710, respectively.[226]

Congressional documents indicate that both Mr. Myers and Mr. Sullivan met with other executives, indicating the need to "do whatever necessary to get Telco/Margins back in line."[227] Mr. Myers has subsequently indicated that once they started down the road, it was tough to stop.[228]

Later discussions between Mr. Myers and the head of WorldCom's internal audit group, Cynthia Cooper, reflect that he understood "there were no specific accounting pronouncements" that would justify the changes.[229] When Ms. Cooper raised the question to Mr. Myers about how the changes could be explained to the SEC, Mr. Myers, reflecting the view that it was a temporary change to see the company through until the financial picture changed, said that "he had hoped it would not have to be explained."[230]

Corporate Governance at WorldCom

The board at WorldCom was often referred to as "Bernie's Board."[231] Carl Aycock had been a member of the board since 1983, when the original company was founded.[232] Max Bobbitt and Francesco Galesi, who were friends of Mr. Ebbers, joined the board in 1992.[233] And one board member, Stiles A. Kellett Jr., an original board member and friend of Mr. Ebbers from the early motel-meeting days, resigned in October 2002 after revelations about his extensive use of the company jet.[234] All of the directors became millionaires after the days of their humble beginnings, when the board meetings were held at the Western Sizzlin' Steakhouse in Hattiesburg, Mississippi.[235] A former board member, Mike Lewis, said few board members would disagree with Mr. Ebbers: "Rule No. 1: Don't bet against Bernie. Rule No. 2: See Rule No. 1."[236]

Although board members were entitled to WorldCom or MCI stock in lieu of fees and were awarded options each year, their annual retainer was $35,000 per year, with $750 for committee meetings attended on the same day as the board meetings and $1,000 for other committee meetings.[237] But this was a generous board when it came to Mr. Ebbers. Even upon Mr. Ebbers's departure, with significant loans due and owing, the

[226] See proxy statements, 14-A, at http://www.sec.gov under WorldCom for 1997–2001.

[227] Donnell and Backover, "WorldCom's Bad Math May Date Back to 1999," p. 1B.

[228] *Id.*

[229] Yochi J. Dreazen and Deborah Solomon, "WorldCom Aide Conceded Flaws," *Wall Street Journal*, July 16, 2002, p. A3.

[230] *Id.*

[231] Jared Sandberg and Joann S. Lublin, "An Already Tarnished Board also Faces Tough Questions over Accounting Fiasco," *Wall Street Journal*, June 28, 2002, p. A3.

[232] Seth Schiebel, "Most of Board at WorldCom Resign Post," *New York Times*, December 18, 2002, p. C7.

[233] *Id.*

[234] Susan Pulliam, Jared Sandberg and Deborah Solomon, "WorldCom Board Will Consider Rescinding Ebbers's Severance," *Wall Street Journal*, September 10, 2002, p. A1.

[235] Jared Sandberg, "Six Directors Quit as WorldCom Breaks with Past," *Wall Street Journal*, December 18, 2002, p. A3.

[236] Sandberg and Lublin, "An Already Tarnished Board also Faces Tough Questions over Accounting Fiasco," p. A3.

[237] http://www.sec.gov; and WorldCom proxy for 2001, p. 6. Accessed June 30, 2010.

board gave Mr. Ebbers a severance package that included $1.5 million per year for the rest of his life, thirty hours of use of the company jet, full medical and life insurance coverage, and the possibility of consulting fees beyond a minimum amount required under the terms of the package.[238]

The WorldCom board was not an active or curious one. Despite experiencing a lawsuit in which employees with specific knowledge about the company's accounting practices filed affidavits, the board made no further inquiries. In fact, the company dismissed the employees and ignored their affidavits when a judge dismissed the class action suit.[239] The board was not aware of $75 million in loans to Mr. Ebbers or a $100 million loan guarantee for Mr. Ebbers's personal loans until two months after the loans and guarantees had been signed for him. Two board meetings went by after the loan approvals before the board was informed and approval given. Further, the board's approval came without any request for advice from WorldCom's general counsel.[240]

What Went Wrong: Management and Operations

The creative and not-so-creative accounting at WorldCom may have been a symptom, and not the problem. Mr. Ebbers made no secret of the fact that he was often bored by business details, operations, and fundamentals. He far preferred the art of the deal.[241] When Mr. Ebbers did get involved in operations, his involvement was more like that of an entrepreneur or small businessperson trying to micromanage details. For example, when Mr. Ebbers visited his dealerships in Mississippi, he usually went in with the idea of cutting costs and would do so by focusing on things such as allotting cell phones to sales personnel, eliminating the water cooler, and even requiring that the heating bills be reduced.[242] As a result, WorldCom could hardly be said to have a crackerjack management team.[243] It had an abysmal record on receivables, being lax in bringing in cash from regular billings.[244] One analyst described the operations side of WorldCom as follows: "WorldCom wasn't operated at all, it was just on auto pilot, using bubble gum and Band-Aids as solutions to its problems."[245]

The constant mergers threw the billing system for WorldCom customers into turmoil.[246] WorldCom had fifty-five different billing systems and the litigation from customers to show that the billing systems were not studies in accuracy.[247] MCI customers would find their service disconnected for nonpayment because the WorldCom side, which did the billing, never got the payments, which went to the MCI side.[248] Even when the customer's account was located, there was a great deal of foot-dragging by

[238] *Id.*

[239] Neil Weinberg, "WorldCom's Board Alerted to Fraud in 2001," *Forbes*, August 12, 2002, p. 56. See also Kurt Eichenwald, "Auditing Woes at WorldCom Were Noted Two Years Ago," *New York Times*, July 15, 2002, p. C1.

[240] Andrew Backover, "Questions on Ebbers Loans May Aid Probes," *USA Today*, November 6, 2002, p. 3B.

[241] Feder, "An Abrupt Departure Is Seen as a Harbinger," pp. C1, C2; and Eichenwald, "For WorldCom, Acquisitions Were behind Its Rise and Fall," p. A1.

[242] Jayne O'Donnell and Andrew Backover, "Ebbers' High-Risk Act Came Crashing Down on Him," *USA Today*, December 12, 2002, pp. 1B, 2B.

[243] Feder, "An Abrupt Departure Is Seen as a Harbinger," pp. C1, C2.

[244] Marcy Gordon, "WorldCom CEO Blames Former Execs for Woes," *The Tribune*, from the Associated Press, July 2, 2002, p. B1.

[245] Eichenwald, "For WorldCom, Acquisitions Were behind Its Rise and Fall," p. A1.

[246] One analyst noted that Mr. Ebbers may not have even seen the importance of operations: "Bernie viewed this as a series of financial-engineering maneuvers and never truly understood the business that he was in." *Id.*, p. C2.

[247] The CEO of one WorldCom customer said, "They can't even tell you what they're owed." Scott Woolley, "Bernie at Bay," *Fortune*, April 15, 2002, p. 63.

[248] Eichenwald, "For WorldCom, Acquisitions Were behind Its Rise and Fall," p. A1.

WorldCom in terms of both bill payment and acknowledgment of customer corrections.[249] Cherry Communications, a large customer of WorldCom, filed suit against WorldCom for $100 million in "false and questionable" bills from 1992 to 1996.[250] Cherry went into Chapter 11 bankruptcy owing WorldCom $200 million in uncollectable revenues, less the $100 million in disputes spread across the fifty-five billing systems. WorldCom did get stock in a reorganized Cherry Communications—a typical result, because WorldCom extended credit to small companies that were high credit risks. On average, two to three of World-Corn's commercial customers filed for bankruptcy during any given quarter.[251]

One part of the SEC investigation of WorldCom focused on whether WorldCom capitalized on the chaotic billing system to boost revenues. One technique investigated was whether services sold to one customer were then booked twice as revenues in different divisions, all at different rates and under multiple billing systems.[252] In fact, three stellar performers at WorldCom were fired because they had used the fact that revenues could often be booked twice in the confusing systems to pump up the commission figures for their sales teams. The three simply listed sales from other divisions for their employees and were able to boost commissions substantially.[253] In September 2000, WorldCom did take a write-down of $685 million for uncollectable revenues.[254]

The rapidity of the mergers left employees and managers with the day-to-day work of trying to integrate the acquired company's technology with WorldCom's in order to create a seamless communications network. That seamless network never happened because technical problems and employees consumed with constant troubleshooting meant that customer service suffered and the overall systemic issues could not be addressed.[255]

The problems were never solved because of one additional management issue, and that was the constant merger of executives from other companies with WorldCom managers.[256] One former WorldCom employee summarized the company atmosphere: "Nobody had time to adjust. There was a [reorganization] every couple of months, so people didn't know who they were supposed to be reporting to or what they were supposed to be working on."[257] MCI had the experience, but WorldCom had control. No one took the lead in an integration effort, and the result was that WorldCom was saddled with excess and expensive capacity from improperly integrated dual systems. Power struggles apparently contributed to a type of nepotism in which Mississippi-based executives were awarded the vice president positions in charge of operations and billing, and they lacked the experience and expertise that was necessary to fix the problems created by the mergers and create an effective billing system and integrated technology.

WorldCom Bubble Bursts

While the operations in the company became more and more fractured, the internal auditors' work continued. However, they were forced to work secretly.[258] The internal

[249] Kevin Maney, "WorldCom Unraveled as Top Execs' Unity Crumbled," *USA Today*, June 28, 2002, pp. 1B, 2B.

[250] *Id.*

[251] Scott Woolley, "Bernie at Bay," *Fortune*, April 15, 2002, p. 64.

[252] *Id.*

[253] Yochi J. Dreazen, "WorldCom Suspends Executives in Scandal over Order Booking," *Wall Street Journal*, February 15, 2002, p. A3.

[254] Eichenwald, "For WorldCom, Acquisitions Were behind Its Rise and Fall," p. A1.

[255] *Id.*

[256] Maney, "WorldCom Unraveled as Top Execs' Unity Unraveled," pp. 1B, 2B.

[257] Eichenwald, "For WorldCom, Acquisitions Were behind Its Rise and Fall," p. A1.

[258] Pulliam and Solomon, "How Three Unlikely Sleuths Discovered Fraud at WorldCom," pp. A1, A6.

auditors worked at night to avoid detection and, at one point, concerned that their work might be sabotaged, purchased a CD-ROM burner privately and began recording the data they were gathering, and storing the CDs elsewhere.[259] Indeed, so chilly was their reception when they met with Mr. Sullivan that Ms. Cooper arranged to meet with Max Bobbitt, the head of the board's audit committee, in secret fashion at a local Hampton Inn so that there would be no repercussions for her or her staff as they completed their work.[260] Ms. Cooper was forced to go to the board and the audit committee because she was unable to secure an adequate explanation from Mr. Sullivan, who, as noted earlier, had even asked her to delay her audit.

At one point, while Ms. Cooper's internal audit team was conducting its investigation, Mr. Sullivan confronted one of her auditors, Gene Morse, in the cafeteria. During his five years at WorldCom, he had only spoken to Mr. Sullivan twice. Mr. Sullivan asked what he was working on, and Mr. Morse responded with information about another project, "International capital expenditures," which seemed to satisfy Mr. Sullivan.[261]

Mr. Sullivan was given an opportunity to respond at that board meeting but could offer no explanation other than his belief that the expenses were correctly booked. He refused to resign and defended his accounting practices until that final meeting, when he was fired that day by the board.[262] David Myers, the controller for the company, resigned the following day.[263] Following sufficient review by Ms. Cooper and the company's new auditor, KPMG, WorldCom announced on June 25, 2002, that it had overstated cash flow by $3.9 billion for 2001 and the first quarter of 2002 by booking ordinary expenses as capital expenditures.[264] WorldCom's shares dropped 76 percent, to 20 cents per share.[265] Trading was halted for three sessions, and when it was reopened, more than 1.5 billion shares of WorldCom were dumped on the market, sending the share price down from 20 cents to 6 cents in what was then the highest-volume selling frenzy in the history of the market. It was the first time in the history of the market that more than 1 billion shares had ever been traded in one day. The pace exceeded the previous record of 671 million shares sold in one day, a record WorldCom held only for a few days until this trading reopened. WorldCom was delisted from the NASDAQ on July 5, 2002.[266]

WorldCom's bonds dropped from 79 cents just before the announcement of the accounting irregularities to 13 cents just following the announcement.[267] There was a flurry of subpoenas from Congress for the officers of the company.[268] The officers all took the Fifth Amendment, and $2 billion in federal contracts held by WorldCom were

[259] Ripley, "The Night Detective," pp. 45, 47.

[260] There is a certain irony here. WorldCom was hatched in a low-priced motel, and its unraveling began at a similar location.

[261] Pulliam and Solomon, "How Three Unlikely Sleuths Discovered Fraud at WorldCom," pp. A1, A6.

[262] Ripley, "The Night Detective," p. 49.

[263] *Id.*

[264] Andrew Backover, Thor Valdmanis, and Matt Krantz, "WorldCom Finds Accounting Fraud," *USA Today*, June 26, 2002, p. 1B.

[265] *Id.* This restatement remained the largest in history, more than doubling the previous record set by Rite-Aid of $1.6 billion, until Parmalat collapsed. See http://www.bankruptcydata.com.

[266] Matt Krantz, "Investors Dump WorldCom Stock at Record Pace," *USA Today*, July 3, 2002, p. 3B; and WorldCom, "Press Releases, 2001," July 29, 2002, http://www.worldcom.com. These press releases may or may not be available at http://www.mci.com. However, they were researched when the WorldCom site was functioning.

[267] Henny Sender and Carrick Mollenkamp, "WorldCom Bondholders Study Plan," *Wall Street Journal*, July 5, 2002, p. A6.

[268] Andrew Backover and Thor Valdmanis, "WorldCom Scandal Brings Subpoenas, Condemnation," *USA Today*, June 28, 2002, p. 1A; and Michael Schroder, Jerry Markon, Tom Hamburger, and Greg Hitt, "Congress Begins WorldCom Investigation," *Wall Street Journal*, June 28, 2002, p. A3.

under review by the General Services Administration because federal regulations prohibit federal agencies from doing business with companies under investigation for financial improprieties.[269]

The SEC filed fraud charges within three days and asked for an explanation from WorldCom about exactly what had been done in its accounting.[270] On August 8, 2002, WorldCom announced that it had found an additional $3.3 billion in earnings misstatements, from 2000, with portions from 1999.[271] WorldCom declared bankruptcy on July 22, 2002, the largest bankruptcy in the history of the United States.[272]

Shortly after WorldCom filed for bankruptcy, the federal government indicted Scott Sullivan, David Myers, Betty Vinson, Buford Yates, Troy Normand, and a host of other characters involved in developing the company's financial reports.[273] Mr. Ebbers was not indicted until after Mr. Sullivan entered a guilty plea.[274]

Mr. Sullivan was indicted on federal charges of fraud and conspiracy on August 1, 2002.[275] Mr. Myers entered a guilty plea to three felony counts of fraud on September 26, 2002.[276] Mr. Yates initially entered a not guilty plea.[277] However, just one month later, Mr. Yates entered a guilty plea to securities fraud and conspiracy and agreed to cooperate with the Justice Department.[278] Ms. Vinson and Mr. Normand also entered guilty pleas to fraud and conspiracy just three days after Mr. Yates's plea.[279] When Ms. Vinson testified she was asked why she made the accounting entries that she knew were wrong, she said she considered quitting, but, as the primary breadwinner in her household, she succumbed: "I felt like if I didn't make the entries, I wouldn't be working there."[280] Ms. Vinson and Troy Normand raised their concerns to Mr. Sullivan, but he was able to convince them to go along.[281] His colorful analogy was that WorldCom was akin to an aircraft carrier. He had some planes out there that he needed to land on deck before they came clean on the creative interpretations.[282] When Betty Vinson was asked how she decided which accounts she would change, her response in court was dramatic and sadly illegal: "I just really pulled some out of the air. I used the spreadsheets."[283]

[269] Yochi J. Dreazen, "WorldCom's Federal Contracts May Be Vital," *Wall Street Journal*, July 10, 2002, p. C4. For information on the Fifth Amendment, see Andrew Backover and Paul Davidson, "WorldCom Grilling Turns Up No Definitive Answers," *USA Today*, July 9, 2002, p. 1B.

[270] Andrew Backover and Thor Valdmanis, "WorldCom Report Will Face Scrutiny," *USA Today*, July 1, 2002, p. 1B

[271] Kevin Maney and Thor Valdmanis, "WorldCom Reveals $3.3B More in Discrepancies," *USA Today,* August 9, 2002, p. 1B.

[272] Simon Romero and Riva D. Atlas, "WorldCom Files for Bankruptcy; Largest U.S. Case," *New York Times*, July 22, 2002, p. A1; and Kevin Maney and Andrew Backover, "WorldCom's Bomb," *USA Today*, July 22, 2002, pp. 1B, 2B.

[273] Kurt Eichenwald, "2 Ex-Officials at WorldCom Are Charged in Huge Fraud," *New York Times*, August 2, 2002, p. A1. See also Deborah Solomon and Susan Pulliam, "U.S., Pushing WorldCom Case, Indicts Ex-CFO and His Aide," *Wall Street Journal*, August 29, 2002, p. A1.

[274] Simon Romero and Jonathan D. Glater, "Wider WorldCom Case Is Called Likely," *New York Times*, September 5, 2002, p. C9.

[275] Eichenwald, "2 Ex-Officials at WorldCom Are Charged in Huge Fraud," p. A1.

[276] Deborah Solomon, "WorldCom's Ex-Controller Pleads Guilty to Fraud," *Wall Street Journal*, September 27, 2002, p. A3.

[277] Jerry Markon, "WorldCom's Yates Pleads Guilty," *Wall Street Journal*, October 8, 2002, p. A3.

[278] *Id.*

[279] "2 Ex-Officials of WorldCom Plead Guilty," *New York Times*, October 11, 2002, p. C10.

[280] Susan Pulliam, "A Staffer Ordered to Commit Fraud Balked, Then Caved," *Wall Street Journal*, June 23, 2003, pp. A1, at A6; and "Ex-WorldCom Accountant Gets Prison Term," *New York Times*, August 6, 2005, p. B13.

[281] See Simon Romero and Jonathan D. Glater, "Wider WorldCom Case Is Called Likely," *New York Times*, September 5, 2002, p. C9, for background and titles of employees.

[282] Pulliam, "A Staffer Ordered to Commit Fraud Balked," pp. A1, at A6.

[283] "Ex-WorldCom Accountant Gets Prison Term," p. B13.

Troy Normand got three years of probation. Betty Vinson was sentenced to five months in jail, and Yates and Myers received one-year-and-a-day sentences.[284] Mr. Sullivan was sentenced to five years.

Before the year ended, most of the WorldCom board had resigned, Michael D. Capellas, the former CEO of Compaq Computers, replaced John Sidgmore, and there was another revision of WorldCom revenues, bringing the total revisions to $9 billion.[285] However, WorldCom did reach a settlement with the SEC on the $9 billion accounting problems. The civil fraud suit settlement did not admit any wrongdoing, and required the payment of fines totaling $500 million.[286] The consent decree required WorldCom, now MCI, to submit to oversight by a type of probation officer over the company's activities and gave the SEC discretion in terms of the amount of fines that could be assessed in the future.[287] On December 9, 2002, WorldCom ran full-page ads in the country's major newspapers with the following message: "We're changing management. We're changing business practices. We're changing WorldCom."[288]

In what was an unprecedented move, ten of WorldCom's former directors agreed to personally pay restitution to shareholders as part of the settlement of the lawsuit. The ten directors paid a total of $18 million to the shareholders in order to be released from liability in the suit.[289] The funds had to be paid from their own assets; they were not permitted to use insurance funds to pay the settlement. Mr. Ebbers was tried and convicted on multiple counts of conspiracy and fraud in March 2005. In exchange for a sentence of five years, Scott Sullivan testified against his former boss. He testified on his own behalf as part of the defense. There was uniform agreement among trial lawyers, experts, and, apparently, the jury that he did not help his case. Mr. Ebbers appealed his case to the federal court of appeals, but the verdict was affirmed.[290]

In July 2005, Mr. Ebbers was sentenced to twenty-five years in prison. In addition, Ebbers had to turn over all of his assets as part of his fine. A federal marshal who was responsible for collecting the property indicated that the government took between $35 and $40 million in assets and left Mr. and Mrs. Ebbers with the furniture in their home and their silverware. They will sell their home and all of Mr. Ebbers's personal investments. Mrs. Ebbers was allowed to retain $50,000 as a means for transitioning to self-support.

Mr. Ebbers was sentenced following a ninety-minute hearing. The judge, in sentencing Ebbers, said,

> Mr. Ebbers was the instigator in this fraud. Mr. Ebbers's statements deprived investors of their money. They might have made different decisions had they known the truth.[291] I recognize that this sentence is likely to be a life sentence. But I find a sentence of anything less would not reflect the seriousness of this crime.[292]

[284] Greg Farrell, "Final WorldCom Sentence Due Today," *USA Today*, August 11, 2005, p. 1B.

[285] Seth Schiesel, "WorldCom Sees More Revisions of Its Figures," *New York Times*, November 11, 2002, p. C1; Jared Sandberg, "Six Directors Quit as WorldCom Breaks with Past," *New York Times*, December 18, 2002, p. A3; Andrew Backover and Kevin Maney, "WorldCom to Replace Sidgmore," *USA Today*, September 11, 2002, p. 1B; and Stephanie N. Mehta, "Can Mike Save WorldCom?" *Fortune*, December 9, 2002, p. 163.

[286] Seth Schiesel and Simon Romero, "WorldCom Strikes a Deal with S.E.C.," *New York Times*, November 27, 2002, p. C1.

[287] Jon Swartz, "WorldCom Settles Big Issues with SEC," *USA Today*, November 27, 2002, p. 1B; and *SEC v. WorldCom, Inc.*, 2002 WL 31760246 (S.D.N.Y. 2002).

[288] *New York Times*, December 9, 2002, p. C3; and *USA Today*, December 11, 2002, p. 4A.

[289] Gretchen Morgenson, "10 Ex-Directors from WorldCom to Pay Millions," *New York Times*, January 6, 2005, p. A1.

[290] *Ebbers v. U.S.*, 453 F.3d 110 (2nd Cir. 2006). *cert. den.* 549 U.S. 1274 (2007).

[291] Ken Belson, "WorldCom Head Is Given 25 years for Huge Fraud," *New York Times*, July 14, 2005, p. A1.

[292] Dionne Searcey, Shawn Young, and Kara Scannell, "Ebbers Is Sentenced to 25 Years for $11 Billion WorldCom Fraud," *Wall Street Journal*, July 14, 2005, pp. A1, A8.

Mr. Ebbers did not speak on his own behalf at the hearing, but he had submitted evidence of a heart condition as well as 169 letters from friends and colleagues. Interestingly, Mr. Ebbers is the one executive among all those indicted who was not selling his stock as the market and company collapsed. He retained all of his stock and saw his $1 billion in WorldCom holdings all but disappear as the stock dropped from a high of $64 to about $0.10. However, the judge found that neither the letters nor his stock retention was compelling and that Ebbers's heart condition was not serious. She did agree to let Ebbers serve his time in a prison near his home in Mississippi.

The maximum sentence was thirty years. Mr. Ebbers can shave off 10 percent for good behavior. The earliest he could be released is 2027, when he turns 85 (Mr. Ebbers was 63 at the time of his sentencing).

Mr. Ebbers's sentence is the longest of any for the so-called bubble crimes. Jeffrey Skilling received 24.4 years (later reduced). Timothy Rigas of Adelphia was sentenced to twenty years, and his father, John, to fifteen.

Discussion Questions

1. Consider the following statement by a government official. Securities Exchange Commissioner Cynthia Classman included the following in a speech she gave to the American Society of Corporate Secretaries on September 27, 2002:

   > [T]he distribution of securities by companies that had not made a previous public offering reached the highest level in history. This activity in new issues took place in a climate of general optimism and speculative interest. The public eagerly sought stocks of companies in certain "glamour" industries, especially the electronics industry, in the expectation that they would rise to a substantial premium—an expectation that was often fulfilled. Within a few days or even hours after the initial distribution, these so-called hot issues would be traded at premiums of as much as 300 percent above the original offering price. In many cases the price of a "hot" issue later fell to a fraction of its original offering price.

   What impact do you think the psychology of the market had on allowing WorldCom, Mr. Ebbers, and others to engage in creative accounting? Is this a case of "everyone does it"?

2. Consider the following:

   > This phenomenon of confusion ruling in a bullish market is not unique to the 1990s stock market. Following the 1929 stock market crash, one of the biggest collapses, and a shocker to the investment world, was the bankruptcy of Middle West Utilities. The company was run by Samuel Insull according to the prevailing, and confusing, structure of the time, "elaborate webs of holding companies, each helping hide the others' financial weaknesses, an artifice strangely similar to what Enron did with its partnerships."[293] Following the bubble burst in the early 1970s, accounting firm Peat Marwick, Mitchell was censured for its failure to conduct proper audits of five companies that crashed after PMM had given the firms clean and ongoing entity opinions. After the October 1987 crash, Drexel, Burnham & Lambert, Michael Milken's junk bond firm, collapsed along with a host of other companies and the savings and loan industry.[294]

   What does this market history tell you about WorldCom? How could the employees in WorldCom who went along benefit from this information? What fears did these employees have?

3. Bill Parish, investment manager for Parish & Co., explained the collapse of Enron, World Com, and others with this insight: "There's massive corruption of the system. Earnings are grossly overstated."[295] Accounting Professor Brent Trueman at the University of California, Berkeley, added, "Reported numbers may not reflect the true income from operations." The phenomenon

[293] E. S. Browning, "Burst Bubbles Often Expose Cooked Books and Trigger SEC Probes, Bankruptcy Filings," *Wall Street Journal*, February 11, 2002, pp. C1, C4.

[294] *Id.*

[295] Matt Krantz, "There's Just No Accounting for Teaching Earnings," *USA Today*, June 20, 2001, p. 1B.

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accompanies bubbles. "It is absolutely what almost invariably happens after every bubble. You should expect them [bankruptcies, scandals, and accounting disclosures], but that doesn't mean that people who haven't been through it before aren't going to be surprised. The bigger the binge, the longer and more severe the hangover.[296]

Is he right? Is fraud inevitable in a fast-paced market? Are these just natural market corrections? Is this "everyone does it"?

4. WorldCom was eerily meeting its earnings targets precisely. One analyst did, however, notice that WorldCom was making its targets for several quarters in a row within fractions of cents. "When you see that they're making it by one one-hundredth of a penny you know the odds of that happening twice in a row are very slim. It indicates they're willing to stretch to make the quarter."[297] Are investors to blame for relying on the precise numbers and predictions? Shouldn't they have acted with greater skepticism?
5. Mr. Ebbers's conduct shows that he still believes he has done nothing wrong. At church services in Mississippi immediately following the revelation of the WorldCom accounting impropriety, Mr. Ebbers arrived as usual to teach his Sunday school class and attend services. He addressed the congregation, saying, "I just want you to know you aren't going to church with a crook. This has been a strange week at best.... On Tuesday I received a call telling me what was happening at WorldCom. I don't know what the situation is with all that has been reported. I don't know what all is going to happen or what mistakes have been made.... No one will find me to have knowingly committed fraud. More than anything else, I hope that my witness for Jesus Christ [will not be jeopardized]." The congregation gave Mr. Ebbers a standing ovation.[298] Mr. Ebbers continues to teach Sunday school each Sunday at 9:15 A.M. and then stays for the ninety-minute service held afterward.[299] What relationship do religious views and affiliations play in business ethics?
6. What did Scott Sullivan miss in making his analysis to capitalize ordinary expenses? What skills that you learned in Units 1 and 2 might have helped him see the decision and the impact of his decision differently? Why did he not listen to employees and block questions?
7. Even when the first multibillion-dollar restatement came, many near Clinton, Mississippi, appeared to be more in mourning than angry. One employee, sharing the shock with bar patrons at Bravo Italian Restaurant & Bar, said, "People are taking it with exceptional grace. In my experience with MCI, I have never worked for a better company."[300] Others, such as Bernie's minister, give him the benefit of the doubt, concluding that he might not have known about the distortion of the numbers: "We've kind of held judgment until we know the entire story and whether he had knowledge."[301]

   Evaluate the effect of these companies on the hometowns in which they operate. What role do hubris and the fear of letting the locals down play in situations such as WorldCom's?

Compare & Contrast

1. At his sentencing, Scott Sullivan told the federal judge of his diabetic wife's need for care and of their 4-year-old daughter and said, "Every day I regret what happened at WorldCom. I am sorry for the hurt caused by my cowardly decisions."[302] Scott Sullivan stated at his sentencing hearing, "I chose the wrong road, and in the face of intense pressure I turned away from the truth."[303] He added, "It was a misguided attempt to save the company."[304]

[296] E. S. Browning, "Burst Bubbles Often Expose Cooked Books and Trigger SEC Probes, Bankruptcy Filings," *Wall Street Journal*, February 11, 2002, pp. C1, C4.

[297] Jared Sandberg, Deborah Solomon, and Nicole Harris, "WorldCom Investigations Shift Focus to Ousted CEO Ebbers," *Wall Street Journal*, July 1, 2002, pp. A1, A8.

[298] *Id.*, p. A1.

[299] Jayne O'Donnell, "Ebbers Acts as if Nothing Is Amiss," *USA Today*, September 19, 2002, pp. 1B, 2B.

[300] Kelly Greene and Rick Brooks, "WorldCom Staff Now Are Saying 'Just Like Enron,'" *Wall Street Journal*, June 27, 2002, p. A9.

[301] O'Donnell, "Ebbers Acts as if Nothing Is Amiss," pp. 1B, 2B.

[302] Greg Farrell, "Sullivan Gets a 5-Year Prison Sentence," *USA Today*, August 12, 2005, p. 1B.

[303] Jennifer Bayot and Roben Farzad, "WorldCom Executive Sentenced," *New York Times*, August 12, 2005, pp. C1, C14.

[304] *Id.*

What is the difference between Sullivan at the sentencing hearing and Sullivan at WorldCom making the accounting decisions? What elements for your credo can you find in this tale?

2. One analyst noted, "You always had this question about whether WorldCom was a house of cards. Everything was pro-forma. It drove us nuts."[305] Yet another analyst described the WorldCom phenomenon as "a game of chicken, where you get as close as possible to the end before getting out. We all knew WorldCom couldn't go on forever."[306] Competitors were flummoxed by the company's performance. Recall the observations of William T. Esrey, the CEO of Sprint, and the replacement of Michael G. Keith, the head of AT&T's business service division, for his failure to reach WorldCom heights. During this time, Sprint and AT&T were considered "dogs," whereas WorldCom was the darling of Wall Street. Howard Anderson of the Yankee Group, a research firm in Boston, said, "Wall Street was more than captivated by these new guys; they were eating the lotus leaves and it made companies like AT&T and Sprint look stodgy in comparison. There was never any question that in terms of the strength and reliability of the network, none of these new guys compared to AT&T. AT&T made a lot of legitimate moves and the stock market did not reward them."[307]

3. Another analyst observed about WorldCom upon its collapse, "The real issue isn't accounting. It is the incentive people had to use questionable accounting. The truth is that this never was an industry [that] made phenomenal returns. People forget this was foremost a utility business."[308] WorldCom's numbers, like Enron's, defied market possibilities:

   - WorldCom's revenues went from $950 million in 1992 to $4.5 billion by 1996.[309]
   - Operating income rose 132 percent from 1997 to 1998.
   - Sales increased to $800 billion, and the price of WorldCom's stock rose 137 percent.[310]
   - In 1999, WorldCom's increase in net income was 217 percent.[311]

   How are Sprint and AT&T doing today? In comparison to WorldCom? What lessons can competitors and analysts learn from these insights they had at the time of WorldCom's pinnacle? Do you think Michael Keith has new credibility?

4. Compare and contrast the WorldCom case with the others you have studied, and develop a list of common threads and "takeaways" you would have to incorporate into a company as prevention tools. Be sure to consider elements for your credo in the process.

Case 4.16

Bank of America: The Merrill Takeover, the Disclosures, and the Board

Timothy J. Mayopoulos was the general counsel for Bank of America until just shortly before its merger with/acquisition of Merrill Lynch was approved by the shareholders. Mr. Mayopoulos was escorted from the Bank of America building in Charlotte, North Carolina, following the day he met with the board, a meeting at which the board was told that Merrill had heretofore undisclosed losses that had not been publicly disclosed

[305] Rebecca Blumenstein and Jared Sandberg, "WorldCom CEO Quits amid Probe of Firm's Finances," *Wall Street Journal*, April 30, 2002, pp. A1, at A9.

[306] Kurt Eichenwald, "Corporate Loans Used Personally, Report Discloses," *New York Times*, November 5, 2002, p. C1.

[307] *Id.*

[308] Henny Sender, "WorldCom Discovers It Has Few Friends," *Wall Street Journal*, June 28, 2002, pp. C1, C3.

[309] These numbers were all computed using the company's annual reports found under WorldCom, "Investor Relations," http://www.worldcom.com. The numbers were computed using "Selected Financial Data" as called out in each of the annual reports.

[310] WorldCom, *Annual Report*, 1998, http://www.worldcom.com. No longer available on the Web. Go to www.sec.gov and use the EDGAR database to access annual reports.

[311] Bernard Ebbers's letter to shareholders, in WorldCom's: *Annual Report*, 1999, http://www.worldcom.com. No longer available on the Web. Go to www.sec.gov and use the EDGAR database to access annual reports.

to shareholders who would be asked to approve the planned merger. Mr. Mayopoulos had talked with Bank of America's CFO about the losses prior to his meeting with the board. He was escorted out by security personnel and was not permitted to return to his office and collect his belongings.

Mr. Mayopoulos gave testimony to then-New York Attorney General Andrew Cuomo, the official who investigated whether information about the scope of the losses was withheld from Bank of America's shareholders prior to their vote on approval of the merger/acquisition. Mr. Mayopoulos, however, declined to disclose to Mr. Cuomo's office the content of the advice he gave to the bank, citing legal ethics rules.[312]

Mr. Cuomo asked Bank of America to waive "the privilege" because its refusal was hindering his office's ability to investigate what happened in the days leading up to the merger/acquisition.

Bank of America refused initially to waive its attorney-client privilege in the investigation of the merger/acquisition by the SEC. Bank of America and the SEC reached a $33 million settlement following the investigation.[313] However, a federal judge blocked the settlement because he wanted more details on the role of Mr. Mayopoulos. The case was then settled in 2010 for a fine of $150 million.[314] However, Mr. Cuomo charged both Mr. Lewis and CFO Joe Price with fraud.[315]

Bank of America's CFO has given testimony to Mr. Cuomo that indicates he simply followed Mr. Mayopoulos's advice. Mr. Mayopoulos did testify in the Cuomo investigation that he had spoken with outside counsel about the merger/acquisition/disclosure issues. Bank of America's outside counsel is Wachtell, Lipton, Rosen & Katz.

Bank of America's then-CEO, Kenneth D. Lewis, testified that Mr. Mayopoulos was fired because Bank of America had more executives than it needed following the merger. Merrill Lynch executives have testified that they were in a meeting with Mr. Mayopoulos regarding the structure of the combined legal departments of the two companies when he was called from the meeting and dismissed from the company.

Mr. Mayopoulos became general counsel for Fannie Mae, and is now CEO, but, in an ironic note, Mr. Mayopoulos resided for a time in Charlotte, North Carolina, on the same street as Mr. Lewis. The neighborhood block parties during the summer of 2009 must have been tense. Mr. Lewis retired from his CEO position at Bank of America, and the bank has continued to struggle with settling litigation, handling mortgage foreclosures, and a dropping share price. Mr. Mayopoulos's position as CEO of Fannie Mae, the quasi-federal corporation that insured the faulty mortgages that caused the 2008 collapse of Merrill Lynch, means that he must deal with the flawed mortgages and their uncollectability.

Discussion Questions

1. What is the lawyer–client privilege and when does it apply? Does it apply to general counsel and to outside counsel? When is the privilege waived? What does SOX have to do with this case?
2. Why do you think Mr. Mayopoulos stood so firm on his refusal to answer questions about what happened in the days leading up to the merger and his termination prior to Bank of America's waiver of the privilege?
3. What impact would Mr. Mayopoulos's termination have on the culture of Bank of America?

[312] Louise Story, "Bank Firing of Counsel Is Examined," *New York Times*, September 9, 2009, p. C1.

[313] Dan Fitzpatrick, "New York Nears Charges on Merrill Deal," *Wall Street Journal*, September 9, 2009, p. C1.

[314] Louise Story, "Cuomo Sues Bank of America Even as It Settles with S.E.C.," *New York Times*, February 4, 2010, p. B1; and http://www.sec.gov/litigation/litreleases/2010/lr21407.htm. Accessed July 17, 2010.

[315] Kevin McCoy, "Bank of America Charged with Fraud," *USA Today*, February 4, 2010, p. 2B.

Reading 4.17

Getting Information from Employees Who Know to Those Who Can and Will Respond[316]

> In the course of performing my duties for the Firm, I have reason to believe that certain conduct on the part of senior management of the Firm may be in violation of the Code. The following is a summary of the conduct I believe may violate the Code and which I feel compelled, by the terms of the Code, to bring to your attention.[317]

So wrote Matthew Lee, on May 18, 2008, to the CFO and Chief Risk Officer of Lehman Brothers, a firm that had employed him as an analyst since 1994. Mr. Lee, who headed global balance-sheet and legal-entity accounting, then went on to describe "tens of billions of dollars" on the firm's balance sheet that could not be substantiated. Mr. Lee also highlighted Lehman's use of Repo 105, a means Lehman used to make appear to be solvent. Repo 105 was used to move about $50 billion in debt off the Lehman balance sheet.

The response to Mr. Lee was astonishing but typical: (1) Ernst & Young, the firm's auditor, referred to Mr. Lee's memo as "pretty ugly," but concluded the issues that he raised were immaterial and his allegations unfounded; and (2) Mr. Lee was fired.

Lehman declared bankruptcy on September 15, 2008. Mr. Lee was correct, and the bankruptcy report is a scathing one that demonstrates the top executives at Lehman were aware of both the level of risk exposure as well as the accounting practices used to conceal that exposure.

In the ongoing litigation by Pursuit Partners LLC against UBS AG, there is a similar revelation from an employee about the knowledge floating internally about the quality of its collateralized debt obligations (CDOs) that were being sold as investment-grade instruments but were anything but. In the fall of 2007, internal documents show that UBS employees were concerned about the debt securities the bank was carrying and were laboring mightily to find a way to unload them on the unwitting. In one e-mail, a UBS AG employee, who is discussing the fact that the toxic instruments are on the bank's books, complains, "OK still have this vomit."[318] A judge has ruled that UBS had an "awareness" that the instruments would turn into "toxic waste," but that it still persuaded Pursuit to purchase the CDOs based upon the UBS promise that it sold only investment-grade securities. Other e-mails gave employees instructions to "unload" the CDOs but warned that there was no need to signal this strategy publicly.

These revelations come on the heels of a jailhouse interview with Bernie Madoff in which he commented that he was "astonished" that he escaped detection of his Ponzi scheme through six SEC investigations.[319] There was the controlled and secretive access to the computer trading room, the failure to verify trades with the firms Mr. Madoff said he was using (i.e., no one checked the clearinghouse), and the failure to heed the tips and warnings the agency was receiving from those inside the firm as well as from the industry.

[316] Adapted from Marianne M. Jennings., "The Employee We Ignore, the Signs We Miss, and the Reality We Avoid," *Corporate Finance Review* 14(6):42–44 (2010).

[317] Letter of Matthew Lee, dated May 18, 2008, as included and discussed in the Report of the examiner for the bankruptcy trustee in the Lehman bankruptcy.

[318] Serena Ng and Carrick Mollenkamp, "In UBS Case, Emails Show CDO Worries," *Wall Street Journal*, September 11, 2009, p. C1.

[319] Diana B. Henriques, "Lapses Kept Scheme Alive, Madoff Told Investigators," *New York Times*, October 31, 2009, p. A1.

There are two powerful common threads in these three market failures that have once again dissipated market trust: (1) Those involved were aware of their ethical and legal lapses; and (2) the warnings of employees and others were not heeded. These common threads were also present at Enron, WorldCom, HealthSouth and the problem companies that emerged in our turn-of-the-century scandals.

The key to prevention for stopping these schemes and poor ethical choices is getting the information from those in the organization who have it to those who can and will do something about it. Because these issues all involved or affected CFOs, it is a good time to review those tools that help employees speak up and get information to the right responders. Those who do take action to resolve an issue are not always the first responders who receive the information. There are some cultural and individual leadership skills changes that CFOs can make to prevent these types of situations in which the issues are obvious, and the answers and actions necessary are clear, but fail to surface until post-financial collapse. Firms do fall into the trap of ignoring the employee's warnings. Indeed, too often the bearer of bad financial reporting news (the messenger) often ends up being killed, which provides the firm with a temporary means of coping.

Have Your Reporting Systems in Place

Some means of anonymous reporting, either through a hotline or a computer third-party reporting system, is a bare minimum. This company-wide mechanism allows those employees who are uncomfortable in their own environments or, worse, may be working under the folks involved in the unethical or illegal actions, the chance to raise issues. However, these systems do bring out the cranks and, as a result, do give us the reports that have little to do with financial reporting, accounting, or reporting the fact that the folks on the loading dock are using a thirty-two-day month for shipping goods.

However, those reports may come from repeating pockets in the company. Even if the individual report contains no allegations relevant to financial reporting or accounting issues, the employee who submitted may simply not be able to articulate what is happening. However, the pockets of consistent reports indicate something more is afoot than just a manager who irritates employees. Follow sources and patterns to determine whether there may be areas in the company that require more analysis of the complaints to determine the root cause, a cause that may well involve financial reporting issues.

On Dissent and Discussion: The Humble Firm

In a conversation with an executive at a company at the top of its industry and one that is studied by others for its management practices, I asked for a one-line descriptor of the secret to his company's longstanding success. He paused and then gave this pithy response, "We go to work each day and say, 'We suck, now let's get better.'" The Gen X folks are now in management, complete with their jargon. His point is, however, one worth exploring. In these healthy companies, the arrogance of results and top performance is kept at bay. That humility permits a more open environment to take hold. An open environment is one in which a manager with fourteen years of experience would not be fired for raising concerns about accounting practices and the code of ethics. Rather, that manager would be given the opportunity to explain his concerns and the issues. Indeed, in a firm of humility a fourteen-year manager would not need to write a memo of concern—the issues would come up in discussions on the financials, the risk, and certainly with the auditors.

Meetings in the humble firm have lively discussions, not tense ones. As noted many times in this column over the years, another common thread in firms that crash and burn financially is that managers and employees remained sullen and mute in discussions and meetings. However, they certainly did let loose with their concerns only in their e-mails to colleagues, thus providing the documentation that is the stuff of civil litigation and, on occasion, criminal liability. In the humble firm, the e-mail thoughts are the ones stated publicly, discussed, and evaluated.

Develop Your Own Sensing Mechanisms

Even in the humblest of firms, issues still may not emerge. The CFO, as ethical leader, will need to use sensing mechanisms beyond the hotlines and open discussions. The most important sensing mechanism comes from this advice: Get out of your office. That is, what an employee might never utter in a meeting or put in an anonymous report may come out in the cafeteria, the hallways, or at one of the coffee room birthday celebrations. Often spontaneity comes at employee volunteer projects or unannounced visits to plants, divisions, stores, or offices. This egalitarian access has an effect on employees and their willingness to speak up and raise questions. Psychologists could provide more insight into the whys of this situational forthrightness, but once the CFO takes on a new identity as an approachable individual as opposed to an iconic and feared figure, there is new communication. Human translation breaks down the barriers of fear and silence that prevent information from getting it from that place in the company where it is common knowledge to those in the company who can and will take appropriate steps and make changes.

Many CEOs and CFOs do have quarterly or annual meetings with small groups of employees, a means they offer as evidence that they are using sensing mechanisms. Those are scheduled meetings. Those are formal meetings. Spontaneous “blurts” of concern require spontaneous settings. This sensing tool is really an update of the 1970s OB theory, MBWA (management by walking around). This theory is akin to that employed when parents of teens come home early and unannounced: one never knows what one will find. Some companies are now requiring both executives and boards to have a certain number of “visits” to company sites, plants, offices, and divisions so that they understand what the company does and how it works. Further, those visits cannot be “gaggle” visits, those group visits that are little more than a tour group swoop. Rather, the visits are individual ones with the same goal as the executives’ egalitarian interactions.

In the United States a new reality show, *Undercover Boss*, finds CEOs, COOs, and CFOs working side by side with employees. They have come away with new insights in what worries employees, what their jobs require, and even when the employees are cheating a bit on their time clocks. The greater the isolation an executive has, the less information flows from the frontlines. Ironically, CFOs spend their days in nonstop meetings and keep overbooked schedules that find them wondering where this spontaneity can possibly fit. Asking that question provides the answer. The realignment of thinking finds the spontaneity as the priority, with the meetings fitted nicely in around that interaction.

Don’t Look for Absolution; Look for Resolution

In the Lehman, UBS, and Madoff situations, there was another common thread, and one that is typical for companies that experience financial collapse: they all had outsiders who were questioning, looking, and worrying about the companies’ true, real financial situations. David Einhorn gave public speeches about Lehman’s risk and exposure but could not obtain satisfactory answers to his questions. CFO Erin Cowan dismissed his questions, using each conference call as part of a checklist to survive for another day. With Einhorn’s persistence, Lehman finally responded by firing Ms. Cowan in June 2008. The termination brought a temporary reprieve, but three months later the bankruptcy revealed that the problem was not Ms. Cowan; the problem was the firm's failed financial strategy based on a risk model that was never fully disclosed.

At UBS, the directive was, "No disclosure; just sell, sell, sell." Mr. Madoff only looked to survive the next government inquiry. Survival that relies on the strategy of dodging bullets is unsustainable. There is a finite period of survival in ignoring issues and hoping for absolution from questions in order to survive another day. In these three firms, there was no confrontation of reality—what the real risk levels were, whether there was financial solvency, and how to accurately reflect both in a timely manner in financial statements. Rather, the goal was avoiding the painful fixes and hoping the masquerade could continue.

For most companies, it would take some time and a great deal of manipulation to reach the point of the Lehman, UBS, or Madoff meltdowns. However, none began their evasions suddenly. They all began with a few steps in financial strategy and reporting, steps that served to gloss over real and increasing risk. But that glossing must necessarily evolve in Repo 105 programs as the underlying issues remain unaddressed. If the strategy is failing, the solution is not subterfuge; the solution is a new strategy. Taking that hit when you switch strategies seems to be what these firms sought, futilely, to avoid. Resolution, not absolution, is needed when the financial strategy is no longer working.

Discussion Questions

1. What are sensing mechanisms, and why are they important?
2. What is the humble firm, and how does it encourage ethical behavior?
3. Describe what leads to the types of behaviors at Lehman and other companies that eventually collapse.
4. Why can't managers simply rely on their ethics hotlines?

Case 4.18

Westland/Hallmark Meat Packing Company and the Cattle Standers

The U.S. Department of Agriculture issued its biggest meat recall in its history when it ordered a recall of 143 million pounds of meat processed and sold by Westland/Hallmark Meat Packing Company. The Humane Society of the United States had undercover video made at the company's plant that showed how the company handled the so-called "downer cattle." Under federal law, cattle scheduled for slaughter must be able to stand upright. If the cattle cannot walk or are too ill to stand, the law provides that they must be euthanized but cannot be put into the meat supply. The rule is based on the reality that cattle that cannot stand or walk are more likely to carry some form of disease such as mad cow or salmonella. The Humane Society video showed workers at the plant using a liberal definition of a "stander," and using shocks and forklifts to get the cattle upright for purposes of inspection so that the cattle could then be slaughtered. Downers are considered unfit for human consumption, but the downers the workers prodded into standing were slaughtered and made their way into the food supply. The workers were compensated on the basis of number of head of cattle slaughtered per day.

Westland/Hallmark was named USDA supplier of the year in 2006; it is a company with a good reputation. However, over 50 million pounds of the meat had made their way into school lunch programs. Some of the meat had already been eaten, with no illnesses reported.

Reforms are already in the works, both in Congress and at the USDA. The video that was taken undercover can be viewed on YouTube. The video was aired at the congressional hearings on Westland/Hallmark, and when the general manager saw the video he said, "The video just astounded us. Our jaws dropped…. We thought this place was sparkling perfect."[320]

Westland/Hallmark paid a fine of $497 million, and father and son, Donald Hallmark Sr. and Donald Hallmark Jr., general partners of Hallmark Meat Co., have five years to pay a separate settlement of $316,802.

Discussion Questions

1. Was getting the cows to stand up a way of complying with the law? Was it ethical?
2. What effect would Hallmark's compensation system for its employees have on their conduct?
3. Is there something to learn about a manager's role from the general manager's comment that the video surprised him?

For More Information

Schmitt, Julie, "Impact of Beef Recall Widens," *USA Today*, February 25, 2008, p. 1A.

Schmitt, Julie, and Elizabeth Weise, "Feds Still Tracing Some Recalled Meat," *USA Today*, February 22, 2008, p. 1B.

"The Biggest Recall Ever," *New York Times,* February 21, 2008, p. A2.

Zhang, Jane, David Kesmodel, and Elizabeth Williamson, "Meat Recall Sparks Calls for Food-Safety Changes," *Wall Street Journal*, February 20, 2008, p. A3.

[320] David Kesmodel and Jane Zhang, "Meatpacker in Cow-Abuse Scandal May Shut as Congress Turns Up Heat," *Wall Street Journal*, February 25, 2008, pp. A1, A10.

SECTION E

The Industry Practices and Legal Factors

At this level, companies look around at industry practices and decide that they must make the same decisions as others in their industry or they will be at a competitive disadvantage. They make decisions that they might not otherwise make because they feel there is no choice.

Reading 4.19

The Subprime Saga: Bear Stearns, Lehman, Merrill, and CDOs[321]

"What were they smoking?" The *Fortune* cover story featured those words in a 3.5-inch headline, as well as photos of Chuck Prince, Citigroup ($9.8 billion loss), Jimmy Cayne, Bear Stearns ($450 million loss),[322] John Mack, Morgan Stanley ($3.7 billion loss), and Stan O'Neal, Merrill Lynch ($7.9 billion).[323] Their photos and losses were followed by the subtitle, "How the best minds on Wall Street lost millions."[324] We had just managed to get our minds around the options backdating problem, with the comfort that came from knowing that such bad habits by executive and too complicit board compensation committees could no longer occur because Sarbanes-Oxley had more timely reporting requirements. Sure, we were at $5.3 billion in total restatements for options, had one CEO convicted, and three out of ten indicted general counsel pleading guilty, but we had caught the problem, installed statutory prevention tools, and were ready to gloss over this tempest-from-a-past-era teapot. Like a water torture program, however, the subprime mess trickled forth. Beazer Homes admitted that it broke federal laws in helping buyers qualify for mortgages, but that was just one builder.[325] Countrywide Financial had its problems, but what would you expect in their subprime market? So, by August 2007, we had cut its stock value in half.[326] And we witnessed the default rate on home mortgages climbing, but attributing that problem to a downturn in the economy, which was due to oil prices, which was due to war, which was due to…, gave us comfort.[327]

[321] Adapted from "The Lessons of the Subprime Lending Market," by Marianne M. Jennings in 12 *Corporate Finance Review*: 44 (2007).

[322] Bear Stearns has since announced a $1.2 billion write-down, and a resulting loss, the first loss in the firm's eighty-four-year history. Jennifer Levitz and Kate Kelly, "Bear Faces First Loss, Fraud Complaint," *Wall Street Journal*, November 15, 2007, pp. C1, C2.

[323] The losses for the others changed daily, monthly, and yearly. The author surrenders in terms of how high the figures actually were. One thing is certain—there were multibillion losses.

[324] *Fortune*, November 26, 2007 (cover).

[325] Floyd Norris, "Builder Said It Broke Federal Rules; Will Restate Earnings," *New York Times*, October 12, 2007, p. C3.

[326] James R. Hagerty and Karen Richardson, "Why Is Countrywide Sliding? It's Unclear, That's the Issue," *Wall Street Journal*, August 29, 2005, pp. C1, C4; Gretchen Morgenson, "Inside the Countrywide Lending Spree," *New York Times*, August 26, 2007, pp. SB-1, 8.

[327] Richard Beales, Alex Barker, and Saskia Scholtes, "Fraud Inquiry Goes to Roots of Debt Chaos," *Financial Times*, March 29, 2007, p. 21.

Unmistakably, the mortgage market was melting down, but a shoulder shrug and "so what if a few deadbeats lose their homes" were the responses. However, with collateralized debt obligations (CDOs), a mortgage market runs wider and deeper than even the best of the best on Wall Street contemplated. The banks were heavily invested in that subprime market, and the subprime mortgages had gone south. Once again, we found the classic scenario of companies, operating in a regulatory no-man's land, staying at the party a little too long and drinking too much. A few had even arrived late and still partook.

Not to pour too much salt on fresh wounds of 35 percent and 36 percent share price drops for Citigroup and Merrill, respectively, but we have been down this road of high risk, overly optimistic bets, initial phenomenal returns, and collapses. Junk bonds, savings and loans and their property appraisals, and the high-tech/dot-com boom were of the same pattern from other eras. Different investment vehicles; same crash and burn. A look back at some other *Fortune* covers is an eerie reminder of lessons not learned. The cover of *Fortune* for May 14, 2001, just after that era's bubble burst, featured analyst Mary Meeker and the caption "Can We Ever Trust Again?" How did they miss that one? How could the analysts have been so wrong? Still, one year later the cover of *Fortune* featured Sallie Krawcheck and the caption "In Search of the Last Honest Analyst."[328] We were not confident the problem had been solved. Here we are today, with slightly more plebian phraseology, asking the same question Judge Stanley Sporkin asked in 1990 when we had the S&L losses: "Where were these professionals … when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions?"[329] Once again, we are stunned by the failure of financial wizards to catch these multibillion dollar overvaluations.

However, there is something quite troublingly different about this meltdown from those of the junk bond, S&L, and dot-com eras: we have not managed to make it ten years without a breach of trust. We were living with the assumption that these types of financial and ethical debacles would only arise once a decade as those new to the businesses affected by the last issue forgot the historical underpinnings of the market and their own institutional histories. Five years out from the promised transparency of Sarbanes-Oxley finds investors asking the same question: Can we trust these people? As the *Fortune* piece noted in its introduction,

> Two things stand out about the credit crisis cascading through Wall Street: It is both totally shocking and utterly predictable. Shocking, because a pack of the highest-paid executives on the planet, lauded as the best minds in business and backed by cadres of math whizzes and computer geeks, managed to lose tens of billions of dollars on exotic instruments built on the shaky foundation of subprime mortgages?[330]

The shocking part is incorrect. The utterly predictable part is indeed correct. Herewith some thoughts on those two thoughts through a discussion of the governance and ethics issues the best of the best missed on the road to this breakdown in financial reporting and accountability.

[328] *Fortune*, June 10, 2002, and beneath the caption was the stinging phrase, "Her analysts are paid for research, not deals."

[329] *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F.Supp. 901, at 920 (D.C.Cir.1990). Judge Sporkin referred to both lawyers and accountants/auditors in his question.

[330] Shawn Tully, "Wall Street's Money Machine Breaks Down," *Fortune*, November 26, 2007, pp. 65, 66.

Why We're Not "Shocked, Shocked" at the Losses[331]

Many of us, although unable to quantify the extent of the losses, have been expressing concerns about subprime loans in general, including the use of subprime loans as a foundation for financial instruments for the past two years. We were, as in the dot-com and Enron eras, pooh-poohed as being overly cautious and, again, overly focused on ethical issues. Yet, the ethical issues in the subprime lending market were compelling. The subprime market saw loans for 100 percent of purchase price, loans based on false information (the Beazer issue), and loans to those ill-equipped to handle credit generally and certainly incapable of managing ARM mortgages that would find their payments doubling when market rates kicked in on their loans. Of course, opening up mortgages to the ill-equipped with poor track records resulted in more mortgages, and the low-hanging fruit of high credit risks found the mortgage brokers calling with creative packages. Even with a skill set for applying *caveat emptor*, these credit risks were no match for brokers who had tasted double-digit returns and driven Ferraris, whether leased or owned. Neither business models nor markets can have "taking advantage of those with lesser information or bargaining power" as a foundation. Whether the path is one of pyramid scheme, false advertising, or inherent bargaining disparity, all such roads lead to negative firm and market impact, with perhaps the greatest casually being market trust as we cope with, "Not again!"

Perhaps a contra example of how the subprime market should have been handled makes a compelling case against the companies argument that they are "shocked, shocked" by their numbers. North Carolina has largely escaped the wrath of the subprime foreclosures and resulting market downturn because of tougher lending laws it enacted in 1999. Its so-called predatory lending law, passed in a state with some of the United State's largest financial institutions headquartered there, is one that has become the model for other states as well as for proposed reforms wending their way through Congress. The legislation, which helped consumers, lenders, and the North Carolina economy, is perhaps a case study in how staying ahead of evolving issues and placing restraints on nefarious activities can benefit business. That regulatory cycle emerges again: deal with the abuses in the regulatory no-man's land before they become a financial, regulatory, or litigation crisis.

North Carolina's predatory lending law includes the following protections, protections that surely would have been wise self-restraints by lenders during the real estate boom and certainly would have helped preserve the value and lower the risk in the CDO portfolios of the banks now forced to take the write-downs:[332]

- Limitations on the amount of interest that can be charged on residential mortgage loans in the amount of $300,000 or less, as well as any additional fees lenders add on to the loans
- Limits on fees that may be charged in connection with a modification, renewal, extension, or amendment of any of the terms of a home loan, other than a high-cost home loan. The permitted fees are essentially the same as those allowed for the making of a new loan, with the exception of a loan application, origination, or commitment fee.
- Limits on fees to third parties involved with the processing of the loan
- Elimination of penalties for consumers who pay off their debts early
- Requirement for lenders to verify income of debtors
- Limitations on fees brokers can collect for arranging mortgages

[331] *Casa Blanca* (Warner Brothers 1942); *See also*, Marianne M. Jennings, "Fraud Is the Moving Target, Not Corporate Securities Attorneys: The Market Relevance of Firing Before Being Fired Upon and Not Being 'Shocked, Shocked' That Fraud Is Going On," 46 *Washburn L. Rev.* 27 (2007).

[332] N.C.G.S.A. § 24-8.

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Martin Eakes, one of the business people (and a trained lawyer), who worked to get North Carolina's law in place said, "Subprime mortgages can be productive and fruitful. We just have to put boundaries in place."[333] Ah, there it is. There is nothing inherently evil about the subprime market; but those boundaries are important. North Carolina also provided the data for what harms can befall an economy when subprime loans go south. Studies by then–attorney general Mike Easely (now North Carolina's governor) showed what foreclosures did in poorer neighborhoods. The impact on the general area as well as the real estate market was a bit of a foreshadowing of the much larger nationwide economic impact we have witnessed. The systemic effects of subprime loans were documented clearly in this state's reforms even before the real estate market experienced its boom. The impact of the foreclosed loans was the risk inherent in instruments tied to such loans.

The very basic notions of consumer law, fairness, disclosure, and risk were ignored or minimized in the sophisticated models used for structuring and evaluating the portfolios of companies such as Citigroup and Merrill Lynch. A model based on a flawed assumption about something as simple as the quality of the mortgages is still a flawed model. The question underpinning all the CDOs and related derivative investments should have been "How high is the risk on the mortgages?" or "What's the credit quality of the borrower?" That basic question was either not evaluated or not answered realistically for both the investment decisions and the ongoing evaluations of value for purposes of financial reports.

"Utterly Predictable"

If the underlying question on the subprime/mortgage investment vehicles was such a basic finance question, how come so few with so much experience and so many tools at their disposal got it so wrong for so long? The answer to this question rests in the culture of the companies. These companies had many of the same traits that existed in other giants fallen through a lack of financial transparency and the eventual disclosure of a less than pretty picture. Think Enron with its off-the-books debt and mark-to-market accounting, WorldCom with its capitalization of ordinary expenses, Adelphia with its executive loans, and so on. We have a different set of companies in a different industry, but the traits that contribute to the lack of transparency and eventual losses are the same. High risk, little transparency, and iffy evaluation lead to what insiders claim to be surprise losses. However, as dissimilar as the companies are in industry and tactics, there are similarities in culture. There are seven cultural traits that characterize companies that have ethical lapses, such as a lack of transparency in financial statements, with the resulting financial meltdowns. The companies with the largest write-downs had at least four of those traits.

Iconic CEOs

These companies had Street legends at their helms. Chuck Prince was handpicked by Sandy Weill to head up Citigroup. Weill steered the ship during the rowdiness of Jack Grubman and the WorldCom unwavering support, and Prince was his protégé. Who would question Prince? In fact, even when there were bizarre rumblings, we did not bat an eye. In early 2007, Prince had a mess on his hands as he terminated Todd S. Thomson, the head of global investment, with stories circulating about Thomson's relationship with Maria S. Bartiromo, private jets, and the conflict regarding her role as a

[333] Nanette Byrnes, "These Tough Lending Laws Could Travel," *BusinessWeek*, November 5, 2007, pp. 70–71.

CNBC anchor.[334] Known as "the money-honey mess," some outside the company predicted that the ouster, on what were called meager grounds, meant there was more Citigroup bad news on the horizon as Prince found scapegoats.[335] Thomson was a known dissenter when it came to Prince.

Stan O'Neal was an indefatigable "numbers guy" who was brought in to streamline Merrill Lynch. Mr. O'Neal initiated the relationship with Long-Term Capital Management, a hedge fund. O'Neal took Merrill from a safe, trading house to a leveraged player. Merrill weathered the storm from the infamous Enron barge deal with a judicial opinion that, although reversing the convictions of the Merrill employers, was not flattering. In a nut shell the court held that the Merrill employees could not be held criminally liable when the company itself (Enron) made the Enron executives do it, and the Merrill folks were outsiders who could not be considered part of a fraud when the very officers of Enron were presenting the deal as good for Enron (if that makes any sense):

> Here, the private and personal benefit, i.e. increased personal bonuses, that allegedly diverged from the corporate interest was itself a promise of the corporation. According to the Government, Enron itself created an incentive structure tying employee compensation to the attainment of corporate earnings targets. In other words, this case presents a situation in which the employer itself created among its employees an understanding of its interest that, however benighted that understanding, was thought to be furthered by a scheme involving a fiduciary breach; in essence, all were driven by the concern that Enron would suffer absent the scheme. Given that the only personal benefit or incentive originated with Enron itself—not from a third party as in the case of bribery or kickbacks, nor from one's own business affairs outside the fiduciary relationship as in the case of self-dealing—Enron's legitimate interests were not so clearly distinguishable from the corporate goals communicated to the Defendants (via their compensation incentives) that the Defendants should have recognized, based on the nature of our past case law, that the "employee services" taken to achieve those corporate goals constituted a criminal breach of duty to Enron. We therefore conclude that the scheme as alleged falls outside the scope of honest-services fraud.[336]

On the mortgage instrument front, O'Neal stated, just three months prior to the announcement of the multibillion dollar write-downs, that Merrill's hit was not bad and all was under control. When he announced $5 billion in early October, the market concluded that the extent of the write-down meant the models were flawed.[337] Just three weeks later, the upping of the figure to $8 billion meant his resignation.

John Mack was brought back to Morgan Stanley after Phil Purcell retired under unrelenting pressure from both internal and external sources. Mack had retired in 2001 after Purcell refused to yield in a power struggle. Such a triumphant return is bound to set an iconic tone, to wit, "Mack is back!"[338]

Jimmy Cayne's status and leadership approach emerged when the Bear Sterns losses did. He spent a good deal of time in recreational activities, something that made for derisive reports, but only from outsiders.[339] No one inside the company would question Cayne.

And there are others in the high-risk fold that were not highlighted on the cover. UBS, Wachovia, Bank of America, and Lehman have all had losses creeping up with

[334] Bill Carter, "As Citigroup Chief Totters, CNBC Reporter Is Having a Great Year," *New York Times*, November 5, 2007, pp. C1, C5.

[335] Barney Gimbel, "Deconstructing the Money-Honey Mess," *Fortune*, March 5, 2007, p. 14.

[336] *U.S. v. Brown*, 495 F.3d 509 (5th Cir.2006).

[337] Randall Smith, "A Five Billion Bath At Merrill Bares Deeper Divisions," *Wall Street Journal*, October 6, 2007, p. A1.

[338] Ann Davis, "Morgan Stanley's Change in Focus," *Wall Street Journal*, June 27, 2005, pp. C1, C5.

[339] Cayne was golfing and on a bridge tournament trip during the critical time of the crisis. Kate Kelly, "Bear CEO's Handling of Crisis Raises Issues," *Wall Street Journal*, November 1, 2007, pp. A1, A16. Mr. Cayne spent ten of July's twenty-one working days golfing or at the tournament.

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trickle releases. Presently, the write-downs do not appear to be completed or accurate. Even Merrill may have to recognize more losses.

In the three companies with the surprising losses (either by scope or reputation), stars were at the helm and had been brought in to clean up some messiness. For a time, they were all very successful, providing returns to shareholders and premium yields on bonds. But their star quality, coupled with results, meant that few in their companies would either challenge them or be willing to be the bearers of bad news (see below). The write-down "surprises" are easily explained and do not reflect well on either their business models or the willingness of employees to talk with these leaders about emerging issues. In simplest terms, the problem was the mortgages backing the bonds had been assigned risk levels based on default rates in a primo market, not a declining one. In short, the default rates were faulty (and the risk levels incorrect) because of a failure to take full account of the subprime market and its inherent and higher risk. As noted earlier, this higher risk was not unknown information about subprimes, but no one seemed willing to discuss that issue with their leaders.

Pressure to Meet Numbers

It was not that bright people in the companies did not see the problems or risk. The structure, the incentives, and the returns and rewards all contributed to a silence that belied common sense. One cannot, after all, wish his or her way into value.

One post-mortem analysis noted that at Merrill, "They lost more than others. Merrill tended to focus its efforts in the highest risk areas because that's where the rate of return was greatest."[340] And an executive commented after the $5 billion loss was announced, "We've seen this before."[341] O'Neal was, ironically, a numbers man who grilled his executives on results. One of his frequent tactics was making comparisons between Merrill and Goldman, such as why Goldman had higher growth in bond profits, with one Merrill executive noting, "It got to the point where you didn't want to be in the office on Goldman earnings days."[342] Employees called operations meetings "staged" and always found O'Neal aloof. And there were a series of terminations in the last year that found three high-ranking Merrill executives summoned for five- to fifteen-minute sessions in which they were shown the door for not reaching numbers goals. Those terminations were scuttlebutt throughout the company. And those interested in staying knew that results, not bad news, were the key to remaining employed. When you have forgotten the basic notion that higher returns mean higher risk, that pertinent information needs to percolate to the top and did not in the case of Merrill because it was afflicted with the same type of culture that allowed the Enron-era companies to go on for so long with so much wrong that was not factored into financials.

Prince had the Thomson termination, something that had a similar chilling effect as the Merrill terminations. Cayne's aloofness created a similar reticence on the parts of employees and executives who probably understood their exposure on CDOs.

The latest research shows that uncovering financial issues and fraud has its best shot in employees.[343] Neither regulators nor auditors are as likely to have information about financial report missteps as employees. The key is creating a culture in which the

[340] Jenny Anderson, "A Big Loss at Merrill Stirs Worries About Risk Control," *New York Times*, October 6, 2007, pp. B1, B2.

[341] *Id.*

[342] Randall Smith, "O'Neal Out as Merrill Reels from Loss," *Wall Street Journal*, October 29, 2007, pp. A1, A16.

[343] Alexander Dyck, Adair Morse, & Luigi Zingales, "Who Blows the Whistle on Corporate Fraud?" *Financial Economics*, February 2007. The authors find that employees are the best source for detecting fraud and support financial incentives for gaining more information from them, for example, more *qui tam* recovery.

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employees, who now tell us they were aware of the subprime issues and the need for write-downs, have the avenues and motivation for disclosure to those who will respond. Those companies now experiencing the lightest hits from the subprimes had cultures in which the numbers were questioned, from the top. Jamie Dimon at J.P. Morgan is known for his extensive involvement in operations there and his ability to hone in on numbers and ask the tough questions of employees. His approach is one that signals to employees not that the company wants only results, but that the results must be accurate and legitimate.[344] Compare the J. P. Morgan write down of $339 million with the other firms' billions. Likewise, Goldman and Lehman have small write-downs in comparison because of the hands-on operational experience and drilling techniques of officers who ask where the numbers came from and don't just accept numbers presented.

Innovation like No Other

"The banks were in denial. They thought they were smarter than the market."[345] Somehow the companies examined here were able to convince themselves that showing phenomenal earnings for such a long stretch meant invincibility and an immunity from the basics of market risk, returns, and exposure. Fancying yourself above the fray means that the rules, whether of the market or accounting, do not apply to your business model. Ignoring those basic principles simply postpones the inevitable subjugation to those principles, and the longer the postponement, the greater the losses.

Weak Boards

All of the boards, including Citigroup, have credentialed members. Robert Rubin, the former treasury secretary, has stepped up as chairman at Citi, but how did he miss the problem? By Rubin's own admission he did not know what a liquidity put was until the summer of 2007. And in what should be a shocking interview for governance gurus everywhere (and a big help on shareholder litigation), Rubin noted, "I tried to help people as they thought their way through this. Myself, at that point, I had no familiarity at all with CDOs."[346] Those on the board of a bank have an obligation to understand the instruments that are a foundation of the bank's portfolio. Yet Rubin insists it was not his job to know: "The answer is simple. It did not go on under my nose. I am not senior management. I have this side role."[347]

That former AT&T CEO Michael Armstrong missed the signals is even more extraordinary because Armstrong was a survivor of the overvaluation era that characterized the telecoms. Yet, as chair of Citi's audit committee, he did not see the similar strains or was unwilling to raise the flag. There is an ugly history with Armstrong, Weill, and Jack Grubman. Weill leaned on Grubman for a favorable AT&T rating in exchange for Weill's influence in getting Grubman's twins into preschool.[348] And Armstrong then sided with Weill in the battle for control of Citi against his co-CEO, John Reed. Credentials do not make for a strong board, and Prince's departure alone cannot fix the lax supervision of numbers at Citi. A board shakeup could have benefited the company

[344] Randall Smith and Aaron Luchetti, "Merrill Taps Thain as CEO," *Wall Street Journal*, November 15, 2007, pp. A1, A21.

[345] Shawn Tully, "Wall Street's Money Machine Breaks Down," *Fortune*, November 26, 2007, pp. 65, 78.

[346] Carol J. Loomis, "Robert Rubin on The Job He Never Wanted," *Fortune*, November 26, 2007, pp. 68–69.

[347] *Id.*

[348] Mara Der Hovanasian, "Can Citi Regroup?" *BusinessWeek*, November 19, 2007, pp. 31, 32. The history is found at Charles Gasparino, "Ghosts of E-Mails Continue to Haunt Wall Street," *Wall Street Journal*, November 18, 2002, pp. C1, C13; and Charles Gasparino, Anita Raghavan, and Rebecca Blumenstein, "Citigroup Now Has New Worry: What Grubman Will Say," *Wall Street Journal*, October 10, 2002, p. A1.

back in the Weill days and is necessary now as it moves forward and sheds the Weill and Prince shadows and styles. Indeed, all the boards may want to revisit the notion of expertise: Why did no one on the boards question the risk, the numbers, the operations, or even, just three months prior to the announcements of the write-downs, whether the subprime meltdown would affect their companies' financials? An even more basic question is Why did the board members not take the time to understand the definitions and risks of the instruments that were the cornerstone of the companies' portfolios?

"The Sage Advice Lost in the Computer Models"

Even without the common traits analysis, we have some simpler principles that would have helped the boards, the media, the analysts, and even the investors in these banks. That old adage applies: "If it sounds too good to be true, it is too good to be true." The kinds of returns that the banks and their investors were enjoying on investments based on subprime loans were too high to not have high risk associated with them. They simply had not been transparent about that risk.

There is another simple lesson, which is that there is no substitute for learning not just what the numbers are, but how staff got to those numbers. In looking at the companies that have had the least impact we find that, as noted earlier, there was a culture of "How exactly did you get these numbers?"—a natural and ongoing skepticism that signaled employees that the numbers had to be supportable, not just within range. The value of dissent in companies had been vastly underestimated and underutilized.

One final lesson was noted in the introduction. A sustainable competitive business model cannot be based on taking advantage of those with less information. A market works, not because of asymmetrical information, but because of transparency. That transparency was not there at the point of the subprime loan negotiations and the fog carried through to the risk evaluation as well as the valuations of the collateralized mortgage bonds themselves. Throughout the chain, the terms, the value, and the risk were not clear to the players. Such failure to disclose is neither the stuff of ethics nor of thriving markets. The subprime mess, when all is said and done, comes down to the basic ethical standard of forthrightness at all levels of companies and throughout the market.

Discussion Questions

1. What was not clear to investors in subprime mortgages?
2. How could the adage "If it sounds too good to be true …" influence the structure of an investment portfolio?
3. What is the role of boards in curbing unethical behavior at companies?

Case 4.20

Enron: The CFO, Conflicts, and Cooking the Books with Natural Gas and Electricity[349]

Introduction

Enron Corp. was an energy company that was incorporated in Oregon in 1985, with its principal executive offices located in Houston, Texas. By the end of 2001, Enron Corp.

[349] Adapted from Marianne M. Jennings, "A Primer on ENRON: Lessons from a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures," 39 *California Western Law Review* 163 (2003).

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was the world's largest energy company, holding 25 percent of all of the world's energy trading contracts.[350] Enron's own public relations materials described it as "one of the world's leading electricity, natural gas, and communications companies" that "markets electricity and natural gas, delivers physical commodities and financial and risk management services to companies around the world, and has developed an intelligent network platform to facilitate online business."[351] Enron was also one of the world's most admired corporations, holding a consistent place in *Fortune* magazine's 100 best companies to work for. The sign in the lobby of Enron's headquarters read, "WORLD'S LEADING COMPANY."[352] Employees at Enron's headquarters had access to an on-site health club, subsidized Starbucks coffee, concierge service that included massages, and car washes, all for free.[353] Those employees with Enron Broadband received free Palm Pilots, free cell phones, and free wireless laptops.[354]

In November 2001, a week following credit agencies' downgrading of its debt to "junk" grade, Enron filed for bankruptcy. At that time, it was the largest bankruptcy ($62 billion) in the history of the United States.[355] Since then, it has dropped and is now just one of the ten largest bankruptcies in the history of the United States.

Background on Enron

Enron began as the merger of two gas pipelines, Houston Natural Gas and Internorth, orchestrated by Kenneth Lay, and emerged as an energy trading company. Poised to ride the wave of deregulation of electricity, Enron would be a power supplier to utilities. It would trade in energy and offer electricity for sale around the country by locking in supply contracts at fixed prices and then hedging on those contracts in other markets. There are few who dispute that its strategic plan at the beginning showed great foresight and that its timing for market entry was impeccable. It was the first mover in this market and enjoyed phenomenal growth. It became the largest energy trader in the world, with $40 billion in revenue in 1998, $60 billion in 1999, and $101 billion in 2000. Its internal strategy was to grow revenue by 15 percent per year.[356]

When Enron rolled out its online trading of energy as a commodity, it was as if there had been a Wall Street created for energy contracts. Enron itself had 1,800 contracts in that online market. It had really created a market for weather futures so that utilities could be insulated by swings in the weather and the resulting impact on the prices of power. It virtually controlled the energy market in the United States. By December 2000, Enron's shares were selling for $85 each. Its employees had their 401(k)s heavily invested in Enron stock, and the company had a matching program in which it contributed additional shares of stock to savings and retirement plans when employees chose to fund them with Enron stock.

When competition began to heat up in energy trading, Enron began some diversification activities that proved to be disasters in terms of producing earnings. It acquired a water business that collapsed nearly instantaneously. It also had some international

[350] Noelle Knox, "Enron to Fire 4,000 from Headquarters," *USA Today*, December 4, 2001, p. 1B.

[351] From the class action complaint filed in the Southern District of Texas, *Kaufman v. Enron,* 761 F. Supp.2d 504 (S.D. Tex. 2011).

[352] Bethany McClean, "Why Enron Went Bust," *Fortune*, December 24, 2001, pp. 59–72.

[353] Alexei Barrionuevo, "Jobless in a Flash, Enron's Ex-Employees Are Stunned, Bitter, Ashamed," *Wall Street Journal*, December 11, 2001, pp. B1, B12.

[354] *Id.*

[355] Richard A. Oppel Jr. and Riva D. Atlas, "Hobbled Enron Tries to Stay on Its Feet," *New York Times*, December 4, 2001, pp. C1, C8.

[356] "Why John Olson Wasn't Bullish on Enron," http://knowledge.Wharton.upenn.edu/013002_ss3. Accessed July 28, 2010.

investments that had gone south, particularly power plants in Brazil and India. Its $1 billion investment in a 2,184-megawatt power plant in India was in ongoing disputes as its political and regulatory relations in that country had deteriorated, and the state utility stopped paying its bills for the power.[357]

In 1999, it announced its foray into fiber optics and the broadband market. Enron over-anticipated the market in this area and experienced substantial losses related to the expansion of its broadband market. Like Corning and other companies that overbuilt, Enron began bleeding quickly from losses related to this diversification.[358]

The Financial Reporting Issues

Mark-to-Market Accounting

Enron followed the FASB's rules for energy traders, which permit such companies to include in current earnings those profits they expect to earn on energy contracts and related derivative estimates.[359] The result is that many energy companies had been posting earnings, quite substantial, for noncash gains that they expect to realize some time in the future. Known as *mark-to-market accounting*, energy companies and other industries utilize a financial reporting tool intended to provide insight into the true value of the company through a matching of contracts to market price in commodities with price fluctuations. However, those mark-to-market earnings are based on assumptions. An example helps to illustrate the wild differences that might occur when values are placed on these energy contracts that are marked to the market price. Suppose that an energy company has a contract to sell gas for $2.00 per gallon, with the contract to begin in 2004 and run through 2014. If the price of gas in 2007 is $1.80 per gallon, then the value of that contract can be booked accordingly and handsomely, with a showing of a 20 percent profit margin. However, suppose that the price of gasoline then climbs to $2.20 per gallon during 2008. What is the manager's resolution and reconciliation in the financial statement of this change in price? The company has a ten-year commitment to sell gas at a price that will produce losses. Likewise, suppose that the price of gas declines further to $0.50 per gallon in 2008. How is this change reflected in the financial statements, or does the company leave the value as it was originally booked in 2007? And how much of the contract is booked into the present year? And what is its value presently?

The difficulty with mark-to-market accounting is that the numbers that the energy companies carry for earnings on these future contracts are subjective. The numbers they carry depend upon assumptions about market factors. Those assumptions used in computing future earnings booked in the present are not revealed in the financial reports, and investors have no way of knowing the validity of those assumptions or even whether they are conservative or aggressive assumptions about energy market expectations. It becomes difficult for investors to cross-compare financial statements of energy companies because they are unable to compare what are apples and oranges in terms of earnings because of the futuristic nature of the income and the possibility that those figures may never come to fruition.

For example, the unrealized gains portion of Enron's pretax profit for 2000 was about 50 percent of the total $1.41 billion profit originally reported. That amount was one-third in 1999.

[357] Saritha Rai, "New Doubts on Enron's India Investment," *New York Times*, November 21, 2001, p. W1.

[358] Complaint, class action litigation, November 2001, *In re Enron Corp. Securities, Derivatives, & ERISA Litigation*, 761 F. Supp. 2d 504 (S.D. Tex. 2011).

[359] Jonathan Weil, "After Enron, 'Mark to Market' Accounting Gets Scrutiny," *Wall Street Journal*, December 4, 2001, pp. C1, C2.

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This practice of mark-to-market accounting proved to be particularly hazardous for Enron management because their bonuses and performance ratings were tied to meeting earnings goals. The result was that their judgment on the fair value of these energy contracts, some as long as twenty years into the future, was greatly biased in favor of present recognition of substantial value.[360] The value of these contracts is dependent upon assumptions and variables that are not discussed in the financial statements, are not readily available to investors and shareholders, and include wild cards such as the weather, the price of natural gas, and market conditions in general. One analyst has noted, "Whenever there's a considerable amount of discretion that companies have in reporting their earnings, one gets concerned that some companies may overstate those earnings in certain situations where they feel pressure to make earnings goals."[361] A FASB study showed that when a hypothetical example on energy contracts was given at a conference, the valuations by managers for the contracts ranged from $40 million to $153 million.[362]

Some analysts were concerned about this method of accounting because these are noncash earnings. Some noted that Enron's noncash earnings were over 50 percent of its revenues. Others discovered the same issues when they noted that Enron's margins and cash flow did not match up with its phenomenal earnings records.[363] For example, Jim Chanos, of Kynikos Associates, commented that no one was really sure how Enron made money and that its operating margins were very low for the reported revenue. Mr. Chanos concluded that Enron was a "giant hedge fund sitting on top of a pipeline."[364] Mr. Chanos noted that Wall Street loved Enron because it consistently met targets, but he was skeptical because of off-the-balance sheet transactions (see below for more information).[365] Mr. Chanos and others who brought questions to Enron were readily dismissed. For example, *Fortune* reporter Bethany McClean experienced pressure in 2000 when she began asking questions about the revenues and margins. Then-Chairman, and now the late Ken Lay, called her editor to request that she be removed from the story. The Enron CEO at the time, Jeffrey Skilling, refused to answer her questions and labeled her line of inquiry as "unethical."[366] During an analysts' telephonic conference with Mr. Skilling in which Mr. Chanos asked why Enron had not provided a balance sheet, Mr. Skilling called Mr. Chanos an "a—h ______."[367] Mr. Chanos opted for selling Enron shares short and declined to disclose the amount of money he made as a result of his position.

John Olson, presently an analyst with a Houston company, reflected that most analysts were unwilling to ask questions. When Mr. Olson asked Mr. Skilling questions about how Enron was making money, Mr. Skilling responded that Enron was part of

[360] Susan Lee, "Enron's Success Story," *Wall Street Journal,* December 26, 2001, p. A11.

[361] *Id.*

[362] Weil, "After Enron, 'Mark to Market' Accounting Gets Scrutiny," p. C2.

[363] McClean, "Why Enron Went Bust," pp. 62–63. Ms. McLean had written a story in the summer of 2001 entitled, "Is Enron Overpriced?" for *Fortune*. The lead line to the story was "How exactly does Enron make its money?" The story was buried. It enjoyed little coverage or attention until November 2001. Ms. McClean quickly became an analyst on the Enron case for NBC and was featured on numerous news shows. Felicity Barringer, "10 Months Ago, Questions on Enron Came and Went with Little Notice," *New York Times*, January 28, 2002, p. A11. Ms. McClean wrote a book with Peter Elkind, *The Smartest Guys in the Room* (2003), which was later made into a successful documentary film.

[364] *Id.*

[365] Cassell Bryan-Low and Suzanne McGee, "Enron Short Seller Detected Red Flags in Regulatory Filings," *Wall Street Journal*, November 5, 2001, pp. C1, C2.

[366] McClean, "Why Enron Went Bust," p. 60.

[367] Bryan-Low and McGee, "Enron Short Seller Detected Red Flags in Regulatory Filings," p. C2.

the new economy and that Olson "didn't get it."[368] Mr. Olson advised his company's clients not to invest in Enron because, as he explained to them, "Never invest in something you can't understand."[369] Mr. Olson was fired by Merrill Lynch following the publication of his skeptical analysis about Enron. Merrill Lynch continues to deny that it fired Mr. Olson for that reason. Enron was a critical client for Merrill Lynch. In fact, Merrill would become known for its role in Andrew Fastow's infamous "Wanna buy a barge?" deal, in which Merrill purchased a barge temporarily from Enron. The purchase permitted Enron to meet its numbers goals, and even the general counsel at Merrill had expressed concern that Merrill might be participating in Enron's earnings management. Four former Merrill investment bankers were indicted and convicted for their roles in the "Wanna buy a barge?" Enron transaction.[370] All but one of the convictions were reversed on appeal because the investment bankers could not have known the extent of Fastow's frauds or the full scope and meaning of the transaction. The court held that the investment bankers were allowed to rely on the representations of a company's officer and could not be convicted of participating in fraud when an agent of the company arranged the transaction.

When *U.S. News & World Report* published Mr. Olson's analysis and advice, Kenneth Lay sent Mr. Olson's boss a handwritten note with the following:

> John Olson has been wrong about Enron for over 10 years and is still wrong. But he is consistant [*sic*].

Upon reading the note sent to his boss, Mr. Olson responded, "You know that I'm old and I'm worthless, but at least I can spell *consistent.*"[371]

Off-the-Books Entities

Not only did Enron's books suffer from the problem of mark-to-market accounting, but also the company made minimal disclosures about its off-the-balance-sheet liabilities that it was carrying.[372] These problems, coupled with the mark-to-market value of the energy contracts, permitted Enron's financial statements to paint a picture that did not adequately reflect the risk investors had.

Enron had created, by the time it collapsed, about 3,000 off-the-books entities, partnerships, limited partnerships, and limited liability companies (called *special purposes entities*, or SPEs, in the accounting profession) that carried Enron debt and obligations that had been spun off but did not have to be disclosed in Enron's financial reports because, under an accounting rule known as FASB 125, the debt and obligations in off-the-books entities did not have to be disclosed so long as Enron's ownership interests in the entities never exceeded 49 percent. Disclosure requirements under GAAP and FASB kicked in at 50 percent ownership at that time. Under the old rules, when a company owned 50 percent or more of a company, it had to disclose transactions with that company in the financials as *related party transactions*.

Enron created a complex network of these entities, and some of the officers of the company even served as principals in these companies and began earning commissions for the sale of Enron assets to them. Andrew Fastow, Enron's CFO, was a principal in

[368] "Why John Olson Wasn't Bullish on Enron," http://knowledge.Wharton.upenn.edu/013002_ss3. Accessed July 28, 2010.

[369] *Id.*

[370] Kurt Eichenwald, "Jury Convicts 5 Involved in Enron Deal with Merrill," *New York Times*, November 4, 2004, pp. C1, C4.

[371] "Why John Olson Wasn't Bullish on Enron."

[372] Richard A. Oppel Jr. and Andrew Ross Sorkin, "Enron Corp. Files Largest U.S. Claim for Bankruptcy," *New York Times*, December 3, 2001, pp. A1, A16.

many of these off-the-book entities. His wife, Lea, also a senior officer at Enron, was also involved in handling many of the SPEs. In some of the SPEs, the two discussed the possibility of having some of the payments come to their two small children.

In 1999, Enron described one of these relationships in its 10K (an annual report companies must file with the SEC) as follows:

> In June 1999, Enron entered into a series of transactions involving a third party and LJM Cayman, L.P. (LJM). LJM is a private investment company, which engages in acquiring or investing in primarily energy-related investments. A senior officer of Enron is the managing member of LJM's general partner.[373]

The effect of all of these partnerships was to allow Enron to transfer an asset from its books, along with the accompanying debt, to the partnership. An outside investor would fund as little as 3 percent of the partnership, with Enron occasionally providing even the front money for the investor. Enron would then guarantee the bank loan to the partnership for the purchase of the asset. Enron would pledge shares as collateral for these loans it guaranteed in cases where the bank felt the asset transferred to the partnership was insufficient collateral for the loan amount.[374] By the time it collapsed, Enron had $38 billion in debt among all the various SPEs, but carried only $13 billion on its balance sheet.[375]

To add to the complexity of these off-the-books loans and the transfer of Enron debt, many of the entities formed to take the asset and debt were corporations in the Cayman Islands. Enron had 881 such corporations, with 700 formed in the Cayman Islands, and, in addition to transferring the debt off its balance sheet, it enjoyed a substantial number of tax benefits because corporations operate tax-free there. The result is that Enron paid little or no federal income taxes between 1997 and 2000.[376] Comedian Robin Williams referred to Enron executives as “the Investment Pirates of the Caribbean.”

Relatives and Doing Business with Enron

In addition to these limited liability company and limited partnership asset transfers, there were apparently a series of transactions authorized by Mr. Lay in which Enron did business with companies owned by Mr. Lay's son, Mark, and his sister, Sharon Lay. Jeffrey Skilling had hired Mark Lay in 1989 when Mark graduated with a degree in economics from UCLA. However, Mr. Lay left Enron feeling that he needed to “stand on his own and work outside of Enron.”[377] Enron eventually ended up acquiring Mr. Lay's son's company and hired him as an Enron executive with a guaranteed pay package of $1 million over three years as well as 20,000 stock options for Enron shares.[378] There was a criminal investigation into the activities of one of the companies founded by Mark Lay, but he was not charged with wrongdoing. He did pay over $100,000 to settle a civil complaint in the matter, but admitted no wrongdoing. Mark Lay entered a Baptist seminary in Houston and plans to become a minister.[379]

Sharon Lay owned a Houston travel agency and received over $10 million in revenue from Enron during the period from 1998 through 2001 years, one-half of her company's

[373] Enron Corp. 10K, Filed December 31, 1999, p. 16.

[374] John R. Emshwiller and Rebecca Smith, “Murky Waters: A Primer on Enron Partnerships,” *Wall Street Journal*, January 21, 2002, pp. C1, C14.

[375] Bethany McLean and Peter Elkind, “Partners in Crime,” *Fortune*, October 27, 2003, p. 79.

[376] David Gonzalez, “Enron Footprints Revive Old Image of Caymans,” *New York Times*, January 28, 2002, p. A10.

[377] David Barboza and Kurt Eichenwald, “Son and Sister of Enron Chief Secured Deals,” *New York Times*, February 2, 2002, pp. A1, B5.

[378] *Id.*

[379] *Id.*

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revenue during that period.[380] Both Ms. and the late Mr. Lay say that they made all the necessary disclosures to the board and regulators about their business with Enron.

Enron's Demise

Enron's slow and steady decline began in the November–December 2000 time frame, when its share price was at $85. By the time Jeffrey Skilling announced his departure as CEO on August 14, 2001, with no explanation, the share price was at about $43. Mr. Skilling says that he left the company simply to spend more time with his family, but his departure raised questions among analysts even as Kenneth Lay returned as CEO.[381] The *Wall Street Journal* raised questions about Enron's disclosures on August 28, 2001, as Enron was beginning an aggressive movement for selling off assets.[382] By October, Enron disclosed that it was reporting a third-quarter loss and it took a $1.2 billion reduction in shareholder equity. Within days of those announcements, CFO Andrew Fastow was terminated, and in less than two weeks, Enron restated its earnings dating back to 1997, a $586 million, or 20 percent, reduction.

Following these disclosures and the announcement of Enron's liability on a previously undisclosed $690 million loan, CEO Kenneth Lay left the company as CEO, but remained as chairman of the board.[383] Mr. Lay waived any rights to his parachute, reportedly worth $60 million, and also agreed to repay a $2 million loan from the company.[384] Mr. Lay's wife, Linda, appeared on NBC with correspondent Lisa Meyer on January 28, 2002, and indicated that she and Mr. Lay were "fighting for liquidity."[385] She indicated that all their property was for sale, but a follow-up check by Ms. Meyer found only one of a dozen homes owned by the Lays was for sale. Mr. Lay consulted privately with the Reverend Jesse Jackson for spiritual advice, according to Mrs. Lay.[386]

The Enron Culture

Enron was a company with a swagger. It had an aggressive culture in which a rating system required that 20 percent of all employees be rated at below performance and encouraged to leave the company. As a result of this policy, no employee wanted to be the bearer of bad news.

Margaret Ceconi, an employee with Enron Energy Services, wrote a five-page memo to Kenneth Lay on August 28, 2001, stating that losses from Enron Energy Services were being moved to another sector in Enron in order to make the Energy Service arm look profitable. One line from her memo read, "Some would say the house of cards are falling."[387] Mr. Lay did not meet with Ms. Ceconi, but she was contacted by Enron Human Resources and counseled on employee morale. When she raised the accounting issues in her meeting with HR managers, she was told they would be investigated and

[380] *Id.*

[381] John E. Emshwiller and Rebecca Smith, "Behind Enron's Fall, a Culture of Operating outside Public View," *Wall Street Journal*, December 5, 2001, pp. A1, A10.

[382] John E. Emshwiller, Rebecca Smith, Robin Sidel, and Jonathan Weil, "Enron Cuts Profit Data of 4 Years by 20%," *Wall Street Journal*, November 9, 2001, p. A3.

[383] *Id.*

[384] Richard A. Oppel Jr. and Floyd Norris, "Enron Chief Will Give Up Severance," *New York Times*, November 14, 2001, pp. C1, C10.

[385] Alessandra Stanley and Jim Yardley, "Lay's Family Is Financially Ruined, His Wife Says," *New York Times*, January 29, 2002, pp. C1, C6.

[386] *Id.*

[387] Julie Mason, "Concerned Ex-worker Was Sent to Human Resources," *Houston Chronicle*, January 30, 2002, www.chron.com.

taken very seriously, but she was never contacted by anyone about her memo. Her memo remained dormant until January 2002, when she sent it to the U.S. House of Representatives' Committee on Energy and Commerce, the body conducting a series of hearings on the Enron collapse.

Ms. Ceconi's memo followed two weeks after Sherron Watkins, a former executive, wrote of her concerns about "accounting scandals" at Enron. Ms. Watkins was a former Andersen employee who had been hired into the executive ranks by Enron. Ms. Watkins wrote a letter to Kenneth Lay on August 15, 2001, that included the following: "I am incredibly nervous that we will implode in a wave of accounting scandals. I have heard from one manager-level employee from the principal investments group say, 'I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company.'"[388] She also warned that Mr. Skilling's swift departure would raise questions about accounting improprieties and stated, "It sure looks to the layman on the street that we are hiding losses in a related company."[389] In her memo, she listed J. Clifford Baxter as someone Mr. Lay could talk to in order to verify her facts and affirmed that her concerns about the company were legitimate. Ms. Watkins wrote the memo anonymously on August 15, 2001, but by August 22, and after discussing the memo with former colleagues at Andersen, she told her bosses that she was the one who had written the memo.

In the months prior to Enron's collapse, employees became suspicious about what was called "aggressive accounting" and voiced their concerns in online chat rooms.[390] Clayton Verdon was fired in November 2001 for his comments about "overstating profits," made in an employee chat room. A second employee was fired when he revealed in the chat room that the company had paid $55 million in bonuses to executives on the eve of its bankruptcy.[391] Enron indicated that the terminations were necessary because the employees had breached company security.

In his testimony at the trial of his former bosses, Ken Lay and Jeffrey Skilling, former CFO Andrew Fastow offered some insights into the culture at Enron and the tone he set as a senior executive. Andrew Fastow, when confronted by Daniel Petrocelli, lawyer for Jeffrey Skilling, about his clear wrongdoing, offered the following: "Within the culture of corruption that Enron had, that valued financial reporting rather than economic value, I believed I was being a hero."[392] He went on to add, "I thought I was being a hero for Enron. At the time, I thought I was helping myself and helping Enron to make its numbers."[393] He explained further, "At Enron, the culture was and the business practice was to do transactions that maximized the financial reporting earnings as opposed to maximizing the true economic value of the transactions."[394] However, Mr. Fastow said he did see the writing on the wall near the end and encouraged others to reveal the true financial picture at Enron: "We have to open up the kimono and show them the skeletons in the closet, what our assets are really worth."[395]

[388] Michael Duffy, "What Did They Know and When Did They Know It?" *Time*, January 28, 2002, pp. 16–27.

[389] *Id.*

[390] Alex Berenson, "Enron Fired Workers for Complaining Online," *New York Times*, January 21, 2002, pp. C1, C8.

[391] *Id.*

[392] March 8, 2006, trial testimony of Andrew Fastow, in Greg Farrell, "Fastow 'Juiced' Books," *USA Today*, March 8, 2006, p. 1A.

[393] *Id.*

[394] Farrell, "Fastow 'Juiced' Books," p. 1A.

[395] Alexei Barrionuevo, "Ex-Enron Official Insists Chief Knew He Was Lying," *New York Times*, March 2, 2006, p. C3. (Mixed metaphors aside.)

The Enron Board

Some institutional investors have raised questions about conflicts and the lack of independence in Enron's board.[396] Members of Enron's board were well compensated with a total of $380,619 paid to each director in cash and stock for 2001. One member of the board was Dr. Wendy L. Gramm, the former chairwoman of the Commodity Futures Trading Commission and wife of Senator Phil Gramm, the senior U.S. senator from Texas, who has received campaign donations from Enron employees and its PAC. Dr. Gramm opted to own no Enron stock and accepted payment for her board service only in a deferred compensation account.

Dr. John Mendelsohn, the president of the University of Texas M.D. Anderson Cancer Center in Houston, also served on the Enron board, including its audit committee. Dr. Mendelsohn's center received $92,508 from Enron and $240,250 from Linda and Ken Lay after Dr. Mendelsohn joined the Enron board in 1999.[397]

After the Fall

Enron fired 5,100 of its 7,500 employees by December 3, 2001. Although Enron continues to operate as a company today, only 1,900 employees retained their jobs. Each employee received a $4,500 severance package. However, many of the employees were looking forward to a comfortable retirement, basing that assumption on the value of their Enron stock. Many held Enron stock and were compensated with Enron stock options. The stock was trading at $0.40 per share on December 3, 2001, following a high of $90 at its peak. Employee pension funds lost $2 billion. Enron employees' 401(k) plans, funded with Enron stock, lost $1.2 billion in 2001. "Almost everyone is gone. Upper management is not talking. No managing directors are around, and police are on every floor. It's so unreal," said one departing employee.[398] One employee, George Kemper, a maintenance foreman, who is part of a suit filed against Enron related to the employees' 401(k) plans, whose plan was once worth $225,000 and is now worth less than $10,000, said, "How am I going to retire now? Everything I worked for the past 25 years has been wiped out."[399] The auditors have admitted that they simply cannot make sense of the company's books for 2001, but have concluded that the cash flow of $3 billion claimed for 2000 was actually a negative $153 million and that the profits of $1 billion reported in 2000 did not exist.[400]

Just prior to declaring bankruptcy, Enron paid $55 million in bonuses to executives described as "retention executives," or those the company needs to stay on board in order to continue operations.[401]

Tragically, J. Clifford Baxter, a former Enron vice chairman, and the one officer Ms. Watkins suggested Mr. Lay talk with, took his own life in his 2002 Mercedes Benz about a mile from his $700,000 home in Sugar Land, Texas, a suburb twenty-five miles from Houston. Mr. Baxter, who earned his MBA at Columbia, had left Enron in May 2001, following what some employees say was his voicing of concerns over the accounting

[396] Reed Abelson, "Enron Board Comes under a Storm of Criticism," *New York Times*, December 16, 2001, p. BU4.

[397] Jo Thomas and Reed Abelson, "How a Top Medical Researcher Became Entangled with Enron," *New York Times*, January 28, 2002, pp. C1, C2.

[398] Richard A. Oppel Jr. and Riva D. Atlas, "Hobbled Enron Tries to Stay on Its Feet," *New York Times*, December 4, 2001, pp. C1, C8.

[399] Christine Dugas, "Enron Workers Sue over Retirement Plan," *USA Today*, November 27, 2001, p. 5B.

[400] Cathy Booth Thomas, "The Enron Effect," *Time*, June 5, 2006, pp. 34–36.

[401] Richard A. Oppel Jr. and Kurt Eichenwald, "Enron Paid $55 Million for Bonuses," *New York Times*, December 4, 2001, pp. C1, C4.

practices of Enron and its disclosures.[402] SEC records disclose that Mr. Baxter sold 577,000 shares of Enron stock for $35.2 million between October 1998 and early 2001.[403] He had been asked to appear before Congress to testify, was a defendant in all the pending litigation, and was last seen in public at his yacht club, where he took his yacht out for a sail. Those who saw him indicated that his hair had become substantially grayer since October, when the public disclosures about Enron's condition began. Mr. Baxter was depicted as a philanthropist in the Houston area, having raised money for charities such as Junior Achievement and other organizations to benefit children. He had created the Baxter Foundation with $200,000 from Enron and $20,000 of his own money to assist charities such as Junior Achievement, the American Cancer Society, and the American Diabetes Association.[404]

As noted, Enron had a matching plan for its employees on the 401(k). However, 60 percent of their plan was invested in Enron stock. Between October 17 and November 19, 2001, when the issues surrounding Enron's accounting practices and related transactions began to surface, the company put a lockdown on the plan so that employees could not sell their shares.[405] Prior to the lockdown, most of the executives had sold off large blocks of Enron stock. For example, Jeffrey Skilling, who left the company in August 2001, sold off 500,000 shares on September 17, 2001.[406] He had sold 240,000 shares in early 2001 and at the time of Enron's bankruptcy owned 600,000 shares and an undisclosed number of options.[407] Mr. Lay also sold a substantial amount of stock in August 2001, but his lawyer had indicated the sale of the stock was necessary in order to repay loans.[408]

Person	Title	Charges	Disposition
Ken Lay	Chairman, CEO	Securities fraud	Convicted; conviction reversed following Mr. Lay's untimely death on July 5, 2006, one month after his conviction.
		Wire fraud	Same as above.
Jeffrey Skilling	CEO	Securities fraud	Convicted on all but two counts; serving a sentence of 24.4 years, but a 2010 U.S. Supreme Court decision on honest services fraud remanded the case after reversing his conviction for honest services fraud because he had not engaged in bribery (required for proof of honest services fraud). With that conviction out of the mix, Mr. Skilling must be resentenced to a lesser period of time.

[402] Elissa Gootman, "Hometown Remembers Man Who Wore Success Quietly," *New York Times*, January 30, 2002, p. C7.

[403] Mark Babineck, "Deceased Enron Executive Earned Respect in the Ranks," *Houston Chronicle*, January 26, 2002, http://www.chron.com.

[404] *Id.*

[405] *Id.*

[406] Richard A. Oppel Jr., "Former Head of Enron Denies Wrongdoing," *New York Times*, December 22, 2001, pp. C1, C2.

[407] *Id.*

[408] Richard A. Oppel Jr., "Enron Chief Says His Sale of Stock Was to Pay Loans," *New York Times*, January 21, 2002, pp. A1, A13.

Person	Title	Charges	Disposition
		Wire fraud	Same as above.
Andrew Fastow	CFO	Securities fraud	Guilty plea; six years (will probably be released in four because of his extensive cooperation in the criminal trials of Skilling and Lay as well as the civil suits)
		Wire fraud	Guilty plea.
		Tax evasion	Guilty plea.
Lea Fastow	Senior Officer	Tax evasion	Guilty plea; one year; served (ended with last month in halfway house in July 2005) her term first so that Andrew Fastow could be at home with their two young children before he began his term in 2006.
David Delainey	CEO Enron North America	Insider trading	Guilty plea; served slightly over one year.
Ben Glisan	Treasurer	Conspiracy	Guilty plea; five years.
Richard Causey	Chief Accounting Officer	Insider trading	Guilty plea to one count of securities fraud in exchange for seven-year sentence recommendation and cooperation with federal prosecutors on Skilling and Lay case.[409] He was sentenced to 5.5 years.
Michael J. Kopper	Officer who worked directly with Fastow	Fraud	Guilty plea to money laundering and conspiracy to commit wire fraud; sentenced to three years and one month.
Kenneth D. Rice	CEO, Enron Broadband		Guilty plea to one count.
Mark Koenig	Vice president of investor relations		Guilty plea to one count of aiding and abetting securities fraud; eighteen months.

Note: Thirty-two Enron executives were indicted in total, with guilty pleas or convictions for all. Mr. Lay was the last Enron official indicted, in July 2004.

In addition to the impact on Enron, its employees, and Houston, there was a worldwide ripple effect. Enron had large stakes in natural gas pipelines in the United States and around the world as well as interests in power plants everywhere from Latin America to Venezuela. It is also a partial owner of utilities, including telecommunications networks. Congressional hearings were held as the House Energy and Commerce Committee investigated the company's collapse. Representative Billy Tauzin of Louisiana scheduled the investigations and noted, "How a company can sink so far, so fast, is very troubling. We need to find out if the company's accounting practices masked severe

[409] John Emshwiller, "Enron Prosecutors, after Plea Bargain, Can Reduce Technical Jargon at Trial," *Wall Street Journal*, January 4, 2006, pp. C1, C5.

underlying financial problems."[410] Senator Jeff Bingham, then-chairman of the Senate Energy Committee, said, "I believe that our committee is keenly aware of the need for enhanced oversight and market monitoring."[411]

Enron's bankruptcy filing included a list of creditors fifty-four pages long. Although the bankruptcy filing showed $24.76 billion in assets and $13.15 billion in debt, these figures did not include those off-the-balance sheet obligations, estimated to be about $27 billion.[412]

Enron energy customers, which include Pepsico, the California state university system, JCPenney, Owens-Illinois, and Starwood Hotels & Resorts, also felt the effects of the company's collapse. Enron had contracts with 28,500 customers. These customers had to revise their contracts and scramble to place energy contingency plans in place. California's state universities were in negotiations for renewal of their 1998 contract with Enron, but those talks went into a stalemate, and the university system found another provider.[413]

Trammell Crow halted the groundbreaking ceremony for its planned construction of new Enron headquarters, a building that would have been fifty stories high and included offices, apartments, and stores.[414]

The ripple effect stretched into unrelated investments. Five major Japanese money market funds with heavy Enron investments fell below their face value by December 3, 2001.[415] These losses had additional consumer-level effects because these funds were held by retirees because they were seen as "safe haven" funds for investors.

The Enron board hired Stephen F. Cooper as CEO to replace Mr. Lay. Mr. Cooper is a specialist in leading companies through bankruptcy, including TWA and Federated Department Stores.[416]

Enron's collapse ended the movement toward the deregulation of electricity. Following Enron's collapse, federal and state regulators saw the impact on consumers of allowing energy companies to operate in a regulatory no-man's land, and the state moved back to the model of price regulation of the sale of energy to consumers.[417]

The SEC, a national team of lawyers, and the Justice Department began a six-year investigation of the company, its conduct, and it officers.[418] The civil suits press on, with Andrew Fastow providing the plaintiffs in the cases, many of them former employees, information and details that are aiding them in recovering funds from banks, auditors, and insurers. In the bankruptcy, Enron's creditors received 18.3 cents on the dollar, an amount far below the normal payout in a bankruptcy.[419]

[410] Richard A. Oppel Jr. and Andrew Ross Sorkin, "Ripples Spreading from Enron's Expected Bankruptcy," *New York Times*, November 30, 2001, pp. C1, C6, C7.

[411] "Financial Threat from Enron Failure Continues to Widen," *Financial Times*, December 1, 2001, p. 1.

[412] Rebecca Smith and Mitchell Pacelle, "Enron Files for Chapter 11 Bankruptcy, Sues Dynegy," *Wall Street Journal*, December 3, 2001, p. A2.

[413] Rhonda L. Rundle, "Enron Customers Seek Backup Suppliers," *Wall Street Journal*, December 3, 2001, p. A10.

[414] Allen R. Myerson, "With Enron's Fall, Many Dominoes Tremble," *New York Times*, December 2, 2001, pp. 3–1, MB1.

[415] Ken Belson, "Enron Causes 5 Major Japanese Money Market Funds to Plunge," *New York Times*, December 4, 2001, p. C9.

[416] Shaila K. Dewan and Jennifer Lee, "Enron Names an Interim Chief to Oversee Its Bankruptcy," *New York Times*, January 30, 2002, p. C7.

[417] Rebecca Smith, "Enron Continues to Haunt the Energy Industry," *Wall Street Journal*, March 16, 2006, p. C1; and Joseph Kahn and Jeff Gerth, "Collapse May Reshape the Battlefield of Deregulation," *New York Times*, December 4, 2001, pp. C1, C8.

[418] Jo Thomas, "A Specialist in Tough Cases Steps into the Legal Tangle," *New York Times*, January 21, 2002, p. C8.

[419] Mitchell Pacelle, "Enron's Creditors to Get Peanuts," *Wall Street Journal*, July 11, 2003, pp. C1, C7.

Many noted at the time of Enron's collapse that "evidence of fraud may well be elusive" as the SEC and prosecutors investigate.[420] Professor Douglas Carmichael, a professor of accounting at Baruch College, is one who agrees: "It's conceivable that they complied with the rules. Absent a smoking-gun e-mail or something similar, it is an issue of trying to attack the reasonableness of their assumptions."[421] One auditor said that it never occurred to him that anyone would "use models to try and forecast energy prices for 10 years, and then use those models to report profits, but that the rule had not placed a limit on such trades."[422] When asked about the accounting practices of Enron, Mr. Skilling said, "We are doing God's work. We are on the side of angels."[423]

Mr. Skilling and Mr. Lay were tried in a case that ran from February to June 2006. They were both convicted following six days of deliberations by the jurors. Mr. Fastow was the government's key witness against the two men. Both men took the stand as part of their defense, and both men got angry on the stand when faced with cross-examination. Mr. Lay was convicted on all counts. Mr. Skilling was convicted on eighteen of twenty-seven counts, Mr. Lay died of a massive heart attack on July 5, 2006, while at his Colorado vacation home.[424] His conviction was set aside because he had not had the opportunity to appeal the verdict. One comment on his passing was "His death was a cop-out."[425] A former Enron employee told the *Houston Chronicle*, "Glad he's dead. May he burn in hell. I'll dance on his grave."[426]

Mr. Skilling awaits his resentencing following a U.S. Supreme Court reversal of his "honest services" fraud conviction. Mr. Petrocelli was paid $23 million from a trust fund Mr. Skilling had set aside for his defense, and Enron's insurer paid $17 million to Mr. Petrocelli's firm of O'Melveny and Myers, for a total of $40 million. However, the firm and Mr. Petrocelli are still owed $30 million for their defense work, an amount Mr. Skilling is unable to pay.[427]

Discussion Questions

1. Can you see that Enron broke any laws? Andrew Fastow testified at the Lay and Skilling trial as follows: "A significant number of senior management participated in this activity to misrepresent our company. And we all benefited financially from this at the expense of others. And I have come to grips with this. That, in my mind, was stealing."[428] Is Mr. Fastow correct? Was it stealing? How should Fastow's' relationships with Enron's partially owned subsidiaries have been handled in terms of disclosure.
2. Do you think that Enron's financial reports gave a false impression? Does it matter that most investors in Enron were relatively sophisticated financial institutions? What about the employees' ownership of stock and their 401(k) plans?
3. What questions could the officers of Enron have used to evaluate the wisdom and ethics of their decisions on the off-the-book entities and mark-to-market accounting? Be sure to apply the various models you have learned.
4. Did Mr. Fastow have a conflict of interest?

[420] Floyd Norris and Kurt Eichenwald, "Fuzzy Rules of Accounting and Enron," *New York Times*, January 30, 2002, pp. C1, C6.

[421] *Id.*

[422] *Id.*

[423] Neil Weinberg and Daniel Fisher, "Power Player," *Forbes*, December 24, 2001, pp. 53–58.

[424] Bethany McClean and Peter Elkind, "Death of a Disgraced Energy Salesman," *Fortune*, July 30, 2006, pp. 3–32.

[425] *Id.*

[426] *Id.*

[427] Carrie Johnson, "After Enron Trial, Defense Firm Is Stuck with the Tab," *Washington Post*, June 16, 2006, pp. D1, D3.

[428] Alexei Barrionuevo, "Fastow Testifies Lay Knew of Enron's Problems," *New York Times*, March 9, 2006, pp. C1, C4.

5. What elements for your personal credo can you take away from the following testimony from David Delainey and Andrew Fastow? As you think about this question, consider the following from their testimony at the Skilling and Lay trial.

   When asked why he did not raise the issue or simply walk away, Mr. Delainey responded, "I wish on my kids' lives I would have stepped up and walked away from the table that day."[429] Mr. Fastow had the following exchange with Daniel Petrocelli, Mr. Skilling's lawyer (Mr. Petrocelli represented the Brown and Goldman families in their civil suit against O. J. Simpson):

   Petrocelli: To do those things, you must be consumed with insatiable greed. Is that fair to say?

   Fastow: I believe I was very greedy and that I lost my moral compass.[430]

   Fastow also testified as follows: "My actions caused my wife to go to prison."[431] Defense attorneys, being the capable souls that they are, extracted even more: "I feel like I've taken a lot of blame for Enron these past few days. It's not relevant to me whether Mr. Skilling's or Mr. Lay's names are on that page.... I'm ashamed of the past. What they write about the past I can't affect. I want to focus on the future. Even after being caught, it took me awhile to come to grips with what I'd done.... I've destroyed my life. All I can do is ask for forgiveness and be the best person I can be."[432] Mr. Fastow also said, "I have asked my family, my friends, and my community for forgiveness. I've agreed to pay a terrible penalty for it. It's an awful thing that I did, and it's shameful. But I wasn't thinking that at the time."[433]

   Mr. Fastown has quoted Herman Melville's *Moby Dick* as to why Ishmael let himself be dragged into the doomed ship by Captain Ahab as a way of explaining what he did and for so long. "Ishmael said, 'But when a man suspects any wrong, it sometimes happens that if he be already involved in the matter, he insensibly strives to cover up his suspicions even from himself. And much this way it was with me. I said nothing, and tried to think nothing.'" What does he mean by this quote? Apply one of the categories of ethical personalities to his behavior? Amoral technician?

6. Was Ms. Watkins a whistleblower? Discuss the timing of her disclosures. Compare and contrast her behavior with Paula Reiker's. Paula H. Reiker, the former manager of investor relations for Enron, was paid $5 million between 2000 and 2001. She testified that she was aware during teleconferences that the numbers being reported were inaccurate. Upon cross-examination she was asked why she didn't speak up, as Mr. Petrocelli queried, "Why didn't you just quit?" Her response: "I considered it on a number of occasions. I was very well compensated. I didn't have the nerve to quit."[434] Did she make the right decision?

Compare & Contrast

1. Evaluate Enron's culture. Be sure to compare and contrast with that of Fannie Mae, Bausch & Lomb, Goldman, and Krispy Kreme. As you evaluate, consider the revelations from the testimony of David W. Delainey at the Skilling and Lay criminal trial. Mr. Delainey, the former head of Enron Energy Services. Energy Services retail unit, testified that he saw the legal and ethical issues unfold ing as he worked for Enron. When he was asked to transfer $200 million in losses from his unit to another division in order to then show a profit, he

[429] *Id.*

[430] John Emshwiller and Gary McWilliams, "Fastow Is Grilled at Enron Trial," *Wall Street Journal*, March 9, 2006, pp. C1, C4.

[431] Emshwiller and McWilliams, "Fastow Is Grilled at Enron Trial," pp. C1, C4.

[432] Greg Farrell, "Defense Goes after Fastow's 'Greed' with a Vengeance," *USA Today*, March 9, 2006, p. 1; and Alexei Barrionuevo, "Fastow Testifies Lay Knew of Enron's Problems," *New York Times*, March 9, 2006, pp. C1, C4.

[433] Alexei Barrionuevo, "The Courtroom Showdown, Played as Greek Tragedy," *New York Times*, March 12, 2006, pp. 1, 3.

[434] Alexei Barrionuevo, "Enron Defense Chips Away at Witness's Motives," *New York Times*, February 24, 2006, p. C3.

testified, "That was the worst conduct I had ever been a part of and everybody knew exactly what was going on at that meeting."[435]

Now compare and contrast the decisions and actions of Mr. Olson and Merrill Lynch.

2. Experts have commented that one of the reasons for the success of the Enron task force is that it worked its way up through employees in the company. That is, it got plea agreements and information from lower-level employees and then used the information to go after higher-ranking officers in the company. For example, Mr. Fastow was facing over 180 years in prison if convicted of all of the charges in his indictment. He agreed to turn state's evidence in exchange for a recommendation of a prison sentence of eleven years. He did such a good job in testifying against Mr. Skilling and Mr. Lay that the judge sentenced him to only six years. He was released from prison in 2011 and is on supervised probation until December 2013. Mr. Skilling, on the other hand, was sentenced to 24.4 years. What is the moral of this story? What can we learn about our role as employees? As officers? When asked to comment about the reduction in Mr. Skilling's sentence, Mr. Fastow noted that fourteen years is still a very long time.

   At a speech to the Association of Certified Fraud Examiners in June 2013, Mr. Fastow said, "I'm here because I'm guilty, and this is a much different place than I thought I would be when I was named CFO of the year in 2000."[436] He then added, "I did not embezzle, avoid taxes or do any sort of insider trading. What I am guilty of is creating financial structures that made Enron look better to the public than it actually was. Accounting rules can be vague and we at Enron viewed that vagueness as an opportunity."[437] Are there any inconsistencies in the two statements?

Case 4.21

Arthur Andersen: A Fallen Giant[438]

Arthur Andersen, once known as the "gold standard of auditing," was founded in Chicago in 1913 on a legend of integrity as Andersen, Delaney & Co. In those early years, when the business was struggling, Arthur Andersen was approached by a well-known railway company about audit work. When the audit was complete, the company CEO was outraged over the results and asked Andersen to change the numbers or lose his only major client. A twenty-eight-year-old Andersen responded, "There's not enough money in the city of Chicago to induce me to change that report!" Months later, the railway filed for bankruptcy.[439]

Over the years Andersen evolved into a multiservice company of management consultants, audit services, information systems, and virtually all aspects of operations and financial reporting. Ultimately, Andersen would serve as auditor for Enron, WorldCom, Waste Management, Sunbeam, and the Baptist Foundation, several of the largest bankruptcies of the century as well as poster companies for the corporate governance and audit reforms of the Sarbanes-Oxley Act, federal legislation enacted in the wake of the Enron and WorldCom collapses. However, it would be Andersen's relationship with Enron that would be its downfall.

[435] Alexei Barrionuevo, "Ex-Enron Official Insists Chief Knew He Was Lying," *New York Times*, March 2, 2006, p. C3.

[436] Walter Pavlo, "Former Enron CFO Andrew Fastow Speaks At ACFE Annual Conference," *Forbes*, June 26, 2013, http://www.forbes.com/sites/walterpavlo/2013/06/26/fmr-enron-cfo-andrew-fastow-speaks-at-acfe-annual-conference/. Accessed August 31, 2013.

[437] *Id.*

[438] Adapted with permission from Marianne M. Jennings, "A Primer on Enron: Lessons from A Perfect Storm of Financial Reporting, Corporate Governance, and Ethical Culture Failures," 39 *California Western Law Review* 161 (2003).

[439] Barbara Ley Toffler, *Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen* (2003), p. 12.

Andersen served as Enron's outside auditor, and the following information regarding various conflicts of interest became public both through journalistic investigations and via the Senate hearings held upon Enron's declaration of bankruptcy:[440]

- Andersen earned over one-half ($27 million) of its $52 million in annual fees from consulting services furnished to Enron.[441]
- There was a fluid atmosphere of transfers back and forth between those working for Andersen doing Enron consulting or audit work and those working for Enron who went with Andersen.[442]

David Duncan, the audit partner in the Houston offices of Andersen who was in charge of the Enron account, was a close personal friend of Richard Causey, Enron's chief accounting officer, who had the ultimate responsibility for signing off on all of CFO Andrew Fastow's off-the-books entities.[443] The two men traveled, golfed, and fished together.[444] Employees of both Andersen and Enron have indicated since the time of their companies' collapses that the two firms were so closely connected that they were often not sure who worked for which firm. Many Andersen employees had permanent offices at Enron, including Mr. Duncan. Office decorum thus found Enron employees arranging in-office birthday celebrations for Andersen auditors so as to be certain not to offend anyone. In addition, there was a fluid line between Andersen employment and Enron employment, with auditors joining Enron on a regular basis. For example, in 2000, seven Andersen auditors joined Enron.[445]

Andersen's Imprimatur for Enron Accounting

Enron's executives and internal accountants and the Andersen auditors resorted to two discretionary accounting areas, special purposes entities (SPEs), and mark-to-market accounting, for booking the revenues from its substantial energy contracts, approximately 25 percent of all the existing energy contracts in the United States by 2001.[446] Their use of these discretionary areas allowed them to maintain the appearance of sustained financial performance through 2001. One observer who watched the rise and fall of Enron noted, in reference to Enron but clearly applicable to all of the companies examined here, "If they had been going [at] a slower speed, their results would not have been disastrous. It's a lot harder to keep it on the track at 200 miles per hour. You hit a bump and you're off the track."[447] The earnings from 1997 to 2001 were ultimately restated, with a resulting reduction of $568 million, or 20 percent of Enron's earnings for those four years.[448]

[440] "The Role of the Board of Directors in Enron's Collapse," report of the Permanent Subcommittee on Investigations of the Senate Government Affairs Committee, 107th Congress, Report 107-70, July 8, 2002, 39–41 (hereinafter, "PSI Report").

[441] Deborah Solomon, "After Enron, a Push to Limit Accountants to … Accounting," *Wall Street Journal*, January 25, 2002, p. C1.

[442] Seven Andersen audit employees became Enron employees in the year 2000 alone. John Schwartz and Reed Abelson, "Auditor Struck Many as Smart and Upright," *New York Times*, January 17, 2002, p. C11.

[443] Anita Raghavan, "How a Bright Star at Andersen Fell along with Enron," *Wall Street Journal*, May 15, 2002, pp. A1, A8. See also Cathy Booth Thomas and Deborah Fowler, "Will Enron's Auditor Sing?" *Time*, February 11, 2002, p. 44.

[444] *Id.*

[445] John Schwartz and Reed Abelson, "Auditor Struck Many as Smart and Upright," *New York Times*, January 17, 2002, p. C11.

[446] Noelle Knox, "Enron to Fire 4,000 from Headquarters," *USA Today*, December 4, 2001, p. 1B.

[447] Bob McNair, a Houston entrepreneur who sold his company to Enron in 1998, quoted in John Schwartz and Richard A. Oppel Jr., "Risk Maker Awaits Fall of Company Built on Risk," *New York Times*, November 29, 2001, p. C1.

[448] John R. Emshwiller, Rebecca Smith, Robin Sidel, and Jonathan Weil, "Enron Cuts Profit Data of 4 Years by 20 percent," *Wall Street Journal*, November 9, 2001, p. A3.

Sherron Watkins, who became one of *Time*'s persons of the year for her role in bringing the financial situation of Enron to public light, was the vice president for corporate development at Enron when she first expressed concerns about the company's financial health in August 2001. A former Andersen employee, she was fairly savvy about accounting rules, and with access to the financial records for purposes of her new job, she quickly realized that the large off-the-books structure that had absorbed the company's debt load was problematic.[449] Labeling the SPEs "fuzzy" accounting, she began looking for another job as she prepared her memo detailing the accounting issues, because she understood that raising those issues meant that she would lose her Enron job.[450] Ms. Watkins did write her memo, anonymously, to Kenneth Lay, then-chair of Enron's board and former CEO, but she never discussed her concerns or discussed writing the memo with Jeffrey Skilling, then Enron's CEO, or Andrew Fastow, its CFO, because "it would have been a job-terminating move."[451] She did eventually confess to writing the memo when word of its existence permeated the executive suite. Mr. Fastow reacted by noting that Ms. Watkins wrote the memo because she was seeking his job.[452]

Andersen recognized the focus on numbers in an internal memo as it evaluated its exposure in continuing to have Enron as a client. What follows is an excerpt from a 2000 memo that David Duncan and four other Andersen partners prepared as they evaluated what they called the "risk drivers" at Enron. Following a discussion of "Management Pressures" and "Accounting and Financial Management Reporting Risks," the following drivers were listed:

- Enron has aggressive earnings targets and enters into numerous complex transactions to achieve those targets.
- The company's personnel are very sophisticated and enter into numerous complex transactions and are often aggressive in restructuring transactions to achieve derived financial reporting objectives.
- Form-over-substance transactions.[453]

Mr. Duncan presented the board with a one-page summary of Enron's accounting practices.[454] The summary, called "Selected Observations 1998 Financial Reporting," highlighted Mr. Duncan's areas of concern, and it was presented to the board in 1999, a full two years before Enron's collapse. Called "key accounting issues" by Mr. Duncan, the areas of concern included "Highly Structured Transactions," "Commodity and Equity Portfolio," "Purchase Accounting," and "Balance Sheet Issues." Mr. Duncan had assigned three categories of risk for these accounting areas, which included "Accounting Judgments," "Disclosure Judgements [*sic*]," and "Rule Changes," and he then assigned letters to each of these three categories: *H* for high risk, *M* for medium risk, and *L* for low risk.[455] Each accounting issue had at least two *H* grades in the three risk categories.

Andersen's Concerns about Conflicts

Enron's Code of Ethics had both a general and a specific policy on conflicts of interest, both of which had to be waived in order to allow its officers to function as officers of the

[449] Jodie Morse and Amanda Bower, "The Party Crasher," *Time*, January 6, 2003, pp. 53–55.

[450] *Id.*

[451] Rebecca Smith, "Fastow Memo Defends Enron Partnerships and Sees Criticism as Ploy to Get His Job," *Wall Street Journal*, February 20, 2002, p. A3.

[452] *Id.*

[453] "PSI Report," Hearing Exhibit 2b, Audit Committee Minutes of 2/7/99, p. 18.

[454] *Id.*, p. 16.

[455] *Id.*

many off-the-books entities that it was creating. The general ethical principle on conflicts is as follows:

> Employees of Enron Corp., its subsidiaries, and its affiliated companies (collectively the "Company") are charged with conducting their business affairs in accordance with the highest ethical standards. An employee shall not conduct himself or herself in a manner which directly or indirectly would be detrimental to the best interests of the Company or in a manner which would bring to the employee financial gain separately derived as a direct consequence of his or her employment with the company.[456]

Enron's code also had a specific provision on conflicts related to ownership of businesses that do business with Enron, which provides,

> The employer is entitled to expect of such person complete loyalty to the best interests of the Company.... Therefore, it follows that no full-time officer or employee should: ... (c) Own an interest in or participate, directly or indirectly, in the profits of another entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp., and such officer has determined that such interest or participation does not adversely affect the best interests of the Company.[457]

The board's minutes show that it waived this policy for Andrew Fastow on at least three different occasions.[458] In post-collapse interviews, members of the board have insisted that they were not waiving Enron's code of ethics for Mr. Fastow. In its defense in shareholder lawsuits, the board members and company have argued that in granting a waiver they were simply following the code's policies and procedures.[459] Granting the waiver was a red flag. Even the conflicted Enron board saw the issue and engaged, at least once, in what was called in the minutes "vigorous discussion."[460]

David Duncan was concerned about this conflict of interest, and when Mr. Fastow first proposed his role in the first off-the-books entity, Mr. Duncan, on May 28, 1999, e-mailed a message of inquiry about the Fastow proposal to Benjamin Neuhausen, a member of Andersen's Professional Standards Group in Chicago. Mr. Neuhausen responded, with some of the response in uppercase letters for emphasis: "Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts galore. Why would any director in his or her right mind ever approve such a scheme?" Mr. Duncan wrote back to Mr. Neuhausen on June 1, 1999, "[O]n your point 1 (i.e., the whole thing is a bad idea), I really couldn't agree more. Rest assured that I have already communicated and it has been agreed to by Andy that CEO, General [Counsel], and Board discussion and approval will be a requirement, on our part, for acceptance of a venture similar to what we have been discussing."[461] Mr. Duncan, the Andersen audit partner responsible for the Enron account, had expressed concern about the aggressive accounting practices Enron sought to use. Attorney Rusty Hardin, who served as Andersen's lead defense lawyer in the obstruction of justice case against the company for document shredding, noted that "no question David Duncan was a client pleaser."[462] Mr. Duncan also experienced pressure from his client and even consulted his pastor about how to resolve the dilemmas he faced in terms of approval of the financial statements: "He basically said it was unrelenting. It

[456] Enron Corporation, "Code of Ethics, Executive and Management," (July 2000), p. 12.

[457] *Id.*, p. 57.

[458] "PSI Report," p. 26.

[459] *Id.*, p. 25.

[460] *Id.*, p. 28, citing the Hearing Record, p. 157.

[461] *Id.*, p. 26.

[462] Raghavan, "How a Bright Star at Andersen Fell Along with Enron," pp. A1, A8.

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was a constant fight. Wherever he drew that line, Enron pushed that line—he was under constant pressure from year to year to push that line."[463]

Enron and Andersen Fall

The special report commissioned by the Enron board following its collapse described Enron's culture as "a flawed idea, self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple (and not so simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits."[464] In an interview with *CFO Magazine* in 1999, when he was named CFO of the year, Mr. Fastow explained that he was able to keep Enron's share price high because he spun debt off its books into SPEs.[465]

As the problems at Enron began to go from percolating to parboil, there was a cloud of nervousness that hung over Andersen. Based on an increasing number of questions that were coming into the Chicago office as Enron stories continued to appear in the news, Andersen's in-house counsel, Nancy Temple, sent around a memo that included the following advice on the firm's document destruction policy: "It will be helpful to make sure that we have complied with the policy."[466] Andersen's policy allowed for destruction of records when those records "are no longer useful for an audit.[467] There ensued a bit of a fine-line scramble on the Enron papers and documents that Andersen held.

When Enron announced, on October 16, 2001, its third quarter results, the $1.01 billion charge to earnings was not an easy thing for the market to absorb. The release characterized the charge to earnings as "non-recurring." Andersen officials had spoken with Enron executives to express their doubts about this characterization of the charge, but Enron refused to alter the release. Ms. Temple wrote an e-mail to Duncan that "suggested deleting some language that might suggest we have concluded the release is misleading."[468] The following day, the SEC notified Enron by letter that it had opened an investigation in August and requested certain information and documents. On October 19, 2001, Enron forwarded a copy of that letter to Andersen.

Also on October 19, 2001, Ms. Temple sent an internal team of accounting experts a memo on document destruction and attached a copy of the document policy. On October 20, 2001, the Enron crisis-response team held a conference call, during which Temple instructed everyone to "[m]ake sure to follow the [document] policy." On October 23, 2001, then–Enron CEO Lay declined to answer questions during a call with analysts because of "potential lawsuits, as well as the SEC inquiry." After the call, Duncan met with other Andersen partners on the Enron engagement team and told them that they should ensure team members were complying with the document policy. Another meeting for all team members followed, during which Duncan distributed the policy and told everyone to comply. These and other smaller meetings were followed by substantial destruction of paper and electronic documents.

On October 26, 2001, one of Andersen's senior partners circulated a *New York Times* article discussing the SEC's response to Enron. His e-mail commented that "the problems are just beginning and we will be in the cross hairs. The marketplace is going to

[463] *Id.*, p. A8.

[464] Kurt Eichenwald, "Enron Panel Finds Inflated Profits and Few Controls," *New York Times*, February 3, 2002, p. A1.

[465] David Barboza and John Schwartz, "The Finance Wizard behind Enron's Deals," *New York Times*, February 6, 2002, pp. A1, C9.

[466] Tony Mauro, "One Little E-Mail, One Big Legal Issue," *National Law Journal*, April 25, 2005, p. 7.

[467] *Id.*

[468] 544 U.S. at 700.

keep the pressure on this and is going to force the SEC to be tough."[469] On October 30, the SEC opened a formal investigation and sent Enron a letter that requested accounting documents. Throughout this time period, the document destruction continued, despite reservations by some of Andersen's managers. On November 8, 2001, Enron announced that it would issue a comprehensive restatement of its earnings and assets. Also on November 8, the SEC served Enron and petitioner with subpoenas for records. On November 9, Duncan's secretary sent an e-mail that stated, "Per Dave—No more shredding.… We have been officially served for our documents."[470]

Andersen maintained that the shredding was routine, but the federal government indicted the company and Mr. Duncan. Mr. Duncan entered a guilty plea to obstruction of justice and ultimately testified against Andersen in court. Andersen was convicted of obstruction of justice. Its felony conviction meant that it could no longer conduct audits, and those clients that remained were now required to hire other auditors. Within a period of two years, Andersen went from an international firm of 36,000 employees to nonexistence.

However, Andersen did take the case to the U.S. Supreme Court, which ruled in its favor the conviction for obstruction of justice.[471] The court found that although there may have been intent on the part of the individuals involved in the shredding, the jury was not properly instructed on the proof and intent required to convict the accounting firm itself. Following the Supreme Court's reversal of the decision, Mr. Duncan withdrew his guilty plea. The government has the option of prosecuting Mr. Duncan but has, so far, declined to do so.

Discussion Questions

1. With regard to the destruction of the documents, was there a difference between what was legally obstruction of justice and what was ethical in terms of understanding what was happening at Enron? When the U.S. Supreme Court reversed the Andersen decision, the *Wall Street Journal* noted that the Andersen case was a bad legal case and a poor prosecutorial decision on the part of the Bush administration.[472] Why do you think the prosecutors took the case forward? What changes under SOX would make the case easier to pursue today?
2. David Duncan was active in his church, a father of three young daughters, and a respected alumnus of Texas A&M. Mr. Duncan's pastor talked with the *New York Times* following Enron's collapse and Duncan's indictment, and discussed with the reporter what a truly decent human being Duncan was.[473] What can we learn about the nature of those who commit these missteps? What can you add to your credo as a result of Duncan's experience? Was the multimillion-dollar compensation he received a factor in his decision-making processes? Can you develop a decision tree on Duncan's thought processes from the time of the first SPE until the shredding? Using the models you learned in Units 1 and 2, what can you see that he missed in his analysis?
3. In 2000, a full two years before WorldCom's collapse, Steven Brabbs, WorldCom's director of international finance and control, who was based in London, raised objections when he discovered after he had completed his division's books for the year that $33.6 million in line costs had been dropped from his books through a journal entry.[474] He was told that the changes were made pursuant to orders from CFO Scott Sullivan. He next suggested that the treatment be cleared

[469] 544 U.S. at 701.

[470] 544 U.S. at 702.

[471] Arthur Andersen *LLP v. U.S.*, 544 U.S. 696 (2005).

[472] The editorial is "Arthur Andersen's 'Victory,'" *Wall Street Journal*, June 1, 2005, p. A20. The court decision is *Arthur Andersen LLP v. U.S.*, 544 U.S. 696 (2005).

[473] Raghavan, "How a Bright Star at Andersen Fell Along with Enron," pp. A1, A8.

[474] Kurt Eichenwald, "Auditing Woes at WorldCom Were Noted Two Years Ago," *New York Times*, July 15, 2002, pp. C1, C9.

with Arthur Andersen.[475] When there was no response to his suggestion that the external auditor be consulted, Mr. Brabbs again raised his objections in a meeting with internal financial executives a few months later. Following the meeting, Mr. Brabbs was chastised by WorldCom's controller for raising the issue again.[476] The following quarter, Mr. Brabbs received orders from WorldCom headquarters to make another similar change, but to do so at his level rather than having it done from corporate headquarters via journal entry. Unwilling to have the entries generate from his division, he created another entity and transferred the costs to it.[477] He voiced his concerns again and was told that there was no choice because the accounting was a "Scott Sullivan directive."[478] Mr. Brabbs also had a meeting with Arthur Andersen auditors to discuss his concerns. Following the meeting he received an e-mail from WorldCom's controller, David Myers, which directed that Mr. Brabbs was "not [to] have any more meetings with AA for any reason."[479] When WorldCom's internal audit staff began to raise questions about the reserves and the capitalization of ordinary expenses, they were prohibited from doing further work and, for the most part, worked nights and weekends to untangle the accounting nightmare they had first discovered with a simple question about receipts for some capitalized expenses. CFO Scott Sullivan asked the audit staff to wait at least another quarter before continuing with their investigation. Andersen auditors reported any internal audit inquiries to Sullivan and did not follow through on questions and concerns raised.[480] What controls were missing? Why the reporting lines to Sullivan?

4. One of the tragic ironies to emerge from the collapse of Arthur Andersen, following its audit work for Sunbeam, WorldCom, and Enron, was that it had survived the 1980s savings-and-loan scandals unscathed. In *Final Accounting: Ambition, Greed and the Fall of Arthur Andersen*, the following poignant description appears: "The savings-and-loan crisis, when it came, ensnared almost every one of the Big 8. But Arthur Andersen skated away virtually clean, because it had made the decision, years earlier[,] to resign all of its clients in the industry. S&Ls for years had taken advantage of a loophole that allowed them to boost earnings by recording the value of deferred taxes. Arthur Andersen accountants thought the rule was misleading and tried to convince their clients to change their accounting. When they refused, Andersen did what it felt it had to: It resigned all of its accounts rather than stand behind accounting that it felt to be wrong."[481] What takes a company from the gold standard to indictment and conviction?

Compare & Contrast

Following its declaration of bankruptcy, Lehman Brothers' trustee released a report that indicated it was able to spin off its risky debt instruments to SPEs under what was known as Repo 105. Lehman controlled 25 percent of the boards of these SPEs, although its relationship with the SPEs was depicted as arms-length.[482] As a result of these layers of transfer, Lehman was able to look financially sound right up until the collapse of the market in 2008 when the CDO market collapsed.

The bankruptcy trustee gave this summary of the Lehman practices:

> Lehman employed off-balance sheet devices, known within Lehman as "Repo 105" and "Repo 108" transactions, to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days, and to create a materially misleading picture of the firm's financial condition in late 2007 and

[475] *Id.*, p. C9. The information was taken from Mr. Brabbs's statement to the government during its initial investigation of WorldCom.

[476] *Id.*

[477] *Id.*

[478] *Id.*

[479] Jessica Sommar, "E-Mail Blackmail: WorldCom Memo Threatened Conscience-Stricken Exec," *New York Post*, August 27, 2002, p. 27.

[480] Pulliam and Solomon, "How Three Unlikely Sleuths Discovered Fraud at WorldCom," pp. A1, A6.

[481] Toffler, *Final Accounting*, 19.

[482] Louise Story and Eric Dash, "Lehman Channeled Risks Through Alter Ego' Firm," *New York Times*, April 13, 2010, p. A1.

> 2008. Repo 105 transactions were nearly identical to standard repurchase and resale ("repo") transactions that Lehman (and other investment banks) used to secure short-term financing, with a critical difference: Lehman accounted for Repo 105 transactions as "sales" as opposed to financing transactions based upon the overcollateralization or higher than normal haircut in a Repo 105 transaction. By recharacterizing the Repo 105 transaction as a "sale," Lehman removed the inventory from its balance sheet.

The bankruptcy trustee does not address whether the transactions complied with accounting rules because he concludes that the failure to disclose their escalating debt and increasingly worthless securities was material. What does the bankruptcy trustee mean that compliance with the accounting rules is not the issue? Analyze why the lessons of other collapsed companies are not internalized by businesses that use the same strategies.

Case 4.22

The Ethics of Walking Away

Facing foreclosure, mortgagors who have loans that exceed their property value often have a sense of hopelessness and "nothing to lose." These mortgagors simply leave the property, something that is likely in an underwater mortgage because they have so little to lose. Their credit rating is affected, but they no longer have the payments or the worries of maintenance. In some cities, mortgagors who have abandoned their homes have stripped the property of everything from the stove to the copper plumbing. The federal government has set up special task forces to try to stop the stripping of properties by mortgagors.

Most mortgage agreements require the mortgagor to maintain the property in livable condition, but again, desperate times bring desperate actions. Also, taking items from the mortgaged property is not theft unless and until title has been taken back through the foreclosure process. Stripped and abandoned properties bring down the value of neighborhoods and result in increased crime levels. Areas with high levels of abandoned properties now unoccupied and held by lenders that are unable to sell them have been labeled "foreclosure ghettos." In cities with high foreclosure rates, "walk-aways" and stripping have resulted in urban blight in certain areas. Cities are passing ordinances that require lenders to maintain the abandoned properties, or are actually taking back the properties through eminent domain so that the abandoned homes do not become drug houses or residences for the homeless.

Discussion Questions

1. Does the fact that many are walking away or selling their properties through "short sales" (a sale of the property below the mortgage amount that is approved by the original lender) make it ethical for all owners to do the same?
2. List who is affected by a decision to walk away.

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SECTION F

The Fear-and-Silence Factors

Sometimes those within the organization see critical ethical issues, but remain silent because the culture keeps them silent due to fear, rewards, or just an attitude of "we will survive this."

Case 4.23

HealthSouth: The Scrushy Way

HealthSouth, a chain of hospitals and rehabilitation centers, used its celebrity and sports figure patients as a means of marketing and distinction. Press releases touted sports figures' use of HealthSouth facilities, such as the press release when Lucio, the Brazilian World Cup soccer star, had surgery at a HealthSouth facility.[483]

HealthSouth touted its new hospitals as something others would emulate.[484] The language in their annual reports and brochures was "the hospital model for the future of health care."

HealthSouth's website listed celebrities who have "used HealthSouth facilities: Michael Jordan, Kobe Bryant, Tara Lipinski, Troy Aikman, Bo Jackson, Scottie Pippen, Shaq O'Neal, Terry Bradshaw and Roger Clemens."[485] Its service model, the four steps from diagnosis through surgery, through inpatient rehabilitation, and finally to outpatient rehabilitation, was also its mark of distinction from other health care providers. The four steps are still featured in a logo on the website as well as in its annual reports.

HealthSouth called its new hospitals "the hospitals of the future," and competitors began to copy those models.[486] From 1987 through 1997, HealthSouth's stock rose at a rate of 31 percent per year.[487] The stock had gone from $1 per share at the time of its initial public offering (IPO) in 1986 to $31 per share in 1998. In April 1998, CEO Richard Scrushy told analysts that HealthSouth had matched or beat earnings estimates for forty-seven quarters in a row.[488] It became a billion-dollar company through acquisitions. HealthSouth profits were restated in 2002 and 2003 to reflect $2.5 billion less in earnings, for periods dating back to 1994, with $1.1 billion occurring during 1997 and 1998. Subsequent corrections reveal that HealthSouth's revenues were overstated by $2.5 billion, a figure 2500 percent higher than what was reported from 1997 through 2001.[489] The stock was trading on pink sheets at $0.165 per share in mid-April 2003, from a $31 high in 1998.[490]

[483] HealthSouth press release, December 12, 2002, http://www.healthsouth.com. Accessed June 23, 2003.

[484] Reed Abelson and Milt Freudenheim, "The Scrushy Mix: Strict and So Lenient," *New York Times*, April 20, 2003, pp. BU-1, 12.

[485] HealthSouth, http://www.healthsouth.com/investor. Accessed June 23, 2003.

[486] Abelson and Freudenheim, "The Scrushy Mix," pp. BU-1, 12.

[487] John Helyar, "Insatiable King Richard," *Fortune*, July 7, 2002, pp. 76, 82.

[488] Abelson and Freudenheim, "The Scrushy Mix," pp. BU-1, 12.

[489] Heylar, p. 84.

[490] *Id.*, pp. BU-1, 12.

The Corporate Culture

CEO Richard Scrushy held Monday morning meetings with his executives. When the company was not meeting the numbers and analysts' expectations, Mr. Scrushy's instructions to the officers were "Go figure it out."[491] At one meeting he announced, "I want each one of the [divisional] presidents to e-mail all of their people who miss their budget. I don't care whether it's by a dollar."[492]

One officer noted, "The corporate culture created the fraud, and the fraud created the corporate culture."[493] In an interview in the fall of 2002, Mr. Scrushy explained his management technique: "Shine a light on someone—it's funny how numbers improve."[494]

Monday morning management meetings with HealthSouth's then-CEO Richard Scrushy and his executive team in which they covered "the numbers" were referred to internally as the "Monday-morning beatings." Mr. Scrushy confronted employees not only with strategic issues, such as hospital performance, but also with the sizes of their cellular telephone bills: "Interviews with associates of Mr. Scrushy, government officials and former employees, as well as a review of the litigation history of HealthSouth, paint a picture of an executive who ruled by top-down fear, threatened critics with reprisals and paid his loyal subordinates well."[495]

One of the CFOs recorded conversations he had with Scrushy. For example, Richard Scrushy declared in a recorded conversation with William Owens, one of HealthSouth's CFOs,

> [If you] fixed [financial statements] immediately, you'll get killed. But if you fix it over time, if you go quarter to quarter, you can fix it. Engineer your way out of what you engineered your way into. I don't know what to say. You need to do what you need to do.[496] We just need to get those numbers where we want them to be. You're my guy. You've got the technology and the know-how.[497]

In 1998, employees began posting notices on Yahoo message board about HealthSouth along with derogatory comments about Mr. Scrushy, using pseudonyms. Mr. Scrushy hired security to determine who was responsible for the postings and eventually shut down employee computer access to the message boards.

Mr. Scrushy was known to place calls to his facility administrators from parking lots of HealthSouth facilities at 1 A.M. to notify them that he was standing in their parking lots and that he had found litter there. They were then forced to come to the facility immediately to fix the problem. He began arriving at work with security guards and kept them outside his door at all times.[498]

HealthSouth had a young officer team. For example, the vice president of reimbursements for the company, a critical position because of the importance of compliance in terms of bills submission under Medicare rules as well as the associated financial reporting issues regarding the revenues associated with reimbursement, was given to a 27-year old.[499] HealthSouth had five CFOs from 1998 through 2003, and the final CFO prior to the collapse was just 28 years old when Mr. Scrushy chose him for the ascent to that

[491] Heylar, p. 84.

[492] Heylar, p. 86.

[493] Heylar, p. 84.

[494] Abelson and Freudenheim, pp. BU-1, 12.

[495] *Id.*, pp. BU1, 12.

[496] "Secret Recording Is Played at a HealthSouth Hearing," *New York Times*, April 11, 2003, p. C2.

[497] Helyar, "Insatiable King Richard," pp. 76, at 82.

[498] *Id.*

[499] This information was gleaned from a review of HealthSouth's 10-Ks from 1994 through 2002. See Securities and Exchange Commission website, http://www.sec.gov/edgar, for these documents.

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second-in-command position.[500] Mr. Scrushy did not favor hiring MBAs. He had none in his direct reports, but he did hire what he called "advance-them-up-from-nowhere Alabamians."[501]

Diana Henze, a HealthSouth employee, provided the following testimony at the congressional hearings on the company's collapse:

> My name is Diana Henze, and I live in Birmingham, Alabama. I am 39 years old, married with two children. I graduated from the University of Montevallo in 1985 with a B.S. degree in accounting. After a few accounting positions, I began working for a Birmingham-based healthcare company, ReLife, in 1994. In December of that year, ReLife was acquired by HealthSouth, and I began working in HealthSouth's accounting department. In 1995 and 1996, I helped install a standardized accounting software package for the accounting department. In 1997, I was promoted to Assistant Vice President of Finance, and in 1998, I was promoted to Vice President of Finance. My responsibilities were somewhat ad hoc, but included running the accounting computer system, preparing quarterly consolidations and assisting in the SEC filings.
>
> Sometime in 1998, after re-running several consolidation processes for one quarter end, I noticed that earnings and earnings per share jumped up. The amount and timing of those changes seemed odd to me so I approached my supervisor, Ken Livesay, who was the Assistant Controller. Ken told me that the increase in earnings was the result of the reversal of some over-reserves and over-accruals. At the time, Ken's explanation appeared to be reasonable and I did not pursue the matter further. I did notice a jump in earnings the next quarter, but I did not question Ken about it.
>
> In January of 1999, I went on maternity leave to have my second son, Douglas, and did not work on the year-end consolidation or the 10-K preparation for 1998. Shortly after returning to work in March, I assisted in preparing the first quarter consolidation and 10Q preparation for 1999. During that process, I noticed the numbers changing again, and I approached Ken Livesay a second time. I told him, "You can't tell me that we have enough reserves to reverse that would justify this type of swing in the numbers." When he told me that I was right, I informed him that I did not understand what was going on, but would have no part in any wrong-doing.
>
> Ken apparently went to Bill Owens, the Controller, with my suspicions because Bill called me in an attempt to justify what they were doing. Bill said that HealthSouth had to make its numbers or innocent people would lose their jobs and the company would suffer. I told Bill that I believed that whatever was going on to be fraudulent, and I would not participate in it and wanted no part of it. I also asked him to stop whatever it was they were doing and told him that I was going to keep an eye on it.
>
> The numbers continued to change in the second and third quarter of 1999. After the third quarter, I went to Ken and said "enough is enough," because the numbers still appeared to be moving with irregularities. I told him I was to going to report these suspicions to our Compliance Department because I suspected that fraud was being committed within the accounting department. Ken said to do what I needed to do.
>
> In October or November of 1999, I went to our Corporate Compliance Department and made an official complaint to Kelly Cullison, who was Vice President of Corporate Compliance. I gave her information on my suspicions and where I thought some of the "entries" were being made. I also gave her information on how to write specific types of queries against the transactional tables within our system, which helped her look at the fluctuations that were being made and of which I was suspicious. I did not have access to the supporting documentation of the suspect journal entries, and therefore, could not give her that information. As it turns out, Kelly did not have access to the information necessary to investigate my complaint of suspected fraud.

[500] *Id.*

[501] Helyar, "Insatiable King Richard," pp. 76, 84.

> Ken Livesay called me to ask if I had gone to the Compliance Department with my complaint because he had been called to Mike Martin's (Chief Financial Officer) office about it. I confirmed that I had gone to the Compliance Department and filed a complaint. In a follow-up discussion with Kelly Cullison, I told her that I stood by my complaint and would not withdraw it. I do not mean to imply in any way that Kelly tried to get me to withdraw my complaint because she did not do that.
>
> Shortly after I filed the complaint, Ken Livesay was moved to the position of Chief Information Officer (CIO), and two others were promoted to his previous position of Assistant Controller. I felt that I had been overlooked for this position and I confronted Bill Owens about this. I was told by Bill that he could not put me in that position, because I would not do what "they wanted me to do."
>
> Within a few days or weeks I requested a transfer from the accounting department and was transferred immediately to our ITG (Information Technology Group) Department. Soon after joining ITG, I began working on an internet project and ultimately moved to that department under the supervision of Scott Stone in January 2001. Under HealthSouth's new leadership, in May of 2003, I was promoted to Assistant Controller of the Corporate Division. I enjoy my work now, and believe HealthSouth is a good company which can be a profitable business if run properly.[502]

There was also a high level of turnover in the executive team, particularly among those executives age 50 and older. These executives disappeared rapidly from the slate of officers, and that age group was no longer represented after 1998. Those officers who were experienced were replaced by younger officers who were brought in by Mr. Scrushy. Their bonuses and salaries grew at exponential rates, particularly the longer they stayed.[503] HealthSouth had an extensive loan program for executives in order "to enhance equity ownership." The key executives owed significant amounts of money to the company that they borrowed in order to exercise their stock options.[504]

HealthSouth's former head of internal audit offered the following testimony before Congress on the HealthSouth hearings:

> My name is Teresa Sanders, and I currently live in Birmingham, Alabama. I am 39 years old. In 1986, I graduated from the University of Alabama with a degree in accounting. I received my master's degree in accounting in 1988.
>
> I began working with Ernst & Young in August of 1988 as a staff auditor, and I was laid off in February of 1990. In March of that year (1990), I was hired by Health-South as the Internal Auditor. During my employment I received three promotions, and when I left my title became Group Vice President and Chief Auditing Officer. My immediate supervisor was Richard Scrushy, and I reported directly to him for over nine years. I left HealthSouth in November of 1999.
>
> I was hired by HealthSouth to audit our field operations. When I started at Health-South, the company had thirty-five (35) field facilities, and by the time I left the number had grown to approximately two thousand (2000). I had complete access to the financial books of the field operations in order to do my audits. However, I did not have access to the corporate financial books. I did not need access to the corporate books to perform field audits. Ernst & Young performed the audit on the corporate books and any reports to the SEC.
>
> As part of my duties as the Chief Auditing Officer, I had to make reports to the audit committee of the Board of Directors. All the meetings that I had with the audit committee were before the full Board except

[502] "The Financial Collapse of HealthSouth," Subcommitee on Oversight and Investigations of the House Energy and Commerce Committee http://archives.energycommerce.house.gov/reparchives/108/Hearings/10162003hearing1110/Cohen1747.htm. Accessed September 17, 2010.

[503] *Id.*

[504] Securities and Exchange Commission, http://www.sec.gov/edgar: see disclosures in proxy statements for 1995–2002.

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> one time in either 1997 or 1998, when I met separately with the audit committee. However, that meeting was attended by Tony Tanner.
>
> In 1996, Richard Scrushy approached me about establishing a fifty (50) point checklist which became known as the "Pristine Audit." After Mr. Scrushy asked me to develop the checklist, I sent him a memo expressing my opinion about the checklist. I have attached a copy of my memo. Mr. Scrushy did not appreciate my opinion on the matter and again instructed me to develop the checklist for his approval. Mr. Scrushy informed me the Pristine Audit was to be handled by Ernst & Young.
>
> I developed the fifty (50) point checklist which Mr. Scrushy approved. I am attaching a copy of the checklist. As you can see, the Pristine Checklist has nothing to do with auditing the financial books of a field facility. The Pristine Audit was nothing more than a cosmetic, white glove, walk through of a facility. It was in the nature of quality control and had nothing to do with the financial viability of a particular facility.
>
> By the time I left HealthSouth, I was having problems with Mike Martin. He turned off my computer access to the general ledgers of the field operations. I needed access to those ledgers to do my audits. I had to manually retrieve hard copies of those ledgers, if needed, which was very time consuming. I also did not like the way that Health-South handled an internal sexual harassment investigation. It was my opinion that the offending employee should have been terminated. Although I heard rumors that "they were playing with the books," I had no knowledge that anyone at HealthSouth was committing fraud. I ultimately left HealthSouth because I received a better job offer with Eastern Health Services Systems in the compliance department as the Compliance Officer. I was tired of traveling and my new job did not require any travel.[505]

Scrushy: CEO

Mr. Scrushy was a flamboyant CEO who had Bo Jackson and Jason Hervey, the teenager from the TV series *The Wonder Years,* paid to accompany him to HealthSouth events. Mr. Scrushy had a weekly Birmingham radio show with Mr. Hervey that was sponsored by HealthSouth. Mr. Scrushy doled out the use of the company jet to politicians and athletes on a regular basis. But he also used the company jet himself for transporting his own rock band to various locations for concerts and company events. Mr. Scrushy was in the process of promoting a female rock trio when HealthSouth collapsed.[506]

Mr. Scrushy's personal assets included a mansion in Birmingham, a $3 million, 14,000-square-foot lakefront home in Lake Martin, Alabama; a 92-foot yacht; and thirty-four cars, including two Rolls-Royces and one Lamborghini.[507] He owned eleven businesses that he controlled through one operating company that also owned his wife's clothing company, Upseedaisies.[508] On his payroll were four housekeepers, two nannies, a ship captain, boat crew, and security personnel.[509]

Mr. Scrushy's companies did extensive business with HealthSouth. G.G. Enterprises, a company named for Mr. Scrushy's parents, sold computers to HealthSouth, a contract

[505] "The Financial Collapse of HealthSouth," Subcommitee on Oversight and Investigations of the House Energy and Commerce Committee http://archives.energycommerce.house.gov/reparchives/108/Hearings/10162003hearing1110/Cohen1747.htm. Accessed September 17, 2010.

[506] Helyar, "Insatiable King Richard," pp. 76, 84.

[507] Abelson and Freudenheim, "The Scrushy Mix," p. C1. During the hearing in which he was asking the federal court to release some of his assets (the judge had awarded him $15,000 per week living expenses previously), Mr. Scrushy could not remember what he owned and didn't own and took the Fifth Amendment against self-incrimination thirty times. "Ousted Chief of HealthSouth Resists Questions on His Assets," *New York Times*, April 10, 2003, p. C4. "I can't recall" and "I can't speak to the accuracy of this" were other responses.

[508] Greg Farrell, "Scrushy 'Was Set Up,' Says Lawyer," *USA Today*, April 15, 2003, p. 3B.

[509] Helyar, "Insatiable King Richard," pp. 76, 84.

that eventually resulted in an investigation by the federal government for overcharging. Scrushy's personal accountant committed suicide in September 2002, and Scrushy filed a police report after the death accusing the deceased accountant of embezzling $500,000.

From the Junior Miss Pageant of Alabama to scholarships for his community college alma mater, Richard Scrushy, like Bernie Ebbers (see Case 4.27), was unusually generous with the organizations and people in the small-town atmosphere in which he had experienced his stunning rise to success. The Vestavia Hills Public Library was renamed the Richard M. Scrushy Public Library because of his generous donations.[510] There was the Richard M. Scrushy campus of Jefferson State Community College, from which he graduated, and the Richard M. Scrushy Parkway that ran through the center of town. The Scrushy charity activity was weekly, and he used his celebrity sports clients to draw attention to the events.[511]

The HealthSouth Board

Following the $2.5 billion in earnings restatements by HealthSouth, one of its directors, Joel C. Gordon, observed, "We [directors] really don't know a lot about what has been occurring at the company."[512] However, there were the following revelations about the structure and activities of board members:

- One director had earned $250,000 per year on a consulting contract with HealthSouth for a seven-year period.
- Another director had a joint investment venture with Mr. Scrushy on a $395,000 investment property.
- Another director was awarded a $5.6 million contract for his company to install glass at a hospital being built by HealthSouth.
- Med Center Direct, a hospital supply company that operated online and did business with Health-South, was owned by Mr. Scrushy, six directors, and one of those director's wives.
- The audit committee and the compensation committee had consisted of the same three directors since 1986.
- Two of the directors had served on the board for eighteen years.
- One director received a $425,000 donation to his charity from HealthSouth just prior to his going on the board.[513]

A corporate governance expert has said the conduct of the HealthSouth board amounted to "gross negligence."[514] One Delaware judge has issued an opinion on one aspect of litigation against the board and noted, "The company, under Scrushy's managerial leadership, has been quite generous with a cause very important to Hanson (the director who accepted the donation to his College Football Hall of Fame).... compromising ties to the key officials who are suspected of malfeasance."[515]

Dr. Philip Watkins, a cardiologist, testified at congressional hearings on the HealthSouth collapse and stated the following:

> I became involved with HealthSouth, a brand new company then known as Amcare, in 1983, after I first met Mr. Scrushy. Mr. Scrushy proposed a merger of my practice's cardiac rehabilitation facility with Amcare to form what is known as a "CORF"—Comprehensive Outpatient Rehabilitation Facility. The unique concept of a CORF was to combine outpatient surgery and rehabilitation facilities into one stand-alone medical complex in order to ease patient burden and expense, and ultimately provide for more successful patient recoveries.

[510] *Id.*, pp. 76, 80.

[511] *Id.*

[512] Joann S. Lublin and Ann Carrns, "Directors Had Lucrative Links at HealthSouth," *Wall Street Journal*, April 11, 2003, pp. B1, B3.

[513] Lublin and Carrns, "Directors Had Lucrative Links at HealthSouth," pp. B1, B3.

[514] *Id.*

[515] *Id.*

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In 1984, I was asked by Mr. Scrushy to join the Company's Board of Directors, two years before HealthSouth became a publicly traded company in 1986. As a physician and director, it was determined that I could add valuable insight by talking to physicians and helping to meet their needs in working with our facilities. Our ability to provide high quality, efficient, low cost patient care was the core of the Company's business.

Early on, I was appointed Chairman of the Board's Audit & Compensation Committee. At that time the Company was a startup with such a small board that these two functions were combined to form one committee. At that time, many companies followed this practice. Later, the committees were separated into two distinct committees.

As Chairman of the Audit & Compensation Committee, I worked with and relied upon the outside experts hired by our Board. For example, we hired Mercer Human Resource Consulting to assist the Committee as our compensation consultants. Mercer retains a reputation as one of the largest and most relied upon compensation consulting firms in the country. Mercer analyzed the compensation trends of similar firms in the healthcare industry and, along with other experts, advised the Compensation Committee. It was based upon this information and advice that we determined the compensation packages of HealthSouth's management team.

By all accounts, HealthSouth was growing at an exciting pace, and was singled out by numerous industry publications, including Forbes and Fortune, as an up and coming star in the field of outpatient surgery and rehabilitation. Since I joined the Health-South Board in 1984, I have seen HealthSouth grow from a company with two rehabilitation facilities—one in Little Rock and one in Birmingham—to become the largest outpatient surgery company, rehabilitation company and diagnostic services company in the world with over 48,000 employees throughout the country. The compensation for HealthSouth senior executives, including Mr. Scrushy, was based upon this apparent outstanding performance, and the Committee was always assured by the independent analyses of experts such as Mercer that the Board's compensation philosophy was entirely in keeping with the best practices at the time. Specifically, we implemented a performance based incentive-compensation program, which included annual bonuses and stock option grants under a stockholder-approved option plan.

We now know the numbers we relied on and were certified by our outside accountants to calculate senior management compensation were fraudulent. If the Compensation Committee had known of the fraud, Mr. Scrushy and others would have been terminated immediately and would never have received these salaries, bonuses, and stock options.

I was as shocked and angry as the rest of the public when I learned that senior members of HealthSouth's management team had been perpetrating a fraud on Health-South's stockholders. The Board of Directors was similarly deceived. These criminal conspirators were able to fraudulently conceal or otherwise alter information and documents such that all of the experts including the accounting firm of Ernst & Young did not detect the fraud. As a corporate director, I relied on the accuracy of information provided to me by management and by outside experts such as Ernst & Young. It is now evident that because the truth had been so thoroughly concealed by certain former members of management, the probing questions and activism of this Board could not have discovered the existence of this accounting fraud.

In addition to questioning former management and outside experts, the Company had in place internal control systems designed, in part, to catch fraud. But every system of checks and balances is only as good as the people who are there and use them. Ms. Henze testified that she did use the compliance system we had set up to receive and act upon such information. That's how the compliance system was supposed to work. It is incomprehensible to me how designated compliance personnel could have received such apparently clear information and could not have told Ernst & Young, the Audit Committee or the Board.

Just to be clear, the fraud occurred at a corporate level. Ernst & Young conducted the corporate-wide audit. In contrast, internal audit conducted facility level audits. The Subcommittee heard testimony two weeks ago from Ms. Teresa Sanders and Mr. Greg Smith of HealthSouth's internal audit department. The Audit Committee did meet on a regular basis with Ms. Sanders and Mr. Smith and received their reports

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> and questioned both of them. In fact, I had more internal auditors added to the internal audit staff after talking to Ms. Sanders. They never told us they had any suspicion of impropriety.
>
> Let me conclude by saying that I am proud of my service to the HealthSouth Board. HealthSouth enabled me to combine my obligation as a medical doctor to patients with that as a director of the Company to the stockholders. Had I known of the hidden fraud being perpetrated on us all, I would have acted quickly and decisively, just as the current Board has in removing those responsible. HealthSouth is one of the great healthcare companies in America and I am confident that it will continue to be under the guidance of the new management team. I look forward to answering any questions you or any other members of the Subcommittee may have.[516]

In 1996, eight of the fourteen board members were also company officers. The ratio of insiders did decrease after 1996.

Trials, Pleas, and Convictions

Fifteen of HealthSouth's executives entered guilty pleas to various federal charges. HealthSouth's former CFOs testified against Mr. Scrushy at his criminal trial and for the government. Only one CFO had no culpability. He left the company because of his concerns about the financial reporting. Scrushy had his going-away cake made for him. The cake read, "Eat _____." The other CFOs entered guilty pleas. The following chart provides a summary of the guilty pleas of the CFOs and other officers.

William Owens	CFO	Wire and securities fraud; falsifying financials; filing false certification on financial statements with the SEC
Weston Smith	CFO	Wire and securities fraud; falsifying financials; filing false certification on financial statements with the SEC
Michael Martin	CFO	Conspiracy to commit wire and securities fraud; falsifying financials
Malcolm McVay	CFO	Conspiracy to commit wire and securities fraud; falsifying financials
Aaron Beam	CFO	Bank fraud
Angela Ayers	VP, finance and accounting	Conspiracy to commit securities fraud
Cathy Edwards	VP, asset management	Conspiracy to commit securities fraud
Rebecca Kay Morgan	VP, accounting	Conspiracy to commit securities fraud
Virginia Valentine	Assistant VP	Conspiracy to commit securities fraud
Emery Harris	VP/assistant controller	Conspiracy to commit wire and securities fraud
Kenneth Livesay	Assistant controller/CIO	Conspiracy to commit wire and securities fraud
Richard Botts	Senior VP, tax	Conspiracy to commit securities fraud; falsifying financials; mail fraud[517]

[516] "The Financial Collapse of HealthSouth," Subcommitee on Oversight and Investigations of the House Energy and Commerce Committee http://archives.energycommerce.house.gov/reparchives/108/Hearings/10162003hearing1110/Cohen1747.htm. Accessed September 17, 2010.

[517] "HealthSouth Guilty Pleas," *USA Today*, May 20, 2005, p. 1B.

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Mr. Scrushy joined a church in his hometown just prior to the trial and made substantial contributions. The pastors of the church attended the Scrushy trial each day. Leslie Scrushy, Mr. Scrushy's second wife, attended the church regularly and often spoke in tongues from the pulpit. Mr. Scrushy's son had a daily television show on one of the local television stations that Mr. Scrushy owned. He provided daily coverage of the trial, complete with interviews of the pastors and others attending the trial. The show enjoyed very high ratings. Mr. Scrushy was acquitted of all thirty-six federal felony charges related to the HealthSouth collapse in June 2005, following long (twenty-one days) and intense deliberations by a jury that seemed to have doubts even after that verdict was returned. One sign held by a former HealthSouth employee who stood outside the courtroom read, "Still guilty in God's eyes."[518] In a post-verdict interview, Scrushy said, "The truth has come to the surface."[519]

Mr. Scrushy was subsequently convicted of bribery of an Alabama official in federal district court. He was sentenced to six years and ten months in federal prison.[520] Because of a U.S. Supreme Court decision on the requirements for proof of "honest services fraud," Mr. Scrushy's conviction was reversed, and his sentence will now be reviewed by a federal district court judge. Mr. Scrushy has asked for an early release from prison based on the reversal. As of July 2010, he was at the halfway mark on his seven-year sentence. There are a total of $2.28 billion in civil judgments against him. Both of his multimillion-dollar homes have been taken over by the judgment creditors.

Discussion Questions

1. What in the culture of HealthSouth made it difficult for employees to raise concerns about the company's practices and financial reporting?
2. Find the common factors in the companies in this Unit and others.

Compare & Contrast

What is the difference between the CFOs who left the company and officers who stayed, many of whom were promoted? Consider the congressional testimony of the various officers and others associated with HealthSouth. What made their view of the situation at the company different?

Case 4.24

Royal Dutch and the Reserves[521]

The Royal Dutch/Shell Group was required to take a write-down on the amount of oil reserves it was carrying on its books. Chairman Sir Philip Watts placed tremendous numbers pressure on executives and managers in the company. Walter van de Vijver, the company's exploration chief, was given the directive to get the company's reserves where they needed to be for purposes of ensuring the company's AAA rating. Bonuses for a significant group of officers, in an amount of 2 percent, were tied to increases in reserves, Sir Philip's instructions were to "leave no stone unturned" in making sure that for every barrel of oil sold, there was another barrel added to the reported reserves.[522]

[518] Reed Abelson and Jonathan Glater, "A Style That Connects with Hometown Jurors," *New York Times*, June 29, 2005, pp. C1, C4.

[519] Greg Farrell, "Scrushy Acquitted of All 36 Charges," *USA Today*, June 29, 2005, p. 1A.

[520] Bob Johnson, "Scrushy Gets Nearly 7 Years in Prison," *USA Today*, June 29, 2007, p. 2B.

[521] Adapted from Marianne M. Jennings, "The Seven Signs of Ethical Collapse: How to Spot Moral Meltdowns in Companies before It's Too Late." (2006).

[522] Stephen Labaton and Heather Timmons, "Discord at Top Seen as Factor in Shell's Woes," *New York Times*, April 20, 2004, pp. A1, C7.

As a result of this focus on reserves, the culture at Royal Dutch was one that was quite different from the usual vision of geologists and scientists. Managers were required to write and appear in skits that were then performed for the officers and chairman with a focus on creativity and finding reserves. One manager ran on stage naked to draw attention to his aggressiveness. Another staged a "Jerry Springer" skit, and still another pledged to return to the Dutch oil fields and bring more from those declining wells.[523] Managers were forced to hold hands and share each others' intimate secrets. They were also asked to raise their arms in the air in an exercise whose purpose no one is quite sure of. Some theorized that it might have been a sort of barrel dance to bring the fertile oil fields to their door.

Van de Vijver first raised the issue of the possible overstatement of the company's reserves with Watts in early 2002, and then documented his concerns with a memo to his files.[524] Watts gave van de Vijver a negative evaluation because of increasing tension between the two over the reserves. In response, van de Vijver sent Watts an e-mail in November 2003 with the following complaint: "I am becoming sick and tired of lying about the extent of our reserves issues and the downward revisions that need to be done because of far too aggressive/optimistic bookings."[525] Despite this documented battle between two of the company's highest-ranking officials, months would pass before the company disclosed the overstatement of reserves and took the necessary accounting write-downs.

The bonuses for the management team for 2003 and 2004 were booked before the overstatement release was sent out and the accounting adjustments taken. Memos and e-mails show that a large group of top officers was aware of the reserves issues.[526] By the time the information was finally released to the public, following an SEC inquiry in February 2004, Royal Dutch had to take a 22 percent reduction in its reserves figure. As a result, earnings from 2000 to 2003 were revised downward by $100 million. The company's chief financial officer, Judy Boynton, appeared to be aware of the overstatement of reserves but took no action. The three are no longer working at Royal Dutch.[527]

The company's share price dropped dramatically, and the SEC as well as officials in Britain collected a total of $150 million in fines for the overstatements of the reserve numbers.[528]

Discussion Questions

1. List the elements in the Royal Dutch culture that contributed to the decisions to overstate reserves and to continue those overstatements.
2. What issues did the executives and Sir Philip miss in their decisions to just keep the AAA rating with sufficient reserve numbers?
3. What did the company have in common with HealthSouth?

[523] Chip Cummins and Almar Latour, "How Shell's Move to Revamp Culture Ended in Scandal," *Wall Street Journal*, November 2, 2004, p. A1.

[524] Chip Cummins, "Former Chairman of Shell Was Told of Reserves Issues," *Wall Street Journal*, March 8, 2004, p. A1.

[525] Labaton and Timmons, "Discord at Top Seen as Factor in Shell's Woes," p. C7.

[526] Chip Cummins and Alexei Barrionuevo, "Shell Ex-Officials Hid Troubles amid Clash over Disclosure," *Wall Street Journal*, April 4, 2004, pp. A1, A12.

[527] Laurie P. Cohen and James Bandler, "Shell Finance Chief Has Faced Critics Before," *Wall Street Journal*, March 26, 2004, p. C1.

[528] Heather Timmons, "Shell to Pay $150 Million in Settlements on Reserves," July 30, 2004, pp. C1, C7.

Case 4.25

Dennis Kozlowski: Tyco and the $6,000 Shower Curtain[529]

Tyco International began as a research laboratory, founded in 1960 by Arthur Rosenburg, with the idea of doing contract research work for the government. By 1962, Rosenburg had incorporated and begun doing work for companies in the areas of high-tech materials and energy conversion, with two divisions of the holding company, Tyco Semiconductor and Materials Research Laboratory. By 1964, the company went public and became primarily a manufacturer of products for commercial use. Today, Tyco is a conglomerate with a presence in over 100 countries and over 250,000 employees. Between 1991 and 2001, CEO Dennis Kozlowski took Tyco from $3 billion in annual sales to $36 billion in 2001 by paying $60 billion for more than 200 acquisitions.[530] Tyco's performance was phenomenal.

- From 1992 through 1999, Tyco's stock price grew flfteenfold.[531]
- Tyco's earnings grew by 25 percent each year during Kozlowski's era.[532]
- During 1999, Tyco's stock price rose 65 percent.[533]
- Tyco spent $50 billion on acquisitions in nine years.[534]
- The company's debt-to-equity ratio nearly doubled from 25 percent to 47 percent in one year (2001).[535]

In a move to reduce its U.S. tax bills, Tyco is based out of Bermuda, despite having its headquarters in Exeter, New Hampshire.[536] Tyco, with a stake in telecommunications as well, is the parent company to Grinnell Security Systems, health care products companies, and many other acquired firms, which has been its strategy for growth.[537] In fact, the troubles that Tyco experienced initially were often attributed to a skittish market reacting to the falls of Enron and WorldCom as well as problems with Global Crossing and Kmart.[538]

Shortly after Enron's bankruptcy, Tyco began to experience a decline in its share price. From December 2001 through the middle of January 2002, Tyco's shares lost 20 percent of their value.[539] In fact, following a conference in which then-CEO Dennis Kozlowski tried to reassure the public and analysts that Tyco's accounting was sound, the shares were the most heavily traded of the day (68 million on January 15, 2002), and the price dropped $4.45 to $47.95 per share.[540] However, at the same time as the

[529] Adapted from Marianne M. Jennings, "The Yeehaw Factor," 3 *Wyoming Law Review* 387 (2003).

[530] Daniel Eisenberg, "Dennis the Menace," *Time*, June 17, 2002, 47; and Mark Maremont, John Hechinger, Jerry Markon, and Gregory Zuckerman, "Kozlowski Quits under a Cloud, Worsening Worries about Tyco," *Wall Street Journal*, June 4, 2002, pp. A1, A10.

[531] Alex Berenson, "Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System," *New York Times*, June 10, 2002, p. B1.

[532] *BusinessWeek Online,* January 14, 2002, http://www.businessweek.com.

[533] *BusinessWeek Online,* January 11, 1999, http://www.businessweek.com.

[534] *BusinessWeek Online,* January 14, 2002, http://www.businessweek.com.

[535] *Id.*

[536] Information from Tyco, http://www.tyco.com; see "Investor Relations, Tyco History." See also Alex Berenson, "Tyco Shares Fall as Investors Show Concern on Accounting," *New York Times*, January 16, 2002, p. C1.

[537] *Id.* Tyco bought Grinnell, the security system and fire alarm company; Ludlow, the packaging company; and a host of others during its especially aggressive expansion period from 1973 to 1982.

[538] Kopin Tan, "Tyco's Options Soar, While Volatility Spikes on Concerns over U.S. Accounting Practices," *Wall Street Journal*, January 30, 2002, p. C14.

[539] Alex Berenson, "Tyco Shares Fall as Investors Show Concern on Accounting," *New York Times*, January 16, 2002, p. C1.

[540] *Id.*

loss of investor confidence in the accounting of public corporations came Tyco's announcement that its earnings had dropped 24 percent for fiscal year 2001.[541] By February, the share price had tumbled to $29.90, a drop of 50 percent from January 1, 2002.[542] Tyco was forced to borrow funds as it experienced what one analyst called a "crisis in confidence," noting, "The lack of confidence in the company by the capital markets to a degree becomes a self-fulfilling prophecy."[543]

Then there was another problem that emerged on January 28, 2002. Tyco announced that it had paid $20 million to one of its outside directors, Frank E. Walsh, and a charity of which he was the head, for him to broker a deal for one of Tyco's acquisitions.[544] The acquisition was CIT Group Finance, and Tyco acquired it for $9.5 billion.[545] Mr. Walsh, who would later plead guilty to a violation of a New York statute as well as a violation of federal securities laws, withheld information about the brokerage fee from the Tyco board and did not disclose the information as required in the company's SEC filings.[546] Once the SEC moved in to investigate, the company's stock continued its decline.[547] From January 2002 to August 2002, Tyco's stock price declined 80 percent.[548]

What Went Wrong: The Accounting Issues

Investors and markets are not always jittery for no reason. There were some Tyco accounting issues that centered on its acquisitions and its accounting for those acquisitions.[549] What caused investors to seize upon Tyco's financials was that it seemed to be heavily in debt despite the fact that it was reporting oodles of cash flow.[550] This financial picture resulted because of Tyco's accounting for its "goodwill."[551] When one company acquires another company, it must include the assets acquired in its balance sheet. The acquirer is in charge of establishing the value for the assets acquired. From 1998 to 2001, Tyco spent $30 billion on acquisitions and attributed $30 billion to goodwill.

The problem lies in the fact that the assets that are acquired are not carried on Tyco's books with any significant value. Assets, under accounting rules, lose their value over time. Goodwill stays the same in perpetuity. However, if Tyco turns around and sells the assets it has acquired and booked at virtually zero value, the profit that it makes is

[541] John Hechinger, "Tyco to Lay Off 44% of Its Workers at Telecom Unit," *Wall Street Journal*, February 8, 2002, p. A5.

[542] Alex Berenson and Andrew Ross Sorkin, "Tyco Shares Tumble on Growing Worries of a Cash Squeeze," *New York Times*, February 5, 2002, p. C1.

[543] *Id.*

[544] Kate Kelly and Gregory Zuckerman, "Tyco Worries Send Stock Prices Lower Again," *Wall Street Journal*, February 5, 2002, p. C1.

[545] Laurie P. Cohen and Mark Maremont, "Tyco Ex-Director Pleads Guilty," *Wall Street Journal*, December 18, 2002, p. C1.

[546] Andrew Ross Sorkin, "Tyco Figure Pays $22.5 Million in Guilty Plea," *New York Times*, December 18, 2002, pp. C1, C2; and E. S. Browning, "Stocks Slump in Late-Day Selloff on Round of Ugly Corporate News," *Wall Street Journal*, June 4, 2002, pp. A3, A8.

[547] Michael Schroeder and John Hechinger, "SEC Reopens Tyco Investigation," *Wall Street Journal*, June 13, 2002, p. A2.

[548] Kevin McCoy, "Authorities Widen Tyco Case, Look at Other Officials' Actions," *USA Today*, August 13, 2003, p. 1A.

[549] Floyd Norris, "Now Will Come the Sorting Out of the Chief Executive's Legacy," *New York Times*, June 4, 2002, pp. C1, C10.

[550] Mark Maremont, "Tyco Made $8 Billion of Acquisitions over 3 Years but Didn't Disclose Them," *Wall Street Journal*, February 4, 2002, p. A3.

[551] "Goodwill" is an asset under accounting rules that takes into account the sort of customer value a business has. For example, if you buy a dry-cleaning business, you are paying for not only the hangers and the pressers and racks but also for that dry cleaner's reputation in the community, the tendency of customers to return, and their willingness to bring their dry cleaning to this establishment—goodwill.

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reflected in the income of the company. The only way an investor in Tyco would be able to tell what has really happened in the accounting for an acquisition would be for the investor to have access to the balance sheets of the acquired companies, so that he or she could see the value of the assets as they were carried on the books of the acquired company. The bump to earnings from the sale of the assets is lovely, but the bump to profits, with no offsetting costs, is tremendous.

There were additional accounting issues related to the Tyco acquisitions. One big one was that despite having made 700 acquisitions between 1998 and 2001 for about $8 billion, Tyco never disclosed the acquisitions to the public.[552] The eventual disclosure of the phenomenal number of acquisitions not only explained the lack of cash, but caused the realization in investors that they had been deprived of the chance to determine how much of Tyco's growth was due to acquisitions versus running existing businesses.

The nondisclosure of the acquisitions also helped with another accounting strategy. When Tyco made acquisitions, its goal was always to make the company acquired look as much like a "dog" as possible. Tyco was a spring-loader extraordinaire. (See Reading 4.6 for a full explanation of spring-loading.) Spring-loading at Tyco involved having the company being acquired pay everything for which it has a bill, whether that bill was due or not. When Tyco acquired Raychem, its treasurer sent out the following e-mail:

> At Tyco's request, all major Raychem sites will pay all pending payables, whether they are due or not.... I understand from Ray [Raychem s CFO] that we have agreed to do this, even though we will be spending the money for no tangible benefit either to Raychem or Tyco.[553]

Tyco employees, when working with a company to be acquired, would also pump up the reserves, with one employee of Tyco asking an employee of an acquired firm, "How high can we get these things? How can we justify getting this higher?"[554] The final report of a team led by attorney David Boies (the lawyer who represented Napster, the U.S. government in its case against Microsoft, and also Al Gore in the Florida ballot dispute after the 2000 presidential election), retained by the Tyco board to determine what was going on with the company, indicates that Tyco executives used both incentives and pressure on executives in order to get them to push the envelope on accounting rules to maximize results.[555] Mr. Boies referred to the accounting practices of the executives as "financial engineering."

It was not, however, a case in which the accounting issues went unnoticed. The warnings, from the company's outside legal counsel, went unheeded. A May 25, 2000, e-mail from William McLucas of Wilmer Cutler to Mr. Mark Belnick, then–general counsel for Tyco, contains clear warnings about the questionable accounting treatments as well as the pressure those preparing the financial reports were experiencing, "We have found issues that will likely interest the SEC … creativeness is employed in hitting the forecasts…. There is also a bad letter from the Sigma people just before the acquisition confirming that they were asked to hold product shipment just before the closing."[556] The lawyer concluded that Tyco's financial reports smelled of "something funny which is likely apparent if any decent accountant looks at this."[557]

[552] Maremont, "Tyco Made $8 Billion of Acquisitions over 3 Years but Didn't Disclose Them," p. A3.

[553] Herb Greenberg, "Does Tyco Play Accounting Games?" *Fortune*, April 1, 2002, pp. 83, 86.

[554] *Id.*

[555] Kurt Eichenwald, "Pushing Accounting Rules to the Edge of the Envelope," *New York Times*, December 31, 2002, pp. C1, C2.

[556] Laurie P. Cohen and Mark Maremont, "E-Mails Show Tyco's Lawyers Had Concerns," *Wall Street Journal*, December 27, 2002, p. C1.

[557] Mark Maremont and Laurie P. Cohen, "Tyco Probe Expands to Include Auditor PricewaterhouseCoopers," *Wall Street Journal*, September 30, 2002, p. A1.

What Went Wrong: A Profligate Spender as CEO

Tyco was graced with a CEO whose profligate spending cost the company dearly, in dollars and reputation, and whose tight fist with his own money got him indicted. Dennis Kozlowski was a scary CEO whose philosophy was "Money is the only way to keep score."[558] Mr. Kozlowski was one of the country's highest-paid CEOs. In 2001, his compensation package of $411.8 million put him at number two among the CEOs of the Fortune 500 companies."[559] Mr. Kozlowski was featured on the cover of *BusinessWeek* and called "the most aggressive dealmaker in Corporate America."[560] He was included in the magazine's top twenty-five managers of the year. Indeed, when Tyco's problems and accounting issues emerged, many of Wall Street's "superstar" money managers were stunned.[561]

In addition to his salary, Mr. Kozlowski was a spender. There were extensive personal expenses documented that began to percolate before problems at Tyco emerged. Tyco's outside legal counsel raised concerns about payments Tyco was making to Mr. Kozlowski's then-mistress (and now Kozlowski's second ex-wife), Karen Mayo, and advised that they be disclosed in SEC documents. Employees in Tyco refused to make the disclosures and continued making the payments.[562] The e-mail from partner Lewis Liman at Wilmer Cutler, sent March 23, 2000, to Tyco's general counsel, Mark Belnick, read, "There are payments to a woman whom the folks in finance describe as Dennis's girlfriend. I do not know Dennis's situation, but this is an embarrassing fact."[563]

Before Tyco took its dive, Mr. Kozlowski had accumulated three Harleys; a 130-foot sailing yacht; a private plane; and homes in New York City (including a thirteen-room Fifth Avenue apartment, purchased in 2000),[564] New Hampshire, Nantucket, and Boca Raton (15,000 square feet, purchased in 2001); and he was a part owner of the New Jersey Nets and the New Jersey Devils.[565] His Fifth Avenue apartment cost $16.8 million to buy and $3 million in renovations, and he spent $11 million on furnishings.[566] The items were delineated in the press, and the following purchases for the apartment were charged to Tyco: $6,000 for a shower curtain; $15,000 for a dog umbrella stand; $6,300 for a sewing basket; $17,100 for a traveling toilette box; $2,200 for a gilt metal wastebasket; $2,900 for coat hangers; $5,960 for two sets of sheets; $1,650 for a notebook; and $445 for a pincushion.[567]

For his then–new wife Karen Mayo's fortieth birthday, Kozlowski flew Jimmy Buffett and dozens of Karen's friends to a villa outside Sardinia for a multiday birthday

[558] Eisenberg, "Dennis the Menace," 47.

[559] Jonathan D. Glater, "A Star Lawyer Finds Himself the Target of a Peer," *New York Times*, September 24, 2002, pp. C1, C8.

[560] *BusinessWeek Online,* January 14, 2002, http://www.businessweek.com.

[561] Gregory Zuckerman, "Heralded Investors Suffer Huge Losses with Tyco Meltdown," *Wall Street Journal*, June 10, 2002, p. C1.

[562] Cohen and Maremont, "E-Mails Show Tyco's Lawyers Had Concerns," p. C1.

[563] *Id.*

[564] Theresa Howard, "Tyco Puts Kozlowski's $16.8M NYC Digs on Market," *USA Today*, September 19, 2002, p. 3B.

[565] Laurie P. Cohen and Mark Maremont, "Tyco Relocations to Florida Are Probed," *Wall Street Journal*, June 10, 2002, p. A3; Alex Berenson and William K. Rashbaum, "Tyco Ex-Chief Is Said to Face Wider Inquiry into Finances," *New York Times*, June 7, 2002, p. C1; and Kris Maher, "Scandal and Excess Make It Hard to Sell Mr. Kozlowski's Boat," *New York Times*, September 23, 2002, p. A1.

[566] Andrew Ross Sorkin, "Tyco Details Lavish Lives of Executives," *New York Times*, September 19, 2002, p. C1. The New York City apartment was sold for $21.8 million in October 2004. William Neuman, "Tyco to Sell Ex-Chief's Apartment for $21 Million," *New York Times*, October 9, 2004, pp. B1, B4.

[567] Kevin McCoy, "Directors' Firms on Payroll at Tyco," *USA Today*, September 18, 2002, p. 1B. These items are also listed in the 8-K for September 17, 2002.

celebration.[568] A memo on the party was attached as an exhibit to Tyco's 8-K, filed on September 17, 2002. The process for receiving the guests and the party schedule are described in detail, right down to what type of music was playing and at what level. The waiters were dressed in Roman togas, and there was an ice sculpture of David through which the vodka flowed. The memo includes a guest list and space for the crew of the yacht that the Kozlowskis sailed to Sardinia.[569] The total cost for the party was $2.1 million.[570] Tyco also paid Mr. Kozlowski's American Express bill, which was $80,000 for one month. A later report uncovered a $110,000 bill Tyco paid for a thirteen-day stay by Mr. Kozlowski at a London hotel.[571] Ironically, Mr. Kozlowski told a *BusinessWeek* reporter in 2001, on a tour of Tyco's humble Exeter, New Hampshire, offices, "We don't believe in perks, not even executive parking spots."[572]

Mr. Kozlowski appeared to be financing the lifestyle through Tyco's Key Employee Corporate Loan Program ("the KELP") and relocation loan programs (see the following pages for details). According to SEC documents, Mr. Kozlowski borrowed more than $270 million from the KELP "but us[ed] only about $29 million to cover intended uses for the loans. He used the remaining $242 million of supposed KELP loans for personal expenses, including yachts, fine art, estate jewelry, luxury apartments and vacation estates, personal business ventures, and investments, all unrelated to Tyco."[573]

Mr. Kozlowski was on the board of the Whitney Museum of Art and had Tyco donate $4.5 million to the traveling museum shows that the Whitney sponsored.[574] He was an avid fundraiser for various philanthropic endeavors. In fact, he was at a fundraiser for the New York Botanical Garden when the news of his possible indictment (see the following pages) first spread.[575] Tyco donated $1.7 million for the construction of the Kozlowski Athletic Complex at the private school, Berwick Academy, which one of his daughters attended and where he served as trustee, and $5 million to Seton Hall, his alma mater, for a building that was called the Koz Plex.[576]

Mr. Kozlowski also donated personally, particularly to charities in the Boca Raton area, where he had retained a public relations executive and where he had been given a fair amount of coverage in the *Palm Beach Post* for his contributions to local charities.[577] There is even some confusion about who was donating how much and from which tills.

[568] Don Halasy, "Why Tyco Boss Fell," *New York Post*, June 9, 2002, http://www.nypost.com; and Laurie P. Cohen, "Ex-Tyco CEO's Ex to Post $10 Million for His Bail Bond," *Wall Street Journal*, September 20, 2002, p. A5.

[569] Tyco 8-K filing, September 17, 2002, http://www.sec.gov/edgar.

[570] Mark Maremont and Laurie P. Cohen, "How Tyco's CEO Enriched Himself," *Wall Street Journal*, August 7, 2002, p. A1.

[571] Mark Maremont and Laurie P. Cohen, "Tyco's Internal Inquiry Concludes Questionable Accounting Was Used," *Wall Street Journal*, December 31, 2002, pp. A1, A4; and Alex Berenson, "Changing the Definition of Cash Flow Helped Tyco," *New York Times*, December 31, 2002, pp. C1, C2.

[572] Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, "The Rise and Fall of Dennis Kozlowski," *BusinessWeek Online*, December 23, 2002, http://www.businessweek.com.

[573] Securities and Exchange Commission, http://www.sec.gov/releases/litigation; and Kevin McCoy, "Directors' Firms on Payroll at Tyco," *USA Today*, September 18, 2002, p. 1B. These items are also listed in Tyco's 8-K filed on September 17, 2002; see http://www.sec.gov/edgar. See also Theresa Howard, "Tyco Puts Kozlowski's $16.8M NYC Digs on Market," *USA Today*, September 19, 2002, p. 3B; and Andrew Ross Sorkin, "Tyco Details Lavish Lives of Executives," *New York Times*, September 18, 2002, p. C1. And see Tyco's 8-K filed on September 17, 2002.

[574] Don Halasy, "Why Tyco Boss Fell," June 9, 2002, http://www.nypost.com.

[575] *Id.*; and Carol Vogel, "Kozlowski's Quest for Entrée into the Art World," *New York Times*, June 6, 2002, pp. C1, C5.

[576] Maremont and Cohen, "How Tyco's CEO Enriched Himself," p. A1; and John Byrne, "Seton Hall of Shame," *BusinessWeek Online*, September 20, 2002, http://www.businessweek.com.

[577] *Id.*, p. A6. Barry Epstein, a Palm Beach PR executive, said, "I represented Dennis personally. I reported to him and guided him on community involvement." Mr. Epstein has conceded that most of the money was Tyco's, not Mr. Kozlowski's.

Kozlowski had pledged $106 million in Tyco funds to charity, but $43 million of that was given in his own name.[578] He had donated $1.3 million to the Nantucket Conservation Foundation in his own name with the express desire that the land next to his property there not be developed.[579] Tyco gave $3 million to a hospital in Boca Raton and $500,000 to an arts center there. United Way of America gave Mr. Kozlowski its "million-dollar giver" award.[580]

Mr. Kozlowski saw to it that friends were awarded contracts that Tyco paid. For example, Wendy Valliere was a personal friend of the Kozlowskis and was hired to decorate the New York City apartment. Her firm's bill was $7.5 million.[581] However, Ms. Valliere was not alone as a personal employee.[582] In 1996, Mr. Kozlowski also hired Michael Castania, a consultant who had helped him with his yacht, as an executive who was housed at Boca Raton. He was an Australian yachting expert who went on to lead Team Tyco, a corporate yachting racing team, to fourth place in the Volvo Challenge Race in June 2002.[583] Tyco also hired Ms. Mayo's personal trainer from the days when she was still married to her ex-husband and Mr. Kozlowski was still married to his ex-wife, but Mr. Kozlowski was supporting Ms. Mayo in a beach condo in Nantucket.[584]

Mr. Kozlowski was also an active player in Manhattan's art market. In June 2002, the *New York Times* reported that Mr. Kozlowski was being investigated by the district attorney's office in Manhattan for evasion of $1 million in sales tax on $13 million in art sales over a ten-month period.[585] Mr. Kozlowski resigned from Tyco immediately following the emergence of the report and before an indictment was handed down. A market that was already reeling from Enron and WorldCom dropped 215 points in one day, and Tyco's stock fell 27 percent that same day.[586] In fact, the indictment was handed down the following day.[587]

Tyco's Culture

Mr. Kozlowski had a strategy for getting the type of people he needed to succumb to the pressure for numbers achievement. He told *BusinessWeek* that he chooses managers

[578] Kevin McCoy and Gary Strauss, "Kozlowski, Others Accused of Using Tyco as 'Piggy Bank,'" *USA Today*, September 13, 2002, pp. 1B, 2B.

[579] Maremont and Cohen, "How Tyco's CEO Enriched Himself," pp. A1, A6.

[580] *Id.*

[581] *Id.*

[582] Mark Maremont and Laurie P. Cohen, "Interior Design on a Budget: The Tyco Way," *Wall Street Journal*, September 18, 2002, pp. B1–B5.

[583] Maremont and Cohen, "How Tyco's CEO Enriched Himself," pp. A1, A6.

[584] Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, "The Rise and Fall of Dennis Kozlowski," *BusinessWeek Online,* December 23, 2002, http://www.businessweek.com.

[585] Alex Berenson, "Investigation Is Said to Focus on Tyco Chief over Sales Tax," *New York Times*, June 3, 2002, p. C1; Laurie P. Cohen and Mark Maremont, "Expanding Tyco Inquiry Focuses on Firm's Spending on Executives," *Wall Street Journal*, June 7, 2002, pp. A1, A5; and Nanette Byrnes, "Online Extra: The Hunch That Led to Tyco's Tumble," *BusinessWeek Online*, December 23, 2002, http://www.businessweek.com.

[586] Mark Maremont, John Hechinger, Jerry Markon, and Gregory Zuckerman, "Kozlowski Quits under a Cloud, Worsening Worries about Tyco," *Wall Street Journal*, June 4, 2002, p. A1; and Adam Shell, "Markets Fall as Tyco CEO's Resignation Adds to Woes," *USA Today*, June 4, 2002, p. 1B.

[587] Thor Valdmanis, "Art Purchases Put Ex-Tyco Chief in Hot Water," *USA Today*, June 5, 2002, p. 1B; Mark Maremont and Jerry Markon, "Former Tyco Chief Is Indicted for Avoiding Sales Tax on Art," *Wall Street Journal*, June 5, 2002, p. A1; Alex Berenson and Carol Vogel, "Ex-Tyco Chief Is Indicted in Tax Case," *New York Times*, June 5, 2002, p. C1; David Cay Johnston, "A Tax That's Often Ignored Suddenly Attracts Attention," *New York Times*, June 5, 2002, p, C1; Brooks Barnes and Alexandra Peers, "Sales-Tax Probe Puts Art World in Harsh Light," *Wall Street Journal*, June 5, 2002, pp. B1, B3; Susan Saulny, "Tyco's Ex-Chief to Seek Dismissal of Indictments," August 15, 2002, p. C3; Mark Maremont and Laurie P. Cohen, "Former Tyco CEO Is Charged with Two New Felony Counts," *Wall Street Journal*, June 27, 2002, p. A3; and Andrew Ross Sorkin and Susan Saulny, "Former Tyco Chief Faces New Charges," *New York Times*, June 27, 2002, p. C1.

from the "same model as himself. Smart, poor, and wants to be rich."[588] Meeting numbers meant bonuses; exceeding those numbers meant "the sky was the limit." The CEO of one of Tyco's subsidiaries had a salary of $625,000, but when he boosted sales by 62 percent, his bonus was $13 million.[589]

Mr. Kozlowski was known for being autocratic and prone to temper flare-ups.[590] When he was CEO of Tyco's Grinnell Fire Protection Systems Co., Mr. Kozlowski had an annual awards banquet where he presented awards to the best warehouse manager as well as the worst warehouse manager. The worst manager would have to walk to the front of the room in what other managers described as a "death sentence."[591]

The Loans

Tyco's Key Employee Corporate Loan Program (the "KELP") was established to encourage employees to own Tyco shares by offering dedicated loans to pay the taxes due when shares granted under Tyco's restricted share ownership plan became vested. There was no way to pay the taxes except to sell some of the shares for cash, and the loan program permitted the officers to pledge their shares in exchange for cash that was then used to pay the income tax that was due on this employee benefit.[592] Mr. Kozlowski made it clear that the loan program was available to all of his new hires, including Mark Swartz, the CFO, and Mark Belnick, Tyco's general counsel and executive vice president.[593]

The second loan program was a relocation program, which was established to help employees who had to move from New Hampshire to New York. The idea was to provide low-interest loans for employees who had to relocate from one set of company offices to another in order to lessen the impact of moving to a much costlier housing market.[594] One of the requirements of the relocation program was the employee's certification that he or she was indeed moving from New Hampshire to New York, or, in some cases, to Boca Raton.

Mr. Belnick has explained through his lawyer that he was entitled to the loans from the "relocation program" because he had such in writing from Mr. Kozlowski. Mr. Kozlowski offered this perk to Mr. Belnick despite the fact that Mr. Belnick was a partner in a New York City law firm and would be working in New York City for Tyco. He received the relocation fee for a difference of 25 miles between his home and Tyco's New York offices, and despite the fact that he had never lived in New Hampshire as the relocation loan program required. Although he actually didn't need to move, Mr. Belnick borrowed $4 million anyway and used it to buy and renovate an apartment in New York City. Later, he borrowed another $10 million to construct a home in Park City, Utah, because he was moving his family there and would divide his time between

[588] William C. Symonds and Pamela L. Moore, "The Most Aggressive CEO," *BusinessWeek Online*, May 28, 2001, http://www.businessweek.com.

[589] *Id.*

[590] Bianco, Symonds, Byrnes, and Poleck, "The Rise and Fall of Dennis Kozlowski," http://www.businessweek.com.

[591] *Id.*

[592] This information was obtained from the press release that the SEC issued when it filed suit against Mark Swartz, Dennis Kozlowski, and Mark Belnick for the return of the loan amounts. http://www.sec.gov/releases/litigation.

[593] In an 8-K filed with the SEC on September 17, 2002, Tyco outlined the loans, the spending, and its plans for the future. The 8-K is available at http://www.sec.gov/edgar. A synopsis of the information filed in the 8-K is available at http://www.tyco.com under "Press Releases."

[594] The rate as disclosed in the 2002 proxy was 6.24 percent.

the two locations and the extensive international travel his job required.[595] Mr. Belnick got Mr. Kozlowski's approval for both loans, but he didn't do the corporate paperwork for relocation.

Mr. Belnick told friends from the time that he began his work with Tyco that he was uncomfortable because he was not in the loop with information from either Mr. Kozlowski or the board. However, Mr. Kozlowski offered him more lucrative contracts and additional loans, and Mr. Belnick remained on board.[596] However, as noted in the case, there are e-mails from Tyco's outside counsel, the Wilmer Cutler firm, that indicate some information was seeping through to Mr. Belnick, and that outside counsel had concerns that were kept silent once transmitted to Mr. Belnick.

During the same period, CFO Swartz availed himself of $85 million of KELP loans. However, he used only $13 million for payment of taxes and spent the remaining $72 million for personal investments, business ventures, real estate holdings, and trusts.[597] Mr. Swartz used more than $32 million of interest-free relocation loans, and, according to SEC documents, used almost $9 million of those relocation loans for purposes not authorized under the program, including purchasing a yacht and investing in real estate.[598]

Patricia Prue, the vice president for HR at Tyco and the one responsible for processing the paperwork for the forgiveness of the officers' loans, and who had benefited from the loan forgiveness program herself, approached Mr. Kozlowski in September 2000 and asked for documentation that the board had indeed approved all the loan forgiveness for which she was doing the paperwork. Mr. Kozlowski, without ever producing board minutes, wrote a memo to Ms. Prue, "A decision has been made to forgive the relocation loans for those individuals whose efforts were instrumental to successfully completing the TyCom I.P.O."[599] Ms. Prue had received a loan of $748,309, had the loan forgiven, and then was given $521,087 to pay the taxes on the loan forgiveness.[600] Ms. Prue's bonuses totaled $13,534,523, and she was given $9,424,815 to pay the taxes on the bonuses.[601]

The issue of board approval on the loans remains a question, but compensation committee minutes from February 21, 2002, show that the committee was given a list of loans to officers and also approved Mr. Belnick's new compensation package. There was no public disclosure of these developments or the committee's review.[602] In grand jury testimony, Patricia Prue, who testified in exchange for immunity from prosecution, indicated that board member Joshua Berman pressured her in June 2002 to change the

[595] Nicholas Varchaver, "Fall from Grace," *Fortune*, October 28, 2002, 112, 115; Amy Borrus, Mike McNamee, Williams Symonds, Nanette Byrnes, and Andrew Park, "Reform: Business Gets Religion," *BusinessWeek Online*, February 3, 2003, http://www.businessweek.com; and Jonathan D. Glater, "A Star Lawyer Finds Himself the Target of a Peer," *New York Times*, September 24, 2002, p. C1.

[596] Glater, "A Star Lawyer Finds Himself the Target of a Peer," pp. C1, C8.

[597] Securities and Exchange Commission, http://ww.sec.gov/releases/litigation. The SEC has also filed suit against Mr. Swartz, seeking the return of these funds. Mr. Swartz was also indicted by the State of New York and spent some time in jail as his family scrambled to post his bail.

[598] Securities and Exchange Commission, http://www.sec.gov/releases/litigation. These exhibits and lists are found in the 8-K for September 17, 2002, at http://www.sec.gov/edgar. Andrew Ross Sorkin and Jonathan D. Glater, "Tyco Planning to Disclose Making Loans to Employees," *New York Times*, September 16, 2002, p. C1; and "Ex-Chief of Tyco Posts $10 Million in Bail," *New York Times*, September 21, 2002, p. B14.

[599] *Id.*; and Kevin McCoy, "Kozlowski's Statement in Question," *USA Today*, January 9, 2002, p. 1B.

[600] Andrew Ross Sorkin, "Tyco Details Lavish Lives of Executives," *New York Times*, September 18, 2002, pp. C1, C6.

[601] "Helping Fatcats Dodge the Taxman," *BusinessWeek Online*, June 20, 2002. http://www.businessweek.com.

[602] Andrew Ross Sorkin and Jonathan D. Glater, "Some Tyco Board Members Knew of Pay Packages, Records Show," *New York Times*, September 23, 2002, p. A1. Mr. Belnick was fired before he was indicted on felony charges. Laurie P. Cohen, "Tyco Ex-Counsel Claims Auditors Knew of Loans," *Wall Street Journal*, October 22, 2002, p. A6.

minutes from that February compensation committee meeting.[603] Mr. Berman denies the allegation. However, Ms. Prue did send a memo on June 7, 2002, to John Fort, Mr. Swartz, and the board's governance committee, with the following included: "As a result of the fact that I was recently pressured by Josh Berman to engage in conduct which I regarded as dishonest—and which I have refused to do—I will decline to have any personal contact with him in the future. In addition, I ask that Josh not go to my staff with any requests for information or directions."[604]

Mr. Kozlowski paid $56 million in bonuses to executives eligible for the KELP program, then gave them $39 million to pay the taxes on the bonuses, and then forgave the KELP loans given to pay taxes on the shares awarded in addition to the bonuses. A report commissioned by the Tyco board following the Kozlowski departure refers to the Tyco culture as one of greed and deception designed to ensure personal enrichment.[605]

The relocation loan program was a source of $46 million for Mr. Kozlowski, and SEC documents allege that he "used at least $28 million of those relocation loans to purchase, among other things, luxury properties in New Hampshire, Nantucket, and Connecticut as well as a $7 million Park Avenue apartment for his then (now former) wife."[606]

Mr. Kozlowski's officer team was small and obedient.[607] Tyco had only 400 employees at its central offices, and Kozlowski only interacted with a few, a means of keeping information close to the vest.[608] Mark Swartz, Tyco's former CFO, was 40 years old at the time of Tyco's fall and his indictment on thirty-eight counts of grand larceny, conspiracy, and falsifying business records.[609] Tyco hired him in 1991, away from Deloitte & Touche's due diligence team. By 1993, he was head of Tyco's acquisitions team, and by 1995, he was Tyco's CFO, at age 33. Mr. Kozlowski nominated Mr. Swartz for a CFO award that year, and *CFO Magazine* honored Mr. Swartz with its 2000 Excellence Award.[610] Indeed, Mr. Kozlowski and Mr. Swartz were inextricably intertwined, with Mr. Swartz even serving as trustee for one of Mr. Kozlowski's trusts for holding title to real property.[611] Both men also used a loophole in securities law to sell millions of shares of Tyco stock even as they declared publicly that they were not selling their shares in the company.[612]

Tyco's Fall

Mr. Kozlowski and Mr. Swartz were indicted under New York State laws for stealing $170 million from the company and for profiting $430 million by selling off their shares while withholding information from the public about the true financial condition of

[603] *Id.*, p. A22.

[604] *Id.*, p. A22. Both sides acknowledge the authenticity of the memo from Ms. Prue.

[605] Andrew Ross Sorkin, "Tyco Details Lavish Lives of Executives," *New York Times*, September 18, 2002, p. C1. These bonuses are from the year 2000. Kevin McCoy, "Tyco Spent Millions on Exec Perks, Records Say," *USA Today*, September 17, 2002, p. 1B.

[606] *Id.*; and Cohen, "Ex-Tyco CEO's Ex to Post $10 Million for His Bail Bond," p. A5.

[607] Alex Berenson, "Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System," *New York Times*, June 10, 2002, p. B1.

[608] Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, "The Rise and Fall of Dennis Kozlowski," *BusinessWeek Online*, December 23, 2002, http://www.businessweek.com.

[609] Nicholas Varchaver, "Fall from Grace," *Fortune*, October 28, 2002, 112, 114; and Andrew Ross Sorkin, "2 Top Tyco Executives Charged with $600 Million Fraud Scheme," *New York Times*, September 13, 2002, pp. A1, C3.

[610] *Id.*

[611] Alex Berenson, "From Dream Team at Tyco to a Refrain of Dennis Who?" *New York Times*, June 6, 2002, p. C1.

[612] *Id.*, pp. C1, C5.

Tyco.[613] The charges against the two were based on a state law that prohibits a criminal enterprise, a type of crime generally associated with organized crime. Their joint trial began in October 2003 and ran until April 2004, when the case ended in a bizarre mistrial. When the jury began deliberations, one juror, Ruth Jordan, was labeled by some of her fellow jurors as a holdout who refused to deliberate the case. Some courtroom observers felt that Ms. Jordan had flashed an "okay" hand signal to the defendants and their counsel.[614] The judge urged the jurors to continue deliberating despite obvious rancor. Ms. Jordan came to be labeled "holdout granny" and "batty blueblood" in the media.[615] However, several media outlets published her name (one with a photo), and when she reported to the judge that she had received a threat, the judge declared a mistrial.[616] The thrust of the defense was that everything Mr. Kozlowski and Mr. Swartz did was in the open, with board approval, and therefore did not fit the requirements for a criminal enterprise.[617]

Mr. Belnick was also indicted and tried, and was acquitted of all charges.[618]

Mr. Kozlowski and Mr. Swartz were retried and convicted on the charges of embezzlement and fraud. The two were convicted on twenty-two of the twenty-three counts of larceny in their indictments. The total amount the prosecution proved was looted from the company was $150 million.

Mr. Kozlowski took the stand to testify, and the jurors indicated that he was simply not a credible witness. When asked why he did not report $25 million in income, he responded that he just wasn't thinking when he signed his tax return. Jurors found an oversight of $25 million difficult to believe.

One portion of the case focused on the use of Tyco funds to buy and redecorate Mr. Kozlowski's New York City apartment (at a cost of $18 million). He acknowledged that he did not oversee it as he should have and that some of the decorations purchased were expensive and "godawful." He told jurors that he later stuffed many of the items "into a closet."[619]

Mr. Kozlowski paid $21.2 million to settle charges related to sales tax evasion on his purchases and sales of his personal art collection. Mr. Kozlowski also settled federal income tax evasion charges. Mr. Swartz's trial for tax evasion was postponed in April 2010. The evasion charges related to the underreporting of the income gleaned from the larceny for which they were convicted.

Kozlowski and Swartz were both sentenced on the larceny convictions to between 8⅓ and 25 years in New York State prison. Mr. Kozlowski was also ordered to pay $167 million in restitution and fines. Mr. Swartz was ordered to pay $72 million in fines and restitution. Both were handcuffed and immediately remanded to state prison following their sentences being imposed. The judge did not grant their motion to remain free

[613] Andrew Ross Sorkin, "Ex-Tyco Chief, Free Spender, Going to Court," *New York Times*, September 29, 2003, pp. A1, A15.

[614] David Carr and Adam Liptak, "In Tyco Trial, an Apparent Gesture Has Many Meanings," *New York Times*, March 29, 2004, pp. C1, C6.

[615] *Id.*

[616] Andrew Ross Sorkin, "Judge Ends Trial When Tyco Juror Reports Threat," *New York Times*, April 3, 2004, pp. A1, B4; and "Mistrials and Tribulations," *Fortune*, April 19, 2004, 42.

[617] Jonathan D. Glater, "Tyco Case Shows Difficulty of Deciding Criminal Intent," *New York Times*, April 8, 2004, pp. C1, C4.

[618] "Ex-Tyco Official Says Actions Were Proper," *New York Times*, June 26, 2004, p. B14.

[619] Andrew Ross Sorkin, "Ex-Chief and Aide Guilty of Looting Millions at Tyco," *New York Times*, June 18, 2005, pp. A1, B4.

while their appeals were pending.[620] The two men have exhausted their appeals and continue to serve their prison sentences in New York.

Tyco agreed to pay $3 billion to settle class action suits brought by its shareholders for fraud committed by Kozlowski and Swartz, the fourth largest shareholder settlement of the Enron era.[621] Tyco's share price dropped from $240 per share in 2002 to less than $25 by 2003. Since 2007, the share price has remained at below $50.

Discussion Questions

1. Recall your readings from Unit 2 on the relationship between ethics and economics. How did Tyco's initial problems establish this connection as a very real one for the U.S. markets? What made Tyco's stock price fall initially? Evaluate this comment from a market observer: "When a CEO steps down for (alleged) tax evasion, it sends the message that all of Corporate America is crooked."[622] "It makes you think, 'Why did he do it? Is there another shoe to drop?'"[623]
2. Warren Rudman, former U.S. senator and a member of the board at Raytheon, who knew and worked with Mark Belnick, was astonished at Mr. Belnick's indictment when it was issued. Mr. Rudman said, when told of Mr. Belnick's fall from grace: "I don't understand. Ethical, straight, cross the t's, dot the i's—that's my experience with Mark Belnick."[624] Mr. Belnick was acquitted of all charges after a jury trial in the summer of 2004. Does his acquittal mean that he acted ethically? What ethical breaches can you find in his behavior at Tyco? What provisions in a credo might have helped Mr. Belnick see the issues more clearly?
3. What do you think of the ethics of Ms. Prue?
4. How do you think the spending and the loans were able to go on for so long?
5. What questions could Mr. Kozlowski and Mr. Swartz have asked themselves to better evaluate their conduct?
6. Evaluate the e-mails from Wilmer Cutler to general counsel and others in the company. Why were these warnings signs unheeded?
7. Make a list of the lines Mr. Kozlowski crossed in his tenure as CEO. Can any of those items help you in developing your credo? Mr. Kozlowski said, when he was named CEO of the Year by *BusinessWeek,*

   > Most of us made it to the chief executive position because of a particularly high degree [of] responsibility.… We are offended most by the perception that we would waste the resources of a company that is a major part of our life and livelihood, and that we would be happy with directors who would permit waste.… So as a CEO I want a strong, competent board.[625]

   What was he not seeing in his conduct? Had he grown complacent? Is it difficult for us to see ethical breaches that we commit?

Case 4.26

Bausch & Lomb and Krispy Kreme: Channel Stuffing and Cannibalism

The Hong Kong division of Bausch & Lomb enjoyed double-digit growth during the 1980s and 1990s. In some years, earnings increased 25 percent; by 1993, the Hong Kong operation had total revenues of $100 million. Earnings on contact lenses sales seemed to be absolutely unbeatable, with sales increasing at a double-digit pace.

It was in 1994 that Bausch & Lomb's twelve continuous years of double-digit growth in both sales and earnings (excluding one-time events) came to a halt with a company

[620] Andrew Ross Sorkin, "Ex-Tyco Officers Get 8 to 25 Years," *New York Times*, September 20, 2005, pp. A1, C8; Kevin McCoy, "Ex-Tyco Chiefs Whisked Off to Prison," *USA Today*, September 20, 2005, p. 1B; and Mark Maremont, "Tyco Ex-Officials Get Jail Terms, Big Fines," *Wall Street Journal*, September 20, 2005, pp. C1, C4.

[621] Floyd Norris, "Tyco to Pay $3 Billion in Settlement," *New York Times*, May 16, 2007, pp. C1, C14.

[622] *Id.*

[623] Adam Shell, "Markets Fall as Tyco CEO's Resignation Adds to Woes," *USA Today*, June 4, 2002, p. 1B.

[624] Glater, "A Star Lawyer Finds Himself the Target of a Peer," pp. C1, C8.

[625] "Match Game," *Fortune*, November 18, 2002, p. 34.

announcement that excessive distributor inventories would result in a significant reduction in 1994 earnings. The final result was a decline of 54 percent in earnings to $88.5 million. Sales were down only slightly to $1.9 billion. The below table reflects the shortfalls.[626]

	Millions of dollars		
Division	**1993**	**Planned 1994**	**Actual 1994**
Total Bausch & Lomb			
Sales	1872.2	2051.9	1850.6
Operating Earnings	300.9	344.7	168.8
U.S. Eyewear			
Sales	190.1	200.0	153.5
Operating Earnings	42.3	48.6	19.7
U.S. Contact Lens			
Sales	151.0	176.0	85.8
Operating Earnings	16.8	20.5	–61.7
Asia-Pacific			
Sales	148.9	169.7	107.8
Operating Earnings	34.6	46.8	4.0
Oral Care			
Sales	68.8	73.0	50.8
Operating Earnings	2.6	4.2	–10.3
Miracle Ear*			
Sales	—	57.9	37.3
Operating Earnings	—	2.3	–12.9
Canada and Latin America			
Sales	126.1	154.0	113.4
Operating Earnings	17.8	27.3	6.4
Europe, Middle East, Africa			
Sales	246.5	249.0	240.6
Operating Earnings	60.7	60.3	53.0

*Acquired during 1993

An SEC investigation, as well as one by *BusinessWeek*, revealed some underlying problems in operations of Ray-Ban Sunglasses. For example, the Hong Kong unit was faking sales to real customers but then dumping the glasses at discount prices to gray markets. The contact lens division shipped products that were never ordered to doctors in order to boost sales. Some distributors had up to two years of unordered inventories. The U.S., Latin American, and Asian contact lens divisions also dumped lenses on the gray market, forcing Bausch & Lomb to compete with itself.

The SEC charged Bausch & Lomb with violation of federal securities law for overstatement of earnings. The company issued an earnings restatement that reduced revenues by $42.1 million and net profit by $13 million for 1993.[627] Bausch & Lomb settled the charges with the SEC in 1997. Without admitting or denying the allegations, Bausch & Lomb agreed to a cease and desist order and John Logan, a regional sales director for the contact lens division, agreed to pay a $10,000 fine. The cease and desist order also named the

[626] Mark Maremont, "Blind Ambition," *BusinessWeek*, October 23, 1995, pp. 78–92.

[627] Mark Maremont, "Bausch & Lomb and Former Executives Settle SEC Accounting-Fraud Charges," *Wall Street Journal*, November 18, 1997, p. A6.

former president of Bausch & Lomb's contact lens division, the former controller, the vice president of finance, and the former director of distributor sales.[628]

Bausch & Lomb emphasized that the SEC found no evidence that top management knew of the overstatement of profits at the time it was made. However, the SEC's associate director of enforcement said, "That's precisely the point. Here is a company where there was tremendous pressure down the line to make the numbers. The commission's view is that senior management has to be especially vigilant where the pressure to make the numbers creates the risk of improper revenue recognition."[629]

Former employees testified they were given a target number each year by operating unit, and no excuses were accepted. "Here's your number" was the common direction managers gave to sales personnel and even accountants within the company. When "the number" was not made, they were confronted with this question: "Do you want me to go back to the analysts and tell them we can't make the numbers?"[630] One division manager, expecting a shortfall, said he was told to make the numbers but "don't do anything stupid." The manager said, "I'd walk away saying, 'I'd be stupid not to make the numbers.'" Another manager said that in order to meet targets, they did 70 percent of their shipments in the last three days of the month.[631] Managers lived in fear of what they called "red ball day." *Red ball day* was the end of the calendar quarter, so named because a red sticky dot was placed on the calendar. As red ball day approached, credit was extended to customers who shouldn't have had credit, credit terms went beyond what was healthy and normal for receivables, and deep discounts abounded. One employee described panic-stricken managers doing whatever it took to meet the number for red ball day.

The executive bonus plan was based on the following factors: 30 percent sales growth, 30 percent earnings growth, and 30 percent return on equity. The remaining 10 percent was customer satisfaction.[632]

Bausch & Lomb also settled a shareholder lawsuit over the overstatement of earnings for $42 million.[633] Following this settlement and with the SEC charges behind it, Bausch & Lomb began its climb back from its tarnished image. It has, as the analysts prone to make puns have noted, lost its focus and has had trouble seeing the vision of the future clearly and sharpening its image. Its overseas operations have been a drain because those sales account for $1.8 billion in sales, but the devaluation of other currencies has been costly.[634] It tried to enter the two-week contact lens market but found that Johnson & Johnson had beat it there and had the market fairly cornered.[635]

The 148-year-old company that was once synonymous with eye care and quality has had a rugged climb back up, and it had not yet reached its former levels of success in sales, revenues, or earnings by 2000.[636] However, once it began its recovery in 2002, it was hit with news from an internal probe that revealed accounting issues in its Brazilian operations. Bausch & Lomb self-reported those issues to the SEC. Also in 2002, the

[628] Mark Maremont, "Judgment Day at Bausch & Lomb," *BusinessWeek*, December 25, 1995, p. 39; and Floyd Norris, "Bausch & Lomb and SEC Settle Dispute on '93 Profits," *New York Times*, November 18, 1997, p. C2.

[629] *Id.*

[630] Mark Maremont, "Blind Ambition," *BusinessWeek*, October 23, 1995, pp. 78–92.

[631] Maremont, "Blind Ambition," pp. 78–92.

[632] *Id.*

[633] Mark Maremont, "Bausch & Lomb's Board Puts on Its Glasses," *BusinessWeek*, November 6, 1995, p. 41.

[634] "Bausch & Lomb to Introduce New Contacts," *Wall Street Journal*, March 18, 1999, pp. B1, B9.

[635] Claudia H. Deutsch, "New Chief Inherits a Bausch & Lomb That Is Listing Badly," *New York Times*, November 17, 2001, pp. C1, C2.

[636] Zina Moukheiber, "Eye Strain," *Forbes*, October 4, 1999, pp. 58–60; see also Erile Norton, "CEO Gill to Retire from Bausch & Lomb; Carpenter Is Seen as Possible Successor," *Wall Street Journal*, December 14, 1995, p. B3.

company was hit with a tip from an outsider that its new CEO, Ronald Zarrella,[637] did not have an MBA from NYU, as his résumé listed. The board demanded the correction and an apology, which Mr. Zarrella issued, but he remained as the CEO.[638] The directors noted that Mr. Zarrella was doing a great job of cleaning house and improving performance. The Bausch & Lomb director of communication indicated that "people make mistakes," and "It was his obligation to proofread his bio carefully."[639] One analyst indicated Mr. Zarrella should have resigned because "believability" was critical for Bausch & Lomb as it tried to recover from its long-lasting slump.

In 2003, the company had to recall one of its ReNu soft contact lens solutions (MoistureLoc) because of a connection between the product and *Fusarium* fungus eye infections. When the eye infections began appearing in Asia, the company initially denied a connection, although 63 percent of the patients with the eye disease were using the MoistureLoc product. After several weeks of testing and new infections, the company recalled the product.[640] The product represented $100 million in annual sales for the company, but the company attributed the infections to a lot manufactured in South Carolina that was, therefore, limited in scope.

However, in 2005, Bausch & Lomb, acting more quickly than with the Asian MoistureLoc experience, issued yet another recall of MoistureLoc because of yet another link to eye disease. This time the recall was more generic because of the nature of the product's ingredients, not a flaw in production. Bausch & Lomb sales for 2006 were down by 78 percent as a result of the recall and loss of consumer confidence.[641]

Krispy Kreme: The Atkins Diet and Channel Stuffing

In 2004, Krispy Kreme Doughnuts was under investigation by the SEC for its accounting practices. Upon announcement of the investigation, the company's stock, which had been at $49.74 in 2003, dropped to $15.71, its lowest for 2004.[642] The stock had already dropped earlier in the year because the company announced it would not meet earnings targets, blaming the decline on the low-carb diet craze.[643] CEO Scott Livengood explained, "This [low-carb] phenomenon has affected us most heavily in our off-premises sales channels, in particular sales of packaged doughnuts to grocery store customers."[644] However, suspicions arose as analysts pointed out that Dunkin' Donuts was not experiencing the same Atkins downturn in sales. When an analyst pushed back on why the Atkins and South Beach diets would have such an impact when, traditionally, doughnuts have never been a part of any diet, Mr. Livengood responded, "[O]ur intention is to give you the facts as we know them…. This is not an unraveling…. The jury is out. This could be a new way of eating, even though it is not supported by nutritionists."[645]

[637] Bausch and Lomb Spells It with Two "r" s but GM, Where He Was before He Became CEO of Bausch Spells It with One "r."

[638] William M. Buckeley, "Bausch & Lomb Now Says CEO Has No MBA," *Wall Street Journal,* October 21, 2002, p. A10.

[639] *Id.*

[640] Sylvia Pagán Westphal, "Bausch & Lomb Recalls Contact-Lens Solution," *Wall Street Journal*, May 16, 2003, p. A3.

[641] Jennifer Levitz, "Bausch & Lomb Slashes Forecast amid Signs of Consumer Backlash," *Wall Street Journal*, August 9, 2006, p. A2.

[642] Greg Farrell, "Investigation Dunks Krispy Kreme," *USA Today*, July 30, 2004, p.1B.

[643] Gretchen Morgenson, "Did Someone Say Doughnuts? Yes. The S.E.C.," *New York Times*, July 30, 2004, pp. C1, C6.

[644] Andrew Stein, "Diets Hurt Donuts," CNNMoney.com, May 7, 2004, http://money.cnn.com/2004/05/07/news/midcaps/krispy_kreme.

[645] *Id.*

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There were, however, other issues. By the end of 2005, Krispy Kreme would restate its financial for 2004. Rather than the $48.6 million in profits it had reported, the company actually had losses of $198.3 million. The company also disclosed that it had found material weaknesses in its internal control system resulting in the shipment of goods in advance or without customer orders.[646] The report of the auditor concluded:

> In our judgment, Livengood as CEO and Tate as COO failed to establish a management tone and environment that demanded accurate accounting and financial reporting or to put in place controls, procedures and resources adequate for a business experiencing explosive growth. These failures led or contributed to accounting errors—substantially all of which had the effect of increasing EPS—at the same time that Livengood, Tate and others were profiting greatly from stock options, cash bonuses tied to EPS growth and generous perquisites.[647]

The audit report also gave examples of the accounting errors:

> The most egregious accounting errors we have uncovered involve (i) round-trip transactions in connection with each of the Dallas, Michigan and Northern California franchise acquisitions that resulted in the improper recognition of income or improper reduction of expense, and (ii) the improper recognition of revenue on certain shipments of equipment made months before the franchisees were ready to install the equipment in new stores. Most of these transactions occurred at the end of a fiscal period. Although the individual amounts involved in these transactions are relatively small in dollar amount, each had a material impact on the Company meeting or exceeding its EPS guidance for the particular period because $1 million of pre-tax income for KKD roughly equated to one penny of EPS. These errors raise serious questions about the integrity or competence of those involved and underscore the lack of appropriate accounting and legal controls at the Company.
>
> In the Dallas franchise acquisition, which closed on June 27, 2003, the Company sold doughnut-making equipment to the Dallas franchisee for approximately $700,000 and agreed at the same time to increase the purchase price for the franchise to cover the price of the equipment. The Company erroneously recorded the approximately $700,000 sales price as revenue rather than as an offset to the increased franchise purchase price. This error contributed approximately half a penny of earnings in the second quarter of fiscal 2004, a quarter in which the Company exceeded its EPS guidance by one penny. When later asked by a senior officer responsible for accounting whether the equipment sale was in the ordinary course, Tate did not disclose that the purchase price for the Dallas franchise had been increased to cover the cost of the equipment.

Livengood insisted on being at the center of all decision making, yet he was viewed as unapproachable by his management team. Senior managers functioned in solitary silos without access to all critical facts or an understanding of what others were doing. In addition to the problems with the management culture, the CFO position at Krispy Kreme turned over three times in four years.

The recommendations of the auditor focused on the company's compensation system and recommended an overhaul of the metrics as well as how its payouts are accounted for and reported to the board. The report recommended that the audit committee and the compensation committee review the bonuses that are paid out to employees.

Discussion Questions

1. What went wrong with the Bausch & Lomb culture? A study by Professor Yuri Mishina and others concludes that high-performing companies are more likely to break the law. What do you see at Bausch & Lomb and Krispy Kreme that supports their findings?
2. How were these companies affected? Financially? Competitively?
3. What changes or checks and balances would you put into a company to prevent these types of issues?
4. Why do you think Bausch & Lomb has struggled for so many years to make a recovery that seems to elude it?
5. Reviewing the unfortunate series of events in both companies, what credo moments do you see?

[646] www.sec.gov. 10-Q filing, December 2005.

[647] www.sec.gov. 8-K filing, November 2005.

TABLE 4.1 Employee Concerns and Employee Dissent

Nature of the Perceived Activity Triggering the Concern				
	Illegal, Immoral, or Illegitimate		Not Illegal, Immoral, or Illegitimate	
Expression of the Concern (Voice)	Exit Dimension			
	Stay	Go	Stay	Go
External dissent to someone who can take action	External whistle-blowing	Exit with public protest	Secret sharing	Exit with secret sharing
Internal dissent to someone who can take action	Internal whistle-blowing	Protest during exit interview	Employee participation, grievance	Explain reason for resignation in exit
Dissent in some other form	Discussion, confrontation with wrongdoer	Exit with notice to wrongdoer	Sabotage, strikes	Sabotage, strikes with exit
No expressed dissent	Inactive observation	Inactive departure	Silent disgruntlement	Silent departure

Source: Peter B. Jubb, "Whistleblowing: A Restrictive Definition and Interpretation," 21 *Journal of Business Ethics* 80 (1999). Reprinted with kind permission of Springer Science and Business Media.

Reading 4.27

A Primer on Whistleblowing

Employees who are faced with a situation at work in which their values are at odds with the actions of their employers are grappling with their sense of loyally to the company and their coworkers as well as their own value system. For example, an employee who knows that her company's product is defective is torn between her concern for customers who buy the product and her loyalty to the company and her fellow workers, who may also be her friends. She is concerned about her livelihood, her coworkers' livelihood, and the safety of others. Table 4.1 illustrates the options available to those who find their values at odds with the company's conduct.

Discussion Questions

1. What choices do whistleblowers have?
2. As you read the following cases, decide which type of whistleblower was involved.

Case 4.28

Beech-Nut and the No-Apple-Juice Apple Juice

Beech-Nut was heavily in debt, had only 15 percent of the baby food market, and was operating out of a badly maintained eighty-year-old plant in Canajoharie, New York. Creditors and debt were growing. Beech-Nut needed to keep its costs down, its production up, and increase its market share. In 1977, Beech-Nut made a contract with Interjuice Trading Corporation (the Universal Juice Corporation) to buy its apple juice concentrate. The contract was a lifesaver for Beech-Nut because Interjuice's prices were 20 percent below market, and apple concentrate was used as a base or sweetener in 30 percent of Beech-Nut's baby food products.

With this much lower cost key ingredient (the savings were estimated to be about $250,000 per year), Beech-Nut had reached a turnaround point. Here was a little company that could take on Gerber Baby Foods, the number-one baby food company in the United States. Nestlé Corporation, the international food producer based in Switzerland, saw potential in this little company and bought Beech-Nut in 1979. By the early 1980s, Beech-Nut had become the number-two baby food company in the United States. However, because of its substantially increased marketing costs, Beech-Nut's money pressures remained.

LiCari Raises Questions … Often

Dr. Jerome J. LiCari was the director of research and development for Beech-Nut Nutrition Corporation. Beech-Nut still had the low-cost Interjuice contract, but LiCari was worried. There were rumors of adulteration (the addition or substituted use of inferior substances in a product) flying about in the apple juice industry. Chemists in LiCari's department were suspicious, but they did not yet have tests that could prove the adulteration.

In October 1978, Dr. LiCari learned from other sources that the concentrate might be made of syrups and edible substances that are much cheaper than apples. LiCari reported what he had learned to John Lavery, Beech-Nut's vice president for operations. Lavery's job included management of the purchasing and processing of apple juice concentrates.

Concerned, Lavery sent two employees to inspect Universal's blending operation. What the employees found was only a warehouse without any blending facility. Lavery did nothing more and did not ask about where Interjuice's blending operation was or whether he could have it inspected. Instead, he had Universal officers sign a "hold harmless" agreement, an addendum to the purchase contract that was intended to protect Beech-Nut if any legal claims or suits related to the juice resulted.

Under federal law, a company can sell a product that tastes like apple juice but is not really apple juice so long as the label discloses that it is made from syrups, sweeteners, and flavors. However, Beech-Nut's labels indicated that there was apple product in its apple juice and apple sweetener in the other products in which the concentrate was used, such as the baby fruits, where it provided a sweeter taste. Selling products labeled as apple juice or as containing apple product when they are in fact made with syrups and flavorings is a federal felony. Lavery wanted the hold-harmless agreement for protection against any claims that might be filed under these laws.

During this time, LiCari and his staff were able to develop some tests that did detect the presence of corn starch and other substances in the apple concentrate that were consistent with the composition of adulterated juice. LiCari continued to tell Lavery that he was concerned about the quality of the concentrate supplied by Universal. LiCari told Lavery that if a supplier were willing to adulterate concentrate in the first place, it would likely have little compunction about continuing to supply adulterated product even after signing a hold-harmless document.

Lavery reminded LiCari that Universal's price to Beech-Nut for the concentrate was 50 cents to a dollar per gallon below the price charged by Beech-Nut's previous supplier. He also reminded LiCari of the tremendous economic pressure under which the company was operating. The revenue from Beech-Nut's apple juice was $60 million between 1977 and 1982. Lavery told LiCari that he would not change suppliers unless LiCari brought him tests that would "prove in a court of law that the concentrate was adulterated." He also told LiCari that any further testing of the product was to be a low item on his list of work assignments and priorities.

In 1979, LiCari sent the concentrate to an outside laboratory for independent analysis. The test results showed that the concentrate consisted primarily of sugar syrup. LiCari told Lavery of the lab results, but Lavery did nothing. In July 1979, Lavery also received a memorandum from the company's plant manager in San Jose, California, that indicated that approximately 95,000 pounds of concentrate inventory was "funny" and "adulterated," in that it was "almost pure corn syrup." The plant manager suggested that Beech-Nut demand its money back from the supplier. Instead, Lavery told the manager to go ahead and use the tainted concentrate in the company's mixed juices. Beech-Nut continued to purchase its apple juice concentrate from Universal.

LiCari and his staff continued their efforts to communicate to Lavery and other company officials that the Interjuice concentrate was adulterated. In August 1981, LiCari sent a memorandum to Charles Jones, the company's purchasing manager, with a copy to Lavery, stating that although the scientists had not proven that the concentrate was adulterated, there was "a tremendous amount of circumstantial evidence" to that effect, "paint[ing] a grave case against the current supplier." LiCari's memorandum concluded that "[i]t is imperative that Beech-Nut establish the authenticity of the Apple Juice Concentrate used to formulate our products. If the authenticity cannot be established, I feel that we have sufficient reason to look for a new supplier."[648]

Lavery took no action to change suppliers. Rather, he instructed Jones to ignore LiCari's memorandum, criticized LiCari for not being a "team player," and called his scientists "Chicken Little." He threatened to fire LiCari.[649] In his evaluation of LiCari's performance for 1981, Lavery wrote that LiCari had great technical ability but that his judgment was "colored by naiveté and impractical ideals."[650]

In late 1981, the company received, unsolicited, a report from a Swiss laboratory concluding that Beech-Nut's apple juice product was adulterated, stating, "The apple juice is false, can not see any apple."[651] Lavery reviewed this report, and one of his aides sent it to Universal. Universal made no response, and Beech-Nut took no action.

Nils Hoyvald became the CEO of Beech-Nut in April 1981. Both before and after becoming president of Beech-Nut, Hoyvald was aware, from several sources, about an adulteration problem. In November 1981, Beech-Nut's purchasing manager raised the problem. Hoyvald took no action. Rather, he told Lavery that, for budgetary reasons, he would not approve a change in concentrate suppliers until 1983.[652]

In the spring of 1982, Paul Hillabush, the company's director of quality assurance, advised Hoyvald that there would be some adverse publicity about Beech-Nut's purchases of apple juice concentrate. On June 25, 1982, a detective hired by the Processed Apple Institute visited Lavery at Beech-Nut's Canajoharie, New York, plant, and told him that Beech-Nut was about to be involved in a lawsuit as a result of its use of adulterated juice. The investigator showed Canajoharie plant operators documents from the Interjuice dumpster and new tests indicating that the juice was adulterated. The institute invited Beech-Nut to join its lawsuit against Interjuice (a suit that eventually closed

[648] Chris Welles, "What Led Beech-Nut Down the Road to Disgrace," *BusinessWeek*, February 22, 1988, pp. 124–128.

[649] *U.S. v. Beech-Nut, Inc.*, 871 F.2d 1181 (2nd Cir. 1989), at 1185; 925 F.2d 604 (2nd Cir. 1991); *cert. denied*, 493 U.S. 933 (1989).

[650] Welles, "What Led Beech-Nut Down the Road to Disgrace," p. 128.

[651] *U.S. v. Beech-Nut, Inc.*, 871 F.2d 1181 (2nd Cir. 1989), at 1185; 925 F.2d 604 (2nd Cir. 1991); *cert. denied*, 493 U.S. 933 (1989).

[652] *Id.*

Interjuice). Beech-Nut declined. It did cancel its future contracts with Interjuice, but it continued to use its on-hand supplies for production because of the tremendous cost pressures and competition it was facing.

LiCari also took his evidence of adulteration to Hoyvald. Hoyvald told LiCari he would look into the supplier issue. Several months later, after no action had been taken, LiCari resigned. After leaving Beech-Nut, LiCari wrote an anonymous letter to the U.S. Food and Drug Administration (FDA) disclosing the juice adulteration at Beech-Nut. He signed the letter, "Johnny Appleseed." The FDA began an investigation of Beech-Nut and its products and supplier, but Beech-Nut was not cooperative. The explanation managers offered was simple. When the FDA first notified the company of the problem, Beech-Nut had 700,000 cases of the spurious juice. By stalling, Beech-Nut was able to sell off some of those cases and ship others overseas (details follow), leaving it with the destruction of just 200,000 cases of the fake product.

An FDA investigator observed,

> They played a cat-and-mouse game with us. When FDA would identify a specific apple juice lot as tainted, Beech-Nut would quickly destroy it before the FDA could seize it, an act that would have created negative publicity?[653]

The Cat-and-Mouse Chase

When New York State government tests first revealed that a batch of Beech-Nut's juice contained little or no apple juice, Beech-Nut had the juice moved during the night, using nine tanker trucks. CEO Hoyvald realized that not being able to sell the inventory of juice the company had on hand would be financially crippling. So, he began delaying tactics designed to give the company time to sell it.

To avoid seizure of the inventory in New York by state officials in August 1982, Hoyvald had this juice moved out of state during the night. It was transported from the New York plant to a warehouse in Secaucus, New Jersey, and the records of this shipment and others were withheld from FDA investigators until the investigators independently located the carrier Beech-Nut had used. While the FDA was searching for the adulterated products but before it had discovered the Secaucus warehouse, Hoyvald ordered virtually the entire stock in that warehouse shipped to Beech-Nut's distributor in Puerto Rico; the Puerto Rico distributor had not placed an order for the product and had twice refused to buy the product even at great discounts offered personally by Hoyvald.

In September 1982, Hoyvald ordered a rush shipment of the inventory of apple juice products held at Beech-Nut's San Jose plant and took a number of unusual steps to get rid of the entire stock. He authorized price discounts of 50 percent; the largest discount ever offered before had been 10 percent. Hoyvald insisted that the product be shipped "fast, fast, fast," and gave a distributor in the Dominican Republic only two days, instead of the usual thirty, to respond to this product promotion. In order to get the juice out of the warehouse and out of the country as quickly as possible, Beech-Nut shipped it to the Dominican Republic on the first possible sailing date, which was from an unusually distant port, which raised the freight cost to an amount nearly equal to the value of the goods themselves. Finally, this stock was shipped before Beech-Nut had received the necessary financial documentation from the distributor, which, as one Beech-Nut employee testified, was "tantamount to giving the stuff away."[654]

[653] Welles, "What Led Beech-Nut Down the Road to Disgrace," p. 128.

[654] *U.S. v. Beech-Nut, Inc.*, 871 F.2d, at 1186. This segment of the case was adapted from the judicial opinion.

Hoyvald also used Beech-Nut's lawyers to help delay the government investigation, thereby giving the company more time to sell its inventory of adulterated juice before the product could be seized or a recall could be ordered. For example, in September 1982, the FDA informed Beech-Nut that it intended to seize all of Beech-Nut's apple juice products made from Universal concentrate; in October, New York State authorities advised the company that they planned to initiate a local recall of these products. Beech-Nut's lawyers, at Hoyvald's direction, successfully negotiated with the authorities for a limited recall, excluding products held by retailers and stocks of mixed-juice products. Beech-Nut eventually agreed to conduct a nationwide recall of its apple juice, but by the time of the recall Hoyvald had sold more than 97 percent of the earlier stocks of apple juice. In December 1982, in response to Hoyvald's request, Thomas Ward, a member of a law firm retained by Beech-Nut, sent Hoyvald a letter that summarized the events surrounding the apple juice concentrate problem as follows:

> From the start, we had two main objectives:
>
> 1. to minimize Beech-Nut's potential economic loss, which we understand has been conservatively estimated at $3.5 million, and
> 2. to minimize any damage to the company's reputation.
>
> We determined that this could be done by delaying, for as long as possible, any market withdrawal of products produced from the Universal Juice concentrate....
>
> In spite of the recognition that FDA might wish to have Beech-Nut recall some of its products, management decided to continue sales of all such products for the time being.... The decision to continue sales and some production of the products was based upon the recognition of the significant potential financial loss and loss of goodwill, and the fact that apple juice is a critical lead-in item for Beech-Nut.
>
> Since the mixed fruit juices and other products constituted the bulk of the products produced with Universal concentrate, one of our main goals became to prevent the FDA and state authorities from focusing on these products, and we were in fact successful in limiting the controversy strictly to apple juice.[655]

The Charges and Fates

In November 1986, Beech-Nut, Hoyvald, and Lavery, along with Universal's proprietor, Zeev Kaplansky, and four others ("suppliers"), were indicted on charges relating to the company's sale of adulterated and misbranded apple juice products. Hoyvald and Lavery were charged with (1) one count of conspiring with the suppliers to violate the FDCA, 21 U.S.C. §§331(a), (k), and 333(b) (1982 & Supp. IV 1986), in violation of 18 U.S.C. §371; (2) twenty counts of mail fraud, in violation of 18 U.S.C. §§1341 and 2; and (3) 429 counts of introducing adulterated and misbranded apple juice into interstate commerce, in violation of 21 U.S.C. §§331(a) and 333(b) and 18 U.S.C. §2. The suppliers were also charged with introducing adulterated concentrate into interstate commerce.

Hoyvald and Lavery pleaded not guilty to the charges against them. Eventually, Beech-Nut pleaded guilty to 215 felony violations of §§331(a) and 333(b); it received a $2 million fine and was ordered to pay $140,000 to the FDA for the expenses of its investigation. Kaplansky and the other four supplier-defendants also eventually pleaded guilty to some or all of the charges against them. Hoyvald and Lavery thus went to trial alone. LiCari testified at the trials, "I thought apple juice should be made from apples."[656]

The trial began in November 1987 and continued for three months. The government's evidence included that previously discussed. Hoyvald's principal defense was that all of

[655] *Id.*, pp. 1186–1187.

[656] Welles, "What Led Beech-Nut Down the Road to Disgrace," p. 128.

his acts relating to the problem of adulterated concentrate had been performed on the advice of counsel. For example, there was evidence that the Beech-Nut shipment of adulterated juices from its San Jose plant to the Dominican Republic followed the receipt by Hoyvald of a telex sent by Sheldon Klein, an associate of the law firm representing Beech-Nut, which summarized a telephone conference between Beech-Nut officials and its attorneys as follows:

> We understand that approximately 25,000 cases of apple juice manufactured from concentrate purchased from Universal Juice is [sic] currently in San Jose. It is strongly recommended that such product and all other Universal products in Beech-Nut's possession anywhere in the US be destroyed before a meeting with [the FDA] takes place.[657]

Hoyvald and Klein testified that they had a follow-up conversation in which Klein told Hoyvald that, as an alternative, it would be lawful to export the adulterated apple juice products.

The jury returned a verdict of guilty on all of the counts against Lavery. It returned a verdict of guilty against Hoyvald on 359 counts of adulterating and misbranding apple juice, all of which related to shipments after June 25, 1982. It was unable to reach a verdict on the remaining counts against Hoyvald, which related to events prior to that date.

The federal district court sentenced Hoyvald to a term of imprisonment of a year and a day, fined him $100,000, imposed a $9,000 special assessment, and ordered him to pay the costs of prosecution. In March 1989, the federal court of appeals for the second circuit reversed the conviction on the ground that venue was improperly laid in the Eastern District instead of the Northern District of New York. The case was remanded to the district court for a new trial.[658] In August 1989, Hoyvald was retried before Chief Judge Piatt on nineteen of the counts on which a mistrial had been declared during his first trial. After four weeks of trial, the jury was unable to agree on a verdict, and a mistrial was declared.

Rather than face a third trial, Hoyvald entered into a plea agreement with the government on November 7, 1989. The government recommended that the court impose a suspended sentence; five years of probation, including 1,000 hours of community service; and a $100,000 fine. On November 13, 1989, the district court accepted the plea and imposed sentence. At that plea proceeding, Judge Piatt agreed, at Hoyvald's request, to defer the beginning of his community service to give him three weeks to travel to Denmark to visit his 84-year-old mother.

Six months later, in May 1990, Hoyvald again requested permission from his probation officer to return to Denmark to visit his mother and then to be permitted to visit "East and West Germany, Switzerland, Hungary, Czechoslovakia, and Greece" on business, a journey that would take slightly more than three weeks. The Probation Department expressed no opposition to the trip so long as he "supplies an appropriate itinerary and documentation as to the business portions of his trip." The United States Attorney did not oppose the request. On May 22, 1990, Hoyvald requested permission to travel to the other European countries to "look for a job and to investigate business opportunities" in those countries. The district court ruled that Hoyvald could visit his mother in Denmark but denied the request to travel to other countries.

[657] *U.S. v. Beech-Nut, Inc.*, 871 F.2d 1181, at 1194. Again, this material is adapted from the case.

[658] *U.S. v. Beech-Nut Nutrition Corp.*, 871 F.2d 1181 (2nd Cir.), cert. denied, 493 *U.S.* 933, 110 S.Ct. 324, 107 L.Ed.2d 314 (1989).

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Discussion Questions

1. No one was ever made ill or harmed by the fake apple juice. Was LiCari overreacting?
2. Did LiCari follow the lines of authority in his efforts? Is this important for a whistleblower? Why?
3. What pressures contributed to Beech-Nut's unwillingness to switch suppliers?
4. Using the various models for analysis of ethical dilemmas that you have learned, point out the things that Lavery, Hoyvald, and others in the company failed to consider as they refused to deal with the Interjuice problem.
5. Why did LiCari feel he had to leave Beech-Nut? Why did LiCari write anonymously to the FDA?
6. Is it troublesome that Hoyvald and Lavery escaped sentences on a technicality? Is the sentence too light?
7. Why do you think Hoyvald and the others thought they could get away with the adulterated juice? Why did they play the "cat-and-mouse" game with the FDA? What principles about ethics have you learned that might have helped them analyze their situation more carefully and clearly? Are there some ideas for your credo from both their decisions and LiCari's actions?
8. Beech-Nut's market share went from 19.1 percent of the market to 15.8 percent, where it has hovered ever since. Why? What were the costs of Beech-Nut's fake apple juice and its "cat-and-mouse game"? Do you think consumers still remember this conduct?

Case 4.29

NASA and the Space Shuttle Booster Rockets

Morton Thiokol, Inc., an aerospace company, manufactures the solid-propellant rocket motors for the Peacekeeper missile and the missiles on Trident nuclear submarines. Thiokol also worked closely with the National Aeronautics and Space Administration (NASA) in developing the *Challenger*, one of NASA's reusable space shuttles.

Morton Thiokol served as the manufacturer for the booster rockets used to launch the *Challenger*. NASA had scheduled a special launch of the *Challenger* for January 1986. The launch was highly publicized because NASA had conducted a nationwide search for a teacher to send on the flight. For NASA's twenty-fifth shuttle mission, teacher Christa McAuliffe would be on board.

On the scheduled launch day, January 28, 1986, the weather was cloudy and cold at the John F. Kennedy Space Center in Cape Canaveral, Florida. The launch had already been delayed several times, but NASA officials still contacted Thiokol engineers in Utah to discuss whether the shuttle should be launched in such cold weather. The temperature range for the boosters, as specified in Thiokol's contract with NASA, was between 40°F and 90°F.

The temperature at Cape Canaveral that January morning was below 30°F. The launch of the *Challenger* proceeded nevertheless. A presidential commission later concluded, "Thiokol management reversed its position and recommended the launch of [the *Challenger*] at the urging of [NASA] and contrary to the views of its engineers in order to accommodate a major customer."[659]

Two of the Thiokol engineers involved in the launch, Allan McDonald and Roger Boisjoly, later testified that they had opposed the launch. Boisjoly had done work on the shuttle's booster rockets at the Marshall Space Flight Center in Utah in February 1985, at which time he noted that at low temperatures an O-ring assembly in the rockets eroded and, consequently, failed to seal properly. Though Boisjoly gave a presentation on the issue, little action was taken over the course of the year. Boisjoly conveyed his

[659] Judith Dobrzynski, "Morton Thiokol: Reflections on the Shuttle Disaster," *BusinessWeek*, March 14, 1988, p. 82.

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frustration in his activity reports. Finally, in July 1985, Boisjoly wrote a confidential memo to R. K. (Bob) Lund, Thiokol's vice president for engineering. An excerpt follows:

> This letter is written to insure [sic] that management is fully aware of the seriousness of the current O-ring erosion problem.... The mistakenly accepted position on the joint problem was to fly without fear of failure.... [This position] is now drastically changed as a result of the SRM [shuttle recovery mission] 16A nozzle joint erosion which eroded a secondary O-ring with the primary O-ring never sealing. If the same scenario should occur in a field joint (and it could), then it is a jump ball as to the success or failure of the joint.... The result would be a catastrophe of the highest order—loss of human life....
>
> It is my honest and real fear that if we do not take immediate action to dedicate a team to solve the problem, with the field joint having the number one priority, then we stand in jeopardy of losing a flight along with all the launch pad facilities.[660]

In October 1985, Boisjoly presented the O-ring issue at a conference of the Society of Automotive Engineers and requested suggestions for resolution.[661]

On January 27, 1986, the day before the launch, Boisjoly attempted to halt the launch. Mr. McDonald also offered his insights to a group of NASA and Thiokol engineers, However, four Thiokol managers, including Lund, voted unanimously to recommend the launch. One manager had urged Lund to "take off his engineering hat and put on his management hat."[662] The managers then developed the following revised recommendations. Engineers were excluded from the final decision and the development of these findings.[663]

- Calculations show that SRM-25 [the designation for the Challenger's January 28 flight] O-rings will be 20°F colder than SRM-15 O-rings.
- Temperature data not conclusive on predicting primary O-ring blow-by.
- Engineering assessment is as follows:
  - Colder O-rings will have increased effective durometer [that is, they will be harder].
  - "Harder" O-rings will take longer to seat.
  - More gas may pass primary [SRM-25] O-ring before the primary seal seats (relative to SRM-15).
  - Demonstrated sealing threshold [on SRM-25 O-ring] is three times greater than 0.038" erosion experienced on SRM-15.
  - If the primary seal does not seat, the secondary seal will seat.
  - Pressure will get to secondary seal before the metal parts rotate.
  - O-ring pressure leak check places secondary seal in outboard position which minimizes sealing time.
  - MTI recommends STS-51L launch proceed on 28 January 1986.
  - SRM-25 will not be significantly different from SRM-15.[664]

After the decision was made, Boisjoly returned to his office and wrote in his journal,

> I sincerely hope this launch does not result in a catastrophe. I personally do not agree with some of the statements made in Joe Kilminster's [Kilminster was one of the four Thiokol managers who voted to recommend the launch] written summary stating that SRM-25 is okay to fly.[665]

[660] Russel Boisjoly et al., "Roger Boisjoly and the Challenger Disaster: The Ethical Dimensions," *Journal of Business Ethics* 8 (1989), pp. 2178–2130.

[661] "No. 2 Official Is Appointed at Thiokol," *New York Times*, June 12, 1992, p. C3; and "Whistle-Blowing: Not Always a Losing Game," *EE Spectrum*, December 1990, 49–52.

[662] Boisjoly et al., "Roger Boisjoly and the *Challenger* Disaster," pp. 217–230.

[663] Paul Hoversten, "Engineers Waver, then Decide to Launch," *USA Today*, January 22, 1996, p. 2A.

[664] Boisjoly et al., "Roger Boisjoly and the *Challenger* Disaster," pp. 217–230.

[665] Interview with Roger Boisjoly, June 28, 1993, M. M. Jennings.

Seventy-four seconds into the *Challenger* launch, the low temperature caused the seals at the booster rocket joints to fail. The *Challenger* exploded, killing Christa McAuliffe and the six astronauts on board.[666]

The subsequent investigation by the presidential commission placed the blame for the faulty O-rings squarely with Thiokol. Charles S. Locke, Thiokol's CEO, maintained, "I take the position that we never agreed to the launch at the temperature at the time of the launch. The *Challenger* incident resulted more from human error than mechanical error. The decision to launch should have been referred to headquarters. If we'd been consulted here, we'd never have given clearance, because the temperature was not within the contracted specs."[667]

Both Boisjoly and McDonald testified before the presidential panel regarding their opposition to the launch and the decision of their managers (who were also engineers) to override their recommendation. Both Boisjoly and McDonald also testified that following their expressed opposition to the launch and their willingness to come forward, they had been isolated from NASA and subsequently demoted. Since testifying, McDonald has been assigned to "special projects." Boisjoly, who took medical leave for post-traumatic stress disorder, has left Thiokol but receives disability pay from the company. Currently, Mr. Boisjoly operates a consulting firm in Mesa, Arizona. He speaks frequently on business ethics to professional organizations and companies.[668]

In May 1986, then-CEO Locke stated, in an interview with the *Wall Street Journal*, "This shuttle thing will cost us this year 10¢ a share."[669] Locke later protested that his statement had been taken out of context.[670]

In 1989, Morton Norwich separated from Thiokol Chemical Corporation. The two companies had previously merged to become Morton Thiokol. Following the separation, Thiokol Chemical became Thiokol Corporation. Morton returned to the salt business, and Thiokol, remaining under contract with NASA through 1999, redesigned its space shuttle rocket motor to correct the deficiencies. No one at Thiokol was fired following the *Challenger* accident. Because of this incident and defense contractor indictments, the Government Accountability Project was established in Washington, D.C. The office provides a staff, legal assistance, and pamphlets to help whistleblowers working on government projects.

Discussion Questions

1. Who is responsible for the deaths that resulted from the *Challenger* explosion?
2. If you had been in Allan McDonald's or Roger Boisjoly's position on January 28, 1986, what would you have done?
3. Evaluate Locke's comment on the loss of ten cents per share.
4. Should the possibility that the booster rockets might not perform below 30°F have been a factor in the decision to allow the launch to proceed?
5. Roger Boisjoly offered the following advice on whistleblowing:
   - You owe your organization an opportunity to respond. Speak to them first verbally. Memos are not appropriate for the first step.
   - Gather collegial support for your position. If you cannot get the support, then make sure you are correct.
   - Spell out the problem in a letter.[671]

   Mr. Boisjoly acknowledges he did not gather collegial support. How can such support be obtained? Where would you start? What would you use to persuade others?

[666] Paul Hoversten, Patricia Edmonds, and Haya El Nasser, "Debate Raged Night before Doomed Launch," *USA Today*, January 22, 1996, pp. A1, A2.

[667] Dobrzynski, "Morton Thiokol," p. 82.

[668] Interview with Roger Boisjoly.

[669] Dobrzynski, "Morton Thiokol," p. 82.

[670] "No. 2 Official Is Appointed at Thiokol," p. C3; and "Whistle-Blowing," pp. 49–52.

[671] Joseph R. Herkert, "Management's Hat Trick: Misuse of 'Engineering Judgment' in the Challenger Incident," 10 *Journal of Business Ethics* 617 (1991).

6. Scientist William Lourance has written that "a thing is safe if its attendant risks are judged to be acceptable."[672] Had everyone, including the astronauts, accepted the risks attendant to the *Challenger's* launch?
7. *Groupthink* is defined as

> a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' strivings for unanimity override their motivation to realistically appraise alternative courses of action.... Groupthink refers to the deterioration of mental efficiency, reality testing, and moral judgment that results from in-group pressures.[673]

In another NASA accident, a launch pad fire took the lives of *Apollo I* astronauts Gus Grissom, Ed White, and Roger Chaffee on January 30, 1967. Gene Krantz, the Mission Control Flight Director, addressed his staff by saying, "We were too gung-ho about the schedule and we locked out all of the problems we saw each day in our work.... Not one of us stood up and said, "Damn it, STOP!"[674]

Is this what happened when Thiokol's management group took off its "engineering hats"?

Case 4.30

Diamond Walnuts and Troubled Growers

Diamond Foods, Inc., was once a cooperative among walnut growers, known as Diamond Walnuts. In 2005, it became a publicly traded corporation. The shareholders of the corporation included the farmers who were formerly members of the Diamond Cooperative. Upon this change in structure, the new CEO, Michael J. Mendes, undertook an aggressive strategy to make Diamond one of the country's largest snack food producers. In 2010, Mr. Mendes signed a deal with Procter & Gamble to buy Pringles, the potato chips in a can. However, before the deal could be closed, accounting issues emerged that caused P&G to call off the deal.

Growers noticed that Diamond was not paying them in the same quarter in which they were shipping their goods. Postponing payments from one quarter to the next results in income looking better than if the payment had been made in the proper quarter. Furthermore, there should be some correlation between payments and inventory, and analysts were not seeing the two working in tandem. Finally, the firm's cash account should reflect increase in sales, but again, the cash account did not reflect the increases being reported in sales. In 2011, analysts noticed a $60 million payout to walnut growers, although many of those who received the checks as payment for their walnut crops had not signed agreements to sell walnuts to Diamond.

One of the problems that emerged once Diamond changed from cooperative to publicly traded corporation was that the price for walnuts that Diamond was paying was going lower because shareholder demands were for increased earnings. The result was that the company's revenues were increasing substantially, more than any of its competitors, However, the growers did not complain because they were shareholders and were enjoying the returns of the revenue growth despite the poor pricing that affected them as sellers and also despite the accounting issues that were becoming increasingly obvious.

When the diamond growers received the checks from Diamond, they raised questions to Diamond about their entitlement to payment, but they were told to just cash the checks. However, a company cannot book expenses unless and until it actually has the title to the goods purchased. In this case, the farmers who received the checks were not aware that they were supposed to sell walnuts to Diamond. Indeed, some did not even have a crop to sell in 2010. The payments were made in order to keep revenues down for

[672] Irving L. Janis, *Victims of Groupthink* (1972).

[673] http://history.nasa.gov/Apollo204. Accessed May 19, 2010.

[674] By the time of his sentencing, the issue of his mental competency was raised. In 2005, his lawyer requested an early release from prison for Mr. Bennett because of health issues.

the year so that following the acquisition the earnings would look excellent, something that would have bolstered the CEO's acquisition strategy.

The result was that Diamond placed its CEO and CFO on leave and restated its earnings after it eliminated the $60 million in payments. That restatement placed Diamond in violation of its loan covenants. Following the removal of the CEO and CFO, there was an SEC investigation.

Discussion Questions

1. How is this situation different from the other cases in this segment?
2. What were the consequences of the misrepresentation in the company's financial statements?
3. What should the grower/shareholders have done? Why did they not take any additional steps?

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Case 4.31

New Era: If It Sounds Too Good to Be True, It Is Too Good to Be True

The Foundation for New Era Philanthropy was founded in 1989 by Mr. John G. Bennett Jr. New Era took in over $200 million between 1989 and May 1995, from 180 nonprofit organizations, before the Securities and Exchange Commission (SEC) brought suit against New Era and the foundation went into bankruptcy.

Mr. Bennett was, at that time, a charismatic individual who was able to bring in many individual and institutional investors (most of them nonprofit organizations that included many colleges and universities) with the promise of a double-your-money return.[675] The foundation began as a matching-gift program. Mr. Bennett would take the funds from the nonprofit, deposit them in a Prudential Insurance account that would earn interest at Treasury rates, and then work to find a matching donor. The intentions were good, and initially the funds were small. Mr. Bennett would later admit that there never were any matching donors. As word of his success spread, the size of the funds the nonprofits deposited increased, and the greater the challenge became for finding a matching donor. And the pressure was growing. Mr. Bennett was receiving attention and accolades for his efforts. Former Philadelphia Mayor (now governor) Ed Rendell felt that Mr. Bennett's efforts had the potential for changing how people perceived Philadelphia both because of his success and also because the funds were helping nonprofits in their educational and community improvement efforts.[676]

Mr. Bennett often met personally with investors or their representatives and opened and closed his sessions with them with prayer. Among the individual investors in New Era were Laurance Rockefeller; singer Pat Boone; then-President of Procter & Gamble John Pepper; John Whitehead, the former cohead of Goldman Sachs; and former Treasury Secretary William Simon. The institutional investors included Harvard, Princeton,

[675] Robert Allen and Marshall Romney, "Lessons from New Era," *Internal Auditor*, October 1998, http://findarticles.com/. Accessed July 1, 2010.

[676] Steve Wulf, "Too Good to Be True," *Time*, May 29, 1995, p. 34.

University of Pennsylvania, the Nature Conservancy, and the National Museum of American Jewish History.[677]

In 1991, Melenie and Albert Meyer moved from their native South Africa to Michigan, where Mr. Meyer took a tenure-track position as an accounting professor at Spring Arbor College. Because there were only three accounting majors at the time he was hired, Mr. Meyer was also required to work part-time in the business office.[678]

During his first month in the business office, Mr. Meyer found that the college had transferred $294,000 to Heritage of Values Foundation, Inc. He connected the term *Heritage* with Reverend Jim Bakker and went to the library to research Heritage of Values Foundation, Inc. Although he found no connection to Jim Bakker, he could find no other information on the foundation. Mr. Meyer asked his supervisor, the vice president for business affairs, Ms. Janet M. Tjepkema, about Heritage of Values and the nature of the transfer. She explained that Heritage was the consultant that had found the New Era Foundation and had advised the college to invest in this "double your investment" fund.

Mr. Meyer attempted to research New Era but could find no registration for it in Pennsylvania, its headquarters location. He could not obtain information from New Era (there was no registration in Pennsylvania ever filed, and no tax returns were filed until 1993). Mr. Meyer continued to approach administrators of the college, but they seemed annoyed. He continued to collect information about New Era for the next two years. He gathered income tax returns and even spoke directly with Mr. Bennett. Mr. Meyer remained silent during the time that he gathered information because he was untenured and on a temporary work visa.[679] He also had a family to support, with three children. He was convinced that his concerns were justified when he discovered that New Era had reported only $34,000 in interest income for one year. With the portfolio it purported to hold, the interest income should have been about $1 million.

After he had collected files of information on New Era, which he labeled "Ponzi File," Mr. Meyer wrote a letter to the president of Spring Arbor as well as the chairman of the board of trustees for the college, warning them about his concerns regarding New Era. Mr. Meyer had also tried to talk with his colleagues about the information he had uncovered. He felt shunned by administrators and his colleagues, and by April 1994, he and his wife were no longer attending any social functions held by the college. He was told by administrators that raising funds was tough enough without his meddling. He repeatedly tried to convince administrators not to place any additional funds with New Era. His advice was ignored, and Spring Arbor invested an additional $1.5 million in New Era in 1994. At that time, Spring Arbor College's total endowment was $6 million. The $1.5 million would later be lost as part of the New Era bankruptcy.

In March 1995, Mr. Meyer received tenure and began to try to help others by warning them about his concerns about New Era. He wrote to the SEC and detailed his information and concerns. The SEC then notified Prudential Securities, which was holding $73 million in New Era stock. Prudential began its own investigation and found resistance from New Era officers in releasing information. New Era began to unravel, and by June 1995 it was in bankruptcy. There were 300 creditors named, and net losses were $107 million. New Era was nothing but a Ponzi scheme. It was able to pay out double the investment, but only so long as it could recruit new participants. When it could no longer recruit participants, it was unable to pay on demands for withdrawal.

[677] Steve Secklow, "A New Era Consultant Lured Rich Donors over Pancakes, Prayer," *Wall Street Journal*, June 2, 1995, pp. A1, A4.

[678] Barbara Carton, "Unlikely Hero: A Persistent Accountant Brought New Era's Problems to Light," *Wall Street Journal*, May 19, 1995, pp. B1, B10.

[679] *Id.*

Mr. Bennett was indicted on eighty-two counts of fraud, money laundering, and tax code violations in March 1997.[680] Following his arraignment, he was released after posting his daughter's $115,000 house to cover his bond.[681] Mr. Bennett entered a no-contest plea in 1997 and was sentenced to twelve years in prison, following six days of testimony during his sentencing hearing, including emotional pleas from Mr. Bennett. In ordering a reduced sentence, the judge departed from the 24.5 years dictated by the federal sentencing guidelines because Mr. Bennett had been "extraordinarily cooperative" in the investigation and because he had voluntarily turned over $1.5 million in assets to the bankruptcy court to be distributed to New Era participants.[682] The judge also noted what he felt was Mr. Bennett's diminished capacity.[683] The judge, in particularly harsh language, lectured Mr. Bennett on the egregious nature of his conduct: "It is possible for an ostensibly good and reverent person who is a true believer to engage in egregiously reprehensible and societally disruptive behavior."[684]

The nonprofit organizations that had invested in New Era recovered two-thirds of their investments and filed suit against Prudential Securities for recoupment of the remainder. That suit was settled without disclosure of its terms in 1996. The basis of the suit was that their funds were held in a single account at Prudential and that the funds were being used to repay New Era loans from Prudential instead of being invested as promised.

Mr. Meyer was still not embraced at his school for his efforts. Some still say that if Mr. Meyer had remained quiet, Mr. Bennett could have worked out the problems of New Era. Meyer was named a Michiganian of the Year for 1995.

Discussion Questions

1. Why did Mr. Meyer have so much difficulty convincing his college administrators that there was a problem with New Era?
2. Did Mr. Meyer follow the right steps in trying to bring New Era to the attention of the college officials?
3. What impact did Mr. Meyer's personal situation (visa and tenure issues) have on his desire to carry through with his concerns?
4. Why were administrators so reluctant to hear Mr. Meyer out? Mr. Bennett notified Spring Arbor College officials when Mr. Meyer called him, and asked administrators to keep Mr. Meyer quiet. How would you read this kind of request? What would you do if you were an administrator?
5. About forty of the nonprofit organizations that had invested in New Era and withdrawn their funds and earnings prior to its collapse voluntarily agreed to return their money to the bankruptcy pool.[685] An administrator from Lancaster Bible College, in explaining the return of his college's funds to the trustee, quoted St. Paul's letter to the Philippians: "Let each of you look not only to his own interest, but also to the interests of others" (Phillipians 2:4). Hans Finzel, head of CB International, a missionary fund, said his organization would not be returning the money: "It's true that it's tainted money, but it's also true that we received it in good faith."[686] Compare and contrast the positions of the parties. Would you return the money?
6. Is this case an indication that nonprofits operate as businesses and are susceptible to the same business ethics issues? Should nonprofits have ethics programs and training for their staff and volunteers?

[680] Steve Secklow, "Retired Judge Will Sort Out New Era Mess," Wall Street Journal, June 29, 1995, pp. B1, B16.

[681] Steve Secklow, "How New Era's Boss Led Rich and Gullible into a Web of Deceit," Wall Street Journal, May 19, 1995, pp. A1, A5.

[682] Dinah Wisenberg Brin, "Philanthropy Scam Nets 12 Years," *USA Today*, September 23, 1997, p. 2A.

[683] Carton, "Unlikely Hero," pp. B1, B10.

[684] Joseph Slobodzian, "Bennett Gets 12 for New Era Scam," *National Law Journal*, October 6, 1997, p. A8.

[685] Andrea Gerlin, "Among the Few Given Money by New Era, Many See Blessings in Giving It Back," *Wall Street Journal*, June 20, 1995, pp. B1, B10.

[686] Michael A. Bloom, "Key in New Era Settlement," *National Law Journal*, July 15, 1996, p. A4.

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SECTION G

The Culture of Goodness

Sometimes a culture turns to fraud because of its self-perception of goodness. Because they are doing so much good in terms of contributions, sponsorships, and scholarships, the fact that there is fraud afoot is not problematic because the view of this type of culture is, "Look how much good I was able to accomplish with the money that I made!"

Case 4.32

Bernie Madoff: Just Stay Away from the Seventeenth Floor

Bernard Madoff and his securities firm were an operation that, for over eighteen years, managed to lose $50 billion in investors' funds. Madoff, the former chairman of NASDAQ, was able to dupe employees; regulators; and, of course, investors, with nothing more sophisticated than a Ponzi scheme for eighteen years. When Mr. Madoff was indicted for federal securities fraud, Mr. Madoff's lawyer offered, "We will fight to get through this unfortunate series of events." "Unfortunate series of events" is the name of a children's book series but may not be appropriately descriptive of a gigantic fraud.

Madoff was an iconic CEO. He was instrumental in creating NASDAQ and had served as a board member at NASD, the precursor organization to FINRA. Even Arthur Levitt Jr., the former head of the SEC for eight years, was known to consult with Madoff on market issues. Mr. Madoff was an icon, and in classic Ponzi fashion, when anyone questioned his operation, he gave the person's money back. Folks clamored to get their money in with Bernie.

Still, Mr. Madoff kept his operation close to the vest. Bernie Madoff s direct reports were his sons and brother. Mr. Madoff limited access to the seventeenth floor of his headquarters, the Lipstick Building, where the supposed trading computer was housed. However, the computer was terribly outdated. No one ever wondered why it was never replaced. The reason was simple: a new computer would require someone looking at the old computer and transferring files—files for nonexistent trades. No one ever wondered why such a large investment firm employed a strip-mall accountant.[687] No one ever wondered how Madoff was able to use only twenty people to do the work that would have required 200 in another firm. They just knew that only those twenty people ever got access to the seventeenth floor. The SEC was in to investigate at least three times, but the red flags were not obvious. Mr. Madoff even commented on how his niece had married an investigator from the SEC.

The seventeenth floor was where the money of investors such as Mort Zuckerman, Kevin Bacon, and many of Palm Beach's movers and shakers, was never really invested but was funneled to Mr. Madoff and the charities he favored. Mr. Madoff contributed to his church, universities, and so many philanthropies that he was known in both New York and Florida for his generosity. Mr. Madoff followed the pattern of all Ponzi

[687] Gregory Zuckerman, "Chasing Bernard Madoff," *Wall Street Journal*, December 18, 2008, p. A1.

schemers. They never begin with the idea of a fraud. Indeed, Mr. Madoff was even more true to form. He offered good, but not excessive returns. He was a consistent performer with a steady 12 percent—enough to be better than the rest, but not enough to turn regulatory heads too far in the direction of the seventeenth floor. Also Ponzi schemers continue to believe that they are just one dramatic trade or market move from pulling a rabbit out of a hat and making it all work for everyone. Generally, Ponzi schemes last no longer than one year. Mr. Ponzi himself made it for only nine months. Mr. Madoff lasted eighteen years.[688]

There were those outside the regulatory agencies as well as New York's and Palm Beach's movers and shakers who were wondering. For example, Harry Markopolos wrote in a November 7, 2005, e-mail to the SEC of his concerns about the Madoff operations and concluded, "Madoff Investment Securities LLC is likely a Ponzi scheme."[689] The SEC investigated and closed its investigation eleven months later, writing, "The staff found no evidence of fraud."[690]

After entering a guilty plea, Mr. Madoff was sentenced to 150 years in prison. The federal judge who sentenced him said that Madoff s conduct was "extraordinarily evil." The Ponzi scheme is the largest in history. The sentence is three times longer than what was recommended by the prosecution and ten times longer than what Mr. Madoff s lawyers proposed.

Mrs. Madoff was required to vacate the couple's penthouse apartment, and U.S. Marshalls took possession of it. The Madoffs' assets, including properties in the Hamptons, Palm Beach, and Switzerland, are being sold, with the funds being used to compensate victims of the fraud as well as pay the fines imposed by the judge.

Mr. Madoff turned to the courtroom full of his victims and said that he was sorry but, "I know that doesn't help you."[691] Mr. Madoff blamed his pride for his actions, stating that he could not bring himself to admit his failure as a money manager and that he created the Ponzi scheme to cover up his shortcoming in terms of the returns on investments of his clients.

Discussion Questions

1. Mr. Markopolos was dismissed by his bosses and friends even as he provided a list of twenty-eight red flags. What do we learn from his experience about raising questions on the accounting and returns of companies? What can we learn about the reception whistleblowers receive? Did the market, regulators, and investors not want to raise questions because of the steady returns Madoff provided? What role does a questioning attitude play in preventing company collapses?
2. Should investors have suspected the continuing higher levels of returns that never faltered?
3. The Madoff empire could not have lasted as long as it did without complicity from employees.[692] Mr. Madoff's second-in-command, Frank DiPascali, who entered a guilty plea, told the federal judge,

> I'm standing here to say that from the early 1990s until December 2008, I helped Bernie Madoff and other people carry out a fraud. I knew no trades were happening. I knew what I was doing was criminal. But I did it anyway.[693]

Mr. DiPascali's compensation was $2 million per year. He had not completed college at the time Mr. Madoff hired him in the early years of the firm. What might have helped Mr. DiPascali resist the temptation to participate in the fraud?

[688] Catherine Rampell, "A Scheme with No Off Button," *New York Times*, December 21, 2008, WK, p. 8.

[689] Zuckerman, "Chasing Bernard Madoff," p. A1.

[690] *Id.*

[691] Diana B. Henriques, "Madoff, Apologizing, Is Given 150 Years," *New York Times,* June 30, 2009, p. A1.

[692] Kevin McCoy, "Madoff Insider Pleads Guilty to 9 Charges," *USA Today*, November 4, 2009, p. 4B.

[693] Kevin McCoy and Kathy Chu, "Madoff's CFO Pleads Guilty," *USA Today*, August 12, 2009, p 1B.

Case 4.33

Adelphia: Good Works via a Hand in the Till

John Rigas opened his first business in 1952 in Coudersport, Pennsylvania, an old-fashioned movie theater, something he still would own at the time he would be indicted for fraud and other felonies in running Adelphia, the giant cable firm that would spring from this small beginning in media entertainment.

His foray into cable began when he and his brother bought a cable franchise for $300, also in 1952. They chose the name "Adelphia" for their new company, a name which is Greek for "brothers."[694] Early in the 1980s, John bought out his brother's interest in Adelphia and began bringing his grown sons into the business. By 2002, Adelphia was operating cable companies in thirty-two states and had 5.7 million subscribers. At its peak, Adelphia was the sixth largest cable company in the United States. Adelphia claimed that its aggressive marketing was partially responsible for its amazing growth and earnings.[695] Adelphia's annual reports also touted its "clustering strategy," something others in the cable industry did not really understand.[696] Many doubted the existence of such a strategy and questioned Adelphia's performance, but when it went public, its stock skyrocketed.

The Rigas family was respected, indeed revered, in Coudersport. John Rigas was often called "a Greek god" by the locals for his stunning looks as well as his generosity with everyone from employees to the needy. However, subsequent investigations would show that the Rigases had "borrowed" over $3 billion from the corporation for personal investments in hockey teams, golf courses, and even the independent film company created by daughter Ellen Rigas Venetis (married to Peter Venetis, who was also an officer of Adelphia).[697]

There were also webs of transactions between the Rigas family and Adelphia. For example, John Rigas owned a furniture store from which Adelphia purchased all of its office furniture. However, Adelphia then gave the furniture store free ads on its cable and Internet services. A seasoned federal investigator was quite taken aback by what the Justice Department's review of corporate records uncovered, "We've never seen anything like this. The level of self-dealing is quite serious."[698] Mrs. John Rigas, Doris, was paid $12.8 million for her work as a designer and decorator for Adelphia offices. The Rigas family farm, billed as a honey farm in local literature, really just provided landscaping, maintenance, and snow removal services to Adelphia, for a fee.[699] Adelphia invested $3 million in "Songcatcher," a film produced by Ellen Rigas Venetis.[700]

The family managed to conceal the self-dealing quite well from its auditors. When the financial statements were finally restated, cash flow had to be reduced by about $50 million per quarter. In total, the Rigases had concealed S3 billion of takings from the

[694] Eric Dash, "Sorrow Mixed with Disbelief for Patrons of a Community," *New York*, July 9, 2004, pp. A1, A5.

[695] www.adelphia.com/investorsrelations. Accessed April 28, 2010. Because the company no longer exists, this source used originally is no longer available. The 10K reports can be found at www.sec.gov using the EDGAR data base.

[696] *Id.*

[697] Robert Frank and Deborah Solomon, "Adelphia and Rigas Family Had a Vast Network of Business Ties," *Wall Street Journal*, May 24, 2002, pp. A1, A5.

[698] *Id.*

[699] Susan Pulliam and Deborah Solomon, "Adelphia Faces Irate Shareholders," *Wall Street Journal*, April 4, 2002, pp. C1, C2; and Geraldine Fabrikant, "A Family Affair at Adelphia Communications," *New York Times*, April 4, 2002 p. C1.

[700] Fabrikant, "A Family Affair at Adelphia Communications," p. C1; and Geraldine Fabrikant, "New Questions on Auditors for Adelphia," *New York Times,* May 25, 2002, p. B1, at B4.

company from its external auditor, Deloitte Touche.[701] Timothy Werth, who was Adelphia's director of accounting, entered a guilty plea to fraud, securities fraud, wire fraud, conspiracy, and other crimes related to the concealment as well as the falsification of earnings.[702] In his statement of facts for his guilty plea, Mr. Werth said that he had been cooking the books from the time he first joined Adelphia when he was 30 years old, some ten years.

The Rigases owned 20 percent of Adelphia stock and, as a result, held 60 percent of the voting shares of the company. Because of their share control, the board consisted of 60 percent Rigas family affiliates, including John Rigas, sons Michael, James, and Timothy, and son-in-law, Peter Venetis.[703] The family also did business with Adelphia in other ways, and the transactions always seemed to net a nice profit for the Rigases. For example, Adelphia paid $25 million for the timber rights to a piece of properly that it then sold to the Rigas family for $500,000.[704] There were substantial loans made to members of the Rigas family by the corporation, some used for business investments and some used to keep them from selling Adelphia shares to satisfy personal investment responsibilities. There were also conflicts galore among officers, board members, and the Rigas family, with the officers and board members actually competing with Adelphia for the purchase of cable systems and, with something that takes the term *chutzpah* to a new level, the company providing the credit, collateral, and financing for the family members to make the purchases for themselves. The total amount of the loans to the Rigas family was $2.3 billion, much of that amount concealed from the board and auditors through off-the-book entities.[705] It was when a financial analyst uncovered at least $1 billion in off-the-book debts, that the board filed an 8-K disclosure statement and investigators came calling.[706]

The Rigases also owned finance companies that purchased cable services, and then those finance companies entered into contracts to sell cable services to Adelphia.[707] Adelphia was required to purchase the cable services at full retail prices from the Rigas firms. Nell Minow, a renowned corporate governance expert and head of The Corporate Library, said the following about these arrangements: "Even the existence of a credit line that allows the family to buy cable systems raises conflict-of-interest questions because the company was actually funding the family's ability to compete for properties."[708]

One accounting and financial expert said the conduct by the Rigases at Adelphia was just "plain-vanilla-old-fashioned self-dealing."[709] Many referred to the Rigases' conduct as not clever and nothing more than a classic "personal piggy bank" case.[710] The lines between the Rigases' activities and ownership and Adelphia's ownership were so blurred that local tax records showed that Adelphia paid the real estate taxes for all of the Rigas families and their twelve homes with one check.[711] Adelphia also fronted $12.8 million for the construction of a golf course owned by the Rigas family.[712]

[701] Christine Nuzum, "Adelphia's Accounting Magic' Fooled Auditors, Witness Says," *Wall Street Journal*, May 5 2004, p. C5.

[702] "Former Adelphia Executive Enters a Guilty Plea," *New York Times*, November 3, 2003, p. B3.

[703] This information was taken from the proxy for Adelphia for 2001.

[704] Nuzum, *Id.*

[705] www.sec.gov/edgar. March 27, 2002, 8-K filing. Accessed September 11, 2010.

[706] Geraldine Fabrikant, "Adelphia Fails to Make Note Payment," *New York Times,* May 17, 2002, p. C1.

[707] Geraldine Fabrikant, "New Questions on Auditors for Adelphia," *New York Times*, May 25, 2002, pp. B1, B4.

[708] *Id.*

[709] *Id.*

[710] *Id.*

[711] Devin Leonard, "Adelphia," *Fortune*, August 12, 2002, pp. 137, 146.

[712] Jerry Markon and Robert Frank, "Five Adelphia Officials Arrested on Fraud Charges," *Wall Street Journal*, July 25 2002, p. A3.

Wayne Carlin, the regional director for the SEC's northeast division said, "The thing that makes this case stand out is the scope and magnitude of the looting of the company on the part of the Rigas family. In terms of brazenness and the sheer amount of dollars yanked out of this public company and yanked out of the pockets of investors, it's really quite stunning. It's even stunning to someone like me who is in the business of unraveling these kinds of schemes."[713]

Adelphia was, however, a godsend, as it were, to Pennsylvania.[714] Suffering from declines in the coal and steel industries, the Pennsylvania economy was greatly depressed during Adelphia's rise. Because it was a company in a growing industry, nearly everyone in Coudersport would work directly for Adelphia or would benefit indirectly as their businesses picked up because of the company's growth. Rigas was so respected and beloved in the small central Pennsylvania town that it would often take him one hour to walk one block along Main Street because so many people stopped to talk with him, and mostly to thank him for what he had done with the company as well as for them personally.[715] The Rigas family also benefited local business because of their profligate spending on homes, events, help, and decorating.[716] At least twenty Adelphia employees worked personally for the Rigas family, including one who served as a chef for the family.[717] Country folklore holds that the local drycleaner had the following exchange with Mr. Rigas about his wife, Doris, and her spending: "That woman is costing you millions." To which Mr. Rigas replied, "Well, sometimes it's worth it. Because when she's bothering [the contractors], she's not bothering me."[718]

The Rigas family was very generous with the people of Coudersport. Mr. Rigas donated to the Coudersport Fire Department and paid $50,000 so that the veterans' monument in the town could have the worn-away names of the veterans restored. He gave the necessary funds to McDonald's and Subway so that they could change the outward appearances of their businesses to look more like the Main Street USA image that the Rigases wanted to preserve in Coudersport.[719] The Rigas family threw the Coudersport Christmas party. Doris decorated two large Christmas trees for the party, with 16,000 lights each.[720] Mr. Rigas used the original theater that began his business career to allow more people to attend the movies. The prices at the Rigas Coudersport theater: Adelphia employees admitted for free; others for $4; candy for 60 cents and popcorn in a tub for $2.25.[721]

Adelphia's philanthropic program was called "Because we're concerned," and donations went to Boy Scouts and Girl Scouts of America, the March of Dimes, Ronald McDonald House, YMWC, YWCA, Habitat for Humanity, Leukemia Society of America, Lupus Foundation of America, Meals on Wheels, and Toys for Tots.[722] The Tennessee Titans' stadium was named "Adelphia Field." (The stadium is now LP Field.)

[713] *Id.;* and David Lieberman, "Adelphia's Woes 'a Total Shock' to Many," *USA Today*, April 5, 2002, p. 3B.

[714] Markon and Frank, "Five Adelphia Officials Arrested on Fraud Charges," p. A3; and Lieberman, "Adelphia's Woes 'a Total Shock to Many," *USA Today*, April 5, 2002, p. 3B.

[715] Deborah Solomon and Robert Frank, "Adelphia Story: Founding Family Retreats in Crisis," *Wall Street Journal*, April 5, 2002, pp. B1, B4.

[716] Leonard, "Adelphia," p. 137.

[717] Geraldine Fabrikant, "Adelphia Said to Inflate Customers and Cash Flow," *New York Times*, June 8, 2002, pp. B1 B3.

[718] Leonard, "Adelphia," p. 137.

[719] John Schwartz, "In Hometown of Adelphia, Pride, but Worry About the Future, Too," *New York Times,* May 28, 2002, p. C1.

[720] Leonard, "Adelphia," p. 137.

[721] Schwartz, "In Hometown of Adelphia, Pride, But Worry About the Future, Too," p. C1.

[722] www.adelphia.com/investors—annual reports for 1999 and 2000. Because the company no longer exists, this source used originally is no longer available. The 10K reports can be found at www.sec.gov using the EDGAR data base.

But Rigas philanthropy went beyond these large public actions and donations. When John Rigas read a story in the local paper about someone experiencing financial difficulties, he would send the person a check and a note that read, "I read your story in the newspaper."[723] Mr. Rigas offered the company jet to employees and family members who needed to go out of state for medical care. He would even follow up with personal phone calls to these beneficiaries of the corporate jet by calling to see how the treatment had gone.[724] Mr. Rigas was inducted into the Cable Television Hall of Fame for his good works in Coudersport and the other communities served by Adelphia.[725]

The reaction in Coudersport to the Adelphia collapse and all of the indictments of the Rigas family was one of utter shock and disbelief. One Adelphia officer said that he "hasn't heard Rigas utter a slur or profanity in 32 years. The whole story isn't known. That's part of the problem."[726] One town member explained, "Whatever has to be done to make it right, they'll do. People don't know the real John Rigas."[727]

John Rigas and his son, Timothy, were convicted of bank fraud, securities fraud, and conspiracy. Michael Rigas was acquitted of conspiracy and wire fraud, but there was a hung jury on securities and bank fraud. The judge declared a mistrial.[728] John Rigas was originally sentenced to fifteen years, but with an intervening U.S. Supreme Court decision on the proper application of the sentencing guidelines, he was resentenced in 2007. However, his sentence remained at fifteen years because the federal judge noted that were it not for Mr. Rigas's age and failing health, he would have imposed a longer sentence. Because he was 82 at the time of the sentencing, Mr. Rigas will spend his life in prison unless he is able to show through a doctor's report that he is within six months of death. He will be released if and when that medical certification can be made. The judge also said he would review the sentence again when and if Mr. Rigas has served two years.

Discussion Questions

1. Does using money for good deeds excuse violations of the law or accounting principles? Is John Rigas a Robin Hood?
2. Why do you think the officers got comfortable with the conflicts and mixing together of personal and company business interests? Did the philanthropy and good for Pennsylvania provide their justification?

Compare & Contrast

1. What principles of social responsibility do you develop from this case? Are virtue ethics different from the issues raised in social responsibility? Was the Rigas family socially responsible? Were they ethical? Was Adelphia a socially responsible company? Was its conduct fair to its shareholders?
2. When he was indicted, Mr. Rigas issued the following statement: "We did nothing wrong; my conscience is clear about that."[729] He also attributed all of the government indictments as well as the shareholders' litigation against him as "a big P.R. effort on the part of the outside directors and their lawyers to shift

[723] Leonard, "Adelphia," pp. 137, 146.

[724] Schwartz, "In Hometown of Adelphia, Pride, But Worry About the Future, Too," p. C1.

[725] *Id.*

[726] David Lieberman, "Adelphia's Woes 'a Total Shock' to Many," *USA Today*, April 5, 2002, p. 3B.

[727] *Id.*

[728] Barry Meier, "Michael Rigas Is Free for Now after Mistrial Declared," *New York Times*, July 16, 2004, p. B1.

[729] From *Business: Its Legal, Ethical and Global Environment*, 9th ed., by Marianne Jennings, 60. Copyright © 2011 Reprinted with permission by South-Western, a division of Cengage Learning.

responsibility."[730] Given Mr. Rigas's convictions, why did he remain so defiant and unwilling to acknowledge the misconduct? As you study other cases in the book, note how many other convicted CEOs express the same sentiments. Offer some reasons they might feel so diametrically different from those who have prosecuted them, convicted them, or sought recovery for their losses.

Case 4.34

The Atlanta Public School System: Good Scores by Creative Teachers

For almost a decade the scores of Atlanta Public Schools students on the Criterion Referenced Competency Tests (CRCT) were phenomenal. The students were reading at or above their grade levels, and then-Superintendent Beverly Hall won educator of the year as well as recognition from the White House for her efforts and great success.[731]

However, the scores were not real because cheating was pervasive through the district and "outrageous," as the governor's special investigation report labeled it. The conduct documented in the report included the following:

- Teachers and students erased incorrect answers and put in correct answers after the testing was complete.
- The changing of answers was so sophisticated that plastic transparency answer sheets were created to make changing more efficient.
- Teachers arranged classroom seating so that struggling students were better able to "cheat off" the brighter students.
- First- and second-grade teachers used voice inflection when reading the questions and answers to their students (the tests are administered orally in those grades because not all students can read at that point) so as to give away the correct answers.
- Some teachers just gave the answers aloud to their students.
- Teachers pointed to correct answers while standing next to students' desks as they took the test.
- Some teachers allowed students to go back and change answers on their tests that they had taken the day before.
- One child who had sat under his desk on testing days and refused to take the test still had a passing score.
- The teachers changed test answers with gloves on (no fingerprints wanted) at what they called "test clean-up" parties on the weekends, some of which were held at principals' homes.
- Teachers looked ahead to the questions for the next day and discussed the questions with the students before they took the next day's test.[732]

The governor's report cited three key reasons that such levels of cheating flourished in APS. The first was that the district set unrealistic test-score goals, or "targets."[733] For example, the target each year was always higher for each grade even if the students entering that grade had lower test scores from the previous years. Once inflated by the cheating, it became impossible to attain the new target scores without cheating. The second was the result of that pressure, which was a culture of pressure and retaliation with terminations and bizarre public treatment when test scores fell below targets. The investigative report includes pages of examples of retaliation against principals and teachers who raised objections to changing answers and questioned the validity of the test scores. In

[730] Andrew Ross Sorkin, "Fallen Founder of Adelphia Tries to Explain," *New York Times*, April 7, 2003, p. C1.

[731] Governor's Report, CRCT (Criterion Referenced Competency Test) Investigation (hereinafter CRCT Report), April 2011, vol. 1., http://www.atlanta.k12.ga.us/Page/410.

[732] CRCT Report, p. 18.

[733] *Id.*

situations where those who raised questions were terminated, their claims against the school district were settled if they claimed retaliation so that the matters were kept from the public eye. The third was Ms. Hall emphasizing test results and doling out public praise for those who achieved those results "at the expense of ethics."

Because the targets were raised each time a school reached them, the pressure increased each year. "Cheating one year created a need for more cheating the next," and "Once cheating started, it became a house of cards that collapsed on itself." The report also concluded that "APS became such a 'data-driven' system, with unreasonable and excessive pressure to meet targets, that Beverly Hall and her senior cabinet lost sight of conducting tests with integrity."

Ms. Hall earned over $383,000 in bonuses over a decade for the scores that were achieved through the manipulations. The cheating scandal was able to go on for nearly a decade because of what an investigative report referred to as a culture of fear. There was a code of silence about the behaviors. When a teacher/whistleblower filed a report on the cheating problems, an area superintendent in the district had him alter what he said in his report and then put a reprimand in his file. No action was taken to address the cheating by the teacher named in his report. Another teacher who witnessed tampering with test answers sheets was told that if she did not "keep her mouth shut," she would "be gone."

At district meetings, principals who attained the level of test scores desired were permitted to sit up front near Ms. Hall. Those principals who resisted the cheating and did not attain the level of scores that was required were forced to sit in the bleachers along the side.[734] Teachers with low scores were forced to sit under tables in meetings. And those who dared asked why they were changing students' answers were terminated, transferred, or investigated. Those who achieved their test scores were given bonuses between $750 and $2,600. Twenty-five percent of principals' performance evaluations were based on test scores, and if their schools did not achieve targets within three years, they were replaced.

In 2011, a statistical study by the *Atlanta Journal-Constitution* indicated that the scores were not likely authentic. A subsequent investigation showed that the test answer sheets had been altered in substantial ways. Ms. Hall resigned, and a number of principals and teachers also resigned and were disciplined by the district, which including losing their jobs as well as their teaching certificates. Over 178 employees of the school system were sanctioned for altering test answer sheets, falsifying scores, and helping students answer questions for students during exams. The APS was placed on probation by the accrediting bodies for public education systems.

With a new superintendent, Erroll C. Davis, now in place, the school system is moving forward to correct the problems that resulted from the falsified scores, including the realities that some students were five grade levels behind in their reading scores despite excellent test scores for the past five years. There were significant difficulties with special ed students because they had been unable to get the help that they needed with their work during the cheating era because their test scores were too high to qualify them for assistance.

Ms. Hall and thirty-four other employees of the school system have been indicted by the Fulton County District Attorney on a variety of white-collar crimes including falsifying records, conspiracy, racketeering, false swearing, and obtaining money or property through false pretenses. The last charge relates to the bonuses Ms. Hall and others were

[734] Michael Winerip, "A New Leader Helps Heal Atlanta Schools, Scarred by Scandal," *New York Times*, February 21, 2012, p. A12.

paid for reaching certain goals on the test scores. In addition to district administrators who have been indicted (including the director of human resources), the indictment charges teachers and principals at elementary, middle, and high schools with similar counts of criminal activity.

Some of the charges relate to actions taken when whistleblowers came forward while the test scores were being changed. In several cases, the whistleblowers were given poor performance evaluations as a means of terminating them so that the scandal did not become public knowledge.

Because all of the documents involved, including the tests themselves, are considered to be state records, most of those indicted are charged with falsification or alteration of public documents, a felony.

The twenty-one-month investigation by the district attorney's office includes information obtained when whistleblowers wore wires and gathered recordings of those indicted that reflect their alteration of exam answer sheets. The disclosures in the recorded conversations are particularly damning from a criminal perspective, even as they are heart wrenching as the consequences for their behaviors sets in. The following is one of the recorded conversations reflected in the indictments between Clarietta Davis, a principal at one of the schools, and Milagros Money, the testing coordinator at the school:

Ms. Moner: I can't eat. I can't sleep, my kids want to talk to me, I ignore them.... I don't have the mental energy.

Ms. Davis: You wouldn't believe how people just look at you. People you know.

Ms. Moner: You feel isolated.

Ms. Davis: There's no one to talk to.... See how red my eyes are? And I'm not a drinking woman.

Ms. Moner: It has taken over my life. I don't want to go to work. I pray day and night. I pray at work.

Ms. Davis: You just have to pray for everybody.[735]

Ms. Davis invoked the Fifth Amendment when investigators came to talk to her after the tape was recovered from Ms. Moner.[736]

Discussion Questions

1. Why did the cheating culture exist?
2. What made the cheating culture continue?
3. Explain how those who raised questions were treated.
4. Make a list of all who were affected by the cheating and the consequences.
5. Explain why teachers, principals, and administrators continued to participate in the cheating.

Case 4.35

The NBA Referee and Gambling for Tots

Tim Donaghy, a referee for the NBA, entered a guilty plea to two federal felony charges in connection with his bets and tips on NBA games. The charges are conspiracy to engage in wire fraud and transmitting betting information via interstate commerce. Mr. Donaghy picked teams to win in games he was scheduled to referee. Experts have said that Donaghy committed the equivalent of insider trading on Wall Street by providing outsiders with information about games, players, and referees. He got $5,000 from his tippees for correct picks.

[735] The indictment can be found at http://www.ajc.com/documents/2013/mar/29/read-indictment/.

[736] Michael Winerip, "35 Indicated in Test Scandal at Atlanta Schools," *New York Times*, March 30, 2013, p. A1.

According to the indictments, Donaghy began betting on games in 2003, but in December 2006 began passing along inside information to others who have also been charged in the conspiracy. The communication was in code via cell phone. Through his lawyer, Donaghy has indicated that he has a gambling addiction problem and is currently on medication and under the treatment of a psychiatrist.

The NBA Commissioner, David Stern, has referred to Donaghy as a "rogue referee," but says that the gambling charges were a wake-up call for the NBA and that it must not be "complacent."[737]

Because Mr. Donaghy's bets were through illegal gambling channels, any monitors the NBA had at Las Vegas sports books would not have been triggered. In fact, Mr. Donaghy's missteps were discovered as the federal government was conducting an investigation into the Gambino crime family, based in Brooklyn. The two men who are alleged to have worked with Donaghy on the gambling scheme and inside information are James Battista and Thomas Martin. The three men were friends during high school.

Commissioner Stern says that the NBA will be looking at the checks and balances that the NFL has built into its system, including prohibitions on referees of traveling to Las Vegas and other gambling resorts without prior approval. The NFL also has significant background checks and ongoing monitoring of its referees.

Mr. Donaghy ran a basketball clinic for developmentally disabled boys in Springfield, Pennsylvania (Mr. Donaghy's hometown) for almost a decade. He was a graduate of Villanova and had worked his way up to being one of the NBA's top referees, coming through the ranks of refereeing in both high school and the Continental Basketball Association. His salary with the NBA during 2006 was $260,000.

Mr. Donaghy entered a guilty plea to the federal charges in 2007, was divorced in 2007, served fifteen months in federal prison from 2007–2008, and upon his release, wrote a book about his experience. The original name for the book under one publisher was *Blowing the Whistle: The Culture of Fraud in the NBA*, but the publisher canceled the book after it says the NBA threatened to take legal action, that is, file a defamation suit. Mr. Donaghy found another publisher, with a book that took a slightly different angle, called *Personal Foul: A First-Person Account of the Scandal That Rocked the NBA*. In an interview following his release from prison, Mr. Donaghy commented on the activities of Wall Street traders before the 2008 collapse, noting that what he did was "No different than [*sic*] Wall Street insider trading. Except I didn't affect the economy."[738]

Discussion Questions

1. Why do you think Mr. Donaghy was engaged in the gambling?
2. Doesn't his civic activity paint a different picture of his character?
3. Evaluate Mr. Donaghy's quotes comparing his behavior to what Wall Street traders did.

Case 4.36

Giving and Spending the United Way

The United Way, which evolved from the local community chests of the 1920s, is a national organization that funnels funding to charities through a payroll deduction system.

[737] Roscoe Nance, "Scandal Is a 'Wakeup Call,' Stern Says," *USA Today*, August 16, 2007, p. 2C.

[738] "Tim Donaghy Is Out of Prison But Still in Exile," *New York Times Magazine*, January 7, 2011, http://www.nytimes.com/2011/01/09/magazine/09FOB-Encounter-t.html?_r=0.

Ninety percent of all charitable payroll deductions in 1991 were for the United Way. This system, however, has been criticized as coercive. Bonuses, for example, were offered for achieving 100 percent employee participation. Betty Beene, president of United Way of Tristate (New York, New Jersey, and Connecticut), commented, "If participation is 100 percent, it means someone has been coerced."[739] Tristate discontinued the bonuses and arm-twisting.

United Way's system of spending also came under fire through the actions of William Aramony, president of the United Way from 1970 to 1992. During his tenure, United Way receipts grew from $787 million in 1970 to $3 billion in 1990. But some of Aramony's effects on the organization were less positive.

In early 1992, the *Washington Post* reported that Aramony

- was paid $463,000 per year;
- flew first class on commercial airlines;
- spent $20,000 in one year for limousines; and
- used the Concorde for transatlantic flights.[740]

The article also revealed that one of the taxable spin-off companies Aramony had created to provide travel and bulk purchasing for United Way chapters had bought a $430,000 condominium in Manhattan and a $125,000 apartment in Coral Gables, Florida, for his use. Another spin-off had hired Aramony's son, Robert Aramony, as its president.

When Aramony's expenses and salary became public, Stanley C. Gault, chairman of Goodyear Tire & Rubber Company, asked, "Where was the board? The outside auditors?"[741] Aramony resigned after fifteen chapters of the United Way threatened to withhold their annual dues to the national office.

Said Robert O. Bothwell, executive director of the National Committee for Responsive Philanthropy, "I think it is obscene that he is making that kind of salary and asking people who are making $10,000 a year to give 5 percent of their income."[742]

In August 1992, the United Way board of directors hired Elaine Chao, the Peace Corps director, to replace William Aramony at a salary of $195,000, with no perks.[743] She reduced staff from 275 to 185 and borrowed $1.5 million to compensate for a decline in donations. By 1995, United Way donations had still not returned to their 1991 level of $3.2 billion. Ms. Chao has since left the United Way and served as secretary of labor for the Bush administration from 2001–2009. Ms. Chao is married to Republican U.S. Senator Mitch McConnell of Kentucky.

In September 1994, William Aramony and two other United Way officers, including the chief financial officer, were indicted by a federal grand jury for conspiracy, mail fraud, and tax fraud. The indictment alleged the three officers diverted more than $2.74 million of United Way funds to purchase an apartment in New York City for $383,000, interior decorating for $72,000, a condominium, vacations, and a lifetime pass on American Airlines. In addition, $80,000 of United Way funds were paid to Aramony's girlfriend, a 1986 high school graduate, for consulting, even though she did no work.

On April 3, 1995, Aramony was found guilty of twenty-five counts of fraud, conspiracy, and money laundering. Two other United Way executives were also convicted.

[739] Susan Garland, "Keeping a Sharper Eye on Those Who Pass the Hat," *BusinessWeek*, March 16, 1992, p. 39.

[740] As reported in "Ex-Executives of United Way Indicted," *(Phoenix) Arizona Republic*, September 14, 1994, p. A6.

[741] Garland, "Keeping a Sharper Eye on Those Who Pass the Hat," p. 39.

[742] Felicity Barringer, "United Way Head Is Forced Out in a Furor over His Lavish Style," New York Times, February 28, 1992, p. A1.

[743] Desda Moss, "Peace Corps Director to Head United Way," *USA Today*, August 27, 1992, p. 6A; and Sabra Chartrand, "Head of Peace Corps Named United Way President," *New York Times*, August 27, 1992, p. A8.

Mr. Aramony was sentenced to eighty-four months in prison (and fined $300,000) and was released in 2004. He lives in Alexandria, Virginia, and United Way executives continue to refer to his tenure and all the problems associated with it as "the great unpleasantness."

By April 1998, donation levels were still not completely reinstated but did increase (up 4.7 percent) for the first time since the 1992 Aramony crisis. Relationships between local chapters and the national organization were often strained, and the recent Boy Scouts of America boycott has created additional tension. United Way's donations fell 11 percent since 1991, while overall charitable giving was up 9 percent.

In January 2000, a federal district court judge awarded Mr. Aramony the full value of his deferred compensation plan, or $4.2 million. Judge Shira Scheindlin ruled in favor of Mr. Aramony because she said there was no clause for forfeiting the money if Mr. Aramony committed a felony. Such a so-called "bad boy clause" had been discussed by the board when it was in the process of approving the deferred compensation plan for Mr. Aramony and other United Way executives. However, the bad-boy clause never made it into the final agreement.[744]

Judge Scheindlin also ruled that United Way could withhold $2.02 million of the amount due under the deferred compensation plan to cover salary, investigation costs, and interest on those amounts. She did not award Mr. Aramony attorneys' fees for having to bring the suit against United Way to collect his deferred compensation.

Many in the nonprofit field say that the shadow of William Aramony looms over the nonprofit world. However, when he was released from prison in 2002, the warden, guards, and inmates, who all called him "Mr. Aramony," spoke of him with fondness because of his work in prison in trying to provide educational opportunities for his fellow inmates. They described him as being tireless in his efforts to teach everything from reading to math to, ironically, business operations. Mr. Aramony passed away in November 2011.

Discussion Questions

1. Was there anything unethical about Aramony's expenditures?
2. Was the board responsible for the expenditures?
3. Is the perception as important as the acts themselves?
4. If Aramony were a CEO of a for-profit firm, would your answers change?
5. What obstacles did Chao face as she assumed the United Way helm?
6. Do you think Aramony should have asked for his deferred compensation funds? Why would the board pay him those funds? What could boards do to limit compensation paid to CEOs who resign following misconduct at the company?

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Barringer, Felicity, "Ex-Chief of United Way Vows to Fight Accusations," *New York Times*, April 10, 1992, p. A13.

Duffy, Michael, "Charity Begins at Home," *Time*, March 9, 1992, p. 48.

"Ex-Executives of United Way Indicted," *Arizona Republic*, September 14, 1994, p. A6.

Kinsley, Michael, "Charity Begins with Government," *Time*, April 6, 1992, p. 74.

Moss, Desda, "Change Is Focus of United Way Meeting," *USA Today*, August 19, 1992, p. 7A.

[744] David Cay Johnston, "Ex-United Way Chief Owed $4.2 Million," *New York Times*, January 5, 2000, p. C4.

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Moss, Desda, "Former United Way Chief Charged with Looting Funds," *USA Today*, September 14, 1994, p. 1A

Moss, Desda, "United Way's Ex-Chief Guilty of Using Funds," *USA Today*, April 14, 1995, p. 1A.

Case 4.37

The Baptist Foundation: Funds of the Faithful

Although founded in 1948, the Baptist Foundation of Arizona (BFA) took a dramatic strategic step in 1984 with a shift away from raising funds for starting up churches to a real estate investment nonprofit corporation. In its early days of the new strategy, the BFA did quite well because with a real estate boom, property values were increasing. In addition to a profitable real estate market, the BFA had a psychology going with its fund and with recruiting investors. Each year, at its annual convention the BFA distributed its "Book of Reports," a financial compilation given to the convention attendees. However, the "Book of Reports" could be given to others as a means of recruiting new investors. The BFA used the term *stewardship investment* to describe the sort of higher calling that those who invested in BFA had. And for a good many years it looked as if Providence had had some hand in the BFA, for it was offering higher than market returns.[745]

However, by 1988 both the Arizona economy and its real estate market were sinking fast. Rather than disclose that the downturn had affected its holdings (as it had for all other real estate firms, for-profit and nonprofit alike), BFA opted not to write down its properties. The management team's compensation was tied to the performance of the fund. Arthur Andersen, the auditor for BFA, noted the presence of specific revenue targets set by management for each quarter, with compensation packages tied to those targets.

The nondisclosure was accomplished through the use of complex layers of transactions with related parties, accounts receivable, and a host of other accounting sleights of hand that allowed BFA to look as if it still had both the assets and income it had before the market downturn. BFA carried the properties at their full original values on its books, not at their true market values, figures that would have been significantly less and were driving many other real estate investment firms into bankruptcy. BFA's income doubled between 1996 and 1997, and had climbed from $350,000 in 1988 to $2.5 million in 1997. The numbers seemed quite nearly inexplicable given the downturn and the performance of all other real estate funds. BFA was selling its properties to board members and companies of board members at their book value or slightly higher in an effort to show gains, income, and cash flow for the BFA.

Funds never really changed hands in these related parties' transactions. The transfers of funds and properties were like a large shell game among and between various nonprofit entities. Some of the twenty-one individuals on the BFA board who decided against writing down the properties were also parties to the pseudo sales transactions of the properties to ALO and New Church Ventures. According to forensic auditors, a former director of BFA created ALO, Inc., and New Church Ventures, Inc., also nonprofit organizations. These corporations were shell corporations with no employees. However, significant amounts of BFA income were transferred to these two nonprofits as management fees, accounting fees, and marketing and administrative services fees. ALO purchased BFA's overvalued real estate holdings in exchange for promissory notes.

[745] This information can be found in the criminal information, cease and desist order, and bankruptcy filings all located at the Arizona Corporation Commission website, http://www.ccsd.cc.state.az.us.

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Arizona Corporation Commission records show that for 1997, ALO reported that it owed BFA $70.3 million and New Church ventures $173.6 million.

BFA also created a web of other subsidiaries, including Christian Financial Partners, EVIG, and Select Trading Group. This tangled web made it difficult for potential investors to understand what BFA was doing or how it was earning its funds.

Because BFA's financial statements looked phenomenal, more investors joined, and the fraud lasted until 1999. In 1999, state officials issued a cease and desist order to stop BFA from soliciting and bringing in new investors. In 1998, Andersen identified "earnings management" as a significant problem at BFA. However, Andersen did not see the earnings management as enough of a problem to halt its certification of BFA's financial statements. Andersen did question the significant transfers of fees to ALO and New Church Ventures. However, BFA officials never responded to auditors' requests for these two entities' records. Interestingly, the Arizona Corporation Commission records that showed the negative net worth of these two companies would have been available to anyone as a public record.

By the time the Baptist Foundation of Arizona collapsed in 1999, about 11,000 investors would lose $590 million.[746] The Arizona Attorney General's Office, which issued indictments and tried the fraud cases, called BFA the largest "affinity fraud" in U.S. history. Pastors and ministers had encouraged their parishioners to invest in BFA for their retirement even as the BFA used the funds to "do the Lord's work,"[747] including using the funds to build nursing homes for the aging and infirm, pay the salaries of pastors, and provide funding for Baptist ministries and missionary work. The fund was not a difficult sell because of the pledged noble efforts.

Andersen was charged with violations of Arizona securities laws for its failure to issue a qualified opinion on BFA when it became aware of the failure to write down properties as well as the earnings management strategies. Andersen settled with Arizona officials and agreed to pay $217 million in losses to investors, but by the time of the settlement, Andersen was embroiled in the Enron and WorldCom settlements, and the ability to collect on the agreement was limited. Eight former BFA employees were indicted. Six entered guilty pleas and agreed to testify against Thomas Grabinski, the BFA's former general counsel, and William Crotts, the former BFA president. Following a trial that lasted ten months, Crotts was sentenced to six years and Grabinski to eight years for convictions on fraud and racketeering.[748]

The two men were also required to pay $159 million in restitution. Interestingly, the jury acquitted the two men of theft, and the trial reversed several of the convictions following a motion for post-judgment relief. The sentences were not imposed until September 2006, and the appeal on their cases was decided in 2009, with the appellate court affirming their convictions.[749] The appeal centered on an evidentiary question about a former officer who had entered into a plea agreement in exchange for his testimony. During the course of the trial, the former officer told prosecutors that he had lied in his earlier testimony. However, the appellate court concluded that defense lawyers were given additional time to recall witnesses and clear up the record and that there was no reversible error.

[746] *Arizona v. Crotts*, Az. App. June 2, 2009 (unpublished opinion). http://www.cofad1.state.az.us/memod/cr/cr060818.pdf. Accessed July 1, 2010.

[747] Michael Kiefer, "2 Given Prison for Fraud Involving Baptist Group," *Arizona Republic*, September 30, 2006, pp. B1, B2.

[748] *Id.*

[749] *Arizona v. Crotts*, Az. App. June 2, 2009 (unpublished opinion). http://www.cofad1.state.az.us/memod/cr/cr060818.pdf. Accessed July 1, 2010.

Discussion Questions

1. What similarities do you see between this nonprofit case and the cases of Enron, WorldCom, and Tyco? Compare Andersen's conduct in Enron with Andersen's conduct in this case.
2. List the conflicts of interest you can see from the case.
3. Why do you think the board members thought they were immune from the economic cycle Arizona was experiencing?

Source

Criminal information, the cease and desist order, and bankruptcy filings are all located at the Arizona Corporation Commission website: http://www.azcc.gov.

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Ethics and Contracts

UNIT FIVE

A party cannot escape a contractual obligation by signing with its fingers crossed behind its back, even if that clearly shows its intent not to be bound.

Robbins v. Lynch, 836 F.2d 330 (7th Cir. 1988)

An insured should not have to consult a long line of case law or law review articles and treatises to determine the coverage he or she is purchasing under an insurance policy.

Kovach v. Zurich Am. Ins. Co., 587 F.3d 323 (6th Cir. 2009)

When Paul Ceglia made his claim that he had a contract with Mark Zuckerberg for 50 percent ownership in Facebook, the two ended up in litigation. The case centered on a two-page agreement. Mr. Zuckerberg said that the signature on the second page was his, but the first page contained things that he had not agreed to. Handwriting and documents experts examined the first page and concluded that Mr. Ceglia had baked the first page in the sun to make the ink look aged. Another effect of the baking would be the expert's inability to test the ink. However, the experts found markings on that first page – clip marks where the document had been hung in the sun. One expert said that the clip markings were like the tan lines caused by a swimsuit.

There is contract law. There are standards of proof for contract agreements. And then there are the ethical issues, such as baking a piece of paper in the sun to establish that you had a contract. This section examines the ethical issues in contracts from advertising to obtain contracts to the failure to keep the promises in a contract once you have it.

SECTION A

Contract Negotiations: All Is Fair and Conflicting Interests

Case 5.1

The Governor and Negotiations for Filling a President's Senate Seat

Illinois governor Rod Blagojevich was arrested in the early hours of the morning at his Chicago home on January 9, 2009. He was arrested on the basis of wiretap transcripts of his conversations with various political operatives and officials about who should be appointed by him to fill the U.S. Senate seat vacated by President Barack Obama upon his election to the presidency. The conversations discuss whether the individuals would be willing to hold fundraisers for him and allude to the fact that there was a pay-to-play system in operation. Mr. Blagojevich stated on the tapes, "I want to make money … [the Senate seat] is a valuable thing, you don't just give it away for nothing. … I've got this thing and it is f______ golden, and, uh-uh, I'm just not giving it up for f______ nothing. I'm not gonna do it. And I can always use it. I can parachute me there."[1]

There were also other tapes of Mr. Blagojevich's brother talking with Roland Burris, the man who would eventually be appointed to the seat, during which Robert Blagojevich asks Mr. Burris for checks: "You know if you guys could just write some checks, that'd be fine." Mr. Burris responds, "OK, OK, well, we—I—I will personally do something. I know I could give a check. Myself."[2]

After Mr. Blagojevich was indicted on sixteen felony counts of racketeering conspiracy, wire fraud, extortion conspiracy, attempted extortion, and making false statements to federal agents, he was impeached and thereby removed as governor. Indicted along with the impeached former governor were his brother, two former chiefs of staff, a campaign fundraiser, and a businessperson in what federal authorities referred to as an enterprise of corruption.

One former chief of staff for the former governor has been cooperating with the prosecutors in the case. Prosecutors allege that from the day he took office until he was arrested on January 9, 2009, the former governor was selling everything from signing bills to appointments to commissions. In one portion of the indictment, prosecutors allege that the former governor would simply agree to do something for someone in exchange for their holding a fundraiser for him. Prosecutors are calling the extensive efforts to gain from his political power the Blagojevich Enterprise.

Mrs. Blagojevich, who was heard speaking on some of the taped conversations, was not indicted. Mr. Blagojevich declared his innocence and carried through with his vow

[1] Douglas Belkin, Lauren Etter, and Timothy W. Martin, "Governor Jailed in Alleged Crime Spree," *Wall Street Journal*, December 8, 2008, p. A1; and Judy Keen and Mimi Hall, "Feds: Governor Tried to Sell Senate Seat," *USA Today*, December 10, 2008, p. 1A.

[2] AP, "On Tape, Burris Vows to Help Blagojevich," *USA Today*, May 27, 2009, p. 6A.

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to fight the charges and clear his name as the trial began on June 1, 2010. He proclaimed, "I have done absolutely nothing wrong."[3]

The trial was off to a raucous start, with the judge ordering Mr. Blagojevich to stop tweeting during the trial and his defense lawyer offering the following insights in his opening statement: "That man is as honest as the day is long," as he pointed to his client, and that Mr. Blagojevich has "good ethics" and "beautiful hair" even as he let the jurors know that "Rod has cheated on Patti."[4]

Assistant U.S. Attorney Carrie Hamilton offered the jurors a different perspective: "He corrupted the office of the governor. When you hear him say this senate seat is golden and he's not giving it up for nothing."[5]

Following a six-week trial, the jury deliberated for ten days and convicted Mr. Blagojevich on only one of the twenty-four felony counts, that of lying to the FBI during the course of the investigation. The jury was hung on the remaining counts, and the judge declared a mistrial on those counts. The case was retried on one count of attempting to sell the Senate seat. In the second trial, Mr. Blago took the stand.[6] He was convicted, and at his sentencing hearing offered the following, "I caused it all. I'm not blaming anyone. I was the governor, and I should have known better. I am just so incredibly sorry."[7] He was sentenced to fourteen years, and reported to federal prison on February 16, 2012.[8] He is required to serve 85 percent of his sentence, which means that he is not eligible for early release until May of 2022.

Discussion Questions

1. When the federal charges were announced, Chicago alderman Brian Doherty expressed his outrage over the former governor's conduct, "This is not like a guy taking $500 for a zoning change. This is selling a U.S. Senate seat."[9] Evaluate Mr. Doherty's statement for quality of its ethical reasoning.
2. What ethical category would the governor's conduct fall into?
3. How do you respond to Mr. Blagojevich's defense based on the notion that he was doing things that had always been done in Chicago?
4. List the stakeholders in this scenario, and explain how they are affected.

Case 5.2

Facebook and the Pre-IPO

Before Facebook issued its first publicly traded shares (initial primary offering or IPO) on May 18, 2012, it was required to include a prospectus in its filing with the Securities Exchange Commission (SEC). The prospectus identifies for potential share purchasers the risks that the company has, as well as the risks that could affect the value of the shares going forward. The Facebook prospectus identified thirty-eight different risks,[10] including the following:

[3] 15Judy Keen, "Blagojevich, Five Associates Indicted," *USA Today*, April 3, 2009, p. 3A; and Monica Davey and Susan Saulny, "Blagojevich Indictment Lays Out Broad 'Enterprise' of Corruption," *New York Times*, April 3, 2009, p. A1.

[4] Ruth Rave, "Blago: 'Honest' with 'Beautiful Hair,'" June 8, 2010, http://liveshots.blogs.foxnews.com/2010/06/08/blago-honest-and-with-beautiful-hair. Accessed July 1, 2010.

[5] "Lawyers Give Openings in Blagojevich Trial," June 8, 2010, http://upi.com. Accessed July 1, 2010.

[6] Julie Jargon, "Blagovich Denies Shaking Down Executive," *Wall Street Journal*, May 28–29, 2011, p. A4.

[7] Monica Davey, "Blagojevich Draws 14-Year Sentence for Corruption," *New York Times*, December 8, 2011, p. A14.

[8] Joe Barrett, "Blagojevich Gets 14-Year Term," *Wall Street Journal*, December 8, 2011, p. A5.

[9] *Id.*

[10] The Facebook S-1 registration statement is on the SEC website: http://sec.gov/Archives/edgar/data/1326801/000119312512034517/d287954ds1.htm.

1. There were the usual risks of an Internet company—restricted growth in some countries, such as China; difficult business approval and access for international growth; and retention of a large block of stock by the founder, Mark Zuckerberg (something that limits changes and gives him decision-making control), patent litigation, and concerns about breaches of privacy with the information users post on Facebook.
2. There were disclosures about revenue. Facebook is dependent on advertisers for revenue. If advertisers change their minds about placing ads or question whether Facebook is an effective place to reach customers, those ad dollars disappear. And 85 percent of Facebook's revenue comes from ads.
3. Just one week before the IPO, Facebook amended its prospectus and disclosed a unique risk that Facebook had that was growing. Facebook users were shifting from accessing their accounts on computers to access on their phones. Those who go to their Facebook pages online are more likely to click on ads or discover and buy a new product. The ads were not, at that time, displayed when Facebook users accessed their Facebook pages through their phones. When General Motors (GM) learned of this shift in users' habits, it pulled its advertising from Facebook, a $10 million account. The extent of the shift to mobile access was not made clear in the prospectus, nor were all eventual purchasers of Facebook shares aware of the last-minute changes to the prospectus. Facebook communicated the new information plus some additional information that was not in the prospectus changes to research analysts, who then communicated the information to their large institutional clients, but the information never made it down to the retail or individual investor level.

The IPO was the third largest IPO in Wall Street history, but it was not the most successful. When the IPO began, there were a series of problems with the offering, such as NASDAQ being slow to confirm orders and Morgan Stanley (the lead underwriter for the IPO) having to purchase shares in order to keep the initial offering price of $38 from dropping below that level.[11] By the second day following the offering, the share price had dropped 10.4 percent. As the issue of the mobile shift became clear, Facebook shares dropped within five days from $38 to $31. However, in an analyst call in July 2012, Facebook executives admitted that 543 million users accessed their Facebook accounts on their mobile devices, a jump of 67 percent from the previous year, and a fact that would reduce ad dollars.[12] Following this disclosure and a second-quarter loss of $157 million, the company's share price dropped 11 percent in one day to $23.77.[13]

Less than three full business days after Facebook's initial primary offering (IPO), its new shareholders filed a class action suit. The shareholders sued Morgan Stanley, the Facebook IPO's underwriter for its failure to disclose to *all* shareholders that the Facebook Prospectus and Registration Statement (S-1) were amended at the last minute. The suit is ongoing, but Morgan Stanley, without admitting or denying guilt, paid a $5 million fine to the state of Massachusetts for coaching Facebook on how to share information with research analysts and excluding individual investors from the disclosures.[14] The allegations were that Michael Grimes, the Morgan Stanley Silicon Valley expert, wrote a script for Facebook's CFO, David A. Ebersman, to use in a statement to analysts about the lower earnings expectations because of the switch to mobile devices.[15] By law, Mr. Grimes was not permitted to communicate directly with research analysts because of the conflict of interest in having the research analysts bolster the bank's

[11] Evelyn M. Rusli and Michael J. de la Merced, "Facebook Debut Raises Questions on I.P.O. Process," *New York Times*, May 23, 2012, p. A1. NASDAQ paid a $10 million fine for its bungling of the orders for the offering. Matt Krantz, "Facebook Costs NASDAQ $10M," *USA Today*, May 30, 2013, p. 1B.

[12] Somini Sengupta, "Facebook Shares Plummet in an Earnings Letdown," *New York Times*, July 27, 2012, p. B1.

[13] Jon Swartz, "Facebook, Zynga Earnings Draw Eyes," *USA Today*, July 25, 2012, p. 1B; and Jon Swartz and Matt Krantz, "Facebook Shares Take a Beating," *USA Today*, July 27, 2012, p. 1B.

[14] Susanne Craig and Ben Protess, "Morgan Stanely Is Fined Over Facebook I.P.O. Role," *New York Times*, December 18, 2012, p. B1.

[15] Aaron Lucchetti and Jean Eaglesham, "Morgan Stanley Gets Facebook Fine," *Wall Street Journal*, December 18, 2012, p. C1.

business through the IPO. The risk at that moment is that the analysts would withdraw the "buy" recommendations because of the new information on mobile apps and reduced earnings. If they withdrew their buy recommendations, then the IPO was likely to be canceled, leaving Morgan Stanley losing the fees for the IPO. Mr. Grimes did not communicate directly with the research analysts, but allegedly wrote the script for Mr. Ebersman to use in his direct communications with the analysts. Mr. Grimes, in testimony during the Massachusetts investigation, said that he was not in the meeting between Mr. Ebersman and the research analysts at a New York City hotel. "I was far down the hall so I wouldn't hear anything."[16] However, an e-mail from Mr. Grimes to Mr. Ebersman offered praise to Mr. Ebersman for his meeting with the analysts, saying Mr. Ebersman "was a champ in the hotel tonight."[17] Massachusetts fined Morgan Stanley $5 million for its violations of securities laws.

NASDAQ paid a $10 million fine to the SEC for its problems during the Facebook IPO. Both the SEC and FINRA are looking into Facebook's role in the problematic IPO.

Discussion Questions

1. Is the information withheld from individual investors important in making the decision to buy the stock?
2. Explain the ethical issues involved in Mr. Grimes' actions.
3. Check the price of Facebook stock presently and determine whether the IPO was fairly and accurately priced. Discuss the implications of withholding information from investors.

Case 5.3

Finding a Way Around Government Regulations

The U.S. Department of Commerce has a division known as the Minority Business Development Agency. The role of the division is to help women and minorities to grow their businesses through special access to government contracts. Also, under government contracting rules, federal agencies are required to demonstrate their commitment to awarding contracts to businesses that are certified as women- or minority-owned. To qualify for certification, the business must be able to show that a woman or a protected class member owns at least 30 percent of the economic equity of the firm. Even this requirement can be waived if there are outside investors who own the majority of the equity of the company but the woman or minority control the day-to-day operations of the company.

Once certified, these minority-owned companies often enjoy a fast track to contracts with federal, state, and local governments as well as with major U.S. corporations that are government contractors. These corporate contractors must also be able to demonstrate that they used women and minority-owned companies as subcontractors.

The guidelines often leave plenty of wiggle room. For example, Ron Wallace operates a painting business. Ron is a white male. However, Ron is married and incorporated his painting business with his wife as the controlling shareholder, holding 51 percent of the shares. As a result, Ron is awarded many painting contracts for government facilities. His wife does not work as a painter, does not manage the clerical and bookkeeping tasks in the business, and in fact has very little knowledge of the painting business or her husband's obligations therein.

[16] Susanne Craig and Ben Protess, "Morgan Stanely Is Fined Over Facebook I.P.O. Role," *New York Times*, December 18, 2012, p. B4.

[17] *Id.*

Discussion Questions

1. Ron maintains that he has done nothing wrong because his wife does indeed own at least 30 percent of the equity of his company and that he therefore qualifies for being a certified woman- or minority-owned company. Discuss whether Ron is correct in his analysis.
2. What would happen if everyone adopted Ron's approach to certification? Be sure to identify the stakeholders in providing a response.

Case 5.4

Subway: Is 11 Inches the Same as 12 Inches?

The *New York Post* took a ruler and discovered something interesting: the Subway Footlong is only 11 inches long. The *Post* became curious because in January 2013, a Subway customer from Perth, Australia, took a photo of his Subway Footlong Turkey next to a tape measure, and the Footlong came up one inch short. The *Post* discovered that Subway is not alone. The investigation uncovered other sub shops with similar length issues. Four of every seven sandwiches came up short on length, measuring 11 to 11.5 inches.

Subway's initial response was that "Footlong" is just the name for the sandwich and is not intended to represent the length of the sandwich. Subway Australia posted the following on its Facebook page when the controversy spread through the customer's 100,000 "likes" on his picture of the sandwich. Following the posting of 100,000 likes on the customer‘s Facebook photo, Subway Australia posted on its Facebook page that FOOTLONG was a registered trademark of Subway and not intended to be a description. Subway Australia indicated that sandwiches do vary in length because of the construction process.[18]

Indeed, in many countries, the metric system is followed, where the "Footlong" is still used, as a trademarked name for the sandwich. However, franchise owners note that the length is not only shorter but that the cold-cut sizes have been cut by about 25 percent.

By the end of January 2013, Subway promised to elongate its sandwiches by at least one inch. However, a group of sandwich lovers filed a class action suit against Subway, seeking compensation for the missing one-half inch to one-inch in sandwich that they were missing when they purchased their "Footlongs."[19] One of the plaintiffs in the case said, "They advertise in all these commercials, 'Footlong, Footlong, Footlong,' and now I feel like an idiot." He told The Post, "I can't believe I fell for that trick. The sandwiches are anywhere between a half-inch to an inch shorter … I feel cheated."[20] Subway issued the following statement:

> We regret any instance where we did not fully deliver on our promise to our customers. We freshly bake our bread throughout the day in our more than 38,000 restaurants in 100 countries worldwide, and we have redoubled our efforts to ensure consistency and correct length in every sandwich we serve. Our commitment remains steadfast to ensure that every Subway Footlong sandwich is 12 inches at each location worldwide."[21]

[18] That post has since been deleted. You can find it reproduced at http://www.huffingtonpost.com/2013/01/19/subway-response-footlong-controversy-measurment_n_2511316.html.

[19] Nadia Arumugam, "Why Lawsuits Over Subway's Short Footlong Sandwiches Are Baloney," *Forbes*, January 27, 2013.

[20] *Id.*

[21] Tiffany Hsu, "Subway Pledges to Make All Its Footlong Sandwiches 12 Inches," *Los Angeles Times*, January 25, 2013, http://articles.latimes.com/2013/jan/25/business/la-fi-mo-subway-footlong-20130125.

The basis for the suits is deceptive advertising. The damage claim is $5 million. Subway also notes that its Footlongs may vary in length because dough rises differently; baking in pans changes the shapes of some of the rolls; and shaping does produce variation in shapes and resulting variations in lengths, and that there was no intent to deliver less than a foot of sandwich.

Discussion Questions

1. The Menu Labeling Act, a federal law passed in 2010, requires restaurant chains (with twenty or more outlets) to disclose calorie and nutrition information for the food sold in the stores. There are also state laws, known as Truth in Menu laws that require accurate descriptions—the label cannot say "Made in Vermont," if the syrup was not made in Vermont. And jelly jars cannot say, "Made with real fruit" if there is no real fruit in the jelly. Did Subway violate any of these laws with its less-than-a-foot long Footlong?
2. Evaluate Subway's response to the public attention. Should it have done more?
3. Evaluate the actions of those who have filed suit.

Case 5.5

Sears and High-Cost Auto Repairs

In 1991, the California Department of Consumer Affairs began investigating Sears Auto Repair Centers. Sears' automotive unit, with 850 repair shops nationwide, generated 9 percent of the merchandise group's $19.4 billion in revenues. It was one of the fastest growing and most profitable divisions of Sears over the previous two years.

In the California investigation, agents posed as customers at thirty-three of the seventy-two Sears automotive repair shops located from Los Angeles to Sacramento. They found that they were overcharged 90 percent of the time by an average of $223. In the first phase of the investigation, the agents took thirty-eight cars with worn-out brakes but no other mechanical problems to twenty-seven Sears shops between December 1990 and December 1991. In thirty-four of the cases, the agents were told that their cars needed additional work. At the Sears shop in Concord, a San Francisco suburb, the agent was overcharged $585 to replace the front brake pads, front and rear springs, and control-arm bushings. Sears advertised brake jobs at prices of $48 and $58.[22]

In the second phase of the investigation, Sears was notified of the investigation, and ten shops were targeted. In seven of those cases, the agents were overcharged. No springs and shocks were sold in these cases, but the average overcharge was $100 per agent.

Up until 1990, Sears had paid its repair center service advisors by the hour rather than by the amount of work.[23] But in February 1990, Sears instituted an incentive compensation policy under which employees were paid based on the amount of repairs customers authorized.[24] Service advisors also had to meet sales quotas on specific auto parts; those who did not meet the quotas often had their hours reduced or were assigned to work in other departments in the Sears stores. California regulators said the number of consumer complaints they received about Sears shops increased dramatically after the commission structure was implemented.

The California Department of Consumer Affairs charged all seventy-two Sears automotive shops in the state with fraud, false advertising, and failure to clearly state parts and labor on invoices.

[22] James R. Healey, "Shops under Pressure to Boost Profits," *USA Today*, July 14, 1992, p. 1A.

[23] Gregory A. Patterson, "Distressed Shoppers, Disaffected Workers Prompt Stores to Alter Sales Commissions," *Wall Street Journal*, July 1, 1992, pp. B1, B4.

[24] James R. Healey, "Sears Auto Cuts Commissions," *USA Today*, June 23, 1992, p. 2B.

Jim Conran, the director of the consumer affairs department, stated:

> This is a flagrant breach of the trust and confidence the people of California have placed in Sears for generations. Sears has used trust as a marketing tool, and we don't believe they've lived up to that trust. The violation of the faith that was placed in Sears cannot be allowed to continue, and for past violations of law, a penalty must be paid.[25]

Dick Schenkkan, a San Francisco lawyer representing Sears, charged that Conran issued the complaint in response to bipartisan legislative efforts to cut his agency's funding because of a state budget crunch and claimed, "He is garnering as much publicity as he can as quickly as he can. If you wanted to embark on a massive publicity campaign to demonstrate how aggressive you are and how much need there is for your services in the state, what better target than a big, respected business that would guarantee massive press coverage?"[26]

Richard Kessel, the executive director of the New York State Consumer Protection Board, stated that he also had "some real problems" with Sears' policy of paying people by commission. "If that's the policy," Kessel said, "that in my mind could certainly lead to abuses in car repairs."[27]

Immediately following the issuing of the California complaint, Sears said that the state's investigation was "very seriously flawed and simply does not support the allegations. The service we recommend and the work we perform are in accordance with the highest industry standards."[28]

It then ran the following ad:

> With over two million automotive customers serviced last year in California alone, mistakes may have occurred. However, Sears wants you to know that we would never intentionally violate the trust customers have shown in our company for 105 years.

Ten days after the complaint was announced, the chairman of Sears, Edward A. Brennan, announced that Sears was eliminating the commission-based pay structure for employees who propose auto repairs.[29] He conceded that the pay structure may have created an environment in which mistakes were made because of rigid attention to goals. Brennan announced the compensation system would be replaced with one in which customer satisfaction would now be the primary factor in determining service personnel rewards, shifting the emphasis away from quantity to quality. An outside firm would be hired to conduct unannounced shopping audits of Sears auto centers to be certain the hard sells were eliminated. Further, Brennan said, the sales quotas on parts would be discontinued. Although he did not admit to any scheme to recommend unnecessary repairs, he emphasized that the system encouraged mistakes, and he accepted full responsibility for the policies. "The buck stops with me," he said.[30]

Sears auto repair customers filed class action lawsuits in California, and a New Jersey undercover investigation produced similar findings of overcharging. New Jersey officials found that 100 percent of the Sears stores in its investigation recommended unneeded work compared to 16 percent of stores not owned by Sears.[31] On June 25, 1992, Sears

[25] Lawrence M. Fisher, "Accusation of Fraud at Sears," *New York Times*, June 12, 1992, pp. C2, C12.

[26] *Id.*

[27] *Id.*

[28] Tung Yin, "Sears Is Accused of Billing Fraud at Auto Centers," *Wall Street Journal*, June 12, 1992, p. B1.

[29] Lawrence M. Fisher, "Sears' Auto Centers to Halt Commissions," *New York Times*, June 23, 1992, p. C1.

[30] Gregory A. Patterson, "Sears' Brennan Accepts Blame for Auto Flap," *Wall Street Journal*, June 23, 1992, p. B1.

[31] Jennifer Steinhauer, "Time to Call a Sears Repairman," *New York Times*, January 15, 1998, pp. B1, B2.

ran a full-page ad in all major newspapers throughout the country. The ad, a letter signed by Brennan, had the following text:

An Open Letter to Sears Customers

> *You may have heard recent allegations that some Sears Auto Centers in California and New Jersey have sold customers parts and services they didn't need. We take such charges very seriously, because they strike at the core of our company—our reputation for trust and integrity.*
>
> *We are confident that our Auto Center customers' satisfaction rate is among the highest in the industry. But after an extensive review, we have concluded that our incentive compensation and goal-setting program inadvertently created an environment in which mistakes have occurred. We are moving quickly and aggressively to eliminate that environment.*
>
> *To guard against such things happening in the future, we're taking significant action:*
>
> *We have eliminated incentive compensation and goal-setting systems for automotive service advisors—the folks who diagnose problems and recommend repairs to you. We have replaced these practices with a new non-commission program designed to achieve even higher levels of customer satisfaction. Rewards will now be based on customer satisfaction.*
>
> *We're augmenting our own quality control efforts by retaining an independent organization to conduct ongoing, unannounced "shopping audits" of our automotive services to ensure that company policies are being met.*
>
> *We have written to all state attorneys general, inviting them to compare our auto repair standards and practices with those of their states in order to determine whether differences exist.*
>
> *And we are helping to organize and fund a joint industry-consumer-government effort to review current auto repair practices and recommend uniform industry standards.*
>
> *We're taking these actions so you'll continue to come to Sears with complete confidence. However, one thing we will never change is our commitment to customer safety. Our policy of preventive maintenance—recommending replacement of worn parts before they fail—has been criticized by the California Bureau of Automotive Repair as constituting unneeded repairs. We don't see it that way. We recommend preventive maintenance because that's what our customers want, and because it makes for safer cars on the road. In fact, 75 percent of the consumers we talked to in a nationwide survey last weekend told us that auto repair centers should recommend replacement parts for preventive maintenance. As always, no work will ever be performed without your approval.*
>
> *We understand that when your car needs service, you look for, above all, someone you can trust. And when trust is at stake, you can't merely react, we must overreact.*
>
> *We at Sears are totally committed to maintaining your confidence. You have my word on it.*
>
> *Ed Brennan*
>
> *Chairman and Chief Executive Officer*
>
> *Sears, Roebuck and Co.*[32]

On September 2, 1992, Sears agreed to pay $8 million to resolve the consumer affairs agency claims on overcharging in California. The $8 million included reimbursement costs, new employee training, and coupons for discounts at the service center. Another $15 million in fines was paid in forty-one other states to settle class action suits.[33]

[32] "Open Letter," *Arizona Republic*, June 25, 1992, p. A9.

[33] Barnaby J. Feder, "Sears Post First Loss since 1933," *New York Times*, October 23, 1992, p. C1; and "Sears Gets Handed a Huge Repair Bill," *BusinessWeek*, September 14, 1992, p. 38.

In December 1992, Sears fired John T. Lundegard, the director of its automotive operations. Sears indicated that Lundegard's termination was not related to the controversy surrounding the auto centers.

Sears recorded a net loss of $3.9 billion despite $52.3 billion in sales in 1992—the worst performance ever by the retailer in its 108-year history and its first loss since 1933. Its Allstate Insurance division was reeling from damage claims for Hurricane Andrew in the Gulf Coast and Hurricane Iniki in Hawaii ($1.25 billion). Auto center revenue dropped $80 million in the last quarter of 1992, and Sears paid out a total of $27 million to settle state overcharging claims. Moody's downgraded Sears debt following the loss announcement.

In 1994, Sears partially reinstated its sales incentive practices in its auto centers. Service advisors must earn at least 40 percent of their total pay in commissions on the sale and installation of tires, batteries, shock absorbers, and struts. Not included on commission scales are brakes and front-end alignments (the core of the 1992 problems). Earnings in auto centers have not yet returned to pre-1992 levels. Many of the auto centers have been closed.

There are some who have expressed concerns about the ethical culture at Sears. Although incentive systems may have created the auto center fraud problems, consider the following dilemmas involving Sears since the time of its auto center fraud cases:

- Montgomery Ward obtained an order from a federal court prohibiting Sears from hiring employees away from Ward as it works its way through Chapter 11 bankruptcy. The order was based on an e-mail sent from Sears' regional vice president, Mary Conway, in which Sears managers are instructed to "be predatory" about hiring away Montgomery Ward managers.
- A class action civil suit was filed in Atlanta against Sears by consumers who allege that Sears sold them used batteries as new. One of the plaintiffs in the suit alleges that an investigator purchased 100 "new" batteries from Sears in 1995 (in thirty-two states) and that 78 of them showed signs of previous usage. A Sears internal auto center document explains that the high allowances the centers must give customers on returns of batteries cut into profits and induce the sale of used batteries to compensate. (Sears denies the allegation and attributes it to disgruntled former employees and not understanding that a nick does not necessarily mean a battery is used.)[34]
- Sears admitted to "flawed legal judgment" when it made repayment agreements with its credit card customers who were already in bankruptcy, a practice in violation of creditors' rights and priorities. Sears agreed to refund the amounts collected from the 2,700 customers who were put into the program. Sears warned the refunds could have a "material effect" on earnings. The announcement caused a drop in Sears' stock price of 37/8. Sears included the following notice to its credit card customers:

> NOTICE: *If you previously filed for personal bankruptcy under Chapter 7 and entered into a reaffirmation agreement with Sears, you may be a member of a Settlement Class in a proposed class action settlement. For information, please call 1-800-529-4500. There are deadlines as early as October 8, 1997 applicable to the settlement.*

Sears entered a guilty plea to criminal fraud charges in connection with the bankruptcy issues and agreed to pay a $60 million fine, the largest in the history of bankruptcy fraud cases.[35] The company also settled with the fifty state attorneys general, which included $40 million in state fines, $12 million for state shareholder suits, and a

[34] There were questions and investigations surrounding Exide Corporation, Sears' battery supplier. The questions related to the quality of the batteries, and Exide at one point announced that it expected to face criminal indictment for certain of its business practices. Keith Bradsher, "Exide Says Indictment Is Likely over Its Car Battery Sales to Sears," *New York Times*, January 11, 2001, pp. B1, B7.

[35] Joseph B. Cahill, "Sears Agrees to Plead Guilty to Charges of Criminal Fraud in Credit-Card Case," *Wall Street Journal*, February 10, 1999, p. B2.

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write-off of the $126 million owed by the cardholders involved, which was forgiven as part of the settlement.[36]

Sears also settled the class action suit on the bankruptcy issue by agreeing to pay $36 million in cash and issuing $118 million in coupons to those cardholders affected by its conduct with regard to bankruptcy customers. Sears did not admit any wrongdoing as part of the settlement but indicated the action was taken "to avoid the litigation."[37] Sears spent $56 million in legal and administrative costs in handling the bankruptcy cases.

Sears has been struggling to find its market niche for some time. In 2001, it was forced to close eighty-nine stores as it watched its competitor, Montgomery Ward, close its doors for good.[38] In 2004, Kmart purchased Sears.

Discussion Questions

1. What temptations did the employee compensation system present?
2. If you had been a service advisor, would you have felt comfortable recommending repairs that were not immediately necessary but would be eventually?
3. A public relations expert has said of the Sears debacle: "Don't make the Sears mistake. When responding to a crisis, tell the public what happened and why. Apologize with no crossed fingers. Then say what you're going to do to make sure it doesn't happen again."[39] What are the ethical standards in this public relations formula?
4. What do you believe creates Sears' culture?
5. Sears' stock price and earnings fell. What lesson is there in these consequences?
6. Compute the total costs of the bankruptcy cases to Sears.
7. Are there principles for a credo for, as an example, the mechanics at the auto centers? What about the lawyers who worked for Sears on the bankruptcy issues?

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[36] *Id.*

[37] Leslie Kaufman, "Sears Settles Suit on Raising of Its Credit Card Rates," *New York Times*, March 11, 1999, p. C2.

[38] Amy Merrick, "Sears to Shut 89 Stores and Report Big Changes," *Wall Street Journal*, January 5, 2001, p. A4.

[39] Nat B. Read, "Sears PR Debacle Shows How Not to Handle a Crisis," *Wall Street Journal*, January 11, 1993, p. A14.

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SECTION B

Promises, Performance, and Reality

Did you really perform what was required under the contract terms? There are issues about what constitutes "close enough" and questions about authority under contract terms that offer ethical dilemmas on both sides of the contract.

Case 5.6

Payday Loans and Checking Account Deductions

Payday loans are high-interest-rate loans that are generally made for short terms, such as "until next pay day." The loan must be repaid within 5 to 14 days, or the lender is entitled to repayment plus interest, which can run at 30 percent before default and higher afterward, as well as a service fee for the loan and additional costs for collection, should those steps be necessary. Some payday loans carry as much as a 500 percent interest rate. Some states have already put into place limitations on service fees for payday loans.

There is an additional twist to the payday loans that involves their banks. Most payday lenders require their borrowers to give them access to their checking accounts for automatic deduction of the amounts due under the loans. When the borrower fails to repay the loan, the payday lenders exercise their rights to withdraw funds directly from the borrowers' checking accounts. With penalties and interest, the withdrawals are so high that the borrowers finish with no money or have to pay significant overdraft fees. Without the cooperation of banks in allowing this automatic access, the payday lenders would have significant difficulties with collection. Major banks in the United States have served as facilitators for the payday industry.[40]

Following the appearance of a story on the role of the major banks in the payday loan industry, JPMorgan Chase (Chase) CEO Jamie Dimon spoke about Chase's payday withdrawal policies, calling the practices of the payday loan industry "terrible," and pledged that Chase would be examining its practices and making changes.[41] At the time, two customers had already sued Chase for withdrawals from their accounts that caused the customers to be charged late fees as their accounts continued to be drained by the payday lenders.

While payday loans are illegal in New York, Chase was making withdrawals for online payday lenders. Several Chase customers who are payday borrowers and live in New York have also filed suit alleging that Chase is violating the law by allowing the account withdrawals by payday lenders who are based in other states that do not prohibit these types of loans. There are brick-and-mortar payday lenders who have facilities in strip malls in poverty areas, but there are also online payday lenders who have a big presence in terms of number of customers in states where the loans are prohibited. Without access

[40] Jessica Silver-Greenberg, "Major Banks Aid in Payday Loans Banned by States," *New York Times*, February 23, 2013, p. A1.

[41] Jessica Silver-Greenberg, "Dimon Pledges to Address JPMorgan's Practices on Payday Loans," *New York Times*, February 27, 2013, p. B2.

to banking withdrawals, these online lenders would not be able to collect on borrowers' properties in those states because the lenders have illegal and unenforceable contracts.

Borrowers have tried to claim unconscionability in their suits against lenders but have not had much success. Both state and federal proposed legislation is working its way through the system.

Discussion Questions

1. Evaluate the ethics of this type of loan.
2. Evaluate the ethics of circumventing state laws with borrowers through an online presence.
3. Evaluate the ethics of banks assisting in collection of the payday loans.

Case 5.7

Pensions: Promises, Payments, and Bankruptcy

The city of Detroit pays out almost $200 million per year in pension benefits to its retired workers. The city's annual contributions to its pension plan are less than half of that sum.[42] As payments out have increased, payments in have decreased. How is it possible to have a fully funded pension plan with these numbers? Professionals, including auditors, fiduciaries, and actuaries, have certified that the aggressive investment policies for the fund should make up the difference.[43] Still, the firefighters—who one day expect to be beneficiaries and in turn receive their payouts—now recognize the harsh reality that is playing out with pension funds throughout the United States.[44] Despite all the imprimaturs from professionals, benefits elsewhere have been cut, plans changed, and, in some cases, payments to retirees stopped altogether.[45] With Detroit in bankruptcy, they appear to have few rights to collection of their pensions.

When United Airlines declared bankruptcy in 2002, part of its Chapter 11 proceedings relieved the company of its pension liabilities. The ability of a company to renege on pension benefits when so many protections were built into the law under the Employee Retirement Income Security Act (ERISA) has been an ongoing concern. Congressional hearings following the losses in the United case uncovered loopholes in the accounting processes for pension fund reporting that permitted United, and many others, to report pension numbers that made the health of the fund look better than it actually was. The loopholes were Enron-esque in nature, allowing obligations to be spun off the books so that the existing levels of obligations of the plan looked small and the assets very rich.

Federal Regulation of Pensions

Because of United's pension bailout, Congress changed the accounting for pension plans to avoid the problem of the rosy picture when the funds need further funding. The Pension Protection Act of 2006 closed the accounting loopholes and provides greater assurance for employees that their promised pensions and the funding for them would be available upon their retirement. The effect of the changes is to require companies to

[42] Michael Cooper & Mary Williams Walsh, "Public Pensions, Once Off Limits, Face Budget Cuts," *New York Times*, April 26, 2011, p. A1. For more background information on pensions, actuaries, and fund losses, see Marianne M. Jennings and Sally "A Proactive Proposal for Self-Regulation of the Actuarial Profession," 48 *American Business Law Journal* 641 (2011).

[43] *Id.*

[44] Simon Baribeau and David Mildenberg, "State Workers Run For the Exits," *Bloomberg Businessweek*, April 25–May 1, 2011, p. 32. See also Steven Greenhouse, "States Want More in Pension Contributions," *New York Times*, June 16, 2011, p. B1; and Jeanette Neumann and Michael Korkery, "Public Pension Fund Squeeze," *Wall Street Journal*, March 23, 2011, p. C1.

[45] Cooper and Walsh, *supra* note 18, p. A3.

fund their pension plans according to the numbers they have reported to the SEC in their financials. Apparently, the numbers reported to the SEC vis-à-vis pensions are accurate, whereas the numbers reported for ERISA purposes are inflated. If United had funded its plans when its SEC numbers indicated it needed to (e.g., 1998 would have been the year when funding was first needed), the plan would have been sufficiently funded at the time of the United bankruptcy. However, under ERISA guidelines, it was not required to kick in funds until 2002, when it was grossly underfunded.

The Pension Benefit Guarantee Corporation (PBGC) was created under ERISA and provides insurance for employees for underfunded pensions.[46] The presence of this protection results in a moral hazard. With the presence of the PBGC as a stopgap measure for pension plans that fail or end, there is little accountability for responsible funding and management of pension plans. The pension plan no longer represents a source of exposure so that funding decisions, especially in relation to promised benefits, are often made with inflated expectations or little regard for reality. As one commentator noted,

> Nevertheless, union leaders, who negotiate most pension agreements, often seek pension promises that even they know are excessive, in large part because the PBGC insures these promises. In addition, unions and their constituents rarely ensure that their pensions are fully funded: "As a result of federal pension insurance, employees lack the proper incentives to monitor their employers' funding levels because the employees will not bear the full costs of their inattention." In an effort to resolve this tension, the PBGC does not insure any and all pension promises, instead limiting yearly payouts to beneficiaries. Ironically, the PBGC does this to give employees incentives to make sure their employer funds their plans adequately. Nevertheless, many pension promises are not as insured as most employees would believe.[47]

A conflicts issue that arises in the funding and management of pension plans is that employers who hire actuaries often signal their concerns about the impact of increased funding on earnings. Simultaneously, beneficiaries signal their desire for continuing present funding levels that still provide promised benefits. That tension affects the role of the actuary who determines funding levels and can result in the use of overly optimistic actuarial assumptions. These conflicts and tensions have resulted in an acute crisis in pension funding and structure.

Reductions in Force and Buy-Outs to Relieve Pension Tension

There have been significant reductions in force (RIF) since the 1980s, with post-2008 being a period of significant RIFs. The RIF process incorporates the pension and retirement components. Since 2001, companies that have had to downsize have taken an approach of offering employees buyouts. Indeed, 100 national and regional retailers went out of business between 2008 and 2010, with other national retailers closing large numbers of their locations. For example, Arby's closed eighty of its outlets in 2010. Closures are the ultimate form of downsizing. The following list provides some data on some of the larger companies and the steps they took, as well as some general figures for the recession that followed the 2008 market crash:

2001	Lucent Technologies offered 13,000 employees early retirement incentives.
2001	Merrill Lynch offered voluntary severance packages to a majority of its 65,900 employees.
2003	Almost 10 percent of the 221,000 employees of Verizon accepted an early retirement-buyout offer.

[46] 29 U.S.C. § 1302 (2000).

[47] Joshua Gad-Harf, "The Decline of Traditional Pensions, the Impact of the Pension Protection Act of 2006, and the Future of America's Defined-Benefit Pension System," 83 *Chicago-Kent Law Review*, 1409, 1417 (2008).

2004	Southwest Airlines offered 33,000 of its employees cash, travel privileges, and other benefits as part of a voluntary termination package.
2005	Safeway offered 5,800 clerks voluntary buyouts.
2006	GM offered 131,000 GM and Delphi employees (including 105,000 union workers in that group) buyouts with figures ranging from $35,000 to $140,000 per employee, depending upon their years of employment with GM or Delphi.
2008	Thirty percent of U.S. employers laid off employees.
2009	Boeing cut 10,000 jobs. Caterpillar cut 22,000 jobs. Delta forced 2,000 early retirements.
2010	Fifty percent of U.S. companies did some form of downsizing. In 2012, 283,000 were fired with 60 percent dismissed because of corporate restructuring or cost cutting. Hewlett-Packard cut 27,000 jobs. American Airlines cut 14,200 jobs. Lockheed Martin cut 10,000 jobs. IBM cut 9,000 jobs. Pepsi cut 8,700 jobs. RIM cut 5,000 jobs.

Because of the extensive benefits employees at these companies have, the average cost of keeping an employee is about $67 per hour, with $27 being wages and the remainder made up of pensions and health care benefits. One employee who works in the paint-repair shop at GM's Pontiac plant said that he would give up his $100,000 per year salary to retire, spend more time with grandchildren, and get away from the paint fumes. However, one worker noted, "Where is anybody going to find a job paying $28 per hour with [only] a high-school diploma?"[48]

One worker, who will receive a $140,000 payment, has a small dealership in Doraville, Georgia, where the GM plant is located, at which he sells used pickup trucks. He is not married and has no children, rents out six homes that he owns, and co-owns a beauty parlor. He will retire comfortably.

Following these pension buy-outs, GM was still in dire financial condition. In 2008, the U.S. government provided General Motors with $5.8 billion in funds in order to allow the company to emerge from bankruptcy. As security for the loan and for the advancement of $43 billion in bailout funds to the company, the U.S. government held a 10 percent ownership stake in the auto company. As part of the deal with the government, GM had to agree to certain management changes and promise to repay the funds. GM also had to agree to provide 39 percent share ownership of the company to employees of the company. GM promised to cut 40 percent of its car dealers and eliminate 7,000 jobs. Following its emergence from bankruptcy, GM did cut its car dealers by 40 percent, but following public outcry on the termination of longstanding dealers, it reinstated many of those who had been terminated. GM consolidated plants and closed its Saturn division to push toward the 7,000-job cutback. A government official said that the loss of jobs if the automaker failed was too great to risk and thus required government intervention.

[48] Jeffrey McCracken and Lee Hawkins Jr., "Massive Job Cuts Will Reshape GM," *Wall Street Journal*, March 23, 2006, pp. A1, A15.

Actuaries and Pension Experts Targeted

Pensions, fund managers, and actuaries have been the targets of corruption investigations and litigation by state and local governments that are underfunded with respect to their public employee pension plans. For example, the New York State Pension fund relied on actuarial numbers that, when made public in 2008, made little economic sense.[49] Even under broad standards of interpretation, there was no method for reconciling the actuary firm's findings with actual funding levels. As the details of the questionable numbers that were used for continual expansion of public pension benefits emerged, so also did details about the relationships of the actuary with those affiliated with the pension plan. For example, in the New York case, the actuarial firm providing the professional opinion as to the adequacy of the fund to meet current liabilities was paid at least in part for its opinions by the existing members of the plan who had an inherent interest in the fund being deemed sufficient to cover extended benefits without additional payments, something that would trigger political budget battles.[50] The actuary's opinion was pivotal. Should the actuary have assessed the fund as being underfunded, by law either the legislature would have been required to allocate the funds to bring the plan up to funding level requirements, or benefits would have had to have been reduced? Both options had serious political implications, as future taxpayers would have to make good on the pension promises through increased taxes.[51] The legislative standoff in the state of Wisconsin was the result of the realization of underfunding of public employees' pension plans and the inability of the state to fund the plan sufficiently for promised benefits.[52] The proposed and very volatile, politically charged solution was to require members to increase the amount they paid into their pension plan. An actuarial certification of adequate funding kicks the funding can down the road to either cuts in benefits, changes in contributions, or increased taxes for additional funding and/or payment of benefits not covered by the plan's funds.

The New York experience resulted in reviews of state pension funds around the country.[53] These reviews did not produce the "adequately funded" conclusions that state governments had hoped to find. On average, actuaries had underestimated the cost of providing the promised and often increasing government pension benefits by about one-third.[54] For instance, California's public employee pension fund is underfunded by $500 billion. The scope of that underfunding is understood better when translated to per capita costs; the underfunding costs for California have been computed as $35,700 per California household.[55] The Pew Center study on the condition of state pension funds places the states into three categories: Solid performers, Need Improvement, and Serious Concerns.[56] The Pew Center lists California as being in the middle category, which raises grave questions about the state of funds in those nineteen states the Pew Center study

[49] Cooper & Walsh, *supra* note 18, p. C7.

[50] *Id.*

[51] One actuary noted the conflict and the outdated models caused "[f]inancial burdens [to be] hidden." Cooper & Walsh, *supra* note 18, p. C1. Similar standoffs loom in New York and New Jersey.

[52] Lisa Colangelo, "As Ground Zero in Bargaining Debate, Wisconsin Union Battle Has Repercussions," *New York Daily News*, February 22, 2011, http://articles.nydailynews.com/2011-02-22/local/28639649_1_pension-reform-union-leaders-and-lawmakers-ground-zero.

[53] "Ugly Truth About State Pensions Begins to Emerge," *USA Today*, May 3, 2010, p. 8A.

[54] *Id.*

[55] *Id.*

[56] *Id.*

placed in the Serious Concerns category.[57] Those serious concerns translate to underfunding that reaches levels of 50 percent.

There are now lawsuits against actuaries pending in Alaska; Texas; San Diego, California; Milwaukee, Wisconsin; Evanston, Illinois; and Fort Worth, Texas.[58] The theory underlying these lawsuits is that pension benefits were widely given and expanded because the actuarial methods used undervalued the benefits. The plaintiffs in these suits seek recovery from the professionals who provided their certification that the numbers supported a sufficient investment pool and returns to meet cash distributions at the times provided for in the plan to the full range of plan beneficiaries.[59]

Two examples illustrate the role actuaries have played in defunct pension plans or plans with significant deficits. In Fort Worth, Texas, an investigation was launched when the city discovered that its pension plan was suffering a $410 million deficit.[60] A 1990 actuary's opinion had concluded that the city could put less money into the pension plan but still expand benefits.[61] The opinion was based on an assumed 10.23 percent return on pension investments. Fort Worth's pension plan had never earned a return on investment of 10.23 percent. Over the years, the actuary "tweaked" numbers here and there to keep the benefits at the promised, increased levels.[62] Again, apparent satisfaction with the quality of the actuarial opinion led to renewed contract arrangements with the actuary, presumably because of the "good news" effect of the actuary's findings. In the Alaska litigation, the actuary assumed that health care cost increases would fall by 4.5 percent, when, in reality, health care costs have not declined in the past thirty years.[63]

With the market's decline and increasing retirement rates, more plans failed.[64] By 2005, the FPGC had a deficit of $22.7 billion because of the payouts it was making to claimants due to underfunding as well as the bankruptcies of major companies like United.[65]

In addition to the questionable actuarial opinions and the conflict created by beneficiaries paying for those favorable opinions, there are also pending charges of corruption regarding the retention of investment advisers, actuaries, and other professionals for pension plan management.[66] In 2009, four actuary firms entered guilty pleas in connection with their retention of fund management contracts for New York's public pension fund.[67] California has filed a suit against several private equity firms for their

[57] Pew Center on the States (noting that "solid performer" states are Arizona, Arkansas, Delaware, Florida, Georgia, Idaho, Maine, Montana, Nebraska, New York, North Carolina, Ohio, South Dakota, Tennessee, Utah, and Wisconsin; "need improvement" states are Alabama, California, Iowa, Michigan, Minnesota, Missouri, New Mexico, North Dakota, Oregon, Pennsylvania, Texas, Vermont, Virginia, Washington, and Wyoming; the "serious concern" states are Alaska, Colorado, Connecticut, Hawaii, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Nevada, New Hampshire, New Jersey, Oklahoma, Rhode Island, South Carolina, and West Virginia).

[58] See Cooper & Walsh, *supra* note 18, p. C7 (noting that San Diego's pension numbers were so off base that the SEC took action against the City for securities fraud).

[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] Marcy Gordon, "Pension Safety Net in a Jam," *Arizona Republic*, November 16, 2005, p. B1. See also Nicholas Varchaver, "Pitchman for the Gray Revolution," *Fortune*, July 11, 2005, p. 63 (noting that the FPGC assumed responsibility for the obligation to United Airlines plan members).

[66] Michael J. de la Merced, "4 Firms Agree to Settlement in New York Pension Fund Inquiry," *New York Times*, August 19, 2009, p. B1.

[67] *Id.*

relationships with CalPERS executives that included perks and which, the suit concludes, resulted in "improper relationships" between the firms and the public pension fund.[68]

In 2009, states began to address the ethical issues raised by the funding shortfalls.[69] They have begun to address the relationships between and among fund managers, consultants, and pension boards. For instance, Illinois now prohibits pension trustees, employees, and consultants from benefiting from investment transactions.[70] Several states introduced more competitive processes for procuring consulting and investment services.[71] Other states now require their pension systems to conduct performance reviews of consultants and managers, including a comparison of costs of services.[72]

Discussion Questions

1. Describe the regulatory cycles on pension fund accounting and pension funding.
2. Explain the conflicts issue in the management of pension plans.
3. Give a list of the economic and ethical issues in pension funding, employee wages, and RIFs.
4. Did noble goals on all sides result in unintended consequences at United, GM, and for the public employees at bankrupt government entities?
5. What ethical issues do you see in the government intervention to save GM?

Compare & Contrast

Drawing on the Malden Mills case (Case 7.6), what have we learned about balancing social goals and operating a business? What were the drivers for the Feuerstein decision versus the United decision?

Sources

Maynard, Micheline, "G.M. Will Offer Buyouts to All Its Union Workers," *New York Times*, March 23, 2006, pp. A1, C4.

Williams Walsh, Marry, "Pension Law Loopholes Helped United Hide Its Troubles," *New York Times*, June 7, 2005, p. C1.

Case 5.8

Department Store Returns or Rentals?

Even the well-seasoned Dillard's manager was taken aback by this one. A customer brought in a pair of moderately expensive dress shoes, expressing a desire to return them because they just weren't quite right. As the manager processed the order, she checked inside the box to be sure that the shoes in the box were the shoes that matched the box—past experience dictated that follow-up on returns. The shoes were the correct ones for the box, but the customer had another issue. The shoes had masking tape on the bottom—masking tape that was dirty. Returning to the customer, the manager said, "You forgot to remove the masking tape from your shoes." The customer responded, "I only wore them once. That's all I needed them for."

From Neiman Marcus to Saks to Dillard's and back, managers have to stay one step ahead of customers—or rather, lessees—who buy—or rather, lease for free—dresses and now shoes for one use with premeditated intent to return the merchandise. Stores now

[68] Gina Chona, "Brown Targets Pension Middleman," *Wall Street Journal*, May 7, 2010, p. C5b (noting that the suit alleges executives were offered standing employment opportunities and trips to New York and Florida that resulted in $63,000 in expenses being reimbursed by the company that was awarded $700 million in a CalPERS fund investment).

[69] Matthew Goldstein, "The New Pension Threat," *BusinessWeek*, December 15, 2008, p. 40.

[70] Mary Williams Walsh, "Illinois Plan for Pensions Questioned," *New York Times*, January 26, 2011, p. B1.

[71] *Id.*

[72] PEW Center on the States, *supra* note 75, at 11.

place tags strategically so that the dresses cannot be worn without cutting them off and there are no returns if the tags are cut off on formal wear.

Lest you think that the problem is limited to women and formal wear, talk to your Ace Hardware or Home Depot manager about the folks who "buy" a special tool, use it once, and then try to return it. The hardware/home improvement stores are left with opened packaging and used goods by buy-it-temporarily customers.

Discussion Questions

1. What is the ethical category here?
2. Who is affected by the returners and their conduct?

Case 5.9

Government Contracts, Research, and Double-Dipping

Included in government research grants to universities are indirect cost payments designed to compensate for the researchers' use of the schools' facilities.

Stanford University received approximately $240 million in federal research funds annually. About $75 million went to actual research, whereas Stanford billed the federal government $85 million, or 20 percent of its operating budget, for its overhead.[73] The rest of the research funds went toward employee benefits. An audit of Stanford's research program in 1990 by U.S. Navy accountant Paul Biddle revealed that the school billed the government $3,000 for a cedar-lined closet in president Donald Kennedy's home (Hoover House); $2,000 for flowers; $2,500 for refurbishing a grand piano; $7,000 for bed sheets and table linens; $4,000 for a reception for trustees following Kennedy's 1987 wedding; and $184,000 for depreciation for a seventy-two-foot yacht as part of the indirect costs for federally funded research.[74]

In response to the audit, Stanford withdrew requests for reimbursement totaling $1.35 million as unallowable and inappropriate costs. Stanford's federal funds were cut by $18 million per year.[75]

Kennedy issued the following statements as the funding crisis evolved:

> **December 18, 1990:** What was intended as government policy to build the capacity of universities through reimbursement of indirect costs leads to payments that are all too easily misunderstood.
>
> Therefore, we will be reexamining our policies in an effort to avoid any confusion that might result.
>
> At the same time, it is important to recognize that the items currently questioned, taken together, have an insignificant impact on Stanford's indirect-cost rate. …
>
> Moreover, Stanford routinely charges the government less than our full indirect costs precisely to allow for errors and disallowances.
>
> —From a university statement
>
> **January 14, 1991:** We certainly ought to prune anything that isn't allowable—there isn't any question about that. But we're extending that examination to things that, although we believe are perfectly allowable, don't strike people as reasonable.

[73] Colleen Cordes, "Universities Review Overhead Charges; Some Alter Policies on President's Home," *Chronicle of Higher Education*, April 3, 1991, p. A1.

[74] Maria Shao, "The Cracks in Stanford's Ivory Tower," *BusinessWeek*, March 11, 1991, pp. 64–65.

[75] Gary McWilliams, "Less Gas for the Bunsen Burners," *BusinessWeek*, May 20, 1991, pp. 124–126; and Courtney Leatherman, "Stanford's Shift in Direction," *Chronicle of Higher Education*, September 7, 1994, p. A29.

> I don't care whether it's flowers, or dinners and receptions, or whether it's washing the table linen after it's been used, or buying an antique here or there, or refinishing a piano when its finish gets crappy, or repairing a closet and refinishing it—all those are investments in a university facility that serves a whole array of functions.
>
> —From an interview with the Stanford Daily
>
> **January 23, 1991:** Because acute public attention on these items threatens to overshadow the more important and fundamental issue of the support of federally sponsored research, Stanford is voluntarily withdrawing all general administration costs for operation of Hoover House claimed for the fiscal years since 1981. For those same years, we are also voluntarily withdrawing all such costs claimed for the operations of two other university-owned facilities.
>
> —From a university statement
>
> **February 19, 1991:** I am troubled by costs that are perfectly appropriate as university expenditures and lawful under the government rules but I believe ought not be charged to the taxpayer. I should have been more alert to this policy issue, and I should have insisted on more intensive review of these transactions.
>
> —From remarks to alumni
>
> **March 23, 1991:** Our obligation is not to do all the law permits, but to do what is right. Technical legality is not the guiding principle. Even in matters as arcane as government cost accounting, we must figure out what is appropriate and act accordingly. Over the years, we have not hesitated to reject numerous lawful and attractive business proposals, gifts, and even federal grants because they came with conditions we thought would be inappropriate for Stanford. Yet, with respect to indirect-cost recovery, we pursued what was permissible under the rules, without applying our customary standard of what is proper. …
>
> The expenses for Hoover House—antique furniture, flowers, cedar closets—should have been excluded, and they weren't. That the amounts involved were relatively small is fortunate, but it doesn't excuse us. In our testimony before the subcommittee I did deal with this issue, but I obviously wasn't clear enough. I explained that we were removing Hoover House and some similar accounts from the cost pools that drew indirect-cost recovery because they plainly included inappropriate items. What came out in the papers was that Stanford removed the costs because it was forced to, not because it was wrong. … That is not so. To repeat, the allocation of these expenses to indirect-cost pools is inappropriate, regardless of its propriety under the law.
>
> —From remarks to alumni[76]

By July 1991, Kennedy announced his resignation, effective August 1992, stating, "It is very difficult … for a person identified with a problem to be a spokesman for its solution."[77] Gerhard Casper, who was hired as Stanford's new president, said, "I just want this to remain one of the great universities in the world. I ask that we question what we are doing every day." Kennedy remains at Stanford, teaching biology.[78]

Stanford's donations declined that year; 1999 was the first time it saw an uptick in its donations since the time of this government overhead issue.[79]

Ultimately, Stanford settled with the federal government for $1.3 million, a small percentage of the $185 million of alleged overcharges that appeared in Biddle's report. The federal government also concluded that there was no fraud by Stanford. Biddle filed suit, seeking recovery of the statutory whistleblower fee of 10 percent for finding the submitted costs that the government ultimately recovered from Stanford. His suit was dismissed.

[76] Karen Grassmuch, "What Happened at Stanford: Key Mistakes at Crucial Times in a Battle with the Government over Research Costs," *Chronicle of Higher Education*, May 15, 1991, p. A26.

[77] "Embattled Stanford President to Quit," *Mesa Tribune*, July 30, 1991, p. A6.

[78] Associated Press, "Stanford's Chief Resigns over Billing Controversy," *Arizona Republic*, July 30, 1991, p. A8.

[79] Leatherman, "Stanford's Shift in Direction," p. A29.

Discussion Questions

1. Did Kennedy's ethics evolve during the crisis? Contrast his March 23, 1991, ethical posture with his December 18, 1990, assessment.
2. Is legal behavior always ethical behavior?
3. Do Casper's remarks reflect an ethical formula for Stanford's operations?
4. In a 2000 interview for an internal Stanford publication, Kennedy offered the following when asked about research and cost issues as he assumed the editorship of *Science*:

> One of the factors in the explosive growth of Stanford during the '60s and continuing into the '70s and '80s was the availability of federal funding for research. The policy behind that support was always that the government benefited from basic research because it eventually produced findings that could be converted to human service in one way or another and so the government continually built that capacity and built that capacity in universities. Its policy was that it would pay the full cost of research, including not only the direct cost that could be associated with particular programs but the indirect costs that had to be made by the university in order to stay in the business of doing sponsored research.
>
> Over time, the percentage of all research funding that was allocated to indirect cost grew. And it grew to a point in the late '80s and early '90s when it seemed to many people, some in Congress and some on this faculty, that it was an unacceptably large percentage and we recognized that though, probably not soon enough, made some efforts to constrain it, but in fact it was high enough to trouble people and it was calculated, the indirect costs were calculated on the basis on a pool accounting mechanism no one in the public understood and indeed few people on the faculty understood. And when Congressman Dingell decided to make that the subject of a very high profile Congressional investigation and made Stanford the subject of it, we had a very, very bad time. We took a beating. It was sufficiently bad that after the hearings and during the summer of 1991, it became clear to me that there was so much faculty concern about the ruckus and whether Stanford would continue to be a target for this kind of thing that I decided that if you're part of a problem, you can't be part of a solution and so I resigned. I think that steadied things down considerably. It wasn't any fun to do that. It was not any fun to take a certain amount of newspaper abuse in connection with it. Stanford's recovered nicely. We're still not paid the indirect cost rate I think we are entitled to under articulated government policies, but the sequelae to the whole furor, I think, made it plain to everybody that Stanford hadn't engaged in any wrongdoing.
>
> I think there were a few people in other institutions who got caught up in the problem later when it was revealed that they had engaged in exactly the same practices we had who did a little finger pointing and said "Well, Stanford was pushing the envelope." But in fact we weren't. Our indirect cost rate was high but it was in a cluster of other high rates, two or three or four other institutions which were comparable or within three or four percentage points. So you can't make the case that we were doing stuff that others weren't also doing.[80]

List the rationalizations you see in this statement. Does he think Stanford did anything unethical?

Case 5.10

Yale University and the Compensation of Professors for Government Research: Double-Dipping or Confusion?

The U.S. Attorney for the District of Connecticut reached a settlement with Yale University on allegations that Yale violated federal regulations on grant administration and accounting. Without admitting guilt, Yale agreed to pay the federal government $7.6

[80] http://becoming.stanford.edu/interview/donaldkennedy.html. Accessed July 10, 2010.

million, half as damages and the other half as penalties. The investigation focused on the problem of funds left in federal grants. When the grant ends, the Feds get the funds back. The government alleged those at the university, however, transferred the funds to other unexpired grants for continuing use.

Also, the investigation focused on faculty summer salaries. Faculty members often serve under nine-month contracts. They are not paid in the summer unless they have summer school classes or have research dollars. However, to get those summer research dollars, faculty members must be devoted to research. Yale faculty, allegedly, did other things besides research during those summer periods but still billed the government for 100 percent of their salaries. They were compensated for those additional activities during the summer. The result is that the faculty has two sources of compensation. However, the activity reports faculty members must sign/certify that they have devoted 100 percent of their time to the lab and, because they are required by federal law, are signed under penalty of perjury.

Discussion Questions

1. Why is the university responsible for the conduct of the faculty members?
2. What advice would you offer to universities for the management of their grant funds?
3. Should this all matter if the faculty are indeed performing the required research under their grants?

Case 5.11

When Corporations Pull Promises Made to Government

The interrelationships of corporations with government entities have become a critical part of community development and economic redevelopment. However, sometimes there are benefits but reneged promises. The following scenarios illustrate the types of problems that result from these interrelationships.

Susette Kelo, Little Pink Houses, and Pfizer

When the U.S. Supreme Court decided *Kelo v. City of New London,* 545 U.S. 469(2005), a constitutional and legislative shock wave rumbled across the country. States changed their statutes and constitutions on when and how local government could take private property for redevelopment purposes, and property owners began resisting local redevelopment plans.

The *Kelo* case began in 1978 when the city of New London, Connecticut, undertook a redevelopment plan for the area in and around the existing park at Fort Trumbull. The plan had the goals of the ambience a state park should have, including the absence of existing pink cottages and other architecturally eclectic homes that had long been part of the area, one of which was owned by Susette Kelo. The central focus of the plan was getting the Pfizer pharmaceutical company to bring its new research facility to the Fort Trumbull area with a hoped-for economic boost from a major corporate employer.

Under the plan Kelo's and others' homes would be razed to make room for Pfizer and its facilities. The homeowners filed suit, challenging New London's legal authority to take their homes. The trial court issued an injunction preventing New London from taking certain of the properties, but allowing others to be taken. The appellate court found for New London on all the claims; the Connecticut Supreme Court affirmed (in a 4–3 decision); and the landowners appealed to the U.S. Supreme Court, which affirmed the Connecticut Supreme Court decision by a 5–4 vote.

Ms. Kelo's home and fifteen others were razed. Pfizer merged with Wyeth in 2009 and closed all company operations in New London. The Fort Trumball area has no houses, no research park, no businesses, and is now undeveloped land. However, following Hurricane Irene, officials from the city of New London announced that the citizens of their fair city could dump their branches and fallen trees at the site where Ms. Kelo's home once sat. In short, the Fort Trumball area is now a landfill.

Last week, journalist Jeff Benedict, whose book *Little Pink Houses* documents the story of Ms. Kelo and her neighbors and the failed project, spoke at a dinner honoring the members of the Connecticut Supreme Court. Ms. Kelo was in the audience along with the justices who decided her case. Mr. Benedict told the story of the failed city project and the impact on Ms. Kelo and others. Afterward, Justice Richard Palmer thanked Mr. Benedict for telling the story and then apologized to Ms. Kelo for what happened to her. Ms. Kelo cried because she said it was the first time in the twelve-year-battle that anyone had offered an apology.

Tax Incentives to Come and/or Stay

Nike wants to expand, and Nike says it will stay in Oregon as the state's second largest company, but it wants a forty-year assurance that its taxes will not increase. So, the governor has scheduled a special legislative session to tackle the "Keep Nike" problem.

The director for the Oregon Center for Public Policy characterizes the Nike demand for assurances as Nike putting "an economic gun to the governor's head." Governor John Kitzhaber explains that Nike executives met with him to explain that the company had offers from other states and wants to stay put but that it needs to have stability in its tax rates. Nike officials explain that the company is offering to invest $150 million in the state for its expansion, an expansion that will create 500 more jobs.

Tax incentives to lure or keep businesses within a state are not new, but they are becoming more frequent as the states become more competitive. And some states, such as Kansas and Missouri, battle against each other to lure companies back and forth across their borders.

Film Director Oliver Stone knew he could film 2010's *Wall Street* only in New York City, but he negotiated with New York City and got $10 million in tax credits to film there, saying, "It's good. Or basically the way business is done. I don't understand what the moral qualm is."[81]

Still, there have been ongoing bad feelings, litigation, and questions about government's role and authority in changing tax structures to recruit or retain businesses. For example, during the 1990s, GM was able to obtain several deals from state and local governments in order to locate plants in their economies. GM's North Tarrytown, New York, plant was located there in 1987 because union members voted to accept innovative and cooperative work rules to replace expensive practices under the old contract. Also, state and local governments contributed job training funds, gave tax breaks, and began reconstructing railroad bridges to win the minivan production plant. By 1995, GM had all but closed down the plant, following a series of massive lay-offs. The money spent by the state and local governments could not be recovered. The estimate is that cities and townships alone give up $80 billion in tax revenues each year in order to keep companies in their locations. Texas spends about $19 billion per year to recruit and retain businesses. Alaska, West Virginia, and Nebraska spend the most per capita in order to recruit and retain businesses in their states.

[81] Louise Story, "As Companies Seek Tax Deals, Governments Pay High Price," *New York Times*, December 1, 2012, p. B1.

What rights do government entities have when businesses obtain the tax breaks but then do not follow through on their promises to build plants, create jobs, or remain in operation in exchange for the government tax breaks? Well, the government entities are not without rights if their agreements on the taxes are carefully drafted.

In February 1993, GM announced the closure of the Willow Run plant in Ypsilanti Township, Michigan, a loss of 2,200 jobs. However, Ypsilanti Township and Washtenaw County fought back on the closures. The government entities filed suit challenging the closure, because GM had promised to build cars at Willow Run through the late 1990s in exchange for tax abatements. The suit alleged that GM owed $13.5 million in back taxes by GM for reneging on its promise to operate the plant. GM settled the suit in 1994 by agreeing to pay half the abated taxes. The key to the agreements is spelling out the terms for departure or closure, a sticky topic of negotiations because companies want to have changed business conditions and economic factors be permissible reasons for closing or moving that will not trigger tax provisions or some form of liquidated damages for the government entities. In tough economic times, the companies hold the bargaining power, and most government entities do what it takes to recruit or retain corporations, without any damage clauses for their closure or departure.

The contracts and agreements between corporations and government entities are not unconscionable because of the experience levels of the negotiating parties. The tax rates, as in Oregon, are set by statute and can be written to favor certain types of businesses. However, the ethical and social questions continue to swirl as more companies leave states, cities, and counties after extracting everything from development funds to tax breaks.

Discussion Questions

1. What do the incentives do, and how are they accomplished?
2. What are the rights of the parties if the company pulls out after receiving government benefits or tax breaks?
3. Apart from the legal rights here, are there any "moral qualms" about accepting and/or promising benefits for corporations in exchange for government benefits?
4. List the stakeholders and discuss the impact on them when a corporation reneges on a mutual development promise.

Case 5.12

Intel and the Chips: When You Have Made a Mistake

Intel, which makes components used in 80 percent of all personal computers, introduced the powerful Pentium chip in 1993. Intel had spent $1 billion developing the chip, and the cost of producing it was estimated to be between $50 and $150 each. When the Pentium chip was finally rolled out, Intel shipped 4 million of the chips to computer manufacturers, including IBM.

In July 1994, Intel discovered a flaw in the "floating-point unit" of the chip, which is the section that completes complex calculations quickly.[82]

The flaw caused errors in division calculations involving numbers with more than eight digits to the right of the decimal, such as in this type of equation:[83]

$$\frac{4,195,835}{3,145,727} \times 3,145,727 = 4,195,835$$

[82] Evan Ramstad, "Pentium: A Cautionary Tale," *Arizona Republic*, December 21, 1994, p. C1.

[83] Janice Castro, "When the Chips Are Down," *Time*, December 26, 1994, p. 126.

Pentium-equipped computers computed the answer, in error, as 4,195,579. Before introducing the Pentium chip, Intel had run 1 trillion tests on it. Those tests showed that the Pentium chip would produce an error once every 27,000 years, making the chance of an average user getting an error one in 9 billion.

In November, Thomas Nicely, a mathematician at Lynchburg College in Virginia, discovered the Pentium calculations flaw described above. On Thanksgiving Day 1994, Intel publicly acknowledged the flaw in the Pentium chip, and the next day its stock fell from 651/8 to 637/8. Intel stated that the problem had been corrected, but flawed chips were still being shipped because a three-month production schedule was just ending. Intel initially offered to replace the chips, but only for users who ran complicated calculations as part of their jobs. The replacement offer carried numerous conditions.[84]

On December 12, 1994, IBM announced that it would stop all shipments of its personal computers because its own tests indicated that the Pentium flaw was far more frequent than Intel had indicated.[85] IBM's tests concluded that computer users working on spreadsheets for as little as fifteen minutes per day could produce a mistake every twenty-four days. Intel's then-CEO Andrew Grove called IBM's reaction "unwarranted." No other computer manufacturer adopted IBM's position. IBM's chief of its personal computing division, G. Richard Thoman, emphasized that IBM had little choice: "It is absolutely critical for this industry to grow, that people trust that our products work right."[86] Following the IBM announcement, Intel's stock price dropped 6.5 percent, and trading had to be halted temporarily.

On December 20, 1994, CEO Grove announced that Intel would replace all Pentium chips:

> We were dealing with a consumer community that was upset with us. That they were upset with us—it has finally dawned on us—is because we were telling them what's good for them … I think we insulted them.[87]

Replacing the chips could have cost up to $360 million. Intel offered to send owners a new chip that they could install or to have service firms replace chips for customers who were uncomfortable doing it themselves.

Robert Sombric, the data-processing manager for the city of Portsmouth, New Hampshire, found Intel's decision to continue selling flawed chips for months inexcusable: "I treat the city's money just as if it were my own. And I'm telling you: I wouldn't buy one of these things right now until we really know the truth about it."[88]

Following the replacement announcement, Intel's stock rose $3.44 to $61.25. One market strategist praised the replacement program: "It's about time. It's very clear they were fighting a losing battle, both in public relations as well as user confidence."[89]

[84] James Overstreet, "Pentium Jokes Fly, but Sales Stay Strong," *USA Today*, December 7, 1994, p. 1B.

[85] Ira Sager and Robert D. Hof, "Bare Knuckles at Big Blue," *BusinessWeek*, December 26, 1994, pp. 60–62.

[86] Bart Ziegler and Don Clark, "Computer Giants' War over Flaw in Pentium Jolts the PC Industry," *Wall Street Journal*, December 13, 1994, pp. A1–A11.

[87] Jim Carlton and Stephen Kreider Yoder, "Humble Pie: Intel to Replace Its Pentium Chips," *Wall Street Journal*, December 21, 1994, pp. B1–B9.

[88] Jim Carlton and Scott McCartney, "Corporations Await More Information: Will Consumers Balk?" *Wall Street Journal*, December 14, 1994, pp. B1–B5; and Stephen Kreider Yoder, "The Pentium Proposition: To Buy or Not to Buy," *Wall Street Journal*, December 14, 1994, p. B1.

[89] Carlton and Kreider Yoder, "Humble Pie," pp. B1–B9; "Intel Eats Crow, Replaces Pentiums," *Mesa Tribune*, December 21, 1994, p. F1; and Catalina Ortiz, "Intel to Replace Flawed Pentium Chips," *Arizona Republic*, December 21, 1994, pp. A1–A8.

Grove responded that Intel's delay in offering replacements was based on concerns about precedent. "If we live by an uncompromising standard that demands perfection, it will be bad for everybody," he said.[90] He also acknowledged that Intel had agreed to sell the flawed Pentium chips to a jewelry manufacturer.[91]

By December 16, 1994, ten lawsuits in three states involving eighteen law firms had been filed against Intel for the faulty chips. Chip replacement demands by customers, however, were minimal.

Intel's internal employee newsletter had an April 1, 1995, edition that spoofed the infamous chip.[92] A spoof form provided in the newsletter required customers with Pentium chips to submit a 5,000-word essay on "Why My Pentium Should Be Replaced."

In 1997, Intel launched two new products: Pentium Pro and Pentium II. A new potential bug, again affecting only intensive engineering and scientific mathematical operations, was uncovered. Intel, however, published the list of bugs, with technical information and remedies for both of the new processors. One analyst commented on the new approach, "They have learned a lot since then. You can't approach the consumer market with an engineering mindset."[93]

Discussion Questions

1. Should Intel have disclosed the flaw in the Pentium chip when it first discovered it in July 1994?
2. Should Intel have issued an immediate recall? Why do you think the company didn't do that? Discuss what issues their executives missed by applying the models you learned in Unit 1.
3. Was it ethical to offer limited replacement of the chip?
4. A joke about Intel's Pentium chip (source unknown) circulated on the Internet: Top Ten Reasons to Buy a Pentium-Equipped Computer:

   (10) Your current computer is too accurate.

   (9) You want to get into the Guinness Book of World Records as "owner of most expensive paperweight."

   (8) Math errors add zest to life.

   (7) You need an alibi for the IRS.

   (6) You want to see what all the fuss is about.

   (5) You've always wondered what it would be like to be a plaintiff.

   (4) The "Intel Inside" logo matches your decor perfectly.

   (3) You no longer have to worry about CPU overheating.

   (2) You got a great deal from the Jet Propulsion Laboratory.

   (1) And, the number one reason to buy a Pentium-equipped computer: It'll probably work.[94]

   Based on this circulating joke, discuss the long-term impact on Intel of this chip and Intel's decisions on how to handle it.
5. Assume that you are an Intel manager invited to the 1994 post-Thanksgiving meeting on how to respond to the public revelation of the flawed chips. You believe the failure to offer replacements will damage the company over the long term. Further, you feel strongly that providing a replacement is a balanced and ethical thing to do. However, CEO Grove disagrees. How would you persuade him to offer replacements to all purchasers?
6. If you could not persuade Grove to replace the chips, would you stay at the company?

[90] Ziegler and Clark, "Computer Giants' War over Flaw in Pentium Jolts the PC Industry," pp. A1–A11.

[91] Otis Port, "A Chip on Your Shoulder—or Your Cuffs," *BusinessWeek*, January 23, 1995, p. 8.

[92] Richard B. Schmitt, "Flurry of Lawsuits Filed against Intel over Pentium Flaw," *Wall Street Journal*, December 16,1994, p. B3.

[93] James Kim, "Intel Proactive with Potential Buy," *USA Today*, May 6, 1997, p. 1B.

[94] From memo furnished to author by Intel employee at the time of the Intel chip problems.

Compare & Contrast

Consider the following analysis (from "Intel Eats Crow, Replaces Pentium," *Mesa Tribune*, December 21, 1994, p. Fl):

> Regarding your article "Bare Knuckles at Big Blue" (News: Analysis & Commentary, Dec. 26), future generations of business school students will study Intel Corp.'s response to the problems with the Pentium chip as a classic case study in how to transform a technical problem into a public-relations nightmare. Intel's five-point plan consisted of the following:
>
> 1. Initially deny that the problem exists.
> 2. When irrefutable evidence is presented that the problem exists, downplay its significance.
> 3. Agree to only replace items for people who can demonstrate extreme hardship.
> 4. Continue running your current ad campaign, extolling the virtues of the product as if nothing has happened.
> 5. Count the short-term profits.[95]

List other companies discussed in this book or in other readings that followed this same five-point pattern.

Compare & Contrast

In 2003, the math department at the University of Texas at Austin complained to Dell Computers that its computers were failing. Dell examined the computers for the university, one of its major customers and a major tie-in to the student body there, and concluded that the computers were failing because those using them in the math department were performing too many complex math calculations that overtaxed the computers.

However, internal e-mails that surfaced in the discovery process of a class action lawsuit indicate that the computers sent to UT–Austin had faulty electrical components that were leaking chemicals into the computer, thus resulting in the failures. Ironically, the cause was so clear and so common that all of the computers shipped with these faulty parts failed at the same time.

Despite this knowledge, Dell employees were instructed to tell customers that the problems were not a big issue. Many companies using the computers were relying on the faulty calculations that resulted prior to the failure.

There were also e-mails and instructions to employees about downplaying the problem, telling them, "Don't bring this to the attention of the customer proactively. Emphasize uncertainty."[96] In fact, there were safety issues because of the risk of fire from the failed computers with leaking components.

Was Dell's response similar to or different from Intel's?

Dell has settled the litigation that resulted from the failed computers. Is this a difference from Intel's response?

Dell has been a Harvard Business School case since its initial success for its unique strategy, supply chain, production, and distribution. What conclusions can you draw about business acumen and praise and ethical lapses? Why do you think the employees participated in the cover-up of the underlying problems with the computers?

[95] "Intel Eats Crow, Replaces Pentiums," p. F1.

[96] Ashlee Vance, "Suit Over Faulty Computers Highlights Dell's Decline," *New York Times*, June 29, 2010, pp. B1, B2.

Case 5.13

Mortgage Foreclosure: Robo-Signatures and "Close Enough"

The Mortgage Electronic Registry System (MERS) is best described in part of a court opinion that resulted from one of the many cases filed trying to establish parties' rights under the MERS system. In *Jackson v. Mortgage Electronic*, 770 N.W.2d 487, at 490 (Minn. 2009), the Minnesota Supreme Court explained MERS succinctly:

> MERS is an electronic registration system that was created in the aftermath of the 1993 savings and loan crisis. MERS does not originate, lend, service, or invest in home mortgage loans. Instead, MERS acts as the nominal mortgagee for the loans owned by its members. The MERS system is designed to allow its members, which include originators, lenders, servicers, and investors, to assign home mortgage loans without having to record each transfer in the local land recording offices where the real estate securing the mortgage is located.

Members of MERS, which is incorporated in Delaware, paid membership fees as well as transaction fees to access MERS' records. There was an additional benefit to this centralized electronic recording system, which was that many mortgage lenders used MERS as the "mortgagee of record" on the recorded mortgage documents in lieu of the actual mortgagee because, as they believed at the time, listing MERS as the mortgagee facilitated foreclosure without having to run down who held the mortgage interest at the time of the foreclosure. Within MERS, the transfers and transferees were available to members, but only MERS appeared in the publicly recorded documents.

Such a system, however, means that the chain of title in the public records is neither present nor traceable without access to MERS. As a result, the chain of title on mortgaged properties is not clear. In fact, some courts have disallowed foreclosure using MERS documents and records because the MERS documentation is separate from the land records in government offices and the right to foreclose could not always be connected to the underlying note or the original mortgagee.

One of the problems with the MERS system was this: Who signs the documents when a mortgage holder wishes to pursue foreclosure? That is, the original publicly recorded owner of the mortgage is no longer the owner, but the owner became MERS when the mortgage was first transferred. It was difficult for those holding the mortgage to determine who actually owned the mortgage and therefore had the right to authorize foreclosure. The mortgages lacked the usual chain of title that would have appeared in the public land records if the transfers had been duly recorded.

The result was that lenders turned to foreclosure mills, law firms that processed thousands of foreclosures using a technique known as "robo-signing," where an individual with the title of "vice president" for an alleged financial institution signed all the foreclosure documentation. For example, one "Linda Greene, according to MERS foreclosure documentation, was signing as a vice president for foreclosures initiated by twenty different banks, a job she held at all 20 banks at the same time."[97] Linda Greene was a fictitious person and the signature was "close enough" for those doing the foreclosure.

[97] David E. Woolley and Lisa D. Herzog, "MERS: The Unreported Effects of Lost Chain of Title on Real Property Owners," 8 *Hastings Business Law Journal* 365, at 378. (2012).

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Discussion Questions

1. Discuss the ethical issues in creating banks, a vice president, and robo-signing mortgage foreclosure documents.
2. Determine, using Unit 1, what category of ethical dilemma you have in robo-signing.

Case 5.14

Red Cross and the Use of Funds

Following the September 11, 2001, attacks on the World Trade Center and Washington, D.C., there were many who had lost loved ones, their homes or businesses, or both.

The outpouring of support from the American public was overwhelming. The public donated $543 million for the September 11 disaster relief fund.[98] However, the Red Cross indicated it would use the funds for infrastructure support and not necessarily all of it would go to victims and their families.

When the decision to use the funds in this manner was made, Dr. Bernadine Healy resigned as president of the Red Cross, giving up her $450,010 annual salary and position.

The American public was outraged and demanded that the funds go to the victims and their families. The Red Cross eventually relented, admitted an error in judgment, and agreed to the limited and intended use of the funds.

Discussion Questions

1. Did the Red Cross commit an ethical violation in its initial decision?
2. What do you think of Dr. Healy's decision? Is she a whistleblower?
3. What policies should the Red Cross establish for the future in fundraising and fund disbursement?

[98] Marvin Olasky, "Charity Doesn't Have to Mean Bureaucracy," *Wall Street Journal*, November 21, 2001, p. A15.

Ethics in International Business

UNIT SIX

The world is your oyster.

—William Shakespeare, *The Merry Wives of Windsor*

If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of our own industry, employed in a way in which we have some advantage.

—Adam Smith, *The Wealth of Nations*

We didn't think of the payments as bribes. We thought of them as useful expenditures.

—Reinhard Siekaczek, former Siemens employee, after Siemens paid the largest fine in U.S. history for violations of the Foreign Corrupt Practices Act

Although we have a global market, we do not have global safety laws, ethical standards, or cultural customs. Businesses face many dilemmas as they decide whether to conform to the varying standards of their host nations or to attempt to operate with universal (global) standards. What we would call a bribe and illegal activity in the United States may be culturally acceptable and necessary in another country. Could you participate in such a practice?

SECTION A

Conflicts Between the Corporation's Ethics and Business Practices in Foreign Countries

Reading 6.1

Why an International Code of Ethics Would Be Good for Business[1]

The global market presents firms with more complex ethical issues than they would experience if operations were limited to one country and one culture. Moral standards vary across cultures. In some cases, cultures change and evolve to accept conduct that was not previously acceptable. For example, in some countries, it is permissible for donors to sell body organs for transplantation. Residents of other countries have sold their kidneys to buy televisions or just to improve their standard of living. In the United States, the buying and selling of organs by individuals is not permitted, but recently experts have called for such a system as a means of resolving the supply-and-demand dilemma that exists because of limited availability of donors and a relative excess of needy recipients.

In many executive training seminars for international business, executives are taught to honor customs in other countries and to "do as the Romans do." Employees are often confused by this direction. A manager for a U.S. title insurer provides a typical example. He complained that if he tipped employees in the U.S. public-recording agencies for expediting property filings, the manager would not only be violating the company's code of ethics but could also be charged with violations of the Real Estate Settlement Procedures Act and state and federal antibribery provisions. Yet, that same type of practice is permitted, recognized, and encouraged in other countries as a cost of doing business. Paying a regulatory agency in the United States to expedite a licensing process would be considered bribery of a public official. Yet, many businesses maintain that they cannot obtain such authorizations to do business in other countries unless such payments are made. So-called "grease," or facilitation, payments are permitted under the Foreign Corrupt Practices Act, but legality does not necessarily make such payments ethical.

An inevitable question arises when custom and culture clash with ethical standards and moral values adopted by a firm. Should the national culture or the company code of ethics be the controlling factor?

Typical business responses to the question of whether cultural norms or company codes of ethics should take precedence in international business operations are the following: Who am I to question the culture of another country? Who am I to impose U.S. standards on all the other nations of the world? Isn't legality the equivalent of

[1] From Larry Smeltzer and Marianne M. Jennings, "Why an International Code of Business Ethics Would Be Good for Business," *Journal of Business Ethics* 17 (1998), pp. 57–66.

ethical behavior? The attitude of businesses is one that permits ethical deviations in the name of cultural sensitivity. Many businesses fear that the risk of offending is far too high to impose U.S. ethical standards on the conduct of business in other countries.

One of the misunderstandings of U.S.-based businesses is that ethical standards in the United States vary significantly from the ethical standards in other countries. Operating under this misconception can create a great deal of ethical confusion among employees. What is known as the "Golden Rule" in the United States actually has existed for some time in other religions and cultures and among philosophers. Following is a list of how this simple rule is phrased in different writings. The principle is the same even if the words vary slightly. Strategically, businesses and their employees are more comfortable when they operate under uniform standards. This simple rule may provide them with that standard.

Categorical Imperative: How Would You Want to Be Treated?

Would you be comfortable with a world in which your standards were followed?

Christian Principle: "The Golden Rule":

> *And as ye would that men should do to you, do ye also to them likewise.*
>
> —Luke 6:31

> *Thou shalt love … thy neighbor as thyself.*
>
> —Luke 10:27

Confucius:

> *What you do not want done to yourself, do not do to others.*

Aristotle:

> *We should behave to our friends as we wish our friends to behave to us.*

Judaism:

> *What you hate, do not do to anyone.*

Buddhism:

> *Hurt not others with that which pains thyself.*

Islam:

> *No one of you is a believer until he loves for his brother what he loves for himself.*

Hinduism:

> *Do nothing to thy neighbor which thou wouldst not have him do to thee.*

Sikhism:

> *Treat others as you would be treated yourself.*

Plato:

> *May I do to others as I would that they should do unto me.*

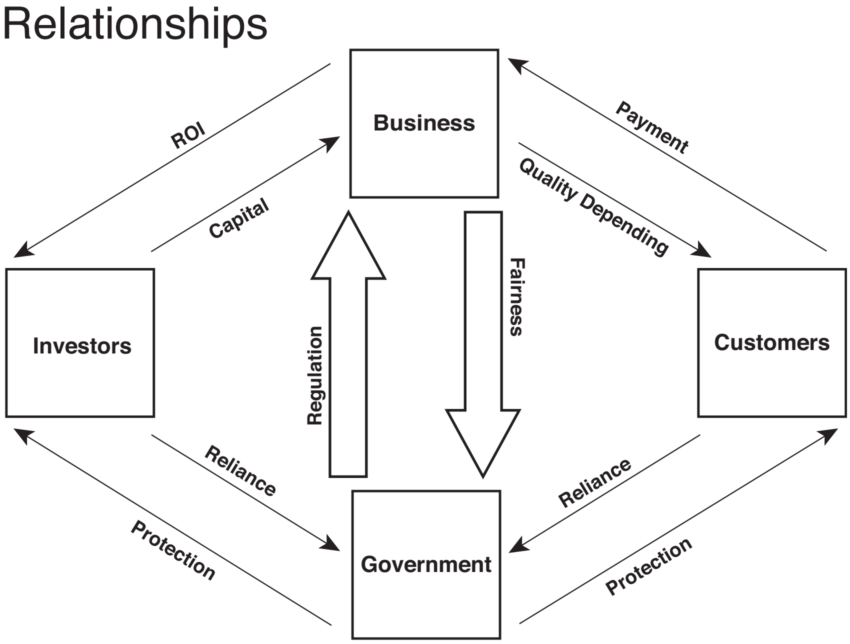
The successful operation of commerce is dependent on an ethical business foundation. A look at the three major parties in business explains this point. These parties are the risk takers, the employees, and the customers. Risk takers—those furnishing the capital necessary for production—are willing to take risks on the assumption that their products will be judged by customers' assessment of their value. Employees are willing to offer production input, skills, and ideas in exchange for wages, rewards, and other incentives. Consumers and customers are willing to purchase products and services so long as they receive value in exchange for their furnishing, through payment, income, and profits to the risk takers and employers. To the extent that the interdependency of the parties in the system is affected by factors outside of their perceived roles and control, the intended business system does not function on its underlying assumptions.

The business system is, in short, an economic system endorsed by society that allows risk takers, employees, and customers to allocate scarce resources to competing ends. Although the roots of business have been described as primarily economic, this economic system cannot survive without recognition of some fundamental values. Some of the inherent—indeed, universal—values built into our capitalistic economic system, as described here, are as follows: (1) The consumer is given value in exchange for the funds expended; (2) employees are rewarded according to their contribution to production; and (3) the risk takers are rewarded for their investment in the form of a return on that investment. This relationship is depicted in Figure 6.1.

Everyone in the system must be ethical. An economic system can be thought of as a four-legged stool. If corruption seeps into one leg, the economic system becomes unbalanced. In international business, very often the government slips into corruption, with bribes controlling which businesses are permitted to enter the country and who is awarded contracts in that country. In the United States, the current wave of reforms at the federal level is the result of perceived corruption by business in their operations in the economic system.

To a large extent, all business is based on trust. The tenets for doing business are dissolved as an economy moves toward a system in which one individual can control the market in order to maximize personal income.

FIGURE 6.1 Interdependence of Trust, Business, and Government



Suppose, for example, that the sale of a firm's product is determined not by perceived consumer value, but rather by access to consumers, which is controlled by government officials. That is, your company's product cannot be sold to consumers in a particular country unless and until you are licensed within that country. Suppose further that the licensing procedures are controlled by government officials and that those officials demand personal payment in exchange for your company's right to even apply for a business license. Payment size may be arbitrarily determined by officials who withhold portions for themselves. The basic values of the system have been changed. Consumers no longer directly determine the demand.

Beyond just the impact on the basic economic system, ethical breaches involving grease payments introduce an element beyond a now recognized component in economic performance: consumer confidence in long-term economic performance. Economist Douglas Brown has described the differences between the United States and other countries in explaining why capitalism works here and not in all nations. His theory is that capitalism is dependent on an interdependent system of production. For economic growth to be possible, consumers, risk takers, and employees must all feel confident about the future, about the concept of a level playing field, and about the absence of corruption. To the extent that consumers, risk takers, and employees feel comfortable about a market driven by the basic assumptions, the investment and commitments necessary for economic growth via capitalism will be made. Significant monetary costs are incurred by business systems based on factors other than customer value, as discussed earlier.

In developing countries where there are "speed," or grease, payments and resulting corruption by government officials, the actual money involved may not be significant in terms of the nation's culture. Such activities and payments introduce an element of demoralization and cynicism that thwart entrepreneurial activity when these nations most need risk takers to step forward.

Bribes and *guanxi* (gifts) in China given to establish connections with the Chinese government are estimated at 3 to 5 percent of operating costs for companies, totaling $3 billion to $5 billion of foreign investment in 1993. But China incurs costs from the choices government officials make in return for payments. For example, *guanxi* are often used to persuade government officials to transfer government assets to foreign investors for substantially less than their value. Chinese government assets have fallen over $50 billion in value over the same period of economic growth, primarily because of the large undervaluation by government officials in these transactions with foreign companies.

Perhaps Italy and Brazil provide the best examples of the long-term impact of foreign business corruption. Although the United States, Japan, and Great Britain have scandals such as the savings and loan failures, political corruption, and insurance regulation, these forms of misconduct are not indicative of corruption that pervades entire economic systems. The same cannot be said about Italy. Elaborate connections between government officials, the Mafia, and business executives have been unearthed. As a result, half of Italy's cabinet has resigned, and hundreds of business executives have been indicted. It has been estimated that the interconnections of these three groups have cost the Italian government $200 billion, as well as compromising the completion of government projects.

In Brazil, the level of corruption has led to a climate of murder and espionage. Many foreign firms have elected not to do business in Brazil because of so much uncertainty and risk—beyond the normal financial risks of international investment. Why send an executive to a country where officials may use force when soliciting huge bribes?

The *Wall Street Journal* offered an example of how Brazil's corruption has damaged the country's economy despite growth and opportunity in surrounding nations. The governor of the northeastern state of Paraiba in Brazil, Ronaldo Cunha Lima, was angry because his predecessor, Tarcisio Burity, had accused Lima's son of corruption. Lima shot Burity twice in the chest while Burity was having lunch at a restaurant. The speaker of Brazil's Senate praised Lima for his courage in doing the shooting himself as opposed to sending someone else. Lima was given a medal by the local city council and granted immunity from prosecution by Paraiba's state legislature. No one spoke for the victim, and the lack of support was reflective of a culture controlled by self-interest that benefits those in control. Unfortunately, these self-interests preclude economic development.

Economists in Brazil document hyperinflation and systemic corruption. A São Paulo businessman observed, "The fundamental reason we can't get our act together is we're an amoral society." This businessperson probably understands capitalism. Privatization that has helped the economies of Chile, Argentina, and Mexico cannot take hold in Brazil because government officials enjoy the benefits of generous wages and returns from the businesses they control. The result is that workers are unable to earn enough even to clothe their families; 20 percent of the Brazilian population lives below the poverty line; and crime has reached levels of nightly firefights. Brazil's predicament has occurred over time, as graft, collusion, and fraud have become entrenched in the government-controlled economy.[2]

Discussion Questions

1. What did you learn about universal values and ethics from the categorical imperative list?
2. What happens when a society does not have ethical standards? Be sure to discuss the example of the situation in Brazil.
3. Who are the victims of corruption and graft?
4. Do you think following U.S. ethical standards in other countries is wise? Would it be unethical not to follow those standards? Explain your answer.

Case 6.2

Chiquita Banana and Mercenary Protection

Chiquita Banana has been known for its poor labor and farming practices in other countries. However, in 1992, the Rainforest Alliance, a group that worked closely with logging companies to minimize harm to rainforests, sent its environmental and worker rights standards to banana companies around the world. Chiquita took the standards to heart and is now ranked as number one among producers in terms of its corporate responsibility. Among the changes Chiquita made are these:

- It recycles 100 percent of the plastic bags and twines used on its farms.
- It provided protective gear for its workers using pesticides.
- It cut pesticide use by 26 percent.
- It improved working conditions for plantation workers.
- It provided housing for workers.
- It provided schools for employees' families.
- It purchased buffer zones around plantations in order to prevent chemical runoff.
- All 110 Chiquita farms are certified by the alliance.

Chiquita notes that its pesticide costs are down, and productivity among workers is up 27 percent. Chiquita's CEO says of the changes he implemented, "This is the first time I've made an investment decision without having a spreadsheet in front of me, and it's one of the best."[3]

As Chiquita was able to put these sustainability issues behind it and earn the respect of human rights and environmental groups, another issue emerged. Between 1997 and

[2] Thomas Kamm, "Why Does Brazil Face Such Woes? Some See a Basic Ethical Lapse," *Wall Street Journal*, February 4, 1994, p. A1.

[3] Jennifer Alsever, "Chiquita Cleans Up Its Act," *Fortune*, November 27, 2006, p. 73.

2004, executives in Chiquita operations in Colombia paid $1.7 million to the United Self-Defense Forces of Colombia (AUC, named for its initials in Spanish). The AUC, according to the U.S. Justice Department, "has been responsible for some of the worst massacres in Colombia's civil conflict and for a sizable percentage of the country's cocaine exports. The U.S. government designated the right-wing militia a terrorist organization in September 2001."[4] The payments were made through a Chiquita wholly owned subsidiary known as Banadex, the company's most profitable unit by 2003.

The payments began in 1997 following a meeting between the then-leader of the AUC, Carlos Castano, and a senior executive of Banadex. No one disputes that during that meeting, Castano implied that Chiquita's failure to make the payments could result in physical harm to Banadex employees and property. Likewise, no one disputes either that the AUC was known for such violence and had been successful in obtaining payments from other companies, either following Castano's meetings with company officials or, when the companies declined, by carrying out the threat of harm as a form of warning. By September 2000, Chiquita's senior executives, its board, and many employees were aware that the payments were being made and were also aware that the AUC was a violent paramilitary organization. Chiquita officers, directors, and employees were also aware of the Banadex payments to the AUC. Chiquita recorded these payments in its financial reports and other records as "security payments" or payments for "security" or "security services." Chiquita never received any actual security services in exchange for the payments.

Beginning in June 2002, Chiquita began paying the AUC in cash according to new procedures established by senior executives of Chiquita. These new procedures concealed direct cash payments to the AUC. However, a senior Chiquita officer had described these new procedures to Chiquita's Audit Committee on April 23, 2002. These procedures were implemented well after the U.S. government designated the AUC as a terrorist organization on September 10, 2001. Under federal law, once an organization is designated by the U.S. government as a terrorist organization, companies cannot continue to do business with them because such restrictions are a means of curbing funding to and money laundering by terrorist groups. The designation of terrorist groups is available from a website the government provides to businesses via subscription. Nonetheless, from September 10, 2001, through February 4, 2004, Chiquita made fifty payments to the AUC, totaling over $825,000 of the total $1.7 million paid from 1997 through 2004.

On February 20, 2003, a Chiquita employee, aware of the payments to the AUC, told a senior Chiquita officer that he had discovered that the AUC had been designated by the U.S. government as a foreign terrorist organization (FTO). The Justice Department discovered the following sequence of events in response to the employee having raised the issue:

> Shortly thereafter, these Chiquita officials spoke with attorneys in the District of Columbia office of a national law firm ("outside counsel") about Chiquita's ongoing payments to the AUC. Beginning on Feb. 21, 2003, outside counsel emphatically advised Chiquita that the payments were illegal under United States law and that Chiquita should immediately stop paying the AUC directly or indirectly. Outside counsel advised Chiquita:
>
> "Must stop payments."
>
> "Bottom Line: Cannot Make the Payment"
>
> "Advised Not to Make Alternative Payment through Convivir"
>
> "General Rule: Cannot do indirectly what you cannot do directly"
>
> Concluded with: "Cannot Make the Payment"

[4] U.S. Department of Justice, press release, March 19, 2007, www.doj.gov.

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> "You voluntarily put yourself in this position. Duress defense can wear out through repetition. Buz [business] decision to stay in harm's way. Chiquita should leave Colombia."
>
> [T]he company should not continue to make the Santa Marta payments, given the AUC's designation as a foreign terrorist organization[.]
>
> [T]he company should not make the payment.
>
> On April 3, 2003, a senior Chiquita officer and a member of Chiquita's Board of Directors first reported to the full Board that Chiquita was making payments to a designated FTO. A Board member objected to the payments and recommended that Chiquita consider taking immediate corrective action, including withdrawing from Colombia. The Board did not follow that recommendation, but instead agreed to disclose promptly to the Department of Justice the fact that Chiquita had been making payments to the AUC Meanwhile, Banadex personnel were instructed to continue making the payments?[5]

On April 24, 2003, Roderick M. Hills, a member of Chiquita's board and head of its audit committee; Chiquita General Counsel Robert Olson; and, some reports indicate, the company's outside counsel met with members of the Justice Department to disclose the payments and explain that they had been made under duress. Mr. Hills, a former chairman of the Securities Exchange Commission, and the Chiquita officer (and perhaps its lawyer) were told that the payments were illegal and had to stop. The payments did not stop, and the company's outside counsel wrote to the board on September 8, 2003, advising that "[Department of Justice] officials have been unwilling to give assurances or guarantees of non-prosecution; in fact, officials have repeatedly stated that they view the circumstances presented as a technical violation and cannot endorse current or future payments."[6]

Nonetheless, the payments continued. From April 24, 2003, through February 4, 2004, Chiquita made twenty payments to the AUC, totaling $300,000. On February 4, 2004, Chiquita sold the Banadex operations to a Colombian-owned company.

Chiquita then cooperated with the government by making its records available. In March 2007, Chiquita entered a guilty plea and agreed to pay a $25 million fine. Chiquita will be on probation for five years and has agreed to create and maintain an effective ethics program. As of August 2007, Mr. Hills and four former Chiquita officers, including Mr. Olson, were under investigation by the Justice Department for their failure to stop the payments. A Justice Department official said of the investigation, "If the only way that a company can conduct business in a particular location is to do so illegally, then the company shouldn't be doing business there."[7]

Discussion Questions

1. Think about this question: How did Chiquita get into this position in the first place? Why did it feel that it had no choice in these circumstances? What of the sale of its most profitable unit in 2004?
2. Why does the term *technical violation* creep into our discussions of ethical and legal issues? Reid Weingarten, Mr. Hills's attorney has said, "That Rod Hills would find himself under investigation for a crime he himself reported is absurd."[8] Evaluate Mr. Weingarten's analysis of the situation.
3. Are there any lines you could draw (some elements for your credo) based on what happened at Chiquita?
4. Discuss the relationship between social responsibility and the sustainability initiative and compliance with the law. What benefits do companies gain from social responsibility actions?

[5] U.S. Department of Justice, press release #07-161:03, http://www.doj.gov.

[6] *Id.*

[7] Neil A. Lewis, "Inquiry Threatens Ex-Leader of Security Agency," *New York Times*, August 16, 2007, p. A18.

[8] Laurie P. Cohen, "Chiquita Under the Gun," *Wall Street Journal*, August 2, 2007, pp. A1, A9.

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Compare & Contrast

Chiquita's chief executive, Fernando Aguirre, said in a statement, "The payments made by the company were always motivated by our good faith concern for the safety of our employees."[9] However, Assistant Attorney General Kenneth L. Wainstein of the National Security Division of the U.S. Department of Justice offered the following thoughts in announcing the guilty plea:

> Like any criminal enterprise, a terrorist organization needs a funding stream to support its operations. For several years, the AUC terrorist group found one in the payments they demanded from Chiquita Brands International. Thanks to Chiquita's cooperation and this prosecution, that funding stream is now dry and corporations are on notice that they cannot make protection payments to terrorists. Funding a terrorist organization can never be treated as a cost of doing business. American businesses must take note that payments to terrorists are of a whole different category. They are crimes. But like adjustments that American businesses made to the passage of the Foreign Corrupt Practices Act decades ago, American businesses, as good corporate citizens, will find ways to conform their conduct to the requirements of the law and still remain competitive.[10]

Reconcile the two positions for the company. What alternatives were there? Is this the either–or conundrum you learned about in Units 1 and 2?

Case 6.3

Pirates! The Bane of Transnational Shipping

Transnational is an international company that arranges transportation for large cargo items and shipments of large orders. Transnational has a fleet of cargo ships. Each cargo ship has a crew of 25 employees.

Transnational's head of security, Jack Davis, is a retired U.S. Navy officer who, until January 2009, worked for the U.S. Department of Homeland Security. Davis has, since the time of his being hired at Transnational, alerted senior management to the evolving issue of pirates. Despite several international incidents and a growing Somalian pirate operation, the response of management to Davis's concerns has been one of postponement. So sophisticated is the pirate operation that they have an impound area at the wharf in Bosaso, on the Gulf of Aden. The pirates have actually developed a business model that they use for obtaining ransom money from the companies that own the ships:

1. The pirates penetrate ships, despite barbed (razor) wire and the use of water hoses, and a host of other pirate prevention tools, including using laser beams that blind pirates trying to approach the ship, ropes to throw into the pirates' boats' propellers to stop them from getting close to the ship, and decoy watchmen (these are dummies that are strapped to the rails to fool pirates into thinking that there is extra security aboard the ship.[11]
2. The pirates demand that the ship be taken to port, although sometimes they use the ship to take other ships during the journey.
3. After seven to ten days, the pirates make contact with the ship's owner to begin negotiations.
4. The pirates hold hostage crew and any passengers on the ship while negotiations are ongoing. Those conducting the negotiations for the ship owners could be specially trained consultants or experts who work for maritime insurance companies.

[9] Matt Apuzzo, "Chiquita to Pay $25 Million in Terrorist Case," AP, http://www.yahoo.com, March 14, 2007.

[10] U.S. Department of Justice, press release #07-161:03.

[11] Ira Boudway, "Risk Management: The Arms Race Against the Pirates," *BusinessWeek*, April 25–May 1, 2011, p. 53.

5. The average length for the negotiations is six to eight weeks. For example, in 2011, Somalian pirates held one ship with a crew of twenty-five for fifty-eight days. The average ransom for regular transport ships is $5 million. Oil tankers bring $10 million. The ship held for fifty-eight days brought a $13.5 million ransom.
6. The ransom is delivered by specially trained experts, generally by floating plastic containers, by tugboat, or through airdrops to the pirates on the ship.
7. The pirates generally take a day to count the cash, and retain hostages as they do so.
8. The ship is then retaken by the owner and escorted out of the harbor by the country's naval forces.
9. The last step is divvying up the ransom. The pirates on the boat get 30 percent. The pirates who negotiate get 10 percent. The remaining 60 percent is paid to government officials and investors. Government officials must be paid in order to ignore calls for assistance from the ship's owners and insurers. And, yes, there are investors who front the pirates for the costs of their boats and getting out to sea for purposes of a takeover. The costs of keeping the ship for fifty-eight days was about $50,000. However, with a payment of $13,500,000, the pirates earned a 26,900 percent return on their investment.[12] From the shipper's perspective, it costs between $15,000 and $50,000 per day to run the ship (crew, power, food, etc.)

The pirate industry has taken hold in Somalia, and with 23,000 ships coming through the Gulf of Aden annually, the operations of pirates appear to be located centrally. There are eighteen to twenty-one ships hijacked each year, with the hijacking going all the way through the harbor negotiation stages. Another forty-five ships, on average, have been boarded by pirates, with necessary steps taken to remove them or pay ransoms. Still another forty-five ships, on average, are fired upon by pirates, with no further possession of the ship. For every 1,000 ships, there are about 90 that are confronted by pirates. Because of these figures, the security business—those who deliver the ransoms—is booming.

Most insurers agree with Thomas Jefferson, who said that force was more economical and more honorable than paying ransoms and that the best protection is the threat of lethal force, which means having people on board the ships who are armed, have plenty of ammunition, and are specially trained. However, a four-person security team costs about $30,000 per day. In exchange, insurers will reduce the cost of insurance by $20,000. One of the problems security firms face is recruiting enough security team members who have sufficient training.

Let us posit a scenario: On September 11, 2013, a group of pirates board a Transnational ship that is, at the time of the takeover, sailing off the coast of Africa. The pirates have demanded payment of $25 million, or $1 million for each crewmember, and imposed a deadline of five hours for Transnational's decision and promise of payment. The pirates have also indicated that they will begin killing crewmembers one at a time if their deadline for Transnational's agreement to the payment is not met. Davis has advised Transnational to go ahead and simply pay the pirates because "Lives of employees are at stake and my job is protecting employees." However, a Transnational senior officer has cautioned in a meeting, "That's a bribe, and Transnational has a longstanding practice of not paying bribes."

Discussion Questions

1. The officers, the board, and Davis seek your advice. Be sure to apply all applicable principles, forms of analyses, readings, and so on, you have studied to date. What advice would you give?
2. Is the descriptor "bribe" accurate in this case?
3. Is this situation different because human life is involved?
4. What impact does the institutionalization of piracy in Somalia have on companies' decision-making processes with regard to handling the pirates and preventing pirate attacks?

[12] Robert Young Pelton, "Sea Dog Millionaires," *BusinessWeek*, May 16–22, 2011, p. 64.

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Case 6.4

The Former Soviet Union: A Study of Three Companies and Values in Conflict

PwC and the Russian Tax Authorities[13]

PriceWaterhouseCoopers (or PwC, as it is known), one of the United States' "Big 4" accounting firms, has had a tax practice in Russia since the time that country changed from Communist rule. One of PwC's clients in Russia was Yukos, a major Russian oil company that is now bankrupt.

Russia's Federal Tax Service, an agency similar to the United States' IRS, has filed suit against PwC, alleging that it concealed tax evasion by Yukos for the years 2002 to 2004. The Tax Service also announced a criminal probe of PwC's conduct with regard to its tax services for Yukos. Twenty Tax Service agents searched PwC's offices in Moscow and questioned PwC employees about the Yukos account. Yukos lost its tax case and has paid $9.2 million in charges for the nonpayment of taxes. However, Yukos and PwC do have the case on appeal.

Many see the battle between PwC and the Tax Service as part of the Russian government's ongoing battle to sell off the assets of Yukos and avoid the surrender of the company's assets to investors and creditors who have filed claims. Those suits are pending in courts in The Hague. Some analysts believe that the Russian government is hoping to press PwC into revealing information that would help it take back the Yukos assets.

If PwC is found to have engaged in evasion, it loses its license to do business in Russia, but if it turns over information, it is likely to lose its clients in Russia.

Discussion Questions

1. How did PwC get into this situation in the first place? What issues should a company consider before doing business in an economically developing country? What are the risks? Did this ethical dilemma begin long before the Russian government's demands of PwC?
2. When countries open up to capitalism and economic freedom, there is much cream—that is, businesses can move in easily and capture markets with little effort. However, what are the issues that accompany this ease of initial introduction?
3. What two PwC values would be in conflict if the Russian government demands disclosure by PwC?

Ikea and the Generators

When Ikea was poised to open a flagship store outside Moscow in 2001, its executives were approached by employees of a local utility. If Ikea wanted electricity for its planned grand opening, some bribes were needed. Ikea is known for its stringent policy of no bribes. However, Ikea was on the eve of a grand opening, complete with creditors and employees. Ikea's solution was to rent diesel generators. But corruption does have its ways. Ikea discovered that one of its managers was accepting kickbacks from the rental company that furnishes Ikea with the generators for operating its stores. Ikea ended the manager's Ikea career, as well as the contract with the rental company, and went to court in Russia to seek damages.

Ah, but who runs the courts? Judges who are, apparently, quite fond of utility workers who demand bribes. Ikea ended up owing damages to the rental company for its breach

[13] From Neil Buckley and Catherine Belton, "Moscow Raids PwC ahead of Yukos Case," *Financial Times*, March 11 2007, p. 1.

of contract. As one Ikea board member noted, "This is unlike anything" the international company has encountered in any of its operations. Ikea is still running stores in Russia, but not expanding. Its disclosure of the details of its electricity/generator experience was done by design: The company hopes that the public can sway corrupt officials into adopting a more transparent way of doing business.

Discussion Questions

1. By not succumbing to the prevailing attitude, "Well, you either bribe or you don't do business there," Ikea found an end-run, a creative solution to international business's ubiquitous either–or conundrum: To bribe or not to bribe. However, what issues did Ikea miss in its analysis of the situation?
2. Ikea discovered in 2010 that one of its executives responsible for leasing the generators was accepting kickbacks for awarding those contracts. Ikea fired the executive, but what issues can arise from this conduct?

AES and the Power Plant

AES, the U.S.-based energy company, provides power in developing countries. Because it does business in Colombia and Brazil, the problems of regimes, corruption, and expropriation are not unusual ones for the company. However, its operation of the Maikuben coal mine in northern Kazakhstan was new and different even for the seasoned international player AES had come to be.

When AES opened the mine in the former Soviet republic in 1996, it had a management experience about which most companies will only dream. The local residents who were miners there dug coal in freezing temperatures and took only tea breaks every other hour to warm up before going right back to digging. As AES expanded its operations to include power plants and transmission lines, it found a workforce with high technical abilities. Further, the work ethic of the Kazakhs was remarkable. It took only five to seven AES managers to supervise 6,500 Kazakhs.

If the employees were great, the customers were terrific. Electric utility customers, grateful for the consistency of electric service, paid on time, even with 20 percent rate increases in some years.

However, the company's relations with the Kazakhstan government were also a unique experience. At one point, in 2005, twenty-four foot soldiers, armed with AK-47s entered the office of the Maikuben mine and demanded documents for a tax case the government had brought against AES. AES officials were able to negotiate a pullback of the forces after two days of phone conversations with regional government officials. The soldiers left, AES paid a fine, and the tax case continued. By 2008, with continuing tense relationships and demands, AES, despite a $200 million investment in a power plant in the country, walked away. AES sold its assets there at fire-sale prices.

The tax rate for companies in Kazakhstan is 30 percent, plus the country's value-added tax. In addition, the regional tax officials do come calling on the companies for collection of additional revenues. Kazakhstan is a country that is rich not only in resources, but also abundant in corruption. Parker Drilling, a company with $655 million in revenue and $104 million in net profits in 2008, paid $51 million that same year in taxes for its drilling rights to Kazakhstan. ExxonMobil paid a $5 billion fine for project delays.

AES managers were grilled about their political affiliations and placed under investigation because, as local officials explained, they worked for "Americans who steal from us."[14] Many managers left the country once AES was charged with antitrust violations, because of a fear that they would be arrested. One manager explained that what was once at least considered taboo, that is, the jailing of business managers, has become the

[14] Nathan Vardi, "Power Putsch," *Forbes*, June 2, 2008, pp. 84, 90.

norm in the country. AES and others continue to pursue the assets taken by the government through arbitration in London.

Discussion Questions

1. What is the underlying cause of AES's difficulty in doing business in Kazakhstan?
2. Use the three cases in this segment to develop a list of questions and concerns for companies considering expansion into countries with rich resources but rugged due process and governance.
3. What factor must be evaluated in doing the numbers related to operations or drilling?

Case 6.5

Product Dumping

Once the Consumer Product Safety Commission prohibits the sale of a particular product in the United States, a manufacturer can no longer sell the product to U.S. wholesalers or retailers. However, the product can be sold in other countries that have not prohibited its sale. The same is true of other countries' sales to the United States. For example, Great Britain outlawed the sale of the prescription sleeping pill Halcion, but sales of the drug continue in the United States.[15] The British medical community reached conclusions regarding the pill's safety that differed from the conclusions reached by the medical community and the Food and Drug Administration here. Some researchers who conducted studies on the drug in the United States simply concluded that stronger warning labels were needed.

The Consumer Product Safety Commission outlawed the sale of three-wheel all-terrain cycles in the United States in 1988.[16] Although some manufacturers had already turned to four-wheel models, other manufacturers still had inventories of three-wheel cycles. Testimony on the cycles ranged from contentions that although the vehicles themselves were safe, the drivers were too young, too inexperienced, and more inclined to take risks (e.g., to "hot dog"). However, even after the three-wheel product was banned here, outlawed vehicles could still be sold outside the United States.

For many companies, chaos follows a product recall because inventory of the recalled product may be high. Often, firms must decide whether to "dump" the product in other countries or to take a write-off that could damage earnings, stock prices, and employment stability.

Discussion Questions

1. If you were a manufacturer holding a substantial inventory of a product that had been outlawed in the United States, would you have any ethical concerns about selling the product in countries that do not prohibit its sale?
2. Suppose the inventory write-down that you will be forced to take because of the regulatory obsolescence is material—nearly a 20 percent reduction in income will result. If you can sell the inventory in a foreign market, legally, there will be no write-down and no income reduction. A reduction of that magnitude would substantially lower share market price, which in turn would lead your large, institutional shareholders to demand explanations and possibly seek changes in your company's board of directors. In short, the write-down would set off a wave of events that would change the structure and stability of your firm. Do you now feel justified in selling the product legally in another country?
3. Is selling the product in another country simply a matter of believing one aspect of the evidence—that the product is safe? Is this decision a matter of the credo as well?
4. Would you include any warnings with the product?

[15] "The Price of a Good Night's Sleep," New *York Times*, January 26, 1992, p. E9.

[16] "Outlawing a Three-Wheeler," *Time*, January 11, 1988, p. 59.

Case 6.6

Bangladesh, Sweatshops, Suicides, Nike, Apple, Foxconn, Apple, and Campus Boycotts

In addition to the international market for goods, there is now also an international market for labor. Many U.S. firms have subcontracted the production of their products to factories in China, Southeast Asia, and Central and South America.

The National Labor Committee (NLC), an activist group, periodically releases information on conditions in foreign factories and the companies utilizing those factories. In 1998, the NLC issued a report that Liz Claiborne, Walmart, Ann Taylor, Esprit, Ralph Lauren, JCPenney, and Kmart were using subcontractors in China that use Chinese women (between the ages of 17 and 25) to work sixty to ninety hours per week for as little as 13 to 23 cents per hour. According to the 1998 report, Chinese subcontractors do not pay overtime, and they house the workers in crowded dormitories, feed them a poor diet, and operate unsafe factories.[17]

In 2012, the NLC issued several reports on international labor conditions, with the following information: Auto workers in Central America are paid 99 cents per hour; Chinese factory workers earn between 99 cents and $1.35 per hour and work twelve-to fourteen-hour days with no set day off, with many scheduled for seven-day workweeks, for overtime rates of thirty-seven hours per week, or 345 percent over the Chinese legal maximum hours per week. China shipped over $23 billion in toys and sporting goods that were manufactured in 8,000 factories in that country. According to the 2012 report, Chinese subcontractors do not pay overtime, and they house the workers in crowded dormitories, feed them a poor diet, and operate unsafe factories.[18] In 2013, there were a series of fires in Chinese factories that were producing clothes for European labels Sol's and Fox & Scott.

The History of International Labor Issues

International attention on conditions in factories outside the United States became a continuing focus of social responsibility and business when, in 1996, celebrity Kathie Lee Gifford was shocked to learn that her clothing line was produced through child labor.[19] She became an activist for reform, and the issues and debate have continued.

Some companies have tried to withdraw from using international labor because of conditions, but the market realities find few staying with U.S. labor. For example, Levi Strauss pulled its manufacturing and sales operations out of China in 1993 because of human rights violations, but announced in 1998 that it would expand its manufacturing there and begin selling clothing there. Peter Jacobi, the then-president of Levi Strauss, indicated that the company had the assurance of local contractors that they would adhere to Levi's guides on labor conditions. Jacobi stated, "Levi Strauss is not in the human rights business. But to the degree that human rights affect our business, we care about it."[20]

The countries of focus have shifted over the years of international trade expansion. For example, Mariana Islands was the site of an investigation by the U.S. Department

[17] Jon Frandsen, "Chinese Labor Practices Assailed," *Mesa (Arizona) Tribune*, March 19, 1998, p. B2.

[18] Accessed from, http://www.globallabourrights.org/results?q=Mariana+Islands&cx=002815250263393764720%3Akyyu5r4spb4&cof=FORID%3A11%3BNB%3A1&ie=UTF-8.

[19] Accessed from http://www.youtube.com/watch?v=zCszZ5lwAgA. 5. American Apparel and Footwear Association, ApparelStats 2012 Report, https://www.wewear.org/aafa-releases-apparelstats-2012-report/?CategoryId=6.

[20] Mark Landler, "Reversing Course, Levi Strauss Will Expand Its Output in China," *New York Times*, April 9, 1998, p. C1.; and G. Pascal Zachary, "Levi Tries to Make Sure Contract Plants in Asia Treat Workers Well," *Wall Street Journal*, July 28, 1994, pp. A1, A5.

of the Interior (because these islands are a U.S. territory) for alleged indentured servitude of children as young as fourteen in factories there.[21] Wendy Doromal, a human rights activist, issued a report that workers there had tuberculosis and oozing sores. In 1996, approximately $820 million worth of clothing items were manufactured there each year, including labels such as The Gap, Liz Claiborne, Banana Republic, JCPenney, Ralph Lauren, and Brooks Brothers.[22] Following a large withdrawal of manufacturers from production there, the Mariana Islands became less of a focus until 2001 and 2006, when Gloria Vanderbilt and Jones Apparel Group became targets for class action suits and settled with labor groups there. Since that time, international labor hot spots have shifted to India and China. Currently, 97 percent of all apparel sold in the United States is manufactured internationally, with 33.2 percent manufactured in China.[23]

Benefits and Risks of International Production and Suppliers

However, U.S. companies' investments in foreign manufacturing in major developing nations like China, Indonesia, and Mexico have produced some positive effects. In Hong Kong, Singapore, South Korea, and Taiwan, where plants make apparel, toys, shoes, and wigs, national incomes have risen from 10 percent to 40 percent of American incomes since 1996. In Indonesia, since the introduction of U.S. plants and subcontractors, the proportion of malnourished children in the country has gone from one-half to one-third.[24] However, as the economics of international production have changed and wages have increased in foreign production, the issue of safety of the factories has risen to the forefront. The May 2013 collapse of a clothing factory in Bangladesh resulted in the deaths of 617 workers there, and a fire in another factory there resulted in the deaths of 112 workers. In the case of the building collapse, there were five factories operating in a single building that had not been approved for industrial use. Eighty percent of Bangladesh's exports are to the United States and Europe and are comprised of textiles. These exports are 10 percent of the country's GDP. The collapsed factory produced clothing for J.C. Penney, Walmart, and Benetton. Both the companies and U.S. officials have been concerned about the safety of the factories in Bangladesh. The United States has been considering revoking the country's most favored nation trade status, but did not do so just prior to the collapse, based on assurances that government officials would increase both standards and inspections. In 2011, a group of companies that used production facilities in Bangladesh had considered joint sponsorship of independent inspections in Bangladesh, but did not reach agreement because of the cost of $500,000 for the paid inspections. Clothing is still most likely to be produced in China where Zengcheng is known as the "Blue Jeans Capital of the World."[25]

Audits and Transparency

Apple dealt with a safety issue that made international headlines because workers at its China Foxconn production factory were committing suicide.[26] As a result, Apple obtained an audit done by the Fair Labor Association, which was revealing and

[21] Zachary, "Levi Tries to Make Sure Contract Plants in Asia Treat Workers Well," pp. A1, A5.

[22] John McCormick and Marc Levinson, "The Supply Police," *Newsweek*, February 15, 1993, pp. 48–49.

[23] American Apparel and Footwear Association, ApparelStats 2012 Report, https://www.wewear.org/aafa-releases-apparelstats-2012-report/?CategoryId=6.

[24] Allen R. Myerson, "In Principle, a Case for More 'Sweatshops,'" *New York Times*, June 22, 1997, p. E5.

[25] Gordon G. Chang, "China's 'Conflict Handbags,'" *Forbes*, June 26, 2011, http://www.forbes.com/sites/gordonchang/2011/06/26/chinas-conflict-handbags/.

[26] You can read Apple's Supplier Responsibility report here: https://www.apple.com/supplierresponsibility/.

troubling.[27] Apple also followed the examples of Hewlett-Packard, Intel, and Nike, and released a list of its suppliers in order to introduce transparency in its overseas vendors.

Apple's disclosure of its suppliers also included the following evaluations of its suppliers:

- Apple listed 156 companies as suppliers, and these companies make up 97 percent of its total payments to suppliers.
- Ninety-three of the suppliers have over one-half of their workers exceeding the sixty-hour-per-week limit that Apple places in its contracts.
- One hundred and eight vendors did not pay overtime as required in their contracts. Apple has required reimbursement by some of its vendors, and those reimbursements have totaled $6.7 million since 2008.
- There were 229 audits by Apple of suppliers (that is an increase of 80 percent over the number of audits in 2010).
- Apple conducted fourteen environmental audits related to conditions at factories (such as fumes) and brought in experts to help solve the problems at those factories. (There have been reports of injuries to 137 employees at Apple's Chinese suppliers due to employee inhalation of n-hexane.)
- Apple has joined the Fair Labor Association, a nonprofit that works to improve factory conditions around the world.
- Apple has expanded its Supplier Employee Education and Development (SEED) program and continues to offer free classes to employees in English, finance, and computer skills.
- Apple terminated two repeat offender suppliers.
- Apple requires suppliers who use underage workers to return those workers to school and finance their education, including continuing income at the same level received when working for the Apple supplier. The 2011 audit found no evidence of underage workers among Apple's suppliers.

Apple's suppliers have even been the subject of a controversial play by Mike Daisey, "The Agony and Ecstasy of Steve Jobs," which ran at the Public Theater in New York. The play focused on Apple's supply chain and its manufacturing processes in China and is credited with bringing international attention to the problems at Apple's suppliers. National Public Radio broadcast the play on one of its weekly public radio programs, *This American Life*. However, Rob Schmitz, an NPR reporter for another public radio program, *Marketplace*, did some fact-checking on the Daisey play, and an NPR hour-long retraction via interviews and disclosures followed. Mr. Daisey was unable to provide contact numbers for the people whose stories were told in the play. Indeed, Mr. Daisey could not even provide a phone number for his interpreter that he said he had used in researching the Apple supplier plants in China. Ira Glass, the NPR producer for *American Life* disclosed that the parts of the Daisey play that audiences found most compelling were the parts that were fabricated. Mr. Daisey responded by explaining why he did not come clean when the fact checking began. "I think I was terrified that if I united these things, that the work, that I know is really good, and tells a story, that does these really great things for making people care, that it would come apart in a way where, where it would ruin everything."[28]

Current Issues and New Solutions

A new target in labor market issues has been the handbag industry. Hong Kong factories produce handbags for upscale handbag brands such as Michael Kors, DKNY, Burberry, Kate Spade, and Coach. In 2011, there was a protest by 4,000 workers in Hong King over working conditions such as being forced to stand during twelve-hour shifts, with only two toilet breaks, and being forbidden to drink water while on the job.

Nike has long been a target of labor activists and continues to be, with a unique twist of campus protests and boycotts for its overseas plant conditions. Students protest against their colleges and universities signing licensing agreements with Nike. For example,

[27] FOXCONN Technology Group Workforce Perception and Satisfaction Report, 2012, http://www.fairlabor.org/sites/default/files/documents/reports/appendix_3_scope_survey_data.pdf.

[28] David Carr, "Theater; Disguised As Real Journalism," *New York Times*, March 19, 2012, p. B1.

Nike ended negotiations with the University of Michigan for a six-year, multimillion dollar licensing agreement because Michigan joined the consortium. And Phil Knight withdrew a pledge to make a $30 million donation to the University of Oregon because the university joined the consortium. Nonetheless, Knight acknowledged a brand image problem: "Nike product has become synonymous with slave wages, forced overtime, and arbitrary abuse."[29]

In 2008, public reports emerged about conditions in Nike's factories in Malaysia. When the stories broke, Nike called representatives from its thirty factories in the country to its headquarters and held several days of discussion and training on the importance of enforcing the company's labor standards. A labor activist from Australia praised the company for its prompt action, noting that ten years earlier a response from Nike would have been slow in coming. However, the activist also noted, "But, we're looking for systematic change that improves conditions across the supply chain, not solutions once problems are exposed."[30] As a result, Nike has introduced "lean manufacturing" into the supply chain. This form of production shifts from low-skill assembly lines to organizing workers into multitask teams. The team members require more training, something that requires factory owners to invest in their workers. With that investment, the worker abuse is reduced or stops because the factory owners want to hang on to the trained employees in order to enjoy returns on the skills training they have given.

Another change Nike has made focuses on its decision processes for shoe design and production. The teams in Beaverton, Oregon, learned that their last-minute changes placed unnecessary stress on the factories and, as a result, the workers. Reducing the production crunch has also reduced the hours, stress, and likelihood of abuse. Beaverton has now developed a sensitivity that its design changes, schedule, and final decisions do impact the supply chain, including the labor conditions.

Nike is also working with suppliers to solve the strains rather than pushing all of the responsibility onto them for compliance with company standards. The adoption of this quasi-partnership means of solving labor issues is also a result of Nike's realization that just terminating contracts is problematic. When Nike simply ended a contract with a company that produced its soccer balls in Pakistan because of labor issues there, Nike experienced backlash from that country for the loss of jobs. Nike and other retailers have learned that international production does provide not only cost savings but also requires a tough balancing act that is sensitive to workers, the nature of the country and its economy, and the needs and practices of their suppliers.

Child Labor

Another troubling issue that clothing companies continue to face is the reality that it is widely accepted in other countries for children, ages 10 to 14, to work in factories for fifty or more hours per week. Their wages enable their families to survive. School is a luxury, and a child attends only until he or she is able to work in a factory. The Gap, Levi Strauss, Esprit, and Leslie Fay have all been listed in social responsibility literature as exploiting their workers.[31] Foxconn Technology Group has admitted that it has employed interns as young as age 14 for work in its Yantai facility, a facility that puts together Nintendo hardware. The young workers were sent to the facility as part of a program the company had with local vocational schools. Foxconn did not check identification for the young workers, and as a result, the young students were working in an area of the factory that produced accessories. They were paid $244 per month, but they had to work overtime if they did not complete their assigned projects. The internships usually last 3.5 months. Foxconn's labor force of 1.2 million had 2.7 percent in interns in the 14- to 16-year-old age group.

[29] Eugenia Levenson, "Citizen Nike," *Fortune*, November 24, 2008, p. 165.

[30] Levenson, "Citizen Nike," p. 165.

[31] Dana Canedy, "Peering into the Shadows of Corporate Dealings," *New York Times*, March 25, 1997, pp. C1, C6.

Nintendo quickly denounced the use of child labor and explained that it was a violation of its company policy on social responsibility as well as the provisions it has in its contracts with all suppliers. Foxconn issued a statement indicating that no Apple products were assembled at its Yantai facility and that it had moved quickly to return the students to their vocational schools.

China Labor Watch indicated that the schools were primarily responsible for sending the underage workers to the plants, but that Foxconn was responsible for confirming their ages.

Foxconn has had a difficult year in terms of labor issues that have affected its U.S.-based customers. In September 2012, Foxconn was forced to close a facility in Taiyuan after labor unrest there resulted in "civil unrest."[32] The legal age for work in China is age 16. Most supplier agreements require suppliers such as Foxconn to comply with the labor laws of their country. The penalties for violation of those laws include termination of the agreement or the addition of on-site monitors to ensure compliance. However, the likelihood of termination is small because the cost of having the hardware for the Wii, for example, produced elsewhere would double or triple because of the differences in wages. The company could also face charges from the government of labor law violations. However, no action has been taken by the Chinese government in this case or any of the other situations found at the company's various facilities.

Industry and Regulatory Efforts

The American Apparel and Footwear Association (AAFA) (formerly the American Apparel Manufacturers Association [AAMA]) and the Footwear Industries of America (FIA), which merged into the AAFA, has 425 U.S. garment makers and shoemakers, representing 1,000 brands, in its membership, and it has a database for its members to check labor compliance by contractors.[33] Seventy-five percent of clothing retailers in the United States are members of AAFA. The National Retail Federation has established the following statement, Principles on Supplier Legal Compliance (now signed by 250 retailers):

1. We are committed to ensuring that sewn products are produced under lawful, humane and ethical conditions. As such, AAFA members make every effort to eliminate the use of forced and child labor from their supply chain.
2. AAFA strongly supports the concept behind the ILO/IFC Better Work program—taking a comprehensive approach to improving compliance with international labor standards within a country with the active participation of the national government, workers, employers, and buyers. We choose suppliers that we believe share that commitment.
3. In our purchase contracts, we require our suppliers to comply with all applicable laws and regulations.
4. If it is found that a factory used by a supplier for the production of our merchandise has committed legal violations, we will take appropriate action, which may include canceling the affected purchase contracts, terminating our relationship with the supplier, commencing legal actions against the supplier, or other actions as warranted.
5. We support law enforcement and cooperate with law enforcement authorities in the proper execution of their responsibilities.
6. We support educational efforts designed to enhance legal compliance on the part of the U.S. apparel manufacturing industry.[34]

[32] Paul Mozur, "Foxconn Factory in China Used 14-Year-Old Workers," *Wall Street Journal*, October 17, 2012, p. B1.

[33] "Slave Labor," *Fortune*, December 9, 1996, p. 12.

[34] Martha Nichols, "Third-World Families at Work: Child Labor or Child Care?" *Harvard Business Review* (January–February 1993), pp. 12–23.

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The U.S. Department of Labor made the following recommendations to companies in order to improve the international labor situation:

1. All sectors of the apparel industry, including manufacturers, retailers, buying agents and merchandisers, should consider the adoption of a code of conduct.
2. All parties should consider whether there would be any additional benefits to adopting more standardized codes of conduct [to eliminate confusion resulting from a proliferation of different codes with varying definitions of child labor].
3. U.S. apparel importers should do more to monitor subcontractors and homeworkers [the areas where child labor violations occur].
4. U.S. garment importers—particularly retailers—should consider taking a more active and direct role in the monitoring and implementation of their codes of conduct.
5. All parties, particularly workers, should be adequately informed about codes of conduct so that the codes can fully serve their purpose.[35]

Some states, such as California, have passed transparency laws that require companies doing business in California to disclose whether the company does the following:[36]

1. Engages in verification of product supply chains to evaluate and address risks of human trafficking and slavery. The disclosure shall specify whether the verification was not conducted by a third party;
2. Conducts audits of suppliers to evaluate supplier compliance with company standards for trafficking and slavery in supply chains. The disclosure shall specify whether the verification was not an independent, unannounced audit.
3. Requires direct suppliers to certify that materials incorporated into the product comply with the laws regarding slavery and human trafficking of the country or countries in which they are doing business;
4. Maintains internal accountability standards and procedures for employees or contractors failing to meet company standards regarding slavery and trafficking; and
5. Provides company employees and management, who have direct responsibility for supply chain management, training on human trafficking and slavery, particularly with respect to mitigating risks within the supply chains of products.[37]

Discussion Questions

1. One executive noted, "We're damned if we do because we exploit. We're damned if we don't because these foreign economies don't develop. Who's to know what's right?" How does this observation compare with the changes and experiences of the companies covered in the case?
2. Would you employ a 12-year-old in one of your factories if it were legal to do so?
3. Would you limit hours and require a minimum wage even if it were not legally mandated?
4. Would you work to provide educational opportunities for these child laborers?
5. Why do you think the public seizes on the Nike issues, but not the Apple issues? That is, there is no boycott of Apple products despite continuing labor issues emerging within the company's international supply chain. Why?

Compare & Contrast

Levi Strauss & Company, discovering that youngsters under the age of 14 were routinely employed in its Bangladesh factories, could either fire forty underage youngsters and impoverish their families or allow them to continue working. Levi compromised and provided the children both access to education and full adult wages.

[35] Daniela Deane, "Senators to Hear of Slave Labor on U.S. Soil," *USA Today*, March 31, 1998, p. 9A.

[36] California Transparency in Supply Chains Act of 2010. (S.B. 657) codified at Cal. Civ. Code.

[37] §1714.43 (2013).

Nike has shoe factories in Indonesia, and the women who work in those factories net $37.46 per month. However, as Nike points out, their wages far exceed those of other factory workers. Nike's Dusty Kidd notes, "Americans focus on wages paid, not what standard of living those wages relate to."

Economist Jeffrey D. Sachs of Harvard has served as a consultant to developing nations such as Bolivia, Russia, Poland, and Malawi. He observes that the conditions in sweatshops are horrible, but they are an essential first step toward modern prosperity. "My concern is not that there are too many sweatshops, but that there are too few. These are precisely the jobs that were the stepping stone for Singapore and Hong Kong, and those are the jobs that have to come to Africa to get them out of their backbreaking rural poverty."[38]

Business executives respond as follows,

> If someone is willing to work for 31 cents an hour, so be it—that's capitalism. But throw in long hours, abusive working conditions, poor safety conditions, and no benefits, and that's slavery. It was exactly those same conditions that spawned the union movement here in the U.S.
>
> —John Waldron

> If the wages of 31 cents per hour were actually fair wages, adults would gladly do the work instead of children.
>
> —Wesley M. Johnson

> Just when you think the vile remnants of those who would build empires on the blood and bones of those less fortunate than ourselves have slithered off into the history books, you come across this kind of tripe. For shame for rationalizing throwing crumbs to your fellow human beings so that you and your ilk can benefit at their expense.
>
> —Jose Guardiola

Economists have made some critical points about wages in developing countries. One point is that the employees hired at the wages in these countries lack the skills necessary for the pace of production that would exist in a country with a trained workforce. The lower wages are a means of pricing the lower productivity. Another point economists make is that joblessness in developing countries presents a greater social cost and precludes the country from evolving economically. For example, there was child labor in the United States until the federal labor legislation addressed it fully during the 1930s. Economists maintain that wages increase as skills do, and the initial wages are a just a first step in economic development for the country.[39]

Discussion Questions

1. Discuss the economic, social, and ethical issues of plants and wages in developing countries.
2. Discuss the merits in the various positions on child labor and sweat shops in a company's supply chain.

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"Nike's Workers in Third World Abused, Report Says," *Arizona Republic*, March 28, 1997, p. A10.

"Susie Tompkins," *Business Ethics*, January/February, 1995, pp. 21–23.

[38] "Slave Labor," p. 12.

[39] For additional perspective on these issues, see "Invasion of the Job Snatchers," *The Economist*, November 2, 1996, p. 18. © 1996 The Economist Newspaper Group Inc.

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Case 6.7

Bhopal: When Safety Standards Differ[40]

Bhopal is a city in central India with a population, in 1984, of 800,000. Because it was, at that time, home to the largest mosque in India, Bhopal was a major railway junction. Its main industries consisted of manufacturing heavy electrical equipment, weaving and printing cotton cloth, and milling flour.

In 1969, American Union Carbide Corporation, a company headquartered in Danbury, Connecticut, reached an agreement with the Indian government for the construction of a Union Carbide plant in Bhopal. Union Carbide would hold a 51 percent interest in the plant through its share of ownership of an Indian subsidiary of American Union Carbide. The agreement was seen as a win–win situation. India would have the plant and its jobs as well as the production of produce pesticides, a product needed badly by Indian farmers in order to increase agricultural productivity. In addition, Union Carbide also agreed that it would use local managers, who would be provided with the necessary skills and management training so that the plant would be truly locally operated.

The plant used methyl isocyanate (MIC) gas as part of the production process for the pesticides. MIC is highly toxic and reacts strongly with other agents, including water. Operation of a plant with MIC processes requires detailed monitoring as well as security processes to prevent sabotage.

Although the plant began operations with high hopes, by 1980 the relationships were strained because the plant was not profitable. Union Carbide had asked the Indian government for permission to close the plant, but the government felt the products from the plant, as well as the jobs, were needed for the Indian economy.

Sometime in the early morning hours of December 3, 1984, MIC stored in a tank at the Bhopal plant came in contact with water, and the result was a boiling effect in the tank. The backup safety systems at the plant, including cooling components for the tanks, did not work. The result was the toxic mixture began to leak, and workers at the plant felt a burning sensation in their eyes. The boiling of the water and MIC caused the safety valves on the tank to explode. Following the explosion, the white smoke from the lethal mixture escaped through a smoke stack and began to spread across the area to the city of Bhopal.

As the gas spread, it wove its way through the shantytowns that were located near the plant. The occupants of these shantytowns were Bhopal's poorest. As the gas floated through these makeshift neighborhoods, 3,500 lives were lost and 200,000 were injured. The injuries included blindness, burns, and lesions in the respiratory system.

The initial deaths and injuries were followed by long-term health effects. Of the women who were pregnant and exposed to the MIC, one-fourth either miscarried or had babies with birth defects. Children developed chronic respiratory problems. Smaller children who survived the toxic gas were sick for months and, weak from a lack of nutrition and ongoing illnesses, also died. MIC also produced strange boils on the bodies of many residents, boils that could not be healed. The problem of tuberculosis in the area was exacerbated by the lung injuries caused by the leaking MIC.

In the year following the accident, the Indian government spent $40 million on food and health care for the Bhopal victims. Warren M. Anderson, Union Carbide's chairman of the board at the time of the accident, pledged that he would devote the remainder of his career to solving the problems that resulted from the accident. However, by the end of the first year, Mr. Anderson told *Business Week*, "I overreacted. Maybe they, early on,

[40] Adapted from Marianne M. Jennings, *Case Studies in Business Ethics,* 2nd ed.

thought we'd give the store away. [Now] we're in litigation mode. I'm not going to roll over and play dead."[41]

Following the accident, Union Carbide's stock fell sixteen points and it became, in the go-go 1980s, a takeover target. When GAF Corporation made an offer, Union Carbide incurred $3.3 billion in debt in order to buy 56 percent of its own stock to avert a takeover. Through 1992, Union Carbide remained in a defensive mode as it coped with litigation, takeover attempts, and the actions of the Indian government in seeking to charge officers, including Anderson, with crimes.[42]

U.S. lawyers brought suit in the United States against Union Carbide on behalf of hundreds of Bhopal victims, but the case was dismissed because the court lacked jurisdiction over the victims as well as the plant. Union Carbide did settle the case with the Indian government for a payment of $470 million. There were 592,635 claims filed by Bhopal victims. The victims received, on average, about $1,000 each. The ordinary payment from the Indian government, as when a government bus harms an individual, is $130 to $700, depending upon the level of the injury. Individual awards were based on earning capacity, so, for example, widows of the Bhopal accident received $7,000.

The Indian government also pursued criminal charges, including against Mr. Anderson. Lawyers for the company and Mr. Anderson continued to fight the charges, largely on the basis that the court had no jurisdiction over Mr. Anderson. However, to be on the safe side, Mr. Anderson did not return to India because of his fear of an arrest.

In May 1992, the Indian government seized the plant and its assets and announced the sale of its 50 percent interest in the plant. When the sale occurred and Union Carbide received its share of the proceeds, it contributed $17 million to the Indian government for purposes of constructing a hospital near Bhopal. The plant now makes dry-cell batteries.

Following the accident, Union Carbide reduced its workforce by 90 percent. Because of the share purchase, Union Carbide had a debt-to-equity ratio of 80 percent. In addition, the Union Carbide brand was affected by the accident, and the company could not seem to gain traction. Dow Chemical would acquire the company in 1999 for $11.6 billion.

In 2008, a study revealed that pesticide residues in the water supply for the area surrounding the plant were at levels above permissible ones. There are about 425 tons of waste buried near the former plant. Advocates continue to appear at Dow shareholder meetings in order to demand cleanup. Dow's response is, "As there was never any ownership, there is no responsibility and no liability—for the Bhopal tragedy or its aftermath."[43]

Discussion Questions

1. Should the Bhopal plant have been operated using U.S. safety and environmental standards? What would the U.S. policy be on the shantytowns?
2. Should the case have been moved to the United States for recover?
3. List all of the costs of the accident to Union Carbide.
4. Evaluate Dow's position on the cleanup.
5. Later studies seem to indicate that the cause of the accident was sabotage. How does this affect your analysis?

[41] Leslie Helm et al., "Bhopal, A Year Later: Union Carbide Takes a Tougher Line," *BusinessWeek*, November 25, 1985, p. 96.

[42] Scott McMurray, "Union Carbide Offers Some Sober Lessons in Crisis Management," *Wall Street Journal*, January 28, 1992, p. A1.

[43] Somini Sengupta, "Decades Later, Toxic Sludge Torments Bhopal," *New York Times*, July 7, 2008, p. A1.

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Case 6.8

Nestlé: Products That Don't Fit Cultures

The Cultural Differences and Sales Tactics

Although the merits and problems of breast-feeding versus using infant formula are debated in the United States and other developed countries, the issue is not so balanced in third-world nations. Studies have demonstrated the difficulties and risks of bottle-feeding babies in such places.

First, refrigeration is not generally available, so the formula, once it is mixed or opened (in the case of premixed types), cannot be stored properly. Second, the lack of purified water for mixing with the formula powder results in diarrhea or other diseases in formula-fed infants. Third, inadequate education and income, along with cultural differences, often lead to the dilution of formula and thus greatly reduced nutrition.

Medical studies also suggest that regardless of the mother's nourishment, sanitation, and income level, an infant can be adequately nourished through breast-feeding.

In spite of medical concerns about using their products in these countries, some infant formula manufacturers heavily promoted bottle-feeding.

These promotions, which went largely unchecked through 1970, included billboards, radio jingles, and posters of healthy, happy infants, as well as baby books and formula samples distributed through the health care systems of various countries.

Also, some firms used "milk nurses" as part of their promotions. Dressed in nurse uniforms, "milk nurses" were assigned to maternity wards by their companies and paid commissions to get new mothers to feed their babies formula. Mothers who did so soon discovered that lactation was undermined and could not be achieved, so the commitment to bottle-feeding was irreversible.

Awareness of the Impact of International Formula Sales

In the early 1970s, physicians working in nations where milk nurses were used began vocalizing their concerns. For example, Dr. Derrick Jelliffe, then the director of the Caribbean Food and Nutrition Institute, had the Protein-Calorie Advisory Group of the United Nations place infant formula promotion methods on its agenda for several of its meetings.

Journalist Mike Muller first brought the issue to public awareness with a series of articles in the *New Internationalist* in the 1970s. He also wrote a pamphlet on the promotion of infant formulas called "The Baby Killer," which was published by a British charity, War on Want. The same pamphlet was published in Switzerland, the headquarters of Nestlé, a major formula maker, under the title "Nestlé Kills Babies." Nestlé sued in 1975, which resulted in extensive media coverage.

In response to the bad publicity, manufacturers of infant formula representing about 75 percent of the market formed the International Council of Infant Food Industries to establish standards for infant formula marketing. The new code banned the milk nurse commissions and required the milk nurses to have identification that would eliminate confusion about their "nurse" status.

The code failed to curb advertising of formulas. In fact, distribution of samples increased. By 1977, groups in the United States began a boycott against formula makers over what Jelliffe called "comerciogenic malnutrition."

One U.S. group, Infant Formula Action Coalition (INFACT), worked with the staff of U.S. Senator Edward Kennedy of Massachusetts to have hearings on the issue by the Senate Subcommittee on Health and Human Resources, which Kennedy chaired. The hearings produced evidence that 40 percent of the worldwide market for infant formula,

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which totaled $1.5 billion at the time, was in Third World countries. No regulations resulted, but Congress did tie certain forms of foreign aid to the development by recipient countries of programs to encourage breast-feeding.

The Impact on Nestle

Boycotts against Nestlé products began in Switzerland in 1975 and in the United States in 1977. The boycotts and Senator Kennedy's involvement heightened media interest in the issue and led to the World Health Organization (WHO) debating the issue of infant formula marketing in 1979 and agreeing to draft a code to govern it.

After four drafts and two U.S. presidential administrations (Jimmy Carter and Ronald Reagan), the 118 member nations of WHO finally voted on a code for infant formula marketing. The United States was the only nation to vote against it; the Reagan administration opposed the code being mandatory. In the end, WHO made the code a recommendation only, but the United States still refused to support it.

The publicity on the vote fueled the boycott of Nestlé, which continued until the formula maker announced it would meet the WHO standards for infant formula marketing. Nestlé created the Nestlé Infant Formula Audit Commission (NIFAC) to demonstrate its commitment to and ensure its implementation of the WHO code.

In 1988, Nestlé introduced a new infant formula, Good Start, through its subsidiary, Carnation. The industry leader, Abbott Laboratories, which held 54 percent of the market with its Similac brand, revealed Carnation's affiliation: "They are Nestlé," said Robert A. Schoellhorn, Abbott's chairman and CEO.[44] Schoellhorn also disclosed that Nestlé was the owner of Beech-Nut Nutrition Corporation, officers of which had been indicted and convicted (later reversed) for selling adulterated apple juice for babies.[45]

Carnation advertised Good Start in magazines and on television. The American Academy of Pediatrics (AAP) objected to this direct advertising, and grocers feared boycotts.

The letters "H.A." came after the name "Good Start," indicating the formula was hypoallergenic. Touted as a medical breakthrough by Carnation, the formula was made from whey and advertised as ideal for babies who were colicky or could not tolerate milk-based formulas.

Within four months of Good Start's introduction in November 1988, the FDA was investigating the formula because of six reported cases of vomiting due to the formula. Carnation then agreed not to label the formula hypoallergenic and to include a warning that milk-allergic babies should be given Good Start only with a doctor's approval and supervision.

Continuing Debate Over Infant Formula

In 1990, with its infant formula market share at 2.8 percent, Carnation's president, Timm F. Crull, called on the AAP to "examine all marketing practices that might hinder breast-feeding."[46] Crull specifically cited manufacturers' practices of giving hospitals education and research grants, as well as free bottles, in exchange for having exclusive rights to supply the hospital with formula and to give free samples to mothers. He also called for scrutiny of the practice of paying pediatricians' expenses to attend conferences on infant formulas.

The AAP looked into prohibiting direct marketing of formula to mothers and physicians' accepting cash awards for research from formula manufacturers.

[44] Rick Reiff, "Baby Bottle Battle," *Forbes*, November 28, 1988, pp. 222–224.

[45] For details of the Beech-Nut apple juice case, see Case 4.27.

[46] Julia F. Siler and D. Woodruff, "The Furor over Formula Is Coming to a Boil," *BusinessWeek*, April 9, 1990 pp. 52–53.

The distribution of samples in Third World countries continued during this time. Studies by the United Nations Children's Fund found that a million infants were dying every year because they were not breast-fed adequately. In many cases, the infant starved because the mother used free formula samples and could not buy more, while her own milk had dried up. In 1991, the International Association of Infant Food Manufacturers agreed to stop distributing infant formula samples by the end of 1992.

In the United States in 1980, the surgeon general established a goal that the nation's breast-feeding rate be 75 percent by 1990. The rate remains below 60 percent, however, despite overwhelming evidence that breast milk reduces susceptibility to illness, especially ear infections and gastrointestinal illnesses. The AAP took a strong position that infant formula makers should not advertise to the public, but, as a result, new entrants into the market (such as Nestlé with its Carnation Good Start) were disadvantaged because the long-time formula makers Abbott and Mead Johnson were well established through physicians. In 1993, Nestlé filed an antitrust suit alleging a conspiracy among the AAP, Abbott, and Mead Johnson.

Some 200 U.S. hospitals have voluntarily stopped distributing discharge packs from formula makers to their maternity patients because they felt it "important not to appear to be endorsing any products or acting as commercial agents."[47] A study at Boston City Hospital showed that mothers who receive discharge packs are less likely to continue nursing, if they nurse at all. UNICEF and WHO offer "Baby Friendly" certification to maternity wards that take steps to eliminate discharge packs and formula samples.

Discussion Questions

1. If you had been an executive with Nestlé, would you have changed your marketing approach after the boycotts began?
2. Did Nestlé suffer long-term damage because of its third-world marketing techniques?
3. How could a marketing plan address the concerns of the AAP and WHO?
4. Is anyone who worked in the infant formula companies responsible for the deaths of infants described in the United Nations study? Is there a line that companies could draw that emerges in this case?
5. Is the moratorium on distributing free formula samples voluntary? Would your company comply?
6. If you were a hospital administrator, what policy would you adopt on discharge packs?
7. Should formula makers advertise directly to the public? What if their ads read, "Remember, breast is best"?

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[47] Andrea Gerlin, "Hospitals Wean from Formula Makers' Freebies," *Wall Street Journal*, December 29, 1994, p. A1.

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Case 6.9

The Internet, Censorship, and Human Rights in China

In 2006, at the request of the Chinese government, Yahoo's Chinese subsidiary turned over the name of journalist Shi Tao. Tao was a dissident who was posting information about the government's activities on the Internet. Tao was arrested and is now serving a ten-year term. His crime was disclosing "state secrets." Yahoo's subsidiary there is now defunct, and it has created a committee within the company to address issues of privacy and freedom of expression.

However, Rep. Chris Smith (R-NJ) has proposed a bill in the House that would ban companies from disclosing information to governments such as China's that would identify individual Internet users. Yahoo's then-CEO Jerry Yang and its general counsel, Michael Callahan, appeared before the House Foreign Affairs Committee to testify regarding the bill. Both apologized for Yahoo's role in the journalist's imprisonment, but both also refused to endorse the bill. The Electronic Frontier Foundation (EFF) has been working with Internet companies to develop a code of Internet privacy policies that would address issues such as the Tao disclosure, but the effort has been moving very slowly. Currently, the EFF has projects on Bloggers' Rights, Coders' Rights, and what the organization refers to as "Free Speech Weak Links" and "Global Chokepoints." The Free Speech Weak Link project refers to points of controls that can be placed on intermediaries between those doing the speaking (such as bloggers) and their audience. The government has controls on web hosts, Internet Service Providers (ISPs), and search engines. For example, the Egyptian government forced that country's ISPs offline during its revolution, which meant that all online speech was blocked. ISPs can also be forced to filter content to prevent access to certain domain names, as is the case with Belgium and Norway requiring filters on child pornography. Iran and China mandate filters on political content sites. The Chinese government regulates search engines. For example, it has required Baidu.com to edit certain of its results, thus limiting what users are able to see online. Even payment service providers can place constraints on speech; Wikileak's ability to survive was in question when PayPal and several other payment services refused to process donations. Companies that choose to enter these markets generally are upbeat upon entry, as are their shareholders because of the potential growth. However, if an ethical issue arises because of their willingness to live with censorship, they will have negative backlash as well as shareholder unease. For example, Yahoo's shares dropped 7.7 percent following the testimony related to its role in China. There was a 2.7 percent NASDAQ drop the same day because of a weakening market.

Companies have attempted to enter these countries by using different names, names that will not affect their major brand should something totalitarian occur involving their services. For example, Yahoo owns a 39 percent interest in Alibaba.com Ltd., a Chinese Internet firm that completed a successful IPO in Hong Kong the same week as the hearings on the Chinese dissidents. Because of the transfer of assets and goodwill to Alibaba, Yahoo maintains that it does not do business in China. Mr. Yang does serve on Alibaba's board. The close connection between the company and these foreign subsidiaries makes it difficult to avoid the backlash.

Rep. Smith said at the time of the Yahoo hearings that he was "absolutely bewildered and angered" by Yahoo's position.[48] Goa Qin Sheng, mother of Tao, wept in the hearing

[48] Jim Hopkins and Jefferson Graham, "Yahoo Shares Savaged over China Journalist," *USA Today*, November 8, 2007, p. 3B.

room as Yang testified. Rep. Tom Lantos told Mr. Yang, "While technologically and financially you are giants, morally, you are pygmies." Yang added, in addressing the family member present, "I want to say we are committed to doing what we can to secure their freedom. And I want to personally apologize for what they are going through."[49]

Another issue that emerged was that Mr. Callahan's testimony, given to Congress in 2006 when the imprisonment in China first occurred, was incorrect. Mr. Callahan testified that Yahoo did not know the nature of the reason for the Chinese government's request when it turned over the information. However, congressional staff members established that Yahoo employees did know the nature of the request, even if Mr. Callahan did not. When Mr. Callahan learned the full story on what had happened, he failed to take steps to inform Congress about the incorrect testimony. However, members of the committee felt that Yahoo was either "negligent" or "deliberately deceptive." "How could a dozen lawyers prepare another lawyer to testify before Congress without anyone thinking to look at the document that had caused the hearing to be called? This is astonishing," was the response of Rep. Smith.

The committee urged Yahoo to get involved in humanitarian efforts to assist the families of the jailed dissidents. Professor John Palfrey of the Berkman Center for the Internet & Society at Harvard Law School said, "There's no avoiding the ethical consequences of doing business as a technology company in regimes like China, where human rights are not held so dear as they are in the United States."

The World Organization for Human Rights USA filed suit against Yahoo. Yahoo defended its actions by indicating that its employees in China faced both civil and criminal sanctions if they refused to comply with the government's requests for the information.

In early 2010, Google reversed its position on doing business with China (its agreement to limit search results) and threatened to withdraw from China unless the government negotiated on issues of privacy and restrictions. Google cofounder Sergey Brin said that previously the company was doing business there in order to "advance the bar." However, he added, "Ultimately, I guess it is where your threshold of discomfort is."[50] By mid-2010, Google was again doing business in China. Although there was some change in government policies on censorship, the end result was not open Internet access; however, Google instituted its Global Transparency Report, a report that makes public the number, location, and type of content-removal requests that Google receives from governments around the world. For example, in 2012, Google received many requests for the removal of YouTube videos. Of the 1,007 requests Google received in 2012, it complied with 54 percent and removed content for the countries making the request. There were 461 court orders sent to Google that requested removal of 6,989 items, and Google complied with 68 percent of those orders.[51] In those cases, Google must comply with the requests if it has offices in those countries in order to be allowed to continue doing business there.

Discussion Questions

1. Did Yahoo and Google act ethically in making their decisions to do business in China?
2. What questions did Google and Yahoo fail to answer in making their business decision to enter this large untapped market?
3. Evaluate Brin's discomfort test for doing business in China. Does Google's transparency report make up for the complicity in government censorship?

[49] Corey Boles, Don Clark, Pui-Wing Tarn, "Yahoo's Lashing Highlights Risks of China Market," *Wall Street Journal*, November 7, 2007, pp. A1, A14.

[50] Mark Landler, "Google Searches for a Foreign Policy," New *York Times*, March 28, 2010, WK, p. 4.

[51] Paul Sonne, "Google's Censorship Juggle," *Wall Street Journal*, June 18, 2012, p. B3.

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Compare & Contrast

A Google spokesperson indicated that it was better to be in China in some way, even with restrictions, than to deprive the citizens there of access to the Internet's information. Google argued for progress in China in small steps.[52] There is some historical perspective for Google in making its decision. Has this approach been used in other countries at points in their development? Consider the issues in South Africa during apartheid. Some companies stayed, and some refused to do business there. Those companies that stayed helped the country develop, and eventually the rights issues were addressed. Was it ethical to stay or boycott? What is the same about the issues in South Africa in comparison to those in China? What is different?

[52] "Rights Group Says Yahoo Helped China," *USA Today,* April 19, 2007, p. 1B.

SECTION B

Bribes, Grease Payments, and "When in Rome …"

Reading 6.10

A Primer on the FCPA[53]

Perhaps the most widely known criminal statute affecting firms that operate internationally is the Foreign Corrupt Practices Act (FCPA).[54] The FCPA applies to business concerns that have their principal offices in the United States. It contains antibribery provisions as well as accounting controls for these firms, and was passed to curb the use of bribery in foreign operations of these companies.

The act prohibits making, authorizing, or promising payments or gifts of money or anything of value to government officials with the intent to corrupt for the purpose of *obtaining* or *retaining business* for or with, or *directing business*. Under the FCPA, payments designed to influence the official acts of foreign officials, political parties, party officials, candidates for office, any nongovernmental organization (NGO), or any person who will transmit the gift or money to one of the other types of persons are prohibited. The NGO coverage was added so that foreign officials are defined to include public international figures, such as officials with the United Nations, the Olympics, or the International Monetary Fund (IMF). In order to constitute an FCPA violation, giving something to influence a utility executive in another country is covered only if the utility is actually controlled by the government.

The Justice Department's Resource Guide for the Foreign Corrupt Practice Acts, released at the end of 2012, gives a nifty list of the types of actions covered for purposes of improper influence:

1. Winning a contract
2. Influencing the procurement process
3. Circumventing rules in order to get products imported
4. Gaining access to nonpublic bid information
5. Evading taxes or penalties
6. Influencing the outcome of lawsuits or regulatory actions
7. Obtaining exceptions to regulations
8. Avoiding contract termination
9. Asking regulators or officials to exclude your competitors from their country
10. Evading customs duties
11. Extending drilling contracts

First passed in 1977, the FCPA is the result of an SEC investigation that uncovered questionable foreign payments by large stock issuers who were based in the United States.

[53] Adapted from Marianne M. Jennings, *Business: Its Legal, Ethical, and Global Environment*, 9th ed.

[54] 15 U.S.C. §§ 78dd-1.

Approximately 435 U.S. corporations had made improper or questionable payments totaling $300 million in Japan, the Netherlands, and Korea. Under the FCPA, any payment made to those designated in the statute, including government and NGO officials, to "secure any improper advantage" in doing business in that country would be a violation. For example, if an American company trying to win a bid on a contract for the construction of highways in a foreign country paid a government official there who was responsible for awarding such construction contracts a "consulting fee" of $25,000, the American company would be in violation of the FCPA. The payment was of money; it was made to a foreign official; and it was made for the purpose of obtaining business within that country. Titan Corporation violated the FCPA when money it paid to an agent in Benin was passed along to the reelection campaign of the president of Benin. The result was an increased management fee for Titan's operation of the telecommunications system in Benin. The payments were uncovered as Lockheed Martin was conducting due diligence for purposes of a merger with Titan. Titan voluntarily disclosed the payment and paid a total fine of $28.5 million as follows: $13 million criminal penalty, $12.6 million disgorgement (benefit), and $2.9 million in interest.

What Can You Give and What Can't You Give

The Resource Guide deals with just what "something of value" is for purposes of FCPA prosecution. Things that do count as payments for influence include the following:

1. Cash
2. Country club membership
3. Excessive comped travel—travel that does not include seminars or presentations and consists of, well, shopping trips to Paris
4. Cash to political parties
5. Payment of cell phone bills
6. Payment of government official's utility bills
7. Sports cars, furs, and other such luxury items

Things that do not count as a means of exercising influence include these:

1. Small gifts of expressions of gratitude, provided there is transparency in the giving
2. Small gifts to local charities, provided the gift is consistent with the company's general philanthropic goals and is not "large"
3. Wedding gift to a government official (if not too large)
4. Hats, T-shirts, pins, and pens offered by a company at a booth at a tradeshow that government officials take
5. Payment of the bar tab for drinks for twelve government officials at a group meeting
6. Payment for travel to the United States for training at a company's facility, and the foreign dignitaries can even take in a baseball game at company expense, while learning, without the company risking an FCPA violation.

Use of Agents and the FCPA

When the FCPA was passed initially, many companies tried to find ways around the bribery prohibitions. Companies would hire foreign agents or consultants to help them gain business in countries and allowed these "third parties" to act independently. However, many of these consultants then paid others who then actually paid bribes to officials. Under the FCPA, even these types of arrangements can constitute a violation if the consulting fees are high, odd payment arrangements occur, or the company has reason to know of a potential or actual violation. Companies must be able to establish that they have performed due diligence in investigating those hired as their agents and consultants in foreign countries. For example, if a U.S. company hired a consultant who charged the company $25,000 in fees and $250,000 in expenses, the U.S. company is, under Justice Department guidelines, on notice for excessive expenses that could signal potential bribes being paid. These types of expenses are known as red flags for U.S. companies. The Justice Department uses this information as a means of establishing intent even when the company may not know precisely what was done with the funds and what was paid to whom.

FCPA and "Grease," or Facilitation, Payments

Payments to any foreign official for "facilitation," often referred to as "grease payments," are not prohibited under FCPA so long as these payments are made only to get these officials to do their normal jobs that they might not do or would do slowly without some payment. These grease payments can be made for obtaining permits, licenses, or other official documents; processing governmental papers, such as visas and work orders; providing police protection and mail pickup and delivery; providing phone service, power, and water supply; loading and unloading cargo, or protecting perishable products; and scheduling inspections associated with contract performance or transit of goods across the country.

Penalties for Violation of FCPA

Penalties for violations of the FCPA can run up to $250,000 per violation and five years' imprisonment for individuals. Corporate fines are up to $2 million per violation. Also, under the Alternative Fines Act, the Justice Department can seek to obtain two times the benefit that the bribe attempted to gain, known as disgorgement. The government's methods for computation of the profits on the contracts that involved FCPA violations are often difficult to discern, but the Justice Department has been using disgorgement consistently as a penalty for companies during the past five years, and the amounts recouped through disgorgement have been increasingly steadily. The Dodd-Frank Wall Street Reform Act allows whistleblowers who report FCPA violations to receive between 10 to 30 percent of the amount of the fine collected from the company.

Investigations and prosecutions under the FCPA are on the rise. In 2012, there were twenty-three prosecutions by the Department of Justice and the SEC, with eighty-nine corporate investigations pending. There are also a significant number of self-reported cases, where the companies have come forward to disclose that their own internal controls and audits produced evidence that violations of the FCPA had occurred within their companies. For example, Ralph Lauren Corporation reported that the Lauren Argentina subsidiary had been paying the customs agents in that country what was called "Loading and Delivery Expenses," ranging between $750 and $3,847 per payment, for a total of $593,000 over a five-year period in order to get Lauren goods into the country. In addition, the customs agents were given purses and other high-dollar items in order to secure their favor for goods entry.[55] Lauren paid a $1.6 million fine to settle the case and closed the Argentina subsidiary.

The U.S. Justice Department has been stepping up prosecutions and penalties because "U.S. companies that are paying bribes to foreign officials are undermining government institutions around the world. It is a hugely destabilizing force."[56] Former Halliburton

[55] Peter Lattman, "Ralph Lauren Corp. Agrees to Pay Fine in Bribery Case," *New York Times*, April 23, 2013.

[56] Russell Gold and David Crawford, "U.S., Other Nations Step Up Bribery Battle," *Wall Street Journal,* September 12, 2008, pp. B1, B6.

executive Albert J. Stanley (a.k.a. Jack Stanley) received a seven-year sentence—the longest one ever imposed since the FCPA was passed in 1977.[57] In 2008, Siemens agreed to pay a $800 million fine, the largest since the FCPA passage.

The Justice Department also notes that cooperation from foreign officials and governments in these prosecutions is also at an all-time high. In the past, requests from the Justice Department for information from foreign governments went unanswered or were ignored. Now, with increased enforcement in those countries as well as negotiated treaties and agreements, the countries are cooperating more. For example, prosecutors from the OECD (Organisation for Economic Co-operation and Development) nations[58] continue to share information in ongoing cases and investigations so that they can better piece together international activities.

Discussion Questions

1. What are the risks associated with making facilitation payments?
2. If you had to draft a policy for a company on FCPA compliance, what would that policy contain?
3. There were complaints from companies in 2010 that Justice Department lawyers were pursuing FCPA cases and building the department's FCPA focus during their government service and then crossing over into the private sector and commanding large salaries for their FCPA expertise.[59] Discuss any ethical issues you see with regard to the conduct of the lawyers.

Case 6.11

Siemens and Bribery, Everywhere

Siemens is a German conglomerate that has been in business since 1847 with its three divisions of Energy, Health Care, and Industry. Siemens has 428,200 employees and operates in 190 countries, producing wind turbines and high-speed trains and providing engineering services on all types of construction projects. Siemens's net income for 2008 was $8.9 billion on net revenue of $116.5 billion. However, a large portion of Siemens's revenues came from projects with governments and their agencies. As a result of a multicountry investigation, authorities uncovered a four-year pattern of bribery by Siemens that is shown in the chart below.

Country	Product	Bribes Paid	Period
Russia	Medical devices	$55 million	2000–2007
Argentina	Identity cards project	$40 million	1998–2004
China	High-voltage transmission lines	$25 million	2002–2003
China	Metro trains	$22 million	2002–2007
Israel	Power plants	$20 million	2002–2005
Bangladesh	Mobile telephone works	$5.3 million	2004–2006
Venezuela	High-speed trains	$16.7 million	2001–2007
Russia	Traffic-control systems	$0.75 million	2004–2006
Vietnam	Medical devices	$0.5 million	2005
China	Medical devices	$14.4 million	2003–2007

[57] Because of Mr. Stanley's plea deal, more indictments are expected as he shares information.

[58] OECD is the Organization for Economic Cooperation and Development. Its 1997 agreement resulted in uniform FCPA acts around the world, a beginning point for the cooperation among the countries that are signatories to the OECD agreement.

[59] Nathan Vardi, "How Federal Crackdown on Bribery Hurts Business and Enriches Insiders," *Forbes,* May 24, 2010 p. 54. Blog, "DOJ, Defense Lawyers Spar Over Pace of FCPA Cases," *Legal Times,*May 7, 2010, accessed August 6, 2010, from http://legaltimes typepad.com/blt/2010/05/doj-defense-lawyers-spar-over-pace-of-fcpa-prosecution.html.

Country	Product	Bribes Paid	Period
Nigeria	Telecommunications projects	€4.2 million	2003
Iraq	Power station	$1.7 million	2000
Italy	Power station	€6.0 million	2003
Greece	Telecommunications	€37 million	2006

Both the SEC and the Justice Department were investigating Siemens. The two agencies concluded that Siemens had paid more than 4,283 bribes totaling $1.4 billion to government officials to secure contracts. The SEC concluded that the bribes resulted in the company obtaining $1.1 billion in profits. Siemens did follow what is known as "the four-eyes principle" of internal control for the FCPA, which is that all payments required two signatures. However, the company had made so many exceptions to the four-eyes principle that, operationally, it was not in effect. The SEC complaint notes how many red flags the board ignored in the years during which the bribery was occurring. Since 1999, when Germany signed on to the antibribery provisions of the OECD, Siemens's executives were concerned about all the companies involved in bribery around the world. Siemen's CEO at the time of the OECD adoption also voiced concern to the board about the number of Siemens executives who were under investigation by the German government for bribery activities. He asked the board to take protective measures because its members could be held responsible for inaction. Despite his plea, the bribes continued with support from some board members.

In 2001, general counsel for the board notified the members that in order for the company to meet U.S. standards for its new New York Stock Exchange (NYSE) listing, it needed to end its practices of having off-the-books accounts for the payment of the bribes. The company took no steps to investigate or end its practices. The SEC noted there was a stunning lack of internal controls as well as a tone at the top that did not take the FCPA seriously.

The U.S. Justice Department and Siemens AG reached an agreement to settle the company's ongoing violations of the FCPA. Siemens agreed to pay $800 million to the United States, a fine twenty times higher than the largest fine ever collected under the FCPA. Siemens is also settling charges with ten other countries and will be paying fines that total $ 5.8 billion. The SEC complaint states that the bribes involved employees at all levels of the company and revealed a culture that had long been at odds with the FCPA.[60]

The company's cooperation with the U.S. government since 2006, as well as its efforts to correct the violations, caused government officials to reduce the fine from $2.7 billion to the $800 million. Siemens's efforts to correct its culture included cooperating with the government, turning over all documents it found, and replacing all but one officer and the board. Three of the company's former officers are under investigation by German authorities for their role in the ongoing bribery web. Siemens has paid a total of $1.3 billion in fines in other countries for the violations.

Discussion Questions

1. Add together all the fines and compare with the profits made from the bribes to determine whether Siemens made a good business decision with its approach to winning contracts.
2. Peter Loscher, the new CEO hired to take over following the settlement of the FCPA charges, indicates that the company was a great innovator, but no longer had marketing skills because it had

[60] www.sec.gov/litigation. Accessed May 19, 2010.

relied on the facile approach of bribery for so long.[61] Thinking about his statement, offer a risk associated with using bribes as a business model.

3. Reinhard Siekaczek, the former Siemens employee, largely responsible for Siemens accounting system that hid bribes for five years, and who has been charged with breach of trust under German law, has made the following statements about his activities, the bribes, and the consequences:

> "People will only say about Siemens that they were unlucky and that they broke the 11th Commandment. The 11th Commandment is: 'Don't get caught.'"[62]
>
> "It was about keeping the business unit alive and not jeopardizing thousands of jobs overnight."
>
> "I was not the man responsible for the bribery. I organized the cash."
>
> "I would have never thought I'd go to jail for my company. Sure, we joked about it, but we thought if our actions ever came to light, we'd get together and there would be enough people to play a game of cards."

Can you describe what type of moral development is involved here? What did he miss in his evaluation of his conduct and the risks? What lines did Siemens cross in getting to this level of bribery payments?

Case 6.12

Walmart in Mexico

One in every five new Walmart stores around the world is located in Mexico. With 209,000 employees there, Walmart is the largest private employer in the country. The expansion of the giant retailer in Mexico has been remarkable. The expansion has also resulted in both an internal investigation as well as one by the U.S. Justice Department for violations of the FCPA.

The internal investigation began in 2005 when a senior U.S. Walmart executive received an e-mail from a former Walmart executive in Mexico, who revealed that Walmart had paid bribes all over the country in order to obtain permits to build the new stores rapidly and ubiquitously. Following the resulting internal investigation, Walmart uncovered $24 million in payments to government officials in exchange for permits for building the stores. The subsequent follow-up and training were delegated to Walmart's general counsel in Mexico City, the man who was identified as having authorized the payments.

However, despite the discovery, Walmart made no public disclosure about the payments or its investigation. Then-chairman of Walmart, H. Lee Scott, told internal investigators that they were being "too aggressive" in handling their work. The payments and evidence were not disclosed to the U.S. Justice Department until December 2011. That disclosure was made after U.S. executives learned that the *New York Times* was investigating and had both documents and statements from those involved in paying the bribes. The *Times* was the first news organization to break the story.[63] Walmart issued a response to the story that explained the steps that it has taken and is taking to eliminate the problem.[64]

One of the critical issues in the outcome (in terms of criminal charges) will be whether the payments were facilitation payments, a means of getting the company's voice heard on obtaining permits, or whether they really were bribes to government

[61] Anita Raghavan, "No More Excuses," *Forbes*, April 27, 2009, p. 121.

[62] *U.S. v. Siemens*, SEC Complaint, 1 :08-cv-02167 (December 12, 2008).

[63] David Barstow, "Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle," *New York Times*, April 21, 2012.

[64] You can read the company statement here: http://www.nytimes.com/2012/04/22/business/at-Walmart-in-mexico-a-bribe-inquiry-silenced.html.

officials. The Walmart internal report describes the payments as follows: "They targeted mayors and city council members, obscure urban planners, low-level bureaucrats who issued permits—anyone with the power to thwart Walmart's growth. The bribes, he said, bought zoning approvals, reductions in environmental impact fees and the allegiance of neighborhood leaders." How the funds were used and to whom they were paid and in exchange for what will be critical in determining whether there was a violation of the FCPA.[65] One example illustrates the efforts the company made for expansion in Mexico. Walmart wanted to build a new store in Elda Pineda's alfalfa field, located just one mile from the Mayan ruins that draw tourists from around the world. The estimated activity of the store was 250 customers per hour, if the location in the alfalfa field could be approved by the city council in San Juan Teotihuacán, Mexico. However, the city council members wanted to limit commercial development near the ruins in order to preserve the area. As a result, the city's zoning map that was approved by the city council prohibited commercial development in the alfalfa field. The zoning map would take effect once it was published in the newspaper. Walmart officials in Mexico City paid $52,000 to a city official to redraw the zoning area on the map prior to publication. The map that was published included the alfalfa field as part of the area zoned for commercial development. The store's construction began a few months later and opened for business in time for Christmas 2004.[66]

Walmart's general counsel had been pushing for a policy of "no payments to government officials," regardless of the reason. However, Walmart executives in Mexico were using *gestores*, a type of unofficial lobbyist who is able to get through to local government officials and who takes a 6 percent commission for winning an expedited permit for the company's new stores.

There was benefit in Walmart self-reporting the issue. However, the delay could prove costly once the government has its arms around the case and what exactly was paid, to whom, and why.

Discussion Starters

1. Why do we worry about these types of payments if the result is more jobs for those in Mexico?
2. Why does it make a difference whether the payments were bribe or "grease"/facilitation payments?
3. Why was general counsel pushing for a "no payments to government officials" policy?
4. Subsequent to the discovery of the payments in Mexico, issues about Walmart behaviors in India emerged. A business consultant there said that the payments result because it is so difficult to open businesses in India and that "All of these conditions have only made India a poorer country."[67] Do the restrictions or the bribery hurt the country's economy more?

Case 6.13

Italy's Freeway Corruption

Highway A3 in Italy was begun in the 1960s, a freeway that was intended to begin just outside of Naples and run 300 miles to the south, ending in Reggio Calabria. Italy received $60 billion in European Union funding in 2000 to complete the freeway, but the project has been stalled for years. Presently, 169 miles of the 300-mile highway

[65] Details from the interviews in the investigations give an idea of the amount and nature of the payments. http://www.nytimes.com/2012/04/22/business/at-Walmart-in-mexico-a-bribe-inquiry-silenced.html.

[66] David Barstow and Alexandra Xanix von Bertrab, "The Bribery Aisle: How Wal-Mart Used Payoffs To Get Its Way in Mexico," *New York Times*, December 18, 2012, p. A1.

[67] Vikas Bajaj, "India Unit of Wal-Mart Suspends Employees," *New York Times*, November 24,

have been completed, with much of that reconstructed because of initial defective work. Contracts for construction are awarded on the basis of payments to public officials, with the result being that the contracted-for work is not completed, is defective, or requires additional contracts and funding to complete. At one point, twenty-two people were convicted of taking or paying kickbacks in the award of contracts for the highway project.

Those who drive through the work areas see a number of hard-hatted workers (there are 1,000 workers assigned to the freeway project each day) but can see little work being done. Over the last twenty-five years, the workers have campaigned to keep the same officials or officials who favor freeway jobs funding in office.

Discussion Questions

1. Explain the societal costs of the payments for the contract awards on the freeway project over the years.
2. Why does the corruption continue on the freeway?
3. Make a list of who is affected by the corruption and the resulting incomplete freeways.

Ethics, Business Operations, and Rights

UNIT SEVEN

Rock stars have a higher mortality rate. Solo performers have a higher mortality rate than drummers and keyboard players. All in all, being a rock star is a risky career for which there are few regulatory protections.

Conclusions from Dying To Be Famous: Retrospective Cohort Study of Rock and Pop Star Mortality.

Mark A. Bellis, Karen Hughes, Olivia Sharples, Tom Hennell, and Katherine A. Hardcastle, *British Medical Journal (Open)*, December 2, 2012.

This unit deals with the interrelationships of companies, managers, and employees and the rights of all of those employees. From safety risks to questions of employee privacy and on through to the obligations of employees to throw down the flag when they are concerned about issues and practices in the workplace, this section grapples with the delicate balances required for preserving a safe work environment with open communication.

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SECTION A

Workplace Safety

Reading 7.1

Two Sets of Books on Safety

Following a twelve-day trial in 2012, Walter Cardin, a safety manager for the Shaw Group, was convicted of eight counts of fraud against the United States, for falsifying injury reports for his company's work at the TVA's Brown's Ferry Nuclear Station. Based on the false reports, the Shaw Group was able to collect safety bonuses worth over $2.5 million from TVA. The jury heard evidence of over 80 injuries, including broken bones; torn ligaments; hernias; lacerations; and shoulder, back, and knee injuries that were not properly recorded by Cardin. The Shaw Group has paid back twice the amount of the ill-gotten safety bonuses, and paid a $1.6 million fine in the Brown's Ferry situation.[1]

The problem of interpretation of what is and is not an injury has been growing and seems to be pervasive. A study in the June 2010 issue of *Annals of Epidemiology* concluded that employers have two sets of books when it comes to injuries in the workplace. OSHA reportable figures (as found in the Bureau of Labor Statistics), or those injury stats reported by employers, are 24 percent to 49 percent lower than the number of injuries the study found in worker compensation claims. Injuries have declined since 2000, but fatalities have not.

Workers' comp numbers are the real thing. Employees don't care what employers report to OSHA—they want coverage for work-related injuries. Why the disparity? Some believe that because incentive plans include safety goals related to the injury rate, managers are motivated to put pressure on workers to not report injuries. Some managers even pressure doctors into characterizing an injury as non-work-related. Other managers ask doctors to write a different diagnosis so as to avoid a reportable injury. Employees often share stories about their managers going with them to the hospital or doctor to get the injury characterized in the "right" way.

There is always the wiggle room of technical compliance with the lost workday reporting requirements. Without question, federal regulations on reportable injuries are confusing, and reasonable minds could differ on some close calls. However, this study seems to indicate that something more than just differing interpretations is driving the disparity. Interpretations seem to cut a wide swath. For example, if an employee can return to work, the injury is not classified as a lost workday. Dr. Robert McClellan, formerly the president of the American College of Occupational and Environmental Medicine, often cites an example of a worker being wheeled onto a construction site with his broken leg so as to avoid a lost workday report. So, an employee reported for beam work with a cast and in a wheelchair, and there was no OSHA reportable injury.

Discussion Questions

1. What are the parallels between this part of business reporting and financial reports?
2. What risks do you see with the two sets of books?
3. What might happen to safety as a result of these approaches to reporting injuries?

[1] OSHA Quick Takes, July 2, 2012, http://passregion2.typepad.com/pass/osha-quick-takes/.

Case 7.2

Sleeping on the Job and on the Way Home

Matt Theurer was an 18-year-old high school senior with many extracurricular activities, including being a member of the National Guard. Mr. Theurer was employed by a McDonald's restaurant (defendant) in Portland, Oregon, on a part-time basis. Although his employer called Mr. Theurer an enthusiastic worker, his friends and family felt that he was doing too much and getting too little sleep.

McDonald's employed many high school students on a part-time basis, and their restaurants closed at 11:00 P.M., with cleanup and other procedures taking up another hour until midnight. McDonald's informal policy did not permit high school students to work more than one midnight shift per week or allow split shifts. Split shifts forced the students to work in the morning and then evening. McDonald's felt the commuting time between the shifts prevented "people from getting their rest." Despite these policies, high school employees frequently complained about being tired, and at least two of McDonald's employees had accidents while driving home after working the closing shift until midnight.

A few times each year, McDonald's scheduled special cleanup projects at the restaurant that required employees to work after the midnight closing until 5 A.M. Student workers were to be used for cleanup shifts only on weekends or during spring break. However, for one scheduled cleanup project, there were not enough regular employees, and the manager asked for volunteers for a midnight to 5 A.M. cleanup shift. Mr. Theurer volunteered; the manager knew that Mr. Theurer had to drive about twenty minutes to and from work.

During the week of the scheduled special cleanup, Mr. Theurer had worked five nights. One night he worked until midnight, another until 11:30 P.M., two until 9 P.M., and another until 11 P.M. On Monday, April 4, 1988, Mr. Theurer worked his regular shift from 3:30 until 7:30 P.M., followed by a cleanup shift from midnight until 5 A.M. on April 5, and then worked another shift from 5 A.M. until 8:21 A.M. During that shift Mr. Theurer, told his manager that he was tired and asked to be excused from his next regular shift. The manager excused him, and Mr. Theurer began his drive home.

Mr. Theurer was driving 45 miles per hour on a two-lane road when he became drowsy or fell asleep, crossed the dividing line into oncoming traffic, crashed into the van of Frederic Faverty (plaintiff), and was killed. Mr. Faverty was seriously injured. Mr. Faverty settled his claims with Mr. Theurer's estate and then filed suit against McDonald's.[2]

Discussion Questions

1. Does McDonald's have responsibility for employee fatigue?
2. Who is affected by McDonald's work-hour policies?
3. What other industries would be affected by sleep-deprivation liability issues?

Case 7.3

Cintas and OSHA

In 2007, Eleazar Torres-Gomez fell into an industrial dryer at the Cintas plant where he worked. He was killed before anyone even noticed that he had fallen into the dryer from the moving conveyor belt where he was picking up loose clothes. The manufacturer of the equipment provides warnings about not having people on the conveyor belt while it is moving. Warnings on the belt caution Cintas employees not to get on the belt while it is moving. All Cintas employees receive training that warns them against getting onto

[2] *Faverty v. McDonald's Restaurants of Oregon, Inc.* 892 P.2d 703 (Ct. App. Or. 1995).

the moving belts at any time. However, surveillance tapes show that at the Tulsa plant where Mr. Torres-Gomez worked and at other Cintas plants the practice was routine. The tapes show employees jumping on the moving belts to clear jams of clothing as they headed into the dryer chutes. Some tapes even showed employees sticking their knees into the chutes as a means of unclogging the clumps of wet laundry making their way into the dryer from the moving belts.

Cintas has an internal memo from its director of safety in 2004 that cautioned the plants about the problem and required plant managers to implement several safety procedures before trying to dislodge laundry. The procedures were not followed at the Tulsa plant.

In interviews with OSHA officials, employees said that they were under a great deal of pressure to keep the laundry moving and not shut down the belt. Cintas has per-piece goals for employees to meet, but Cintas officials say that the goals established for employees are reasonable.

Cintas has had seventy OSHA investigations since 2002, more than any other laundry company, and OSHA has found violations in forty of the investigations. Forty-two of the violations found were "willful." Cintas feels that it has had more inspections because a union organizing effort is ongoing, and employees are reporting violations even when there are no violations.

Discussion Questions

1. Would an employee's compensation package have any effect on his or her decisions at work about risk?
2. What are the values in conflict at Cintas that resulted in the accident and death?
3. What are the ethical issues in employee safety?

Source

Bandler, James, and Kris Maher, "House Panel to Examine Cintas Plants' Safety Record," *Wall Street Journal*, April 23, 2008, pp. B1, B2.

Case 7.4

Massey Coal Mines, Fatalities, and Indictments

In 2010, an explosion at the Upper Big Branch mine in West Virginia resulted in the loss of the lives of twenty-nine miners at the site. The mine was owned and operated by a subsidiary of Massey Energy. The Mine Safety and Health Administration conducted an investigation, and its report on the accident concluded that Massey had a "dubious" record of safety documentation that involved the use of multiple sets of records that resulted in problems at the mine being concealed from federal inspectors.

As a result of the investigation, a series of criminal charges were brought against managers and other employees at the mine. One employee, who was transferred from the Upper Big Branch mine before the 2010 explosion, was convicted of lying to safety officials and sentenced to ten months in prison. David Hughart, the president of the mine-operating unit, entered a guilty plea to conspiracy to defraud the U.S. government by impeding mine safety inspectors and conspiracy to violate safety laws. When asked by the federal judge who ordered him to give miners advance notice of inspections, he responded that his orders came from the CEO.[3] The charges indicate that Mr. Hughart and others ordered workers to violate airflow and coal-dust standards.

Hughie Elbert Stover was the security chief for the Upper Big Branch mine and was indicted on federal charges including lying to investigators, destroying mine records, and alerting employees when federal mine inspectors were coming to the mine. The charges

[3] Kris Maher, "Guilty Plea in Case Tied to Massey Mine Blast," *Wall Street Journal*, March 1, 2013, p. A2.

that Mr. Stover faced involved training security guards on how to use their radio systems to alert employees that federal mine inspectors were on the premises.

Mr. Stover took the stand at his trial, and his testimony included the following statements about his disposal of the records, which he admits doing but claims that he did not understand that what he was doing was criminal:

> It never crossed my mind that I was doing something illegal … There's nothing on earth that would make me commit a crime. I wouldn't wish on anyone the heartache and misery I've put them [his family] through."[4]

Mr. Stover said on the stand that he was simply destroying documents because the mine's warehouse was full, and it was routine to destroy documents as they made room for new records. Mr. Stover's lawyer argued in his opening statement that the records were destroyed mistakenly and that federal officials were able to obtain the lost information from other company sources.

As to the advance notification of the presence of mine inspectors, Mr. Stover, according to the *Wall Street Journal*, testified that he was told by an Upper Big Branch mine superintendent that security guards could announce over the mine radio that safety inspectors were on the site. He said he believed that was an acceptable practice, approved by company lawyers, and different from calling mine managers individually on the phone. He said that he did not lie to investigators when they asked him if he notified miners of an impending inspection because he did not notify anyone individually.[5]

Mr. Stover was found guilty of obstruction, lying to investigators, and giving advance notice of inspections, and was sentenced to three years in prison.[6] The superintendent that Mr. Stover referred to in his testimony was Gary May. Mr. May entered a guilty plea to conspiracy to defraud the United States. The U.S. attorney handling the case made a statement at the time of the plea indicating that "laws were routinely violated" because of the company's and individual managers' beliefs that "following those laws would decrease coal production."[7]

Don Blankenship, the CEO of Massey Energy at the time of the mine explosion, resigned as CEO in December 2010. Massey was sold to Alpha Natural Resources, Inc., in June 2011.

Discussion Questions

1. Describe the ethical categories involved in the explosion and conduct of the managers of the mine.
2. Why does Mr. Stover say he did not have any intent to violate the law that prohibits advance notification of the presence of inspectors?
3. Should the CEO be held accountable?

Case 7.5

BP and the Deepwater Horizon Explosion: Safety First?

Background and Nature of Market

BP PLC is a holding company with three operating segments: Exploration and Production; Refining and Marketing; and Gas, Power, and Renewables. Exploration and Production's

[4] Kris Maher, "First Trial Begins Tied to Massey Mine Blast," *Wall Street Journal*, October 25, 2011, p. A3.

[5] Kris Maher, "Mine-Safety Probe Expands," *Wall Street Journal*, November 29, 2012, p. A8.

[6] Kris Maher, "Ex-Massey Official Gets Three Years," *Wall Street Journal*, March 1, 2012, p. A3.

[7] Kris Maher, "Supervisor Pleads Guilty In 2010 Coal-Mine Blast," *Wall Street Journal*, March 31, 2012, p. A3.

activities include oil and natural gas exploration and field development and production, together with pipeline transportation and natural gas processing. Refining and Marketing includes oil supply and trading, as well as refining and petrochemicals manufacturing and marketing, including the marketing and trading of natural gas. BP is also involved in low-carbon power development, including solar and wholesale marketing and trading (BP Alternative Energy). BP has a presence in 100 countries and employs 96,000 people in these countries. It has nearly 24,000 retail service stations around the world, and its stations sell coffee made from fair-trade beans. It is the second largest oil company in the world and one of the world's ten largest corporations.

Until 2007, BP had been a perennial favorite of nongovernmental organizations (NGOs) and environmental groups. For example, *Business Ethics* named BP the world's most admired company and one of its top corporate citizens. Green Investors named BP its top company because of BP's continuing commitment to investment in alternative energy sources. BP lists its social and community policy as follows:

Objectives

- To earn and build our reputation as a responsible corporate citizen
- To promote and help the company achieve its business objectives
- To encourage and promote employee involvement in community upliftment
- To contribute to social and economic development

BP has been recognized for its work in helping AIDS victims in Africa. BP Alternative Energy was launched in 2005 and anticipates investing some $8 billion in BP Alternative Energy over the next decade, reinforcing its determination to grow its businesses "beyond petroleum."

In July 2006, BP and GE announced their intention to jointly develop and deploy hydrogen power projects that dramatically reduce emissions of the greenhouse gas carbon dioxide from electricity generation. Vivienne Cox, BP's Chief Executive of Gas, Power, and Renewables, said, on announcing the joint venture, "The combination of our two companies' skills and resources in this area is formidable, and is the latest example of our intent to make a real difference in the face of the challenge of climate change."[8]

There were issues that belied BP's good-citizen status. In 2001, BP admitted that it had hired private investigators to collect information on Greenpeace and The Body Shop. Also in 2001, its annual meeting created a stir when a shareholder proposal to stop the erection of a pipeline in mainline China was defeated when the board of directors opposed the proposal.

BP's political donations were also a controversial and newsworthy subject until it abandoned the practice with the following statement:

> In early 2002 the company Chairman, Lord Browne, announced that it will no longer make donations to political parties anywhere in the world. In a speech to the Royal Institute of International Affairs, Browne, [*sic*] said "we have to remember that however large our turnover might be, we still have no democratic legitimacy anywhere in the world.... We've decided, as a global policy, that from now on we will make no political contributions from corporate funds anywhere in the world." However, BP will continue to participate in industry lobbying campaigns and the funding of think-tanks. "We will engage in the policy debate, stating our views and encouraging the development of ideas—but we won't fund any political activity or any political party," he said. In response to a question, Browne said that over the long term donations to political parties were not effective.[9]

[8] "BP and GE to Jointly Develop Hydrogen Technologies," sustainablebusiness.com. July 18, 2006, http://www.sustainablebusiness.com/index.cfm/go/news.display/id/10466. Accessed September 2, 2013.

[9] Adapted from BP political donation press release, http://www.bp.com/centres/press_detail.asp7icM47 (as accessed in original research).

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BP was facing market pressure. The energy market was volatile during 2006. Crude oil futures slid below $60 in mid-September 2006, when the government report on winter heating fuel was released. The El Niño weather patterns resulted in a warm winter and very little demand for home heating oil, and a resulting glut in supply with the accompanying dip in price.

Natural gas prices declined during the same period because of mild temperatures. With no hurricane activity and resulting disruption in production or damage to pipelines, the natural gas inventory remained high. Also, the warmer temperatures meant that the utilities' peaker plants, or plants used in periods of high demand, were not fired up, as it were. With peaker plants run by natural gas, the lower demand crossed into commercial contracts. Amaranth Advisors, the internationally known hedge fund that is based in Connecticut, lost $3 billion in September 2006 because of its position in natural gas.

An Unfortunate Series of Events

From January 2005 through May 2010, BP experienced some production, legal, and operations setbacks. These events changed BP's public image even further.[10]

The Texas City Refinery Explosion

In 2005, BP had a deadly explosion at one of its refineries, located in Texas City, Texas. Fifteen employees were killed, and 500 other employees were injured. OSHA levied the largest fine in its history against BP for its failure to correct safety violations at the refinery, a violation that resulted in a fine of $87 million—four times larger than any fine OSHA had ever before issued against a company.

BP had entered into a 2005 agreement with OSHA to fix the safety violations, but it had failed to do so. At that time, OSHA had found 271 violations at the refinery. After completing its investigation following the explosion, OSHA found 439 "willful and egregious" violations, a finding that resulted in the large fine.

OSHA attributed many of the violations at the plant to overzealous cost cutting on maintenance and safety, undue production pressures, antiquated equipment, and fatigued employees. The OSHA report concluded, "BP often ignored or severely delayed fixing known hazards in its refineries."[11] Jordan Barab, a deputy assistant secretary of labor stated following the OSHA findings, "The only thing you can conclude is that BP has a serious, systemic safety problem in their company."[12] The Chemical Safety Board (CSB) Report concluded that cost cutting played a role in BP's failure to address the ongoing OSHA violations:

> Beginning in 2002, BP commissioned a series of audits and studies that revealed serious safety problems at the Texas City refinery, including a lack of necessary preventative maintenance and training. These audits and studies were shared with BP executives in London, and were provided to at least one member of the executive board. BP's response was too little and too late. Some additional investments were made, but they did not address the core problems in Texas City. Rather, BP executives in 2004 challenged their refineries to cut yet another 25 percent from their budgets for the following year.[13]

Carolyn Merritt, the chair of the CSB, said, "As the investigation unfolded, we were absolutely terrified that such a culture could exist at BP."[14] CSB ordered that the company

[10] A.R.S. §23-212 (2010).

[11] Guy Chazan, "BP Faces Fine Over Safety at Ohio Refinery," *Wall Street Journal*, March 9, 2010, p. A4.

[12] Accessed May 19, 2010. from http://www.publicintegrity.org/articles/entry/2085.

[13] The report recommended that BP comply with 29 CFR 1910.119, Process Safety Management of Highly Hazardous Chemicals and implement an effective means of process safety management.

[14] Sheila McNulty, "BP Safety Culture under Attack," *Financial Times*, March 20, 2007, p. 15.

launch its own investigation by an independent panel. The panel, headed by former Secretary of State James A. Baker, found "instances of a lack of operating discipline, toleration of serious deviations from safe operating practices and apparent complacency toward serious process safety risks at each refinery."[15]

The CSB report noted that cost cutting at the refinery had "drastic effects," with "maintenance and infrastructure deteriorating over time, setting the stage for the disaster."[16]

The following chart shows workplace deaths in the oil and gas industry.

Company	2003	2004	2005	2006
Exxon-Mobil	23	6	8	10
Royal Dutch Shell	45	37	36	37
BP	20	11	27	7
Total Coil Co.	23	16	22	NA
Chevron	12	17	6	NA[17]

The International Association of Oil and Gas Producers points to progress, with fatalities now at a rate of 3.5 per 100 man-hours worked in 2005 versus 5.2 in 2004. The companies also note the extraordinary danger of the industry. For example, all thirty-seven of Royal Dutch's fatalities in 2006 were from kidnappings of workers.

BP had already entered into an agreement with the EPA for a guilty plea to Clean Air Act violations and paid a $50 million fine. BP has also settled civil suits (4,000 in total) and paid them from a fund of $2.1 billion that the company set aside for the litigation.

Prudhoe Bay

Prudhoe Bay is one of BP's refineries located on the 478,000 acres of land BP owns in Alaska.[18] In March 2006, a pipeline at BP's Prudhoe Bay, Alaska, facility burst and spilled 267,000 gallons of oil. The twenty-two-mile pipeline carries oil from BP's facility to the Trans-Alaska Pipeline. State and federal investigators on-site following the spill indicated that the pipeline was severely corroded. As a result of the spill, both internal and government investigations of Prudhoe Bay and BP began. Currently, the Justice Department is presenting evidence to a grand jury regarding the company's conduct. A grand jury has also been impaneled in Anchorage, Alaska. As of June 2010, there had been no indictment.

The Inspecting and Cleaning of Pipes

BP used a coupon method of pipe inspection, one that sends pieces of metal into the pipeline to run with the flow. The "coupons" are then inspected to detect for corrosion. Of the 1,495 locations that BP monitored using the coupon method, only five were located in the area of the spill. BP did not use "smart pig" technology, the industry standard, as other companies do. The *smart pig* is a detection device that runs along the inside of a pipeline to detect corrosion. Larry Tatum, an engineer with corrosion expertise and an officer of the National Association of Corrosion Engineers, said of smart pigging, "If you want to find this type of random, spotty corrosion, you've got to do

[15] *Id.*

[16] *Id.*

[17] Ed Crooks, "BP's Record on Safety Pinned Down," *Financial Times*, March 20, 2007, p. 17.

[18] For complete information about BP's presence in Alaska and its contribution to the economic base there, go to http://www.alaska.bp.com (as accessed in original research).

100 percent ultrasonic scanning, or the smart pig approach."[19] Industry standards require smart pigging every five years. BP had not done smart pigging on the Prudhoe Bay line since 1998. The pipes had not been cleaned since 1992. BP had increased its pipeline maintenance budget to $71 million for 2006, an increase of 80 percent since 2001. The speed of the oil through the pipes had declined over the years, and the flow in 2006 was at a speed one-fourth of the flow rate that existed when the pipes first opened. The BP field manager at Prudhoe Bay said, following the spill, "If we had it to do over again, we would have been pigging those lines."[20]

During the 1990s, when oil was at $20 per barrel, all companies cut down on pipeline maintenance. More pipeline accidents and spills occurred during the 1990s, but they did not receive the attention that Prudhoe Bay did, because gas prices were low. A family of twelve was killed in 2000, when a BP pipeline near its New Mexico campground exploded. The only coverage of the explosion was a small paragraph in the *New York Times*. BP's circa 2000 spill and pipeline issues occurred at a time when gasoline prices were at an all-time high, and the talk of oil company profits was pervasive and across all forms of the media. The number of accidents in 1995 was 250; by 2005, that number had dropped to 50, after a steady decline. However, as the price of oil increased, the incentives for not shutting the pipes down increased. BP employees described Lord John Browne, the former head of BP (see earlier discussion on the company background), as the industry's best cost cutter, who created "a ruthless culture."[21]

The economic life of the pipes was estimated at twenty-five years when the pipes were first installed in 1977. At the time, no one believed that the oil production in the area would last longer than twenty-five years. One expert likened anticorrosion sensing and repairs to maintenance on a car: they have to be done regularly in order to keep the car running.

The External Pressure on the Pipes

In 2004, Walter Massey, the chair of BP's board's environmental committee, wrote a memo to fellow board members expressing concerns about the corrosion problems. Mr. Massey's memo described "[c]ost cutting, causing serious corrosion damage" to the pipes and creating the possibility of a catastrophic event that would put the Prudhoe Bay employees at risk. Internal documents uncovered in the government investigation show that a corrosion consultant who BP hired in 2004 issued a report that described the twenty-two-mile pipeline as experiencing "accelerated corrosion."

Environmental groups called for additional government investigations into BP's environmental record and oil pipeline, refinery, and drilling activities: "The North Slope corrosion problem is simply the latest example of a pattern of neglect and less-than-adequate maintenance over the years."[22] The groups released information about BP's environmental record. The groups' releases were printed in newspapers around the world, including lengthy stories in the newspapers of London, where BP headquarters are located. A 2003 leak from the BP pipeline had harmed caribou in the area. BP officials promised government officials that it would conduct inspections of the pipeline to determine whether corrosion was causing the leaks. In 1999, BP paid a $6.5 million penalty for dumping hazardous waste at the Prudhoe Bay site. BP did report the hazardous waste spill voluntarily.

[19] Matthew Dalton and John M. Biers, "Consultant Warned BP of Pipe-Network Corrosion," *Wall Street Journal*, August 24, 2006, p. A3.

[20] Chris Woodward, Paul Davidson, and Brad Heath, "BP Spill Highlights Aging Oil Field's Increasing Problems," *USA Today*, August 14, 2006, pp. 1B, 2B.

[21] Jon Birger, "What Pipeline Problem?" *Fortune*, September 4, 2006, pp. 23–24.

[22] Woodward, Davidson, and Heath, "BP Spill Highlights Aging Oil Field's Increasing Problems," p. 1B.

BP had been operating on borrowed goodwill when it came to regulatory relations. In 1999, the State of Alaska agreed to approve the proposed Arco-BP merger provided BP would agree to semiannual meetings with state officials to discuss progress on the "serious" corrosion problems for the Prudhoe Bay pipelines. The meetings did not take place as promised.

In the same year as the merger and the promises to Alaska, Chuck Hamel, a union advocate, corporate gadfly, and close friend of actress Sissy Spacek, filed a report with BP management about worker safety concerns based on the corrosion problems with Prudhoe Bay pipes. The memo indicated that workers were asked to skimp on the use of anticorrosion chemicals in the pipe because of expense. Prudhoe Bay BP employees were paid very well and were loyal. They earned $100,000 to $150,000 per year. They worked for two weeks and then had two weeks off because of the remote location of the facility and the near-total darkness, twenty-four hours per day during the winter months.

Hamel took his complaints and information to the U.S. Environmental Protection Agency (EPA) that year, based on the lack of response from BP management.[23] Mr. Hamel at one point owned an oil field in Prudhoe Bay, but subsequently sold it to Exxon. Exxon would later hit a gusher on the field, and Hamel sued for Exxon's failure to disclose to him the potential for oil discovery on his field. Ms. Spacek says Hamel is like an uncle to her: someone who is kind, generous, and trustworthy, and someone who speaks for those who cannot speak for themselves.

One executive at BP describes the Prudhoe Bay spill and pipeline problems as follows: "Sometimes bad things happen to good companies."[24] An executive from Kinder Morgan (a pipeline company) said that Prudhoe Bay has been blown out of proportion: "That pipeline is still the safest part of the journey, including safer than when you put gas in your tank.[25]

One environmentalist wondered how BP can call itself a "green company" when its environmental record is so poor. The BP response was that "[w]e are investing in alternative energy sources. We are putting our money where our mouth is."[26] Environmental groups have taken the position that the conduct of BP should be the "nail in the coffin" for any plans to allow drilling in the north refuge area of Alaska (the Arctic National Wildlife Refuge, or ANWR, one of the world's greatest, yet untapped, sources of oil). "These companies simply cannot behave responsibly," stated one environmentalist leader in reaction to BP's conduct over the past four years at Prudhoe Bay.

In September 2006, the executives of BP were summoned to appear at congressional hearings on oil pipelines. The executives found few friends during their hearings. The chair of the House Energy and Commerce Committee told BP's CEO, "Years of neglecting to inspect the most vital oil-gathering pipeline in this country is not acceptable."[27]

The committee heard testimony from an employee who raised concerns about Prudhoe Bay corrosion in 2004 and was then transferred from the facility. Richard Woolham, BP's chief inspector for the Alaska pipelines, was subpoenaed to testify but took the Fifth Amendment.[28] Another BP executive testified that BP had fallen short of the high standards the public had come to expect of it.

[23] Jim Carlton, "BP's Alaska Woes Are No Surprise for One Gadfly," *Wall Street Journal*, August 12–13, 2006, pp. B1, B5.

[24] *Id.*

[25] Birger, "What Pipeline Problem?" pp. 23–24.

[26] *Id.*

[27] Paul Davidson, "Congressmen Slam BP Executive at Oil Leak Hearings," *USA Today*, September 8, 2006, p. 2B.

[28] John J. Fialka, "BP's Top U.S. Pipeline Inspector Refuses to Testify," *Wall Street Journal*, September 8, 2006, p. A3.

The Trading Markets

In June 2006, the Commodities Futures Trading Commission filed a civil complaint against BP, alleging that its brokers tried to manipulate the price of propane by manipulating the supply, or at least access to information about the real supply levels. One broker wrote in an e-mail that if they "squeezed" the pipeline, they could drive up the price of propane, "and then we could control the market at will," and "… we would own them."[29] The brokers commented to each other about how easily they could control the supply and therefore the market price for propane.

Following the Prudhoe Bay pipeline incident, government investigators also began looking into BP's trading practices. On August 29, 2006, the Justice Department announced investigations into BP's energy trading and stock sales by executives and others. BP officials said it gets such requests regularly.

One of the investigations focused on alleged insider trading by BP brokers. BP runs one of the world's largest energy-trading firms, dealing not only in the sale of oil and gas but also in energy futures. BP also provides risk-management services for other companies. One regulator has referred to the BP operation as one large commodities trading desk. Based on information about BP's storage, refinery, and pipeline facilities, as well as a wide expanse of information about other companies and their risk and exposure, the brokers were indicted for trading in commodities prior to announcements about BP's production quantity and transport systems, information that affects market prices and hence stock prices of companies affected by energy prices.[30] BP had warned its brokers about the inability to use information gained from their positions to profit personally in the markets, commodities or stock, but there are no guarantees that such an artificial wall between information gained, but not used in a personal context, was effective. For example, when the Texas City refinery explosion occurred, BP traders were warned not to trade on that information prior to its dissemination to the public. The shutdown of a major refinery can impact market prices for oil.

Following the indictments, one BP trader entered a guilty plea. BP also entered into a deferred prosecution agreement and paid a $303-million fine, $53 million of which was used to repay investors for the losses they experienced as a result of BP's advance trading. However, in September 2009, a federal judge tossed the indictments of the BP traders because he concluded that the law used for the basis of the indictments was not violated.[31]

The series of events resulted in negative press coverage. One London newspaper has carried the headline "BP = Big Problems for Oil Giant."[32] From this headline, the public began developing its own translations for the BP acronym, such as "Beyond Pitiful" and "Big Putzes." The BP brand was damaged significantly by the unfortunate series of events.

BP Responses

In August 2006, when BP shut down the Prudhoe Bay pipeline for repair and replacement, it announced that it would replace sixteen of the twenty-two miles of pipe from Prudhoe Bay.

[29] Tom Fowler, "How the Case Against BP Traders Went Wrong," *Houston Chronicle*, September 18, 2009, http://www.chron.com/disp/story.mpl/business/energy/6626251.html.

[30] Ann Davis, "Probes of BP Point to Hurdles U.S. Case Faces," *Wall Street Journal*, August 30, 2006, p. C1.

[31] Fowler, "How the Case Against BP Traders Went Wrong," http://www.chron.com/disp/story.mpl/business/energy/6626251.html.

[32] "BP: Big Problems for Oil Giant," *Red Independent*, August 30, 2006, http://news.independent.co.uk/business/analysis_and_features/article1222607.ece (as used in original research).

On Tuesday, September 19, 2006, BP was downgraded by several agencies when it announced further delay in bringing Project Thunder Horse up and on line. Thunder Horse is a subsea drill in the Gulf of Mexico that suffered a severe setback last year when Hurricane Dennis hit the area and caused substantial damage to the work to date on the project. BP had anticipated having the site on line by early 2007.

The following is an excerpt from a lengthy announcement that BP issued in August 2006:

> BP today announced an acceleration of actions to improve the operational integrity and monitoring of its US businesses. BP announced the addition of smart-pigging technology to the monitoring of all of its pipelines, worldwide.
>
> The company said it would add a further $1 billion to the $6 billion already earmarked over the next four years to upgrade all aspects of safety at its US refineries and to repair and replace infield pipelines in Alaska.
>
> Speaking in London, BP chief executive Lord Browne said: "These events in our US businesses have all caused great shock within the BP Group. They have prompted us to look very critically at what we can learn from ourselves and others and at what more we can do in certain key areas to assure ourselves and the outside world that our US businesses are consistently operating safely, and with honesty and integrity.
>
> "We are, of course, continuing to co-operate to the fullest possible extent with the US regulatory bodies investigating these events. But we do not believe we can simply await the outcome of those investigations. In addition to the significant steps we have already taken we have decided we must do more now." Browne said it is intended to appoint an advisory board to assist and advise the Group's wholly-owned US subsidiary, BP America Inc. and its newly-appointed chairman, Robert A. Malone, in monitoring the operations of BP's US businesses with particular focus on compliance, safety and regulatory affairs.
>
> The measures Browne announced today include a step-up in the scale and pace of spending at BP's five US refineries on maintenance, turnarounds, inspections and staff training. Spending will now rise to $1.5 billion this year from $1.2 billion in 2005 and will jump further to an average [of] $1.7 billion each year from 2007 to 2010.
>
> Systems to manage process safety at the refineries will undergo a major upgrade, with some $200 million earmarked to pay for 300 external experts who will conduct comprehensive audits, and re-designs where necessary, of all safety process systems. The new systems are targeted to be installed and working by the end of 2007, a year ahead of the original schedule.
>
> BP today also pledged more rapid action to restore the integrity of its infield pipelines in Alaska. With corrosion monitoring already upgraded, it now plans to remove pipeline residues—through a process known as "pigging"—by November, six months ahead of the original schedule.
>
> The pipeline which leaked in the recent oil spill has been taken out of service and will be replaced by a new line which has already been ordered. If other transit lines are found to be faulty, they will also be replaced.
>
> Browne said a major review by independent external auditors had also been set in train of the BP's compliance systems in its US trading business. In the wake of allegations of market manipulation in US propane trading, the auditors will examine the design of the trading organisation, delegations of authority, standards and guidelines, resources and the effectiveness of control and compliance. The results of the review will be shared with relevant US regulatory authorities and the auditors' recommendations will be urgently acted upon by BP.[33]

[33] From Securities and Exchange Commission, BP 6-k, http://www.sec.gov, August 6, 2006.

BP also announced that it had hired former federal judge Stanley Sporkin to investigate what happened at Prudhoe Bay and why. Judge Sporkin was famous for one line in his work in handling the criminal and civil cases resulting from the savings and loans frauds of the 1990s: "Where were the lawyers? Where were the auditors and the other professionals when this fraud was occurring?" Upon his appointment to the BP position, Judge Sporkin said, "I'll call them as I see them."[34]

On September 20, 2006, BP announced that it would spend $3 billion to upgrade its oil refinery in northwest Indiana, so it can process significantly more heavy crude from Canada, while also boosting its production of motor fuels at the site by up to 15 percent. The heavy crude from Canada is taken from Canada's vast oil sands resources, a source that has been left untapped and is seen as an alternative to the switch to ethanol. BP PLC's U.S. division said the upgrade would create up to eighty new, permanent, full-time jobs and 2,500 jobs during the three-year construction phase. The Whiting refinery, about 10 miles from Gary, Indiana, currently produces about 290,000 barrels a day of transportation fuels such as gasoline and diesel. Mike Hoffman, BP's group vice president for refining, said the project will modernize the equipment at the refinery, include environmental precautions beyond regulatory requirements, "and competitively reposition it as a top tier refinery well into the future." BP indicated that it would deliver the oil to the refinery by an existing pipeline, but that the pipeline would be upgraded. The Indiana Economic Development Corporation provided $450,000 in training grants and $1.2 million in tax credits in order to attract the BP refinery.

Offshore Oil Rigs and Safety

As BP was working to recover from its unfortunate series of events, another area was evolving that BP would need to address: its offshore oil production. Almost two years after Texas City and Prudhoe and nearly two years before the April 2010 Deepwater Horizon rig explosion and spill in the Gulf of Mexico, BP had a 193-barrel oil spill on June 5, 2008, at its Atlantis rig (also in the Gulf of Mexico). The internal report included the following information:

> "[Managers] put off repairing the pump in the context of a tight cost budget."
>
> "Leadership did not clearly question the safety impact of the delay in repair."
>
> A BP safety officer told company investigators, "You only ever got questioned on why you couldn't spend less."[35]

The same problems that dogged refinery and pipeline operations had carried over into offshore production. Nonetheless, during this period of ongoing safety lapses and resulting casualties, BP continued its stellar financial performance. In 2007, BP's shares were at $77. Its debt/equity ratio was .31, its dividend rate was 15 percent, and it had a 20 percent ROE, with gross margins of 27 percent and net margins of 7.47 percent. EPS growth in 2008 was at 64 percent. Managers were rewarded for their performance at the well for trimming 4 percent off costs.

However, that financial performance suffered a blow when one of BP's oil-drilling platforms, located about 50 miles off the coast of Louisiana in the Gulf of Mexico, experienced an explosion followed by an oil spill. The Deepwater Horizon rig, one that drilled at levels down to 18,000 feet, also experienced a fire on that fateful date of April 20, 2010. Eleven workers were killed. Oil began leaking from the rig in three places and

[34] Jim Carlton, "BP Hires Former Judge to Be U.S. Ombudsman," *Wall Street Journal*, September 5, 2006, p. A3.

[35] Guy Chazan, Benoit Faucon, and Ben Casselman, "Safety and Cost Drives Clashed as CEO Hayward Remade BP," *Wall Street Journal*, June 30, 2010, p. A1.

had drifted ashore in Alabama by May 14 and in Louisiana by May 19. By July 7, 2010, the oil had reached Houston and Lake Ponchartrain in New Orleans.

Following the spill, BP lost $30 billion, or 16 percent, of its market value.[36] From the time of the explosion until the well was capped, BP spent $7 million per day trying to contain the spill, not much of which worked. Since that time, BP has continued working to restore the Gulf, efforts that have cost the company billions. Tony Hayward, then-CEO who took over following Browne's tenure, was on-site in Louisiana, overseeing the work to stop the leak. He pledged to pay for all damages and summarized his experience with the tragedy by quoting Winston Churchill: "When you are going through hell, keep going."[37] BP struggled, trying to contain the spill. Several engineering fixes did not work, and the relief wells took months to complete. As BP worked to stop the spill, oil drifted ashore. In total, 200 million gallons of oil spilled. On August 2, 2010, engineers were able to contain the spill.

A whistleblower allegation that had emerged early in 2010 resurfaced, as it were, following the explosion with the release of e-mails related to government investigations of BP, the rig, the well, the explosion, and the deaths and injuries. The e-mails express concern about whether other companies had completed crucial engineering drawings and paperwork necessary prior to operation of offshore rigs. Other information is emerging related to BP's focus on costs versus best practices. E-mails indicate that engineers who asked for an additional ten hours in the critical path to address their concerns about the well, by installing twenty-one centralizers instead of just six, were dismissed by the lead engineer with an "I do not like this."[38] At hearings before the House of Representatives, other oil company CEOs testified that BP did not follow appropriate design standards in drilling the well.[39] A *Wall Street Journal* study found that BP used a risky design for one out of three of its deep-water wells that was cheaper than the preferred type of design. The so-called long string design is one that uses a single pipe for bringing the oil to the surface. Experts indicate that the result of using one long pipe is that natural gas accumulates around the pipe and can rise unchecked. Most experts recommend its use only in low-pressure wells, not wells such as Deepwater Horizon. They also note that long-string drilling would not be appropriate when a company does not know the area, something that was true about this well for BP.

Deepwater Horizon is the largest oil spill in history and has been called the largest environmental disaster in history. BP agreed to a $20-billion fund that would be used to compensate businesses, workers, and others who have been damaged as a result of the spill. The costs, in terms of cash outlays, continue for BP. From April through July, BP spent $7 million per day trying to contain the spill. BP was given an ultimatum by the Obama administration and, shortly after a White House meeting, placed $20 billion in an escrow account for the U.S. government to distribute to those in the Gulf-area states who have been harmed by the spill. BP sold off $7 billion in assets to cover the expenses and the $20 billion. BP took a $32 billion charge in July 2010 for the Gulf Oil spill costs and added the following about its losses in its July 27, 2010 SEC filing:

> The costs and charges involved in meeting our commitments in responding to the Gulf of Mexico oil spill are very significant and this $17 billion reported loss reflects that. However, outside the Gulf it is very encouraging that BP's global business has delivered another strong underlying performance, which means that the company is in robust shape to meet its responsibilities in dealing with the human tragedy and oil spill in the Gulf of Mexico.

[36] Peter Coy and Stanley Reed, "Lessons of the Spill," *Bloomberg BusinessWeek*, May 10–16, 2010, p. 48.

[37] *Id.*, p. 61.

[38] Neil King Jr. and Russell Gold, "BP Crew Focused on Costs: Congress," *Wall Street Journal*, June 15, 2010, pp. A1, A5.

[39] Julie Schmit, "Oil Execs: BP Didn't Meet Standards," *USA Today*, June 16, 2010, p. 1B.

The Oil Industry Post-Deepwater Horizon

The federal government placed a moratorium on all-new offshore drilling following the Deepwater Horizon explosion and spill. However, a federal court issued an injunction against the moratorium taking effect on the grounds that the federal government had acted arbitrarily and capriciously.[40] The Secretary of the Interior redrafted the moratorium, which stayed in effect until the Obama administration lifted it in October 2010. In the initial decision, Federal District Judge Martin Feldman concluded that the failure of one well, even with safety issues, was not grounds for prohibiting all offshore drilling.

> After reviewing the Secretary's Report, the Moratorium Memorandum, and the Notice to Lessees, the Court is unable to divine or fathom a relationship between the findings and the immense scope of the moratorium. The Report, invoked by the Secretary, describes the offshore oil industry in the Gulf and offers many compelling recommendations to improve safety. But it offers no timeline for implementation, though many of the proposed changes are represented to be implemented immediately. The Report patently lacks any analysis of the asserted fear of threat of irreparable injury or safety hazards posed by the thirty-three permitted rigs also reached by the moratorium. It is incident-specific and driven: Deepwater Horizon and BP only. None others. While the Report notes the increase in deepwater drilling over the past ten years and the increased safety risk associated with deepwater drilling, the parameters of "deepwater" remain confused. And drilling elsewhere simply seems driven by political or social agendas on all sides. The Report seems to define "deepwater" as drilling beyond a depth of 1000 feet by referencing the increased difficulty of drilling beyond this depth; similarly, the shallowest depth referenced in the maps and facts included in the Report is "less than 1000 feet." But while there is no mention of the 500 feet depth anywhere in the Report itself, the Notice to Lessees suddenly defines "deepwater" as more than 500 feet.
>
> The Deepwater Horizon oil spill is an unprecedented, sad, ugly and inhuman disaster. What seems clear is that the federal government has been pressed by what happened on the Deepwater Horizon into an otherwise sweeping confirmation that all Gulf deepwater drilling activities put us all in a universal threat of irreparable harm. While the implementation of regulations and a new culture of safety are supportable by the Report and the documents presented, the blanket moratorium, with no parameters, seems to assume that because one rig failed and although no one yet fully knows why, all companies and rigs drilling new wells over 500 feet also universally present an imminent danger.[41]

Tony Hayward was replaced as CEO of BP on July 27, 2010. Robert Dudley, a U.S. citizen and native of Mississippi, was chosen to replace Mr. Hayward. Mr. Hayward issued a statement upon his forced retirement: "The Gulf of Mexico explosion was a terrible tragedy for which—as the man in charge of BP when it happened—I will always feel a deep responsibility, regardless of where blame is ultimately found to lie."[42] The Deepwater Horizon well was plugged permanently in September 2010.

Following BP's guilty plea on charges related to the explosion at its Deepwater Horizon oil rig and payment of a $4.5 billion fine, the EPA announced that BP could not hold any federal contracts (which would include drilling on federal lands) until it was able to demonstrate that its operations meet federal standards.

BP has agreed as part of its plea, to have a safety monitor on its deepwater operations and to retain an ethics monitor to ensure that employees do not violate federal laws and standards in BP operations.[43] Until the ban is lifted, BP cannot bid on federal oil leases that become available.

[40] *Hornbeck Offshore Services, LLC v. Salazar*, 696 F.Supp.2d 627 (E.D. La. 2010).

[41] *Hornbeck Offshore Services, LLC v. Salazar*, 696 F.Supp.2d 627 (E.D. La. 2010).

[42] www.bp.com. Click Press Releases. July 27, 2010. Accessed August 6, 2010.

[43] Tom Fowler, "BP Blocked From Deals," *Wall Street Journal*, November 29, 2012, p. A3.

The ban could prove costly because 25 percent of BP's oil production is in the United States. BP employs 23,000 people in the United States and has spent $52 billion on operations in the United States over the past few years.[44] BP has also been selling assets in other places throughout the world in order to meet the costs of the settlement and other issues related to the Deepwater explosion and spill. The civil fines are estimated to be about $21 billion, but the civil fines have not yet been settled. There is currently a court investigation of the disbursement of the $20 billion compensation fund because of allegations of conflicts of interest and fraud by fund lawyers.

Discussion Questions

1. Discuss the ethical, negligence, and environmental issues you see in this case.
2. BP had rented the rig from Transocean for $500,000 per day. Transocean had been recognized by the U.S. government for its safety record.[45] Can companies distance themselves from liability and responsibility through the use of contractors? What are the risks of using third-party contractors?
3. Discuss how BP got into the position in which it found itself in late 2006 and what might have prevented the spill, the financial fallout, and the loss of reputation. Be sure to factor in the financial implications of any decision made during the period from 2001 to 2006.
4. What was the impact of the emphasis on cost cutting on BP's culture? What was the impact on the company's performance?
5. Evaluate the social responsibility positions of BP in light of the refinery explosion and the pipeline issue. What can companies learn from the BP experience?
6. Applying the regulatory cycle, what do you see happening with regulation in offshore drilling and the refinery and drilling portions of the oil and gas business?
7. When does OSHA assess criminal penalties? When does the Clean Air Act require criminal penalties? Wouldn't workers' comp cover the employees for the deaths and injuries? Why is there civil litigation?
8. The judge's opinion on the moratorium contained this discussion of the government's use of a report by experts on offshore drilling:

   Much to the government's discomfort and this Court's uneasiness, the Summary also states that "the recommendations contained in this report have been peer-reviewed by seven experts identified by the National Academy of Engineering." As the plaintiffs, and the experts themselves, pointedly observe, this statement was misleading. The experts charge it was a "misrepresentation." It was factually incorrect. Although the experts agreed with the safety recommendations contained in the body of the main Report, five of the National Academy experts and three of the other experts have publicly stated that they "do not agree with the six month blanket moratorium" on floating drilling. They envisioned a more limited kind of moratorium, but a blanket moratorium was added after their final review, they complain, and was never agreed to by them. A factor that might cause some apprehension about the probity of the process that led to the Report.

   The draft reviewed by the experts, for example, recommended a six-month moratorium on exploratory wells deeper than 1000 feet (not 500 feet) to allow for implementation of suggested safety measures.

   The Report makes no effort to explicitly justify the moratorium: it does not discuss any irreparable harm that would warrant a suspension of operations, it does not explain how long it would take to implement the recommended safety measures. The Report does generalize that "[w]hile technological progress has enabled the pursuit of deeper oil and gas deposits in deeper water, the risks associated with operating in water depths in excess of 1,000 feet are significantly more complex than in shallow water."[46]

   Evaluate the ethics of the Secretary of Interior regarding the representations of what the experts concluded.
9. Evaluate Mr. Hayward's parting statement and his views on accountability.

[44] John M. Broder and Stanley Reed, "BP Is Barred From Taking Government Contracts," *New York Times*, November 29, 2012, p. B1.

[45] Ben Casselman, Russell Gold, and Angel Gonzalez, "Workers Missing After Gulf Rig Explodes," *Wall Street Journal*, April 22, 2010, pp. A1, A4.

[46] *Id.*

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SECTION B

Workplace Loyalty

Case 7.6

Aaron Feuerstein and Malden Mills[47]

Aaron Feuerstein is the chief executive officer and chairman of the board of Malden Mills, a ninety-three-year-old privately held company that manufactures Polartec and is located in Methuen, Massachusetts. Polartec is a fabric made from recycled plastic that stays dry and provides warmth. It is used in everything from ski parkas to blankets by companies such as L.L. Bean, Patagonia, Lands' End, and Eddie Bauer. Malden employs 2,400 locals, and Mr. Feuerstein and his family have steadfastly refused to move production overseas. Their labor costs are the highest in the industry—an average of $12.50 per hour. Malden Mills is the largest employer in what is one of Massachusetts' poorest towns.

On December 11, 1995, a boiler explosion at Malden Mills resulted in a fire that injured twenty-seven people and destroyed three of the buildings at Malden Mills' factory site. With only one building left in functioning order, many employees assumed they would be laid off temporarily. Other employees worried that Mr. Feuerstein, then seventy years old, would simply take the insurance money and retire. Mr. Feuerstein could have retired with about $300 million in insurance proceeds from the fire.

Instead, Mr. Feuerstein announced on December 14, 1995, that he would pay the employees their salaries for at least thirty days. He continued that promise for six months, when 90 percent of the employees were back to work. The cost to the company of covering the wages was approximately $25 million. During that time, Malden ran its Polartec through its one working facility as it began and completed the reconstruction of the plant, at a cost of $430 million. Only $300 million of that amount was covered by the insurance on the plant; the remainder was borrowed so that Malden Mills would be a state-of-the-art, environmentally friendly plant. Interestingly, production output during this time was nine times what it had been before the fire. One worker noted, "I owe him everything. I'm paying him back."[48] After the fire and Feuerstein's announcement, customers pledged their support, with one customer, Dakotah, sending in $30,000 to help. Within the first month following the fire, $1 million in donations was received.[49]

Malden Mills was rededicated in September 1997 with new buildings and technology. About 10 percent of the 2,400 employees were displaced by the upgraded facilities and equipment, but Feuerstein created a job training and placement center on site in order to ease these employees' transition.

By the end of 2001, six years after the fire, Malden Mills had debts of $140 million and was teetering near bankruptcy. However, Malden Mills had been through bankruptcy before, in the 1980s, and emerged very strongly with its then new product, Polartec, developed through the company's R&D program.

[47] Adapted from Marianne M. Jennings, "Aaron Feuerstein—an Odd CEO," in *Business: Its Legal, Ethical and Global Environment*, 9th ed. (2011), 634–635.

[48] "Maiden Mills," *Dateline NBC*, August 9, 1996.

[49] "Steve Wulf, "The Glow from a Fire," *Time*, January 8, 1996, p. 49.

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Some have suggested that Mr. Feuerstein's generosity during that time was responsible for the resulting financial crisis. However, the fire destroyed the company's furniture upholstery division, and customers were impatient at that time. They were not inclined to wait for production to ramp up, and Malden Mills lost most of those customers. It closed the upholstery division in 1996.

Also, the threat of inexpensive fleece from the Asian markets was ignored largely because of the plant rebuilding and the efforts focused there. Finally, in 2000, the company had a shakeup in its marketing team just as it was launching its electric fabrics—fabrics with heatable wires that are powered by batteries embedded in the fleece.

Once again, however, the goodwill from 1995 remained. Residents of the town sent in checks to help the company, some as small as $10, and began an Internet campaign to "Buy Fleece." The campaign enjoyed some success as Patagonia, Lands' End, and L.L. Bean report increased demand. In addition, the U.S military placed large orders for fleece jackets for soldiers fighting in Operation Enduring Freedom in Afghanistan.

Senators Ted Kennedy and John Kerry lobbied GE not to involuntarily petition Malden Mills into bankruptcy. GE Capital held one-fourth of Malden Mills' debts. Its other creditors included Finova Capital, SAI Investment, Pilgrim Investment, LaSalle Bank, and PNC Bank. The lobbying was to no avail. By 2002, Malden Mills was in bankruptcy. Feuerstein labored to raise the money to pay off creditors and buy his company back, but he was unable to meet the bankruptcy deadline. Malden Mills emerged from bankruptcy on September 30, 2003, but under management other than Mr. Feuerstein. He still hoped to buy the company back, but the price, originally $93 million, had increased to $120 million. Feuerstein served as the president of Malden Mills and on its board, for a salary of $425,000 per year, but he was no longer in charge of day-to-day operations or decisions and could not be unless and until the creditors were repaid.

In January 2004, members of the U.S. House and Senate lobbied to convince the Export-Import Bank to loan Mr. Feuerstein the money he needed to buy back his company. The Ex-Im Bank, swayed by Mr. Feuerstein's commitment to keep Malden's production in the United States, increased the loan amount from the $20 million it had originally pledged to the $35 million Mr. Feuerstein needed.

By the end of January 2004, Malden Mills had three new strategies: Mr. Feuerstein was selling Polarfleece blankets on QVC; the company would be in partnership in China with Shanghai Mills; and the company announced it would expand its military contracts. Mr. Feuerstein remained as president and chairman of the board.

The patience of the company's patient union was wearing thin. During the 2002–2003 time frame of the bankruptcy, the union leader said, "We're ready to make sacrifices for a little while. Whatever he asks us to do to keep the place going."[50] However, a threatened strike in December 2004 resulted in negotiations and a new union three-year contract, a more expensive one for the company.

As for Mr. Feuerstein, his view is simple: "There are times in business when you don't think of the financial consequences, but of the human consequences. There is no doubt this company will survive."[51] In 2006, Malden Mills landed a $16 million contract with the U.S. Department of Defense to be a supplier of the lightweight Polartec blankets for the U.S. military branches. By February 2007, private equity investors took over the company, now known as Polartec LLC, and it is owned by Chrysalis Partners. By July 2007, the company announced its last shipment from the factory, and the factory has been closed. The Pension Benefit Guaranty Corporation (PBGC) had to take over the underfunded pension (it was underfunded by 49 percent) for the 1,500 Malden employees who were trying to start their

[50] Lynnley Browning, "Fire Could Not Stop a Mill, but Debts May," *New York Times*, November 28, 2001, pp. C1, C5.

[51] *Id.*, p. C1.

own fabric-making enterprise. However, the assets of the company were sold, and the missed pension plan payments allowed the PBGC to end its commitment. The employees lost one-half of their pensions.

Discussion Questions

1. Mr. Feuerstein once stated, "I don't deserve credit. Corporate America has made it so that when you behave the way I did, it's abnormal." Given the final outcome, did Mr. Feuerstein end up in the same position as the CEOs of failed companies?
2. Mr. Feuerstein is a Talmudic scholar who often quotes the following proverbs:

   "In a situation where there is no righteous person, try to be a righteous person."

   "Not all who increase their wealth are wise."[52]

   Did he live by the proverbs? What wisdom for your credo comes from these two insights?
3. Did the fact that Malden Mills is privately held make a difference in Mr. Feuerstein's flexibility?
4. Did Mr. Feuerstein focus too much on benevolence and not enough on business? Did he rely only on goodwill to survive, and did he neglect the basics of strategy, marketing, and addressing the competition?

Case 7.7

JCPenney and Its Wealthy Buyer

Purchasing agent Jim G. Locklear began his career as a retail buyer with Federated Department Stores in Dallas, where he became known for his eye for fashion and ability to negotiate low prices. After ten years with Federated, he went to work for Jordan Marsh in Boston in 1987 with an annual salary of $96,000. But three months later, Locklear quit that job to take a position as a housewares buyer with JCPenney, so he could return to Dallas. His salary was $56,000 per year; he was thirty-eight years old; he owed support payments totaling $900 per month for four children from four marriages; and the bank was threatening to foreclose on his $500,000 mortgage.[53]

Locklear was a good performer for Penney. His products sold well, and he was responsible for the very successful JCPenney Home Collection, a color-coordinated line of dinnerware, flatware, and glasses that was eventually copied by most other tabletop retailers. Locklear took sales of Penney's tabletop line from $25 million to $45 million per year and was named the company's "Buyer of the Year" several times.

However, Locklear was taking payments from Penney's vendors directly and through front companies. Some paid him to get information about bids or to obtain contracts, whereas others paid what they believed to be advertising fees to various companies that were fronts owned by Locklear. Between 1987 and 1992, Locklear took in $1.5 million in "fees" from Penney's vendors.

Penney hired an investigator in 1989 to look into Locklear's activities, but the investigator uncovered only Mr. Locklear's personal financial difficulties.

During his time as a buyer, Locklear was able to afford a country club membership, resort vacations, luxury vehicles, and large securities accounts. Although his lifestyle was known to those who worked with him, no questions were asked again until 1992, when Penney received an anonymous letter about Locklear and his relationship with a Dallas manufacturer's representative. Penney investigated, uncovered sufficient evidence of payments to file a civil suit to recover those payments, and referred the case to the U.S. attorney in Dallas for criminal prosecution.

[52] Rabbi Avri Shafran, "Bankruptcy and Wealthy," *Society Today*, July 29, 2007, http://www.aish.com/societyWork/work/Aaron_Feuerstein_Bankrupt_and_Wealthy.asp.

[53] Andrea Gerlin, "How a Penney Buyer Made Up to $1.5 Million on Vendors' Kickbacks," *Wall Street Journal*, February 7, 1995, pp. A1, A18.

Mr. Locklear was charged by the U.S. attorney with mail and wire fraud. Mr. Locklear entered a guilty plea and provided information to the U.S. attorney on suppliers, agents, and manufacturers' reps who had paid him "fees." Mr. Locklear was sentenced to eighteen months in prison and fined $50,000. Penney won a $789,000 judgment against him, and Mr. Locklear's assets have been attached for collection purposes.[54]

Discussion Questions

1. Given Locklear's lifestyle, why did it take so long for Penney to take action? Do you see any red flags in the facts given?
2. A vendor who paid Locklear $25,000 in exchange for a Penney order stated, "It was either pay it or go out of business." Evaluate the ethics of this seller.
3. Do you agree that both the buyer and the seller are guilty in commercial bribery cases? Is the purchasing agent "more" wrong?
4. Many companies provide guidelines for their purchasing agents on accepting gifts, samples, and favors. For example, under Walmart's "no coffee" policy, its buyers cannot accept even a cup of coffee from a vendor. Any samples or models must be returned to vendors once a sales demonstration is complete. Other companies allow buyers to accept items of minimal value. Still others place a specific dollar limit on the value, such as $25. What problems do you see with any of these policies? What advantages do you see?
5. Describe the problems that can result when buyers accept gifts from vendors and manufacturer's representatives.
6. Mr. Locklear said at his sentencing, "I became captive to greed. Once it was discovered, I felt tremendous relief." Mr. Locklear's pastor said Locklear coached Little League and added, "Our country needs more role models like Jim Locklear."[55] Evaluate these two quotes from an ethical perspective. Are there any lessons for your credo in Mr. Locklear's experience?

Case 7.8

The Trading Desk, Perks, and "Dwarf Tossing"

Wall Street firms dream of acquiring the trading business of a mutual fund like Fidelity Investments. Wooing those Fidelity traders during 2006 resulted in at least one Wall Street firm, Jeffries & Co., going well over the $100 limit that the National Association of Securities Dealers (NASD) places as the upper edge for "stuff' that can be given by investment firms to traders. The traders were wooed with, among other things:

- A bachelor party in Miami for Fidelity Boston traders, complete with bikini-clad women, free charter nights from Boston to Miami that cost $31,000, and hotel suites with a party that included "dwarf tossing"
- Trips to the Super Bowl, all free
- $19,000 for Wimbledon tickets
- $7,000 for U.S. Open tickets
- $2,600 for six bottles of 1998 Opus One wine
- $47,000 in chartered nights from Boston to the Caicos Islands
- $1,200 for Justin Timberlake and Christina Aguilera tickets
- $1,000 for a portable DVD player
- $500 for golf clubs

Jeffries spent a total of $1.6 million on fourteen Fidelity traders.[56]

The SEC and the National Association of Securities Dealers (NASD) (now FINRA—Financial Industry Regulatory Authority) brought civil charges against Jeffries and required the firm to pay $5.5 million in fines and $4.2 million to disgorge profits made

[54] Andrea Gerlin, "J. C. Penney Ex-Employee Sentenced to Jail," *Wall Street Journal*, August 28, 1995, p. A9.

[55] *Id.*

[56] Greg Farrell, "Jeffries to Pay $9.7 Million to Settle Fidelity Gift Case," *USA Today*, December 5, 2006, p. 9B.

as a result of the gifts to the Fidelity traders. The SEC was able to tie the bestowing of the gifts to the timing of trades made by the Fidelity traders.[57]

Fidelity disciplined the brokers when news of the bachelor party trickled back to Boston and the company began looking beneath the tip-of-the-iceberg party.[58]

Following the Fidelity settlement for the employees, Peter Lynch, one of the firm's principals, was investigated, and the SEC discovered that Mr. Lynch was getting tickets to events such as the Ryder Golf Classic and U2 and Santana concerts. Lynch's eclectic tastes aside, he was earning between $3 million and $10 million per year when he solicited through Fidelity employees the $15,948 for tickets. Mr. Lynch agreed to repay the value of the tickets plus interest of $4,183, and also expressed regret: "In asking the Fidelity equity trading desk for occasional help locating tickets, I never intended to do anything inappropriate and I regret having made those requests."

Through his use of the Fidelity traders for tickets, Lynch placed his imprimatur on a system of getting and giving "stuff" for Fidelity's trades. In addition to Mr. Lynch, other Fidelity traders and officers racked up $1.6 million in goodies from brokers who were wooing Fidelity trades. One Fidelity trader commented, "Word is out that the order flow is for sale."

The various reports Fidelity had prepared on the trader goodies and stuff from brokers concluded that the conduct resulted in "adverse publicity, loss of credibility with principal regulators, and a loss of Fund shareholders." The SEC noted, "The tone is set at the top. If higher-ups request tickets from a trading desk, it may send a message that such misconduct is tolerated and could contribute to the breakdown of compliance on the desk."[59] It seems the leap from U2 concert tickets to bachelor parties with dwarf tossing as entertainment is relatively shorter than most of those at the top realize.

Discussion Questions

1. Why should we worry about gifts now and then to traders? Aren't all investment firms about the same, offering the same levels of service?
2. Why do NASD, now FINRA, and the SEC worry about traders receiving stuff?
3. Can you draw a definitive line for your credo from this case?
4. What level of discipline would be appropriate for the Fidelity brokers? Was the discipline for Mr. Lynch sufficient?
5. What signals did Mr. Lynch's conduct send to the traders?

Case 7.9

The Analyst Who Needed a Preschool

The stock market of the late 1990s and early 2000s represented a period of irrational exuberance. Investors invested as they never had, egged on by analysts who could say no evil of the companies they were to evaluate. For example, Citigroup is the parent company of Salomon Smith Barney, an investment banker and broker whose star telecommunications analyst, Jack Grubman, was perhaps WorldCom's biggest cheerleader.[60] owing quote from Mr. Grubman included in its 1997 annual report, which was still posted on its Web site through July 2002, "If one were to find comparables to WorldCom … the list would be very short and would include the likes of Merck, Home

[57] See http://www.sec.gov/news/press/2008/2008-291.htm for press releases. Accessed September 2, 2013.

[58] http://www.nasd.com. Accessed May 19, 2010.

[59] Kara Scannell, Susanne Craig, and Jennifer Levitz, '"Gifts' Case Nabs a Star," *Wall Street Journal*, March 6, 2008, p. C1.

[60] Neil Weinberg, "Walmart Could Sue for Libel," *Forbes*, August 12, 2002, p. 56.

Depot, Walmart, Coke, Microsoft, Gillette and Disney."[61] The sycophantism of Mr. Grubman is difficult to describe because it seems almost parody, as the WorldCom ending is now known. Mr. Grubman introduced Mr. Ebbers at analyst meetings as "the smartest guy in the industry."[62] It was not until the stock had lost 90 percent of its value, and just six weeks before its collapse, that Mr. Grubman issued a negative recommendation on WorldCom.[63] Mr. Grubman was free with his negative recommendations on other telecom companies. And Salomon would earn $21 million in fees if the WorldCom-Sprint merger were approved in 1999. He wrote, "We do not think any other telco will be as fully integrated and growth-oriented as this combination."[64] Mr. Grubman attended WorldCom board meetings and offered advice.[65]

The Loans from Citi

Citicorp was WorldCom's biggest lender as well as a personal lender for Bernie Ebbers, WorldCom's CEO (see Case 4.14. Mr. Ebbers's personal loans are reflected in the following chart.

Lender	Amount ($ million)	Status
Citigroup	$552	$88 million repaid
WorldCom	$415	Collateral seized
Bank of America	$253	Repaid
UBS Paine Webber	$51	Repaid
Toronto-Dominion	$40	Repaid
Morgan Keegan	$11.6	Repaid
J.P. Morgan Chase	$10.8	Repaid
Bank of North Georgia	$10.8	Repaid

Source: Susan Pulliam, Deborah Solomon, and Carrick Mollenkamp, "Former WorldCom CEO Built an Empire on Mountain of Debt," *Wall Street Journal*, December 31, 2002, p. A1.

The personal loans to Ebbers brought results for the banks in terms of WorldCom business.[66] Mr. Grubman's continuing positive reports on WorldCom, despite the slide of the company's stock and the clear signals from the market, earned him a subpoena to the congressional hearings, alongside Mr. Ebbers and CFO Scott Sullivan.[67] Former WorldCom employees who were directed to a special number when they wished to exercise their options and were discouraged from doing so by Salomon brokers who handled the WorldCom employee options program have filed a lawsuit.[68]

[61] *Id.*

[62] Randall Smith and Deborah Solomon, "Ebbers's Exit Hurts WorldCom's Biggest Fan," *Wall Street Journal*, May 3 2002, p. C1.

[63] *Id.*

[64] *Id.*, p. C3.

[65] *Id.*

[66] At least one lawsuit by a shareholder alleges that the loans were made in exchange for business with WorldCom Andrew Backover, "Suit Links Loans, WorldCom Stock," *USA Today*, October 15, 2002, p. 3B.

[67] Susan Pulliam, Deborah Solomon, and Randall Smith, "WorldCom Is Denounced at Hearing," *Wall Street Journal* July 9, 2002, p. A3; and Gretchen Morgenson, "Salomon under Inquiry on WorldCom Options," *New York Times*, March 13, 2002, p. C9.

[68] Gretchen Morgenson, "Outrage Is Rising as Options Turn to Dust," *New York Times*, March 11, 2002, p. BU1.

The IPO Allocations

Mr. Grubman's relationship with WorldCom's senior management was a target of investigation at the congressional level and elsewhere for reasons other than the personal loan relationships and the glowing reports from Mr. Grubman.[69] WorldCom gave the bulk of its investment banking business to Salomon Smith Barney, and it gave Mr. Ebbers and others the first shot at hot initial public offering (IPO) stocks.[70] The figures in congressional records indicate that Mr. Ebbers made $11 million in profits from investments in twenty-one IPOs recommended to him by Salomon Smith Barney and, more particularly, Mr. Grubman.[71] Apparently, complex games were going on in terms of how those shares were allocated initially, and Ebbers was one of the players let in on the best IPOs by Salomon Smith Barney. One expert described the allocation system as follows:

> Looking back, it looks more and more like a pyramid scheme. The deals explain why people weren't more diligent in making decisions about funding these small companies. If the money was spread all over the place and everyone who participated early was almost guaranteed a return because of the hype, they had no incentive to try and differentiate the technology. And in the end, all the technology turned out to be identical and commodity-like.[72]

The Glowing Reports

Mr. Grubman continued to issue nothing but positive reports on WorldCom as he became completely intertwined with the company, Mr. Ebbers, and the company's success.[73] In e-mails uncovered by an investigation of analysts conducted by then–New York Attorney General Eliot Spitzer, Mr. Grubman had complained privately that he was forced to continue his "buy" ratings on stocks that he considered "dogs." Mr. Spitzer filed suit against the analysts for "profiteering" in IPOs.[74]

Further, Mr. Ebbers was not the sole beneficiary of the Salomon Smith Barney IPO allocations, although he was the largest beneficiary.[75] Others who benefited from the IPO allocations and who were affiliated with WorldCom included Stiles A. Kellett Jr. (director, 31,500 shares), Scott Sullivan (CFO, 32,300 shares), Francesco Galesi (director), John Sidgmore (officer, director, and CEO after Ebbers's ouster), and James Crowe (former director of WorldCom).[76] Apparently, those who enjoyed the benefits of Salomon's allocations also stuck with Mr. Grubman in terms of his advice once the shares were allocated, often keeping the shares for too long because of Mr. Grubman's overly optimistic views on telecommunications-related companies' stock. However, Citigroup and

[69] Charles Gasparino, Tom Hamburger, and Deborah Solomon, "Salomon Made IPO Allocations Available to Ebbers Others," *Wall Street Journal*, August 28, 2002, p. A1.

[70] Gretchen Morgenson, "Ebbers Made $11 Million on 21 Stock Offerings," *New York Times,* August 31, 2002, p. B1; Gretchen Morgenson, "Ebbers Got Million Shares in Hot Deals," *New York Times*, August 28, 2002, p. C1; and Gretchen Morgenson, "Deals within Telecom Deals," New *York Times*, August 28, 2002, pp. BU1, BU10.

[71] See Morgenson, "Ebbers Got Million Shares in Hot Deals," for Ebbers information; and Andrew Backover, "World Com, Qwest Face SEC Scrutiny," *USA Today*, March 12, 2002, p. 1B, for information on Qwest inquiry; see also Thor Valdmanis and Andrew Backover, "Lawsuit Targets Telecom Execs' Stock Windfalls," *USA Today*, October 1 2002, p. 1B.

[72] Backover, "WorldCom, Qwest Face SEC Scrutiny," p. 1B; and Valdmanis and Backover, "Lawsuit Targets Telecom Execs' Stock Windfalls," p. 1B.

[73] Smith and Solomon, "Ebbers's Exit Hurts WorldCom's Biggest Fan," p. C1; and Andrew Backover and Jayne O'Donnell, "WorldCom Scrutiny Touches on E-mail," *USA Today*, July 8, 2002, p. 1B.

[74] Valdmanis and Backover, "Lawsuit Targets Telecom Execs' Stock Windfalls," p. 1B.

[75] Charles Gasparino, Tom Hamburger, and Deborah Solomon, "Salomon Made IPO Allocations Available to Ebbers Others," *Wall Street Journal*, August 28, 2002, p. A1.

[76] Morgenson, "Deals within Telecom Deals," pp. BU1, BU10.

Salomon both denied that any quid pro quo existed among Ebbers, WorldCom, and the companies for WorldCom's investment banking business.[77]

The Pre-School Deal

No charges were ever brought against Mr. Grubman. He operates his own firm today. However, one additional story related to Mr. Grubman's role as an analyst illustrates that financial analysis may not be as math oriented as we believed. Through a series of e-mails, we learned that Mr. Grubman used his position for some help on the home front. Mr. Grubman was the father of twins whom he wanted to see admitted to one of Manhattan's most prestigious preschools—the 92nd Street Y.

Mr. Grubman wrote a memo to Sanford Weill, the then-chairman of Citigroup, with the following language:

> On another matter, as I alluded to you the other day, we are going through the ridiculous but necessary process of preschool applications in Manhattan. For someone who grew up in a household with a father making $8,000 a year and for someone who attended public school, I do find this process a bit strange, but there are no bounds for what you do for your children.
>
> Anything, anything you could do Sandy would be greatly appreciated. I will keep you posted on the progress with AT&T which I think is going well.
>
> Thank you.

The backdrop for the memo is important. Citigroup pledged $1 million to the school at about the same time Grubman's children were admitted.

Mr. Weill, Mr. Grubman's CEO, asked Mr. Grubman to "take a fresh look" at AT&T, a major corporate client of Citigroup.

Mr. Weill served on the board of AT&T; AT&T's CEO, C. Michael Armstrong, served as a Citigroup director; and Mr. Weill was courting Armstrong's vote for the ouster of his cochairman at Citigroup, John Reed.

A follow-up e-mail from Mr. Grubman to Carol Cutler, another New York analyst, connected the dots:

> I used Sandy to get my kids in the 92nd Street Y preschool (which is harder than Harvard) and Sandy needed Armstrong's vote on our board to nuke Reed in showdown. Once the coast was clear for both of us (ie Sandy clear victor and my kids confirmed) I went back to my normal self on AT&T.

At the same time as all the other movements, Mr. Grubman upgraded AT&T from a "hold" to a "strong buy." After Mr. Reed was ousted, Mr. Grubman downgraded AT&T again.

Mr. Grubman said that he sent the e-mail "in an effort to inflate my professional importance."

In another e-mail, Mr. Grubman wrote, "I have always viewed [AT&T] as a business deal between me and Sandy."

Discussion Questions

1. Were there conflicts of interest?
2. What personal insights do you gain from Mr. Grubman's e-mails and conduct? What elements can be added to your credo from this case?
3. All analysts were participating in the same types of favors and quid pro quo as Grubman. Does industry practice control ethics?
4. Then–Attorney General Eliot Spitzer (now ex-governor of New York) pursued the analysts and

[77] Gretchen Morgenson, "Ebbers Got Million Shares in Hot Deal," p. C15.

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the investment houses for their lack of independence. Although they all settled the cases brought against them, what types of criminal conduct could they be charged with?

5. Mr. Spitzer found the bulk of his evidence for his cases in candid e-mails the analysts sent describing the eventual collapse of these companies even as their face-to-face evaluations of companies were most positive. Does he have the right to view their e-mails?

Compare & Contrast

Refer to Case 8.17 and the Coke employee (Matthew Whitley) who raised questions about payments to a consultant? How is he different from Jack Grubman? Why is one willing to label actions for what they are, whereas the other hangs on despite the evolving problems? Consider their personal interests, and then think about whether their personal credos had an impact on their careers and decisions.

Case 7.10

Taser and Stunning Behavior

Taser began operations in Arizona in 1993 for the purpose of developing and manufacturing nonlethal self-defense devices. From 1993 through 1996, Taser focused on the development and sale of the Air Taser, a self-defense weapon marketed to consumers. In December 1999, Taser introduced the Advanced Taser device, a product developed for sale to law enforcement agencies. The Taser X26 is sold to police and corrections agencies for $799.

The Taser technology uses compressed nitrogen to shoot two small, electrified probes up to a maximum distance of 25 feet. The probes and compressed nitrogen are stored in a replaceable cartridge attached to the Taser base.

Taser's focus from 1999 to 2001 was the development of a chain of distribution for the introduction of the product to law enforcement agencies (primarily in North America), as well as a national training program for the use of the Advanced Taser.

Taser created a training board that consists of four active-duty police officers and one representative from the airline industry as well as Taser's chief master instructor and king of the universe, Hans Marrero. Officers on active duty throughout the country serve as master and certified instructors for the company. They are paid $195 for each training session, and many of the officers, including those on the training board, have been awarded stock options by the company. Officers in Arizona, California, Canada, Texas, and Washington received stock options after recommending that their municipalities and agencies adopt Taser products for use by officers. The officers who received the options are now employed by Taser, Inc. The revelations about the officers and the option compensation came about because of suits filed by the *Arizona Republic* and *SEC Insight*, two publications seeking release of the company documents filed in lawsuits pending before Maricopa County Superior Court in Arizona. The court ruled against Taser and unsealed the documents. When asked by the *Arizona Republic* about the options, CEO Rick Smith responded via a company press release:

> The officers on our [training] board were involved in training operations at their respective departments—not the purchasing departments. They followed all relevant conflict-of-interest regulations at their departments, and the grant of stock options did not violate Taser's code of ethics nor industry norms.

Taser established the Taser Foundation for the families of fallen law enforcement officers in 2004. The Taser Foundation was funded with initial commitments for over $700,000 from Taser International, Inc., employees. The Taser Foundation's mission is to give back to the community by supporting the law enforcement community that helped with the development of distribution lines and training.

As of 2013, five states and the District of Columbia prohibit the possession of stun guns (including Taser weapons).[78] Also, city ordinances throughout the country prohibit private use or possession of stun guns. Taser continues to lobby against such ordinances and state legislation, using statistics on the success of the use of its products by police officers. Because of significant numbers of suits and damage awards, the company's insurance for 2008 has been exhausted, and any further verdicts resulting from injuries and suits during that year would be paid by the company directly and could have a material effect on the company's financial performance. Sales are sluggish because of government budget constraints.

Discussion Questions

1. Evaluate Taser's actions in hiring the officers and using options as payment.
2. Evaluate the conduct of the officers in accepting the positions and the compensation from Taser.
3. What would you have done differently as an executive at Taser? As a police officer?
4. Are the connections among and between government agencies and Taser a necessary and inevitable part of Taser's type of product?

Case 7.11

Boeing and the Recruiting of the Government Purchasing Agent

Darlene Druyun was a lifetime government employee, working her way up through the system to a position of Air Force acquisition officer. In the early 1990s, she was mentioned in an inspector general's report for speeding up payments to McDonnell Douglas through the backdating of some records. She was the only one of five defense department employees involved who was not disciplined for her actions.[79]

Despite this dust-up and investigation, she rose to the position of principal deputy assistant secretary in the U.S. Air Force. Known as the "Dragon Lady," Ms. Druyun had extensive knowledge about Defense Department policies and procedures and defense contractors, and had honed tough negotiating skills. Former Secretary of Defense Donald Rumsfeld said that Ms. Druyun acquired a great deal of authority and made a lot of decisions, and that "there was very little adult supervision."[80] In the last quarter of 2002, Ms. Druyun, nearing her retirement, was interested in job opportunities after leaving government service.

Ms. Druyun's daughter, Heather McKee, was an employee at the St. Louis facilities for Boeing, Inc., a company that does a significant amount of business with the federal government. In court documents, Ms. Druyun indicated that Michael Sears, who was then Boeing's chief financial officer (CFO) and the man considered to be in line to be the next Boeing CEO, helped place her daughter in her job at Boeing. Ms. McKee's husband also worked for Boeing and was hired along with Ms. McKee when he was her fiancé.

[78] This information from the company's April 2013 10-K filing, www.sec.gov. Go to the Edgar database and use "Taser" as the company name. The annual report can also be found at the company's website. http://investor.taser.com/secfiling.cfm?filingID=1193125-13-98571&CIK=1069183.

[79] Geroge Caglink, "Fallen Star," *Government Executive*, February 1, 2004, http://www.govexec.com/magazine/2004/02/fallen-star/15929/.

[80] Thomas E. Ricks, "Rumsfeld: Druyon Had Little Supervision," *Washington Post*, November 24, 2004, http://www.washingtonpost.com/wp-dyn/articles/A8689-2004Nov23.html.

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In September 2002, Ms. McKee sent an e-mail to Mr. Sears to let him know that her mother was planning to retire. Ms. McKee mentioned to Mr. Sears that her mother would probably end up working for Lockheed following her retirement from her government position, but that Ms. Druyun really wanted to work for Boeing.

As a result of this contact, Mr. Sears met with Ms. Druyun in October 2002, which was one month before Ms. Druyun recused herself from working on any contract decisions involving Boeing as a bidder. At the end of the meeting, Ms. Druyun has testified, Mr. Sears said, "This meeting never took place." When he returned to the offices, however, Mr. Sears sent out e-mails indicating that Ms. Druyun was receptive to employment. In a note sent to the chairman's office, Mr. Sears wrote, "Had a 'non-meeting' yesterday. Good reception to job, location, salary."

In October 2002, the two reached an employment arrangement. In January 2003, Ms. Druyun went to work for Boeing in its Chicago offices as a vice president, at a salary of $250,000 per year plus benefits. Pending before the Air Force at the time of the employment agreement was a bid by Boeing to supply the Air Force with 100 Boeing 767 refueling tankers. Also during this time, John Judy, a Boeing lawyer who was moving from Boeing offices in St. Louis to the Washington, D.C., area, purchased Ms. Druyun's home from her.[81]

During the summer of 2003, Boeing began an internal investigation of the circumstances surrounding Ms. Druyun's hiring. Ms. Druyun and Mr. Sears exchanged memos and e-mails with a timeline that they had reconstructed, but one that did not reflect accurately what had really happened and what was easily traceable through meeting places and witnesses. Based on its internal investigation that revealed "compelling evidence" that the two had conspired to employ Ms. Druyun while she still had contracting authority, and their subsequent attempts to cover up their conduct, Boeing dismissed both Ms. Druyun and Mr. Sears. Their dismissal for cause cost them any severance benefits.[82]

Ms. Druyun was charged by the federal government with violations of procurement statutes and conspiracy. She entered a guilty plea to conspiracy in April 2004 and told the court, "I deeply regret my actions and I want to apologize."[83] Ms. Druyun was originally scheduled to be sentenced to six months in prison, because she had agreed to cooperate with federal investigators. However, she was ultimately sentenced to nine months because federal investigators established that she had lied when asked whether she had ever showed favoritism to Boeing in awarding defense contracts. She initially stated that she had not shown such favoritism, but, after failing a lie detector test, she disclosed that she had given Boeing several contracts and pricing breaks in exchange for Boeing hiring her daughter and son-in-law. The supplemental factual statement for her second plea agreement also indicates that Ms. Druyun altered her notebook, the collection of contemporaneous notes she had given to prosecutors. After failing the lie detector test, she acknowledged changing entries and adding materials. She also indicated that she gave Boeing pricing breaks with the hope of helping her daughter and son-in-law with their careers at Boeing. Moreover, she stated that she had approved a settlement with Boeing that was too high. Boeing and the Department of Defense renegotiated that settlement. Then–Boeing CEO Harry Stonecipher pledged that the company would address "any inadequacies that need to be corrected." Ms. Druyun's daughter no longer works for Boeing.[84] Mr. Sears served a four-month sentence, and Ms. Druyun served a

[81] www.eeoc.gov. Click on litigation statistics. Accessed May 19, 2010.

[82] *International Union v. Johnson Controls, Inc.*, 499 U.S. 187, 191 (1991).

[83] *Id.*, p. 191.

[84] *Id.*, p. 192.

nine-month sentence. Ms. Druyun has also been ordered to pay restitution and contribute time to community service. Ms. Druyun was released from prison in October 2005.

Discussion Questions

1. What category of ethical dilemma is involved here?
2. What questions or models did Mr. Sears miss in choosing to recruit Ms. Druyun when he did? What was he hoping would happen? What do you think of his asking Ms. Druyun to cover up their meeting? What should the chairman of the board have done when he received Mr. Sears's e-mail about the "non-meeting"?
3. What were Ms. Druyun's motivations? What questions or models did she miss in making her decision to meet with Mr. Sears?
4. Evaluate the conduct of Ms. Druyun's daughter, Heather.

Case 7.12

Kodak, the Appraiser, and the Assessor: Lots of Backscratching on Valuation

This tale of a sort of sting operation required participation from business, government, and a professional. John Nicolo was a real property appraiser who did appraisal work for Eastman Kodak, Inc. (Kodak) at the request of one of Kodak's now-former employees, Mark Camarata, who served as Kodak's director of state and local taxes while employed there. Charles Schwab was the former assessor for the town of Greece, New York, an area that included Kodak headquarters. Kodak is both the largest employer and the largest property owner in the town of Greece.

According to the indictments in the case, Schwab made reductions in Kodak's real property tax assessment. Those reductions, according to calculations completed by Nicolo and Camarata, saved Kodak $31,527,168 in property taxes over a fifteen-year period. But Schwab did not make those reductions as a matter of assessor policy, fond feelings for Kodak, or the goodness of his public servant heart. He made those reductions at the behest of the other two in exchange for payment. Nicolo's fee from Kodak, arranged according to a percentage of the amount he was able to save the company, was to be $7,881,798 (about 25 percent of Kodak's projected tax savings). After being paid over $4,000,000 of his fee from Kodak, Nicolo paid Camarata $1,553,300 for his role in hiring him and then paid Schwab $1,052,100. The essence of the arrangement was that the appraiser agreed to split the tax savings fee with the assessor in exchange for the reduction and with the Kodak employee in exchange for hiring him.

The group also managed to involve companies that were buying property from Kodak. For example, in 2004, ITT bought one of Kodak's buildings in its industrial park as Kodak was downsizing. Immediately upon its acquisition of the building, ITT got an assessment from Schwab that quadrupled the value of the building for purposes of tax assessment. Mr. Camarata referred the ITT officers to Mr. Nicolo, who then talked Mr. Schwab into reducing the assessment value. However, unbeknownst to ITT, the whole scenario had been set up by the group, according to trial testimony. Schwab reduced the assessment value, and Nicolo split his fee with Camarata and Schwab.

Camarata entered a guilty plea to various federal fraud charges and agreed to cooperate with federal authorities in their prosecution of the other two of the property tax triumvirate, who have been charged with fifty-six counts of fraud, money laundering, and other federal crimes. Mr. Camarata faced a possible penalty of twenty years, but was sentenced in 2009 to two years because of what U.S. Federal District Judge David Latimer described as follows: "Your cooperation with the government was immediate and complete. Without your testimony, I think the verdict might have been much more difficult for the government to accomplish … your help was the linchpin for the government's case."

Mr. Camarata was ordered to pay $10 million in restitution as part of his federal prosecution, but the total amount he will owe remains unclear because of federal income taxes owed, civil damages to Kodak and ITT, and taxes owed to the city based on the undervaluations.

Following an eleven-week trial, Mr. Nicolo was sentenced to twelve years in federal prison. He requested home confinement due to health issues and alleged threats and beatings by prison officials, but was denied the request.

When Kodak learned of the schemes, it immediately entered into discussions with the town of Greece for the reappraisal of its properties. Kodak also filed suit against Camarata and others seeking reimbursement from them for the fees that were paid as part of the scheme. The federal government has been working to sell off property belonging to Mr. Nicolo and others. In 2013, a federal court ordered Mr. Nicolo's lakefront property, estimated to be worth $500,000, to be sold by auction. The federal and local government have already recovered $10 million from Mr. Nicolo. Kodak received $7.8 million of the amount recovered as its settlement in the case.

Discussion Questions

1. Was anyone really hurt by this? Didn't Kodak benefit?
2. Why do we worry about an agreement by an assessor to reduce the assessed value? Couldn't he have done that anyway, regardless of receiving payment?
3. Does the method for paying appraisers on a contingency basis encourage this type of involvement by government officials?
4. Why do you think the three (possibly five) decided to engage in the scheme? Do any thoughts for your credo come from your observations about what happened?

   After his guilty plea and agreement to cooperate, Mr. Camarata's fellow defendants referred to him as a "liar and thief." What lesson do you learn from this reaction and interaction?

Source

Indictment, U.S. v. Camarata, May 5, 2005, http://www.fbi.gov.

Case 7.13

Medtronics, Journal Articles, Consulting, and Ethics

Studies about medical devices and drugs appear in the medical journals as an important method for getting access to the doctors who read those journals. In order to get that kind of information to the journals, pharmas began funding research projects and providing consulting fees to physician scientists and physician editors who then touted the new drugs of the companies that paid the fees.

The Aspiring and Anticlotting Studies

Since 2002, medical publications have touted articles and research on "aspirin resistance." The articles and research suggest that those who are taking aspirin to prevent heart attacks are wasting their money and effort because they are resistant to the effects aspirin is said to have in preventing clotting. The articles also suggest that the solution is for those taking aspirin to take aspirin substitutes that will have similar effects. These substitutes are manufactured by pharmaceutical firms and cost about $4.00 per day.

However, the journals in which the "aspirin-resistant" articles have appeared have failed to disclose ties between the researchers and authors and the drug companies manufacturing the aspirin substitutes that they tout. For example, in July 2005, Dr. Daniel Simon, an associate professor of medicine at the Harvard Medical School, wrote in *Physicians Weekly*, a trade magazine for the profession, that aspirin resistance could affect 30 percent of those who are taking aspirin to prevent heart attacks. He went on to suggest that these aspirin-resistant souls needed other anticlotting drugs. *Physicians Weekly* did not disclose that Dr. Simon is the recipient of research funding from Accumetrics, Inc., a company that produces a test for aspirin resistance. Neither did the publication mention that Dr. Simon also receives research funding from Schering-Plough Corp., a company now testing a drug to be used to help the aspirin-resistant heart patient. Stunningly, editor Keith D'Oria indicated that he was aware of Dr. Simon's ties, but that *Physicians Weekly's* policy is not to disclose the ties, but rather to use the information for different purposes such as contacting Accumetrics or Schering-Plough to determine whether they would like to place ads near the good doctor's discussion of aspirin resistance and resolutions therefore. Dr. Simon's response to questions about conflicts of interest is that one cannot rely on independent researchers because they "are not truly expert."[85]

Sales of anticlotting drugs for the aspirin resistant are up 59 percent. A study appearing in the *New England Journal of Medicine* concluded that combinations of the prescription drugs with aspirin were no more effective than just taking aspirin, but cardiologists have cautioned their patients about eliminating the drugs.

The Medtronics Devices, the Docs, the Consulting and Research Grants, and Journals

In May 2006, University of Minnesota spine surgeon, Dr. David Polly, testified before a U.S. Senate committee, urging the senators to fund research into arm, leg, and spine injuries, including studies of Medtronic's Infuse, a bone-growth product. However, it was not until 2009 that Dr. Polly disclosed to the committee that his trip to Washington, D.C., had been paid for by Medtronic and that he was paid $1.14 million by Medtronic between 2004 and 2007 for consultant work on Infuse. Dr. Polly received a $466,644 grant in early 2007 to evaluate the efficacy of Infuse.[86]

The medical journal *Bone and Joint Surgery* withdrew Dr. Timothy Kuklo's paper on Medtronic's Infuse bone-graft product after administrators at the Walter Reed Army Hospital notified the journal that the signatures of the coauthors were forged and of its belief that the research was falsified because it could not locate patient files to support the findings. The study concluded that there were advantages in healing the legs of injured soldiers when Infuse was used. Medtronic, the maker of Infuse, paid Dr. Kuklo more than $800,000 as consulting fees for product development, training for doctors, and speeches at company events, all related to Infuse.[87]

In 2011, *The Spine Journal* repudiated the research of experts who advocated the use of Infuse, referring to the research as "misleading and biased."[88] The journal devoted its full issue to the repudiation of the research, including discussion of the side effects of the use of Infuse being downplayed. The journal also reported that the researchers had not disclosed their financial interests in the product. For example, Dr. Thomas A. Zdeblick of

[85] David Armstrong, "Doctors with Ties to Companies Push Aspirin Objections," *Wall Street Journal*, April 24, 2006, pp. A1, A12.

[86] David Armstrong and Thomas M. Burton, "Spine Surgeon Didn't Disclose Medtronic Pay in Testimony," *Wall Street Journal*, July 29, 2009, p. B1.

[87] David Armstrong and Thomas M. Burton, "Medtronic Paid the Surgeon Accused of Falsifying Study Nearly $800,000," *Wall Street Journal*, June 18, 2009, B1.

[88] Barry Meier and Duff Wilson, "Spine Experts Repudiate Medtronic Studies," *New York Times*, June 29, 2011, p. B1.

the University of Wisconsin said that he did not have a direct financial interest in Infuse, but failed to disclose that he has received $20 million in royalty payments from sales of the product. The researchers involved in the studies received between $12 million and $16 million in royalties from Medtronic. Infuse has been approved by the FDA for use in spinal injuries and surgeries, but not for other bones in the body. The research supported the off-label use of the drug for wounded soldiers legs and arms and other types of surgeries.

In 2012, documents released during a Senate investigation of the payments indicated that Medtronic was "heavily involved in drafting, editing, and shaping the content of medical journal articles."[89] The Senate documents also showed that the royalty payments to the physician/authors/researchers of the articles were understated or not disclosed. Drs. Scott D. Boden, Regis W. Haid, Volker Sonntag, and Thomas A. Zdeblick each received between $22 million and $34 million in royalties. Other physicians involved in the research (27) received Medtronic payments ranging from a few hundred dollars to $6.4 million each. Another physician/researcher who had received $25.5 million from Medtronic said he did not receive those payments for Infuse, stating, "I hold myself to high standards of integrity."[90]

In 2013, a series of independent studies concluded that Medtronic's Infuse was no better than a traditional spinal operation. Medtronic had turned over the data on Infuse, along with $2.5 million, to Yale University in order to have experts there determine whether the claims by the researchers (who had issues with conflicts) were true. In releasing their results, the researchers who reached a conclusion that was negative for Infuse still praised Medtronic for being willing to release the data so that "the truth could prevail."[91]

Discussion Questions

1. What category of ethical issue are the gifts to physicians? The consulting arrangements? The research arrangements?
2. If you were a doctor, how would you handle funded research from a company whose drug you are testing? Are there credo issues here?
3. A lawsuit filed by Ami P. Kelley, a former senior legal counsel for Medtronic, against the company and ten physicians alleges that Medtronic provided considerable "goodies" to doctors in exchange for the doctors' use of Medtronic products. The suit alleges that Medtronic staff members "routinely" took physicians to the Platinum Plus, a strip club in Memphis and also paid for the physicians to have VIP visits there.[92] The suit also alleges that Medtronic had hundreds of consulting contracts with doctors for which the doctors did little or no work and that were entered into in order to have the doctors use Medtronic devices. According to the suit, Medtronic also paid almost $25,000 to allow physicians to ride on a Mardi Gras float during a New Orleans "seminar" and also provided the doctors with $15,000 worth of Mardi Gras beads for use during the ride.[93]

   Medtronic has actually settled charges of kickbacks with the federal government and paid a $40 million fine. Ms. Kelley seeks private remedies because she was fired after she threw down the flag on the various forms of payment and entertainment that flowed from Medtronic to the docs. Medtronic has since changed its policies on trips and consulting for physicians. Under federal law, a whistleblower is entitled to a percentage of the amount the government recovers because of the information the whistleblower has provided. Ms. Kelley seeks recovery for her termination.

   Describe the role and rights of whistleblowers in situations such as these. Why do you think Ms. Kelley was fired for raising such a simple concern?
4. Several doctors received compensation from GlaxoSmithKline for their work in discussing Glaxo products at professional meetings. The amounts that the good doctors received are minimal. For example, Dr. David Capuzzi received $3,750 over a

[89] John Carreyrou, "Medtronic Documents Spur New Questions," *Wall Street Journal*, October 25, 2012, p. B1.

[90] John Carreyrou, "Medtronic Documents Spur New Questions," *Wall Street Journal*, October 25, 2012, p. B1.

[91] Christpher Weaver, "Studies Fail to Back Medtronic Spine Product," *Wall Street Journal*, June 18, 2013, p. B3.

[92] As an aside, the owner of Platinum Plus entered a guilty plea to charges of prostitution against the club, and the club has since closed.

[93] David Armstrong, "Lawsuit Says Medtronic Gave Doctors Array of Perks," *Wall Street Journal*, September 25 2008, pp. B1, B6.

one-year period from Glaxo. However, during the same period, Avandia, a Glaxo product, was facing increasing scrutiny for its side effects. The FDA was considering whether to halt sales of Avandia. The FDA faced a critical decision because of the importance of Avandia for treatment of diabetes. Yet the FDA was also facing serious questions about the drug's risks. Dr. Capuzzi served on the FDA Advisory Committee that voted to allow Avandia to remain on the market. Dr. Capuzzi's disclosure of his Glaxo consulting fees never made its way to the FDA Advisory Committee prior to the vote. Dr. Capuzzi does not see the payments as a conflict because, he says, "I have not given any talks to doctors' groups promoting Avandia."[94] Evaluate Dr. Capuzzi's analysis.

Source

For a look at more information on this issue and various policies relating to it, visit the websites: http://www.ama.org and http://www.kaisernetwork.org.

Case 7.14

Cornell Researchers and Foundation Funding

Brilliant researchers at Cornell discovered a new imaging technique that can detect lung cancer early enough to allow removal of tumors. Weill Cornell Medical College researcher, Dr. Claudia Hensche, released her groundbreaking work on lung cancer in 2006 in the *New England Journal of Medicine*. A footnote in the article indicated that nearly all of the $3.6 million in funding for her research had come from The Foundation for Lung Cancer: Early Detection, Prevention, and Treatment. However, a 2008 *New York Times* story revealed that nearly all of the funding for the Foundation had come from The Vector Group, the parent of Liggett Group, a cigarette company.[95] A 2009 *Wall Street Journal* article disclosed that Dr. Hensche, whose research work and publication on treating lung cancer focused on the use of the tomography machine, was also receiving royalties from General Electric, one of the leading manufacturers of such machines.[96]

If the physician-researchers are correct in their work and findings, they have made a major breakthrough. However, cries of foul have emerged as the physician-researchers fret that valuable science is being discredited because of "tobacco taint." But another expert has countered that "the Cornell scientists promoting it are also trained professionals who have (conflict of interest disclosure infractions aside) successfully run the gauntlet of peer review. The top Cornell administrator who approved the tobacco payments is also a distinguished physician-scientist."[97]

Discussion Questions

1. Are there grades or levels of conflicts of interest? How are conflicts managed?
2. Who are the stakeholders in analyzing this question about the disclosure of funding for research and royalties related to research focus?
3. What guidelines should universities have for their researchers? What guidelines should companies have for their donations? What guidelines should editors have for publication of research results?

[94] Alicia Mundy, "Panelist Paid Fees By Glaxo," *Wall Street Journal*, July 20, 2010, p. B2.

[95] Gardiner Harris, "Cigarette Company Paid for Lung Cancer Study," *New York Times*, March 26, 2008, p. A1.

[96] Keith J. Winstein, "Medical Journal Criticized Over Lack of Disclosure on Authors," *Wall Street Journal*, January 12, 2009, p. A9.

[97] David A Shaywitz and Thomas P. Stossel, "Attack of the Pharmascolds," *The Weekly Standard*, May 12, 2008, pp. 11–13.

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SECTION C

Workplace Diversity and Atmosphere

Case 7.15

English-Only Employer Policies

English-only policies in the workplace have become the fastest-growing area of Equal Employment Opportunity Commission (EEOC) complaints as well as litigation under Title VII. In 1996, the EEOC had thirty discrimination complaints related to English-only policies of employers. Since 1996, the EEOC has had a 500 percent increase in those complaints.[98] Employers that have implemented English-only policies include the Salvation Army, All-Island Transportation (a Long Island taxi company), a geriatric center in New York, and Oglethorpe University in Atlanta.

One lawyer noted that employers seem more willing to make the policies and risk the legal battles because they think such policies are appropriate and necessary in order to provide adequate customer service or, in the case of health operations such as the geriatric center, correct medical care. Employers are, however, warned by their lawyers that they will have “a target on their backs” if they implement the policies.

A case that an employer lost was *Maldonado v. City of Altus,* 433 F.3d 1294 (10th Cir. 2006). In that case, the city of Altus promulgated an English-only policy that affected twenty-nine of the city’s employees who are Hispanic. All twenty-nine of the employees are fluently bilingual. In the spring of 2002, the city’s street commissioner issued a rule that employees in his division could speak only English while on the job. The city’s HR director told the commissioner that the policy would be upheld only if limited to when the employees were using the radio to communicate for purposes of city business. However, the rule was enforced throughout the workday, even during lunch and breaks. The employees filed suit, alleging that the rule created a hostile environment for them. The Tenth Circuit agreed with the employees and reversed the summary judgment for the city. A portion of the court’s decision appears below:

> Defendants’ evidence of business necessity in this case is scant. As observed by the district court, “[T]here was no written record of any communication problems, morale problems or safety problems resulting from the use of languages other than English prior to implementation of the policy.” And there was little undocumented evidence. Defendants cited only one example of an employee’s complaining about the use of Spanish prior to implementation of the policy. Mr. Willis admitted that he had no knowledge of City business being disrupted or delayed because Spanish was used on the radio. In addition, “city officials who were deposed could give no specific examples of safety problems resulting from the use of languages other than English. . . .” Moreover, Plaintiffs produced evidence that the policy encompassed lunch hours, breaks, and private phone conversations; and Defendants conceded that there would be no business reason for such a restriction.

[98] www.eeoc.gov. Click on enforcement and then go to reports and statistics or plug in “litigation statistics” at the site search engine. Accessed September 2, 2013.

Lawyers offer the following guidelines for enforceable English-only policies:

- Such policies are permitted if they are needed to promote safe or efficient operations;
- Such policies are permitted where communication with customers, coworkers, supervisors (who speak only English) is also important;
- Such policies are permitted where there are frequent emergency encounters in which a common language is necessary for purposes of being able to manage the situation; and
- Such policies are necessary in situations in which cooperation and close working relationships demand a common language and some workers speak only English.

Discussion Questions

1. Do you think the policies are discriminatory?
2. Do you think they create a hostile environment?
3. Give a list of the types of employers you believe could qualify for an English-only policy under the EEOC guidelines.

Source

Baldas, Tresa, "Language Policies Trigger Lawsuits," *National Law Journal*, June 11, 2007, pp. 1 and 17.

Case 7.16

Employer Tattoo and Piercing Policies

Kimberly Cloutier was a member of the Church of Body Modification. In 1997, during her job interview for a position at Costco, Ms. Cloutier sported four tattoos and multiple earrings, but she had no facial piercings. She was hired and given a copy of the Costco dress code, which was modified several times between 1997 and 2001. One of the modifications prohibited employees from having facial piercings. As the policy was modified, Ms. Cloutier increased the number of body piercings she had, including an eyebrow ring. Ms. Cloutier maintained that they were part of her adherence to her faith, the Church of Body Modification (CBM), but she did not join the CBM until 2001. The CBM, which anyone can join via electronic application, had approximately 1,000 members at that time. The members participate in piercing, tattooing, branding, cutting, and body manipulation. Among the goals espoused in the CBM's mission statement are for its members to "grow as individuals through body modification and its teachings," to "promote growth in mind, body and spirit," and to be "confident role models in learning, teaching, and displaying body modification." However, the tenets of the faith do not require that body modifications be on display at all times.

She did not object on religious grounds to the dress code or any of its modifications until, in 2001, when her supervisors asked her to either remove the eyebrow ring while she was working or cover it with some form of adhesive bandage. Costco also proposed having her wear a clear plastic ring in the eyebrow piercing while she was working so that her body modification could still be seen but would not be conspicuous. Ms. Cloutier refused the proposed accommodations and filed a complaint with the EEOC. The EEOC concluded that Costco had discriminated on the basis of Ms. Cloutier's religion, and she then filed suit against Costco for religious discrimination in violation of Title VII. The district court granted summary judgment for Costco, and Cloutier appealed.

Discussion Questions

1. Explain what the court should do with the case.
2. Develop a policy for employers on tattoos and piercing that will survive judicial challenges.

Source

Cloutier v. Costco, 390 F.3d 126 (1st Cir. 2004).

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Case 7.17

On-the-Job Fetal Injuries

Johnson Controls, Inc., is a battery manufacturer. In the battery-manufacturing process, the primary ingredient is lead. Exposure to lead endangers health and can harm a fetus carried by a female who is exposed to lead.

Before Congress passed the Civil Rights Act of 1964, Johnson Controls did not employ any women in the battery manufacturing process. In June 1977, Johnson Controls announced its first official policy with regard to women who desired to work in battery manufacturing, which would expose them to lead:

> Protection of the health of the unborn child is the immediate and direct responsibility of the prospective parents. While the medical professional and the company can support them in the exercise of this responsibility, it cannot assume it for them without simultaneously infringing their rights as persons.
>
> Since not all women who can become mothers wish to become mothers (or will become mothers), it would appear to be illegal discrimination to treat all who are capable of pregnancy as though they will become pregnant.[99]

The policy stopped short of excluding women capable of bearing children from jobs involving lead exposure but emphasized that a woman who expected to have a child should not choose a job that involved such exposure.

Johnson Controls required women who wished to be considered for employment in the lead exposure jobs to sign statements indicating that they had been told of the risks lead exposure posed to an unborn child: "that women exposed to lead have a higher rate of abortion … not as clear as the relationship between cigarette smoking and cancer … but medically speaking, just good sense not to run that risk if you want children and do not want to expose the unborn child to risk, however small."

By 1982, however, the policy of warning had been changed to a policy of exclusion. Johnson Controls was responding to the fact that between 1979 and 1982, eight employees became pregnant while maintaining blood lead levels in excess of 30 micrograms per deciliter, an exposure level that OSHA categorizes as critical. The company's new policy was as follows:

> It is Johnson Controls' policy that women who are pregnant or who are capable of bearing children will not be placed into jobs involving lead exposure or which would expose them to lead through the exercise of job bidding, bumping, transfer or promotion rights.[100]

The policy defined women capable of bearing children as "all women except those whose inability to bear children is medically documented." The policy defined unacceptable lead exposure as the OSHA standard of 30 micrograms per deciliter in the blood or 30 micrograms per cubic centimeter in the air.

In 1984, three Johnson Controls employees filed suit against the company on the grounds that the fetal-protection policy was a form of sex discrimination that violated Title VII of the Civil Rights Act. The three employees included Mary Craig, who had chosen to be sterilized to avoid losing a job that involved lead exposure; Elsie Nason, a 50-year-old divorcee who experienced a wage decrease when she transferred out of a job in which she was exposed to lead; and Donald Penney, a man who was denied a leave of absence so that he could lower his lead level because he intended to become a father. The trial court certified a class action that included all past, present, and future Johnson

[99] *International Union v Johnson Controls, Inc.*, 499 U.S. 187, 191 (1991).

[100] *Id.*

Controls' employees who had been or would continue to be affected by the fetal protection policy Johnson Controls implemented in 1982.

At the trial, uncontroverted evidence showed that lead exposure affects the reproductive abilities of men and women and that the effects of exposure on adults are as great as those on a fetus, although the fetus appears to be more vulnerable to exposure. Johnson Controls maintained that its policy was a product of business necessity.

The employees argued in turn that the company allowed fertile men, but not fertile women, to choose whether they wished to risk their reproductive health for a particular job. Johnson Controls responded that it had based its policy not on any intent to discriminate, but rather on its concern for the health of unborn children. Johnson Controls also pointed out that inasmuch as more than forty states recognize a parent's right to recover for a prenatal injury based on negligence or wrongful death, its policy was designed to prevent its liability for such fetal injury or death. The company maintained that simple compliance with Title VII would not shelter it from state tort liability for injury to a parent or child.

Johnson Controls also maintained that its policy represented a bona fide occupational qualification and that it was requiring medical certification of nonchildbearing status to avoid substantial liability for injuries.

Discussion Questions

1. To what extent should a woman have the right to make decisions that will affect not only her health but also the health of her unborn child? To what extent should a woman's consent to or acknowledgment of danger mitigate an employer's liability? What if a child born with lead-induced birth defects sues? Should the mother's consent apply as a defense?
2. The U.S. Supreme Court eventually decided Johnson Controls' policy was discriminatory and a violation of Title VII.[101,102] What steps would you take as director of human resources to create a "policy-free" work setting?
3. The fallout from the *Johnson Controls* decision has been that many women have been working in jobs that expose them to toxins. The U.S. Supreme Court did acknowledge in its holding that tort liability might result from its decision, but that such liability was often used as a guise or cover for gender discrimination. However, fourteen years after the decision, women who were held to be entitled to the high-risk jobs are now suing their employers for the birth defects in their children. For example, IBM has several suits from employees and their children against it for defects allegedly tied to production-line toxins.[103] The position of many of the employers is that even if evidence existed linking the toxins to birth defects, the women took the jobs with knowledge about the risk and agreed to that risk. How can employers, legislators, and public policy specialists reconcile antidiscrimination laws and these risks of exposure?
4. At what times, if any, should discrimination issues be subordinate to other issues, such as the risk of danger to unborn children?

Case 7.18

Office Romances

From Barack and Michele Obama to Bill and Melinda Gates, to Brad Pitt and Angelina Jolie, romance befalls many at work, whether they are working at a law firm or a software company, or making a movie together. Romance is even more prevalent among the less famous. The data indicate that 39 percent of us have dated a coworker. One question to ask as a follow-up is "Were your employers aware of the dating?"

[101] *International Union v. Johnson Controls, Inc.*, 499 U.S. 187 (1991).

[102] *Id.*

[103] Stephanie Armour, "Workers Take Employers to Court over Birth Defects," *USA Today*, February 26, 2002, pp. 1 A, 2A. For more information, go to http://www.cdc.gov/niosh.

Employers cannot control when and where Cupid's arrow may strike, but they do need to have rules and policies in place to deal with the potential issues that can arise from workplace romances.

Some rules can help both employers and their employees. The goal for employers is to prevent issues of favoritism and sexual harassment. Along the way, the employers' rules may save employees from a broken heart. Below are a few sample rules that companies use for purposes of avoiding the pitfalls of office romance.

1. Some companies simply prohibit employees who work together from having a relationship. Such a rule can be problematic because employees have the relationship anyway and simply hide it from the employer as other employees' gossip. Often, companies accompany this policy with a policy on finding one member of the couple a different position outside of the division or office where both met and are currently working.
2. Some companies prohibit relationships between employees when one reports to the other. For example, Michele was Barack's supervisor at the law firm when he worked as a summer intern at the same law firm. Many companies would require a transfer or that one leave the firm.
3. Some companies follow this rule: Disclose to your supervisor that you are having a romantic relationship with a coworker. The purpose of such disclosure is for the supervisor to determine whether conflicts exist or if an adjustment needs to be made because of reporting lines. That is, two employees who are dating should not be in a direct report relationship. Some companies do not permit even indirect reportees to date supervisors. These companies work to find one of the employees a different position in the company outside of the direct or indirect reporting lines.
4. Most companies remind employees that a consensual relationship that goes south can very often turn into allegations of sexual harassment. Employees are cautioned to proceed within company rules for their own protection. Some companies have what is called a "love contract" that the two employees sign upon disclosure of their relationship so that a written record exists of a consensual relationship—a protection for both the employer and the employees against sexual harassment charges.
5. Although most companies do not address the issue directly, an adulterous relationship between two employees is generally a career killer, at least within the company. During the past year, two CEOs of major firms have had to depart following disclosures of their affairs with employees.[104]

Discussion Questions

1. Explain the concerns employers have about workplace romances.
2. List the types of policies and rules employers have to avoid liability when such romances blossom.
3. How do you factor in the rights of individuals with regard to these employer policies?

Case 7.19

Employee Screening: Personality, Intelligence, and Disparate Impact

CVS Caremark, the pharmacy chain, was giving a personality test to job applicants as a means of screening them for hiring. The test asked applicants to agree or disagree with certain statements, several of which follow:

- People do a lot of things that make you angry.
- There's no use having close friends; they always let you down.
- Many people cannot be trusted.
- You are unsure of what to say when you meet someone.[105]

[104] Susan Adams, "The State of the Office Romance 2013," *Forbes* online, February 13, 2013, http://www.forbes.com/sites/susanadams/2013/02/13/the-state-of-the-office-romance-2013/.

[105] Eve Tahmincioglu, "Personality Tests and Fairness in Hiring," msnbc.com, August 15, 2011.

Employers can use tests as a screen for employment, but they must be tied to validity analysis and not discriminate disproportionately against certain groups, such as by race or gender.

Discussion Questions

1. Evaluate the statements and determine whether they are appropriate screens for employment as a drug store cashier.
2. Are these questions a fair assessment of qualifications for a job as a cashier?

SECTION D

Workplace Diversity and Personal Lives

Case 7.20

Julie Roehm: The Walmart Ad Exec with Expensive Tastes

In 2007, Walmart was in litigation with a former advertising executive, Ms. Julie Roehm, who filed a wrongful termination suit against the company, seeking money under her contract with Walmart because the company had not given her a valid reason for termination. Walmart counterclaimed for its legal fees as well as for the damages (costs) it experienced when it had to rebid the advertising agency contract Ms. Roehm had awarded. Walmart alleged that there was a conflict of interest in the award of that advertising contract because Ms. Roehm had accepted expensive meals and other gifts from the agency, a violation of Walmart's code of ethics.

In its counterclaim, Walmart alleged that Ms. Roehm had an affair with Sean Womack (both are married with children), her second-in-command at the company. E-mails allegedly were sent to Mr. Womack from Ms. Roehm. Mrs. Womack had provided Walmart with copies of the e-mails from the Womacks' personal computer, such as this:

> I hate not being able to call you or write you. I think about us together all the time. Little moments like watching your face when you kiss me.[106]

The filing also accuses the two of seeking employment with Draft FCB. Draft FCB was the company that was awarded the Walmart ad account by Ms. Roehm. As noted earlier, Walmart fired Draft FCB after the revelations about the conflicts and has since hired Interpublic Group. Walmart's decision to terminate Draft FCB's contract came after Walmart learned the following information, perks that Roehm and Womack enjoyed via Draft FCB (and which were included in Walmart's counterclaim filings):

- $1,100 dinner
- $700 LuxBar in Chicago
- $440 at the bar in the Peninsula Hotel

Draft FCB cooperated with Walmart by providing copies of the e-mail communications between its employees and Roehm and Womack. However, Draft FCB also released a statement indicating that the employee who was communicating with Womack about employment for the two had no authority to negotiate such employment contracts and even lacked any authority to engage in business development.

Once Walmart counterclaimed, Ms. Roehm fired back with her own allegations, ones that basically argued that "what's sauce for the goose is sauce for the gander," a timeless legal principle in these battles of will. She alleged that Lee Scott, Walmart's CEO, enjoyed favorable prices from Irwin Jacobs, a supplier of Walmart's, on everything from jewelry

[106] Louise Story and Michael Barbara, "Walmart Criticizes 2 in a Filing," *New York Times*, March 20, 2007, pp. C1, C5 Ms. Roehm says the e-mail is out of context and not from her.

to boats and that Mr. Scott's son, Eric, has worked for Mr. Jacobs for years.[107] Her allegation was that Mr. Scott was not fired for these conflicts and, ergo, she was dismissed wrongfully or inconsistently for her alleged breach of Walmart's conflicts policies. Walmart's code of ethics states that employees are not to have social relationships with suppliers if those relationships create even the appearance of impropriety.[108]

Although Walmart and Mr. Jacobs dismissed the allegations as false and outrageous, Mr. Jacobs and Mr. Scott acknowledged that their families have vacationed together and that Mr. Jacobs attended Mr. Scott's daughter's wedding. Mr. Jacobs has also stated that when the two are out together, Mr. Scott always pays and will not allow Mr. Jacobs to pay for even a lunch or other meal. Mr. Jacobs also says, "I swear to God Lee never called me about [putting Eric to work]."[109]

Less than a year following its filing, Julie Roehm ended her wrongful termination suit against Walmart, and Walmart has agreed not to pursue its claims against Ms. Roehm. Ms. Roehm also noted that some of the allegations she made about Irwin Jacobs, one of Walmart's suppliers, were inaccurate. Ms. Roehm said she was dropping her suit because it was financially draining and because she had been given information that indicated her allegations about Mr. Jacobs were not true. Walmart indicated it was satisfied with the withdrawal of the suit, would not pursue the matter further, and was pleased to be able to move forward. Ms. Roehm did not receive any money in the dismissal settlement.

Discussion Questions

1. How does this case relate to the phrase "tone at the top," and what does "tone at the top" mean as it relates to ethics and ethical culture in a company?
2. What problems do inconsistencies in enforcing rules present to a company? How does inconsistency relate to due process?

Compare & Contrast

1. Ms. Roehm has also alleged that she was terminated because she did not fit into Walmart's simple and conservative culture. Ms. Roehm is a nationally known advertising executive whose ads for Chrysler caused a stir when the ads showed car buyers telling their child that he was conceived in the back seat of a car. How does this "culture fit" issue relate to the Hopkins case? Is it possible for employers to articulate "fit" as a criterion for continuation of employment, or is subjectivity automatically a part of that standard?
2. Why did Ms. Roehm and Mr. Womack feel that the strict and clear Walmart policies on relationships with suppliers and vendors of the company did not apply to them? Why did they accept the expensive restaurant and bar perks, whereas Mr. Scott insisted on paying when he was out with Mr. Jacobs?

Case 7.21

Facebook, YouTube, Instagram, LinkedIn, and Employer Tracking

Employers are using new methods for doing background searches on their potential employees:

- Sixty-one percent of professional service firms, including accounting, consulting, engineering, and law firms, do Google searches on their job candidates and use what they find, including YouTube and MySpace references, in the search to gather background on applicants.

[107] Gary McWilliams and James Covert, "Roehm Claims Walmart Brass Defy Ethics Rules," *Wall Street Journal*, May 27, 2007, pp. A1, A5.

[108] *Id.*

[109] *Id.*

- Fifty percent of professional services employers hired to do background checks use Google. They also use YouTube and MySpace.

One employer commented that a Google search is so simple that it would be irresponsible not to conduct such a search.

Colleges and universities are continuing to work to help students understand that what they post on the web is not private information and can often have unintended consequences. The following examples resulted in student disciplinary proceedings:

- Several students at Ohio State boasted on Facebook (a networking/socializing site) that they had stormed the field after Ohio State beat Penn State and taken part in what erupted into a riot. Law enforcement officials were able to trace the students through the university system, and fifty Ohio State students were referred to the Office of Judicial Affairs for disciplinary proceedings.
- Students at the University of Mississippi were disciplined for stating on an open site that they wanted to have sex with a professor.
- A student at Fisher College was expelled for threatening to take steps to silence a campus police officer.

Another problem with the open sites is that the students are posting personal information with the result that they are accessible by a nefarious element. Students' cell phone numbers, addresses, whereabouts, and other information is easily obtained from these sites and can enable stalkers and identity thieves.

The *New York Times* reported that a 24-year-old law student from Salzburg, Austria, requested his Facebook file.[110] In response, he received 1,222 pages of information that included Facebook posts he had deleted, old messages, and disturbing tracking of where he had been, probably gleaned from his cell phone.

His discovery has been published throughout Europe with the result being that Ireland (the country where Facebook has its center for European operations) is conducting an audit of Facebook's data retention practices.

That data retention, something that is critical for Facebook's survival through its advertising revenue, is controlled by privacy laws in all the EU nations, Canada, Australia, and some of the countries in Latin America. For example, those laws often control how long Facebook and Google can keep information on file. These laws have consent as their foundation; users must give explicit consent to use of their online data, posts, and so on. One EU proposal would allow users to demand deletion of their online information forever. In the United States, no statutes control general Internet data, but separate laws provide privacy on a piecemeal basis. For example, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) provides protections for our medical records. The Fair Credit Reporting Act provides protection for our credit information. The Red Box and other movie rental services are prohibited from disclosing information about our movie rentals. However, no general Internet privacy law has been passed in the United States. There have been legislative proposals in Congress, but they have never gained traction.

Admissions officers indicate that *they* are turning to Facebook and Google. A recent survey by Kaplan Test Prep offers some insight into how widespread the practice is. In 2012, 27 percent of admissions officers said that they had googled an applicant, and 26 percent indicated that they had visited applicants' Facebook sites. Thirty-five percent of the admissions officers say that they have found negative information on the site that affected the admissions outcome. The kinds of negative information admissions officers uncover include incidents of bullying or use of alcohol or drugs or inappropriate types of posting (language and content).[111]

[110] Lori Andrews, "Facebook Is Using You," *New York Times*, February 5, 2012 p. A1. Somini Sangupta, "Should Personal Data Be Personal?" *New York Times*, February 5, 2012. p. A20

[111] Douglas Belkin and Caroline Porter, "Web Profiles Haunt Students," *Wall Street Journal*, October 4, 2012, p. A3.

What the admissions officers did was legal, with some caveats. In 2012, California passed a statute that prohibits admissions officers from asking applicants for access to their Facebook pages. The legislator who drafted the bill indicated that applicants' refusals to allow access might be held against them, so he zeroed in on prevention. Applicants also argued that they should have the right to keep their personal lives personal. There is similar legislation pending around the country, with additional proposed laws on employer use of such resources, as well as legislation that would prohibit employers from requesting Facebook access of job applicants.

Another caveat is the danger in selective checking. Some admissions officers only use Google or Facebook when there is something suspicious about an application. Such an approach can be discriminatory—checking all applicants on the Internet would be necessary to avoid allegations that might result from selective searching and checking. Because of the legal parameters and potential discrimination issues, colleges and universities are now developing policies for the use of Google and Facebook and other Internet tools in admissions processes. Currently, 15 percent of colleges and universities have a policy on admissions use of the Internet tools. About 66 percent of colleges and universities indicate that they will not use the tools.

There are also concerns about how such widely available information is used for other purposes. For example, some lenders are using information from Facebook to determine whether to extend credit or the amount of credit limits. Experts have said that some creditors are now engaged in what is called "weblining."[112] Borrowing from the old mortgage lending practice of "redlining," the term means that lenders draw a red line around certain Internet activities and then deny loans or credit based on assumptions about that activity. Creditors will base decisions on aggregated data or which groups you fit into in terms of your online activities. Advertisers will also select targets for their ads based on assumptions about web activity. The *New York Times* noted that trade school Internet ads are geared toward a certain cross section of young people and that their access to information about colleges may be limited. Another concern is that the information could be used by stalkers or perpetrators of domestic violence in order to determine their victims' locations.

As a result of the increased activity levels on websites and the problems, many colleges and universities are offering their entering students sessions on Internet security and safety. Helping the students understand issues of privacy and risk is a critical part of orientation.

The advice experts offer to job seekers is to remember that what may seem to be something noncontroversial in your youth can later come back to haunt you when you begin your professional careers. They also advise that job seekers watch what they put online in MySpace, Facebook, and all other Internet sites.

Discussion Questions

1. Discuss privacy rights and whether there is an issue of privacy when information is posted voluntarily on the Internet.
2. Would using these sources for background checks involve any sort of discrimination?
3. Professor Harold Abelson has explained rights, privacy, and the Internet as follows: "In today's online world, what your mother told you is true, only more so: people can really judge you by your friends."[113] In which school of ethical thought would you place Professor Abelson in relation to his views on this question of the Internet and privacy?

[112] Lori Andrews, "Facebook Is Using You," *New York Times*, February 5, 2012; and Somini Sangupta, "Should Personal Data Be Personal?" *New York Times*, February 5, 2012,

[113] "Quotation Of the Week," *New York Times*, March 21, 2010, p. SB2.

Source

Bathija, Sandhya, "Have a Profile on MySpace? Better Keep It Clean," *National Law Journal*, June 4, 2007, p. 10.

Case 7.22

Tweeting, Blogging, Chatting, and E-Mailing: Employer Control

"Troll Tracker" was a popular blogger in the world of patent litigation. In fact, the blogger confessed to being a patent lawyer. The focus of the blog was "patent trolls," the name patent lawyers give to businesses that purchase patents and then sue large companies to recover for infringement. While Troll Tracker was blogging away, Cisco and other companies that were ending up as defendants in patent troll suits were lobbying Congress for changes in the law that could afford them some protection from what they felt were the willy-nilly attacks of the trolls. However, Cisco was not aware that Troll Tracker, whose site the company had commended to members of Congress, was its own in-house patent counsel, Rick Frenkel.

Frenkel had blogged that two plaintiffs' patent lawyers had altered dates on documents, a charge that amounted to an accusation of felony misconduct by the lawyers (and the lawyers were named). In addition, Frenkel had allowed such posts on his Troll Tracker blog as "If you shoot and kill Ray Niro tonight, I would consider it a justifiable killing." (Niro was a plaintiff's patent lawyer.)

Eventually, through a subpoena to Google, the lawyers affected were able to track down Frenkel's identity, even though he had his blog hosted by a server in Korea and put down his address as one in Afghanistan.

The lawyers have sued both Frenkel and Cisco for defamation. Cisco has taken full responsibility for the problems but notes that Troll Tracker played an important role in highlighting issues and that it does not want to cut off blogs all together.

The blogosphere represents a risk for companies, despite the fact that many are embracing it. Sun Microsystems indicates that it has 4,000 employees with blogs (its CEO and general counsel are part of the group of blogging employees). Cisco has twelve in-house blogs and seventy-five employees who blog, including its CEO. However, since the Troll Tracker "outing," Cisco has developed new policies that require the bloggers to state that they are employees of Cisco when they are discussing opinions related to matters that affect Cisco.

> The lines between our jobs and personal lives are increasingly blurred. Just three years ago, the focus in the case law was on employee use of company e-mail systems to send personal messages. Today, personal blogs, social media profiles (such as Facebook), Tweets, Linked In and other online activities by employees result in increasing challenges for employers as they try to protect company information and balance employee rights and privacy.[114] Blogging has often resulted in employees disclosing private and/or negative information about their companies. Tweeting is instant and ongoing communication that could reveal, prematurely, information that the company does not want public. The introductory quotes provide examples of the kinds of problems Instagram and Tweeting can cause for companies. On the other hand, there are issues related to employees' rights in terms of opinion, speech, and the ability to organize for workplace benefits and terms and conditions of employment. E-mails, Internet surfing, and blogging require a delicate balancing of both employer and employee rights and interests.

[114] In 2009, Facebook had over one billion users and accounted for 72 percent of online social networking including MySpace, Twitter, and LinkedIn. Nicholas Carlson, "Chart of the Day: How Many Users Does Twitter Really Have?" *Business Insider*, March 31, 2011, www.businessinsder.com/.

Employers Are Accountable for Employee Electronic Content

Employers are held responsible for the content of employee e-mails and employers must have access and control rights over employee information that is released publicly through various electronic means. For example, e-mails that contain off-color jokes or suggestive comments create an atmosphere of harassment. (See Chapter 21 for more information on sexual harassment).[115] Employers are also responsible when employees use e-mail or the Internet at work to violate intellectual property rights. Employers are accountable when employees use e-mails and blogs to defame fellow employees or competitors, vendors, or even customers.

Employee e-mail is spontaneous, candid, and discoverable. As a result, the content of employees' e-mail is often fertile territory for prosecutors who can find evidence of intent in employee e-mails and blogs. For example, in 2008, investigators uncovered e-mails of employees at Standard & Poor's, the investment rating agency, that indicated that while the employee/analysts were rating debt instruments as AAA, they were also having their doubts about them. One employee wrote, "These deals could have been structured by cows and we would still rate them."[116] Another e-mail read, "Rating agencies continue to create [an] even bigger monster—the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters."[117] These candid e-mails were a foundation for settlements paid by the analysts' firms and resulted in general reforms of the analyst industry.

E-mails provide a contemporaneous record of events that often defy our recollections and e-mails on the company's computers and servers are always subject to employer review and use for purposes of disciplining employees (see the following section for discussion). For example, in 2011 the indictment of former Penn State assistant football coach, Jerry Sandusky, for child sexual abuse, resulted in questions about whether university officials had failed to report past incidents of Mr. Sandusky's inappropriate involvement with children. The late and then–head football coach, Joe Paterno, denied any knowledge of a 1998 incident in the football program showers with a young boy. However, a subsequent investigation uncovered e-mails that contradicted Coach Paterno's recollection. On May 13, 1998, Tim Curley, the university's athletic director, sent an e-mail to Gary Schultz, a university vice president of finance and operations, with the caption, "Jerry," and this message, "Anything new in this department? Coach is anxious to now [*sic*] where it stands."[118] Mr. Curley also requested updates on May 18 and May 30, 1998. As a result, Mr. Curley and Mr. Schultz were charged with perjury regarding their testimony of not knowing about previous incidents and Coach Paterno and Penn State were disciplined by the NCAA. The e-mail era means our own words often determine our consequences.

Employer Monitoring: What's Legal?

Because they are held accountable for what employees do in cyberspace, employers use various methods for monitoring employees including random reviews of e-mails, investigations that utilize e-mail content, and even using key-stroking software that allows the employer to see those messages employees typed but did not send. Employers also limit or control web access by employees by using blocking software that limits sites employees can visit, monitoring blogs for content, and examining items posted on Facebook, Twitter, and YouTube.[119]

Any existing laws related to telecommunications and privacy did not have a solid fit when it comes to tackling the privacy issues of employees in using the Internet.

[115] See *Garrity v. John Hancock Mut. Life Ins. Co.*, 2002 WL 974676 (D. Mass. 2002) (memorandum opinion), in which an employer's termination of an employee for sending an e-mail entitled, "The Top Ten Reasons Cookie Dough Is Better Than Men" was upheld on grounds that such content created an atmosphere of harassment. An employer was held liable for its failure to take action against an employee who used a company computer to post nude photographs of his daughter. *Doe v. XYC Corp.*, 887 A.2d 1156 (N.J. Super.Ct. 2005).

[116] Summary Report of Issues Identified in the Commission's Examination of Select Credit Rating Agencies, July 8, 2008.

[117] *Id.*

[118] Freeh Sporkin Sullivan, LLP, Report of the Special Investigative Counsel Regarding the Actions of the Pennsylvania State University Related to the Child Sexual Abuse Committed by Gerald A. Sandusky (2012), p. 4.

[119] Adapted from Marianne Jennings, "Business: Its Legal, Ethical, and Global Environment," (2013).

There were some efforts in the early days of cyberspace to apply the Electronic Communications Privacy Act of 1986 (ECPA), which prohibits the unauthorized access of "live" communications, as when someone uses a listening device to intercept a telephone conversation. However, e-mail and social media are stored information, and the question of this act's application for resolving the privacy issue is doubtful.[120] ECPA also has an exception for consensual interception, as when an employee consents to being monitored as a term and condition of employment.

The Stored Communication Act (SCA) prohibits the unauthorized interception of electronic communications, generally meaning stored communication, not ongoing communication such as text messaging, tweeting, and instant messaging. However, the courts have held consistently that employees give consent to such monitoring, and there are no statutory violations when employers do live listening, interception, or recovery of sent communication that is stored and available electronically.[121] When employers have informal policies or policies that allow employees to reimburse their employers for private use of text services, the courts have held that monitoring and disclosure of those messages is a violation of the law.

Experts worry that there is a tendency to be more reckless with facts and assertions when there is anonymity and that it is tough for those who are affected by the bloggers to track down sources and halt the spread of false information.

Blogging On Our Own Time

Blogging issues arise even when we are blogging away on our own time and our own computers. Shellee Hale put a post on several blogs indicating that a company that manufactured software for tracking sales of adult entertainment had its files tapped into and, as a result, customer information had been compromised.

Three months later, Ms. Hale was served with a suit by the software company for defamation. The company maintains that its files were not compromised. Ms. Hale is defending against the suit on the grounds that she is a reporter and protected by a reporter's privilege of retraction and, absent malice, no liability for defamation.

Courtney Love was sued by a fashion designer for her negative remarks about the designer's line and abilities. Referred to as "impetuous remarks," these tweets, blogs, postings, and comments can reach thousands in a matter of minutes, inflicting damage on everything from reputation to stock price. One lawyer has said that what used to be posted on a bathroom wall can now be blasted across the Internet with exponential effects in terms of how many people are reached and how much damage is done.

As the *Wall Street Journal* notes, your homeowner's insurance policy will not cover these defamation suits, but an umbrella policy can. The umbrella policy is one that protects you from liabilities not covered by your other insurance. Former President Clinton used his umbrella policy to pay the damages in the Paula Jones litigation. Ms. Hale has her lawyer's fees covered by her umbrella policy. In fact, Ms. Hale has some advice: (1) Be careful when blogging. (2) Get an umbrella policy.

Discussion Questions

1. What are the rights of employees on blogs?
2. What are the companies' obligations to them?

Sources

Orey, Michael, "Busting a Rogue Blogger," *BusinessWeek*, April 7, 2008, p. 75.

McQueen, M. P., "Bloggers, Beware: What You Write Can Get You Sued," *Wall Street Journal*, May 21, 2009, p. D1.

[120] "Every circuit court to have considered the matter has held that an 'intercept' under the ECPA must occur contemporaneously with transmission." See *Fraser v. Nationwide Mut. Ins. Co.*, 352 F.3d 107, 113 (3d Cir. 2003).

[121] Jeffrey McCracken and Lee Hawkins Jr., "Massive Job Cuts Will Reshape GM," *Wall Street Journal*, March 23, 2006, pp. A1, A15.

Case 7.23

Jack Welch and the Harvard Interview

Ms. Suzy Wetlaufer, then-editor of the *Harvard Business Review*, interviewed former GE CEO and business legend, Jack Welch, for a piece in the business magazine. She asked in December 2001 that the piece be withdrawn because her objectivity might have been compromised. Those at the magazine did another interview and published that interview in the February issue of the magazine.

Soon afterward, the editorial director of the magazine, Walter Kiechel, who supervised Ms. Wetlaufer, acknowledged that a report in the *Wall Street Journal* about an alleged affair between Ms. Wetlaufer and Mr. Welch was correct and that Mr. Welch's wife, Jane, had called to protest the article's objectivity. At that time, Mr. Welch refused to confirm or deny that there had been an affair. Ms. Wetlaufer was, at the time of the interview, divorced.

Some staff members asked that Ms. Wetlaufer resign from her $277,000 per year job, but she initially survived termination. Their objections were that she compromised her journalistic integrity. Mr. Kiechel, on the other hand, noted that she did "the right thing in raising her concerns."[122]

After the article appeared in print and following thirteen years of marriage, Jane filed for divorce. The Welches did have a prenuptial agreement, but that agreement expired after ten years, leaving Mrs. Welch entitled to one-half of what was estimated at that time to be Welch's nearly $1 billion net worth.[123] The result was a battle over assets that spilled over into the business and popular press. The documents filed in the divorce proceedings proved to be quite revealing about Mr. Welch, his finances, and GE.

Mr. Welch asked the judge to deduct $200 million from his assets as the amount he has pledged to his four children from his first marriage, an arrangement that was part of his divorce settlement with Carolyn B. Welch.[124] That request was refused because the pledge only takes effect at Mr. Welch's death and does not eliminate lifetime obligations to any current spouses. Mr. Welch told the judge, "This is taking up too much time. I'd like to get on with my life and have her get on with her life. These issues are all resolvable."[125]

Jane earned the upper hand in the divorce proceedings by revealing Mr. Welch's retirement perks from General Electric, including the following:

- An apartment in New York owned by GE
- Courtside seats at the U.S. Open
- Security personnel for international travel
- Satellite TV at four of their homes
- $17,307 per day in consulting fees
- Wine
- Car and driver[126]

[122] Del Jones, "Editor Linked with Welch Finds Job at Risk," *USA Today*, March 5, 2002, p. 3B.

[123] Christine Dugas, "Some Prenups Are Set Up to Expire," *USA Today*, March 15, 2002, p. 3B.

[124] Geraldine Fabrikant, "Judge Permits a Litigator to Join the Welch Divorce Team," *New York Times*, October 31, 2002, p. C3.

[125] *Id.*

[126] Rachel Emma Silverman, "Here's the Retirement Jack Welch Built: $1.4 Million a Month," *Wall Street Journal*, October 31, 2002, pp. A1, A15.

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The revelations brought instant reactions from shareholders, who felt that the extensive perks indicated a board that was either asleep at the wheel or not concerned about lavish expenses.[127] The SEC opened an investigation examining the following issues with GE:

- Whether there had been adequate disclosure about the nature of Mr. Welch's retirement contract
- Whether there had been adequate disclosure of Mr. Welch's perks while he was CEO
- Whether all retirement benefits bestowed have been disclosed by GE[128]

Mr. Welch reached a new agreement with GE, published an op-ed piece in the *Wall Street Journal*, and agreed to pay for his retirement perks.[129] In part, the *Wall Street Journal* op-ed stated,

> I want to share a helluva problem that I've been dealing with recently.
>
> Papers filed by my wife in our divorce proceeding became public and grossly misrepresented many aspects of my employment contract with General Electric. I'm not going to get into a public fight refuting every allegation in that filing. But some charges have gotten a lot of media attention. So, for the record, I've always paid for my personal meals, don't have a cook, have no personal tickets to cultural and sporting events. In fact, my favorite team, the Red Sox, has played 162 home games over the past two years, and I've attended just one.
>
> I spent 41 years at GE, the past 21 as chairman. My respect for the company and my fondness for its employees make me hate the fact that my private life has brought unwelcome and inaccurate attention to the company.
>
> I've debated what to do about this. In my mind, it comes down to two choices. I could keep the contract as it is, and tough-out the public attention. Or I could modify the contract and open myself to charges that the contract was unfair in the first place.
>
> My employment contract was drawn up in 1996. GE was enjoying great results and was in the second year of a succession plan for a new CEO. The GE board knew I loved my job, and, frankly, I had no plans to leave, despite persistent rumors in the media that other companies were recruiting me.
>
> But GE's two previous CEOs had retired at ages 62 and 63, and the board wanted to make sure I wouldn't do the same, especially in light of the quintuple bypass surgery I had undergone the year before. With these facts in mind, the board came to me and suggested an employment contract, which offered me a special one-time payment of tens of millions of dollars to remain as CEO until December 2000, when I would be 65.
>
> I instead suggested an employment contract that spelled out my obligations to GE, including my post-retirement obligations, and the benefits I would receive in return. For six years, the contract was disclosed to shareholders through the proxy statement, posted on the Securities and Exchange Commission website, and discussed in the media. I agreed to take the post-retirement benefits that are now being questioned instead of cash compensation—cash compensation that would have been much more expensive for the company.
>
> Over the next five years, GE prospered and I lived up to my end of the bargain.
>
> That said, in spite of the contract's validity and benefits to GE, a good argument can be made for modifying it today.[130]

[127] Del Jones and Garry Strauss, "Jane Welch Reveals Jack's GE Perks in Divorce Case," *USA Today*, September 9, 2002, p. 4B.

[128] Matt Murray, "SEC Investigates GE's Retirement Deal with Jack Welch," *Wall Street Journal*, September 17, 2002, pp. B1, B3.

[129] David Cay Johnston and Reed Abelson, "G.E.'s Ex-Chief to Pay for Perks, but the Question Is: How Much?" *New York Times*, September 17, 2002, pp. C1, C2.

[130] Jack Welch, "My Dilemma—and How I Resolved It," *Wall Street Journal*, September 16, 2002, p. A14.

The Welch divorce was finalized, and Mr. Welch married Ms. Wetlaufer on April 24, 2004, in Boston's Park Street Church. The two now live in a 26,000-square-foot home on Beacon Street in Boston with Ms. Wetlaufer's four children, who were ages 9 to 15 when the couple married.[131] They co-wrote Mr. Welch's second book, which the two sold to Random House for $4 million, based on a two-page proposal.[132] The book, *Winning*, has not reached sales levels anywhere near those of Mr. Welch's first book, *Jack: Straight From the Gut*. However, the book was a bestseller and there have been two follow-up books, *Winning: The Answers* and *The Welch Way*. Mr. Welch said that his wife/coauthor and he make a good team: "We have a lot going on. We've got my greasy fingernails and her brains."[133] The two wrote a weekly column in *BusinessWeek* that began in 2005 and ended in 2009. The column appeared on the last page of the magazine and addressed questions from readers on management, strategy, and a wide range of business issues. In 2010, the two launched an online MBA Program through Chancellor University. Mrs. Welch published her own book, *10-10-10: A Life-Transforming Idea*, in 2009, a book that became a *New York Times* bestseller.

Following its investigation, the SEC brought charges against GE for its failure to fully disclose Mr. Welch's compensation package. Those charges were settled in September 2004 in a consent decree in which GE neither admitted nor denied the SEC's accusations but agreed to make full disclosure of Mr. Welch's compensation package. The SEC was troubled by a proxy disclosure that put the compensation at $399,925, when the real figure was $2.5 million.[134] As a result of the Welch disclosure issues, the SEC promulgated new rules that now mandate the disclosure of perks granted to the top five officers of a publicly traded company. The first perk disclosure season was in Spring 2007, and shareholders discovered that the perks of many executives were similar to the Welch perks but included some additional benefits such as payments for financial advisers for officers, discount shopping for spouses of officers, and significant private jet travel for family and friends.

Discussion Questions

1. Was there a conflict of interest for Ms. Wetlaufer if there was an affair between her and Mr. Welch?
2. Were the staff members correct to protest?
3. What were the consequences of Mr. Welch's affair and divorce? Is it troublesome that he and Ms. Wetlaufer are so successful?
4. Does Mr. Welch rationalize his post-employment perks?
5. Did the headline of the newspaper test apply to Mr. Welch's original contract terms?
6. Are there any credo elements you find from either Mr. Welch or Ms. Wetlaufer?

[131] "Jack and Suzy Wetlaufer," *People*, May 10, 2004, p. 215.

[132] Hugo Lindgren, "Welch Makes another Major Book Deal," *New York Times*, February 4, 2004, pp. C1, C4.

[133] *Id.*

[134] Geraldine Fabrikant, "G.E. Settles S.E.C. Case on Welch Retirement Perks," *New York Times*, September 24, 2004, p. C2.

SECTION E

Workplace Confrontation

Reading 7.24

The Ethics of Confrontation

Why We Avoid Confrontation

The “Don’t rock the boat” attitude is frequently seen as the virtuous road. Confrontation is messy—there are often hurt feelings. There are embarrassing revelations. There are destroyed careers. There are costs. Whether confrontation involves sexual misconduct by an assistant school principal or cooking the books by a manager or bond trader, the impact is the same.

Human nature flees from such situations. Further, there is within human nature that rationalization that avoiding confrontation is being “nice,” and nice is associated with ethics.

There are also the harsh realities of confrontation. To confront the assistant school principal with allegations and carry through with a disciplinary process for the loss of a license to teach are time consuming and reflect on the school and administrators who hired him in the first place. There is exposure to liability.

A good employee evaluation means that the employee is happy, and there are no reviews, no messy discussions, and no allegations of discrimination. Not confronting a rogue trader means enjoying the ride of his performance and earnings and worrying about consequences at another time when perhaps something else will come along to counterbalance any of the harmful activities. Not insisting that a loan be written down carries with it the comfort of steady growth and earnings and a hope that future financial performance can make up for the loss when it eventually must be disclosed.

There is a great deal of rationalization that goes into the avoidance of confrontation. There is a comfort in maintaining status quo. There is at least a postponement of legal issues and liabilities. Often, avoiding confrontation is a painless road that carries with it the hope that whatever lies beneath does not break through and reveal its ugliness. Often, confrontation carries with it the hope that a problem will solve itself or become a moot issue.

The Harms of Avoiding Confrontation

Postponing confrontation does not produce a better result when the issue at the heart of the needed confrontation inevitably emerges. Those harms include liability, individual harms, reputational damage, and the loss of income as the issue chugs along without resolution.

Physical Harm

In *Randi W. v. Muroc Joint Unified School District*, 929 P.2d 582 (Cal. 1997) (Case 7.27), an assistant principal who was accused at several schools of molesting junior-high students was given glowing letters of recommendation by all of the school districts and passed along to new districts where he repeated the behavior. The districts were all held liable for failing to take action and then issuing glowing letters of recommendation. Had the issue of sexual misconduct and the assistant principal been confronted the first time there was misconduct, he would not have gone on to the remaining three schools and further victims.

Liability Increased

Another example is the eventual confrontation between Ford and Firestone over who and what was responsible for the Ford Explorer debacle and the accidents and deaths. The two companies' long-standing business relationship and an unwillingness to deal with data and questions accomplished little. With more information percolating on a regular basis, both companies acknowledged, even as they battled with each other in a media confrontation, that neither has emerged with its reputation intact in the public eye. Civil litigation and an investigation by the federal government, as well as depositions of top executives in the companies, trickled out to the public. Those depositions have had some inconsistencies with some of the public statements by Bridgestone/Firestone.

For example, Bridgestone/Firestone has issued public statements that it was not aware of peeling issues with its tires used on the Ford Explorer. However, a deposition of Firestone's chief of quality reveals that he believes he discussed the issue of the tires with the company's CEO in 1999, a full year before the issue became public, with the resulting recall. David Laubie, who retired from the company in May 2000, said that he handled consumer claims and quality control issues for the company and had received complaints that he passed along to the CEO in memo form as well as in their regular meetings.

In testimony before Congress in September 2000, Firestone's executive vice president, Gary Crigger, testified that the company only became aware of the problem in July or August 2000.

Another issue in the case has been Firestone's allegation that Ford did not put the proper tire pressure instructions with the Ford Explorer. Firestone said that Ford's recommendation of an unusually low tire pressure, 26 pounds per square inch, caused the sidewalk to flex and get hot, which then weakened the tires. However, the depositions of both Mr. Laubie and the current quality control chief of Firestone indicate that no one from Firestone ever discussed the low tire pressure issue with anyone at Ford.[135] The lack of confrontation before, during, and after the public revelations about some issue, whatever that may prove to be, surrounding the Ford Explorer and its tires cost both companies in terms of reputation and perhaps liability.

The Deceptive Lull of "Being Nice"

One of the faulty assumptions in avoiding confrontation is that the "niceness" benefits the individuals affected. A good performance evaluation is beneficial to the employee. Not taking disciplinary action permits a teacher or administrator to continue his career and earn a living. Not raising a financial reporting issue means that shareholders can continue to enjoy returns and market value. Not questioning an employee's unusual success means that the earnings figures stand unscathed. Many are protected when confrontation is avoided.

The difficulty with the protection argument is that it presumes that the truth will not emerge. When it does, the preservation of a career in light of information introduces

[135] James R. Healey and Sara Nathan, "Depositions in Tire Lawsuits Don't Match Company's Lines," *USA Today*, December 11, 2000, p. 3B.

greater liability. Termination of an employee for cause may carry with it the difficulties of challenge and even litigation. Not terminating an employee for cause who goes on later to do more harm exposes the company to liability. The difficulty with not disclosing matters that affect earnings is that when those matters do emerge, there is not just the resulting restatement of earnings but also the accompanying lack of investor trust and resulting reduction in market value. The greatest harm in avoiding confrontation is that what the confrontation could have minimized is exacerbated by the postponement.

The Ethics of Confrontation

Although not widely accepted as a principle of virtue, there is an ethical duty of confrontation. Edmund Burke was a proponent of such a duty with his admonition of two centuries ago, "All that is necessary for evil to triumph is for good men to do nothing." There is the more modern phraseology that holds that if there is a legal or ethical problem in a company and an employee or manager or executive says nothing, they become part of the problem.

However, one of the reasons for the hesitancy in confrontation not discussed earlier is a certain degree of ineptness on the part of those who must do the confronting. If confrontation is indeed a virtue, are there guides for its exercise? The following offers a model for confrontation.

Determine the Facts

An underlying disdain for confrontation arises because too often those who do the confronting are wrong. Prior to confrontation, prepare as if you were working on a budget, a product launch, or a financing. Know what is happening or what has happened, and obtain as much background information as possible. Preparation also serves as protection for any fears of liability from taking action. Employers need to understand that well-documented personnel actions are not a basis for discrimination suits. And termination of employees who are harming others is not actionable if the harm is established.

If You Don't Know the Facts, or Can't Know the Facts, Present the Issue to Those Involved and Affected

Ford and Firestone will perhaps not know the issues of liability and accountability for years to come with regard to the Explorer and the tires. However, their lack of information should not have prevented them from confronting each other or confronting the customers and public with the information they did have.

In the case of allegations or when an employee has raised a question about how a particular matter is being carried on the books, you may only be presented with one side. That lack of information need not preclude you from raising the question. In the case of the school administrator, the students made an allegation against the assistant principal. The principal has no way of knowing whether the allegation is true or false, but he can go to the assistant principal and raise the issue and then can proceed with the types of hearings or inquiries that can provide the information or at least constitute the confrontation.

A financial officer can hear from employees a number of views on carrying certain items on the books. The very definition of materiality opens the door to that type of disagreement. But a good financial officer knows that an open discussion of the issue, and confrontation of the issue with those who tout various views, is the solution that serves the company best in the long run. Without such confrontation, the failure to listen to an employee's view exacerbates the eventual fallout from a bad decision. The public confrontation of the issue is, in and of itself, insurance against the fallout should that decision prove to be wrong.

Always Give the Opportunity for Self-Remedy

One of the reasons confrontation enjoys such universal disdain is that very often the confrontation is done circuitously. If your attorney has done something questionable, confront him or her first, and then report the person to the state bar for discipline. If an employee has engaged in misconduct, tell the employee, and don't let him or her hear it from someone else. If earnings are overstated, employees should work within the company for self-remedy before heading to the SEC.

One of the virtue constraints in the ethics of confrontation is having the courage to discuss the issues and concerns with those who are involved in creating them. An end run is not a confrontation. It is an act of cowardice that can result in the liability discussed earlier.

Don't Fear the Fallout and Hassle

Among the reasons for the lack of confrontation discussed earlier was the realistic observation that many avoid confrontation because it is too much trouble. However, as also noted earlier, if there is a problem that remains unconfronted, it does not improve with age. Indeed, the failure to make a timely confrontation often proves to result in more costs in the long run. Hassles don't dissipate as confrontation is postponed or avoided.

Conclusion

The ethics of confrontation is, quite simply, that confrontation is a necessary part of managing an honest business. Confrontation openly airs disagreement. Confrontation prevents the damage that comes from concealed truth. Confrontation preserves reputations when it produces the self-remedies that are nearly always cheaper than those imposed from the lack of confrontation. Niceness is rarely the ethical route when issues and facts need to be aired. Confrontation, although not always pleasant, is often the only resolution of a problem.

Discussion Questions

1. What are the consequences of the failure to raise an issue, whether legal or ethical, when it first arises?
2. What factors contribute to the failure to confront an issue?
3. What steps could a business take to encourage confrontation?

Reading 7.25

The Ethics of Performance Evaluations

Many employees believe that a good performance evaluation does not translate into more money or benefits.[136] And many employees are unclear as to what "meets expectations" means.[137] Some employees believe the annual performance evaluations are a means to protect companies from discrimination suits. Still others believe that they are used as a way to rid the company of the slackers. Most all employees have experience with higher-ups who are not aware of individual performance standards intervening in the evaluation process and altering a direct supervisor's evaluation. Employees despise "forced ranking" systems in which one-third of employees are rated high; another one-third are rated average; and the bottom one-third knows that they are on their way out

[136] "Good Performance Does Not Mean Good Pay," *USA Today*, August 29, 2007, p. 1B.

[137] Jared Sandberg, "Performance Reviews Need Some Work, Don't Meet Potential," *Wall Street Journal*, November 20, 2007, p. B1.

the door. As Jared Sandberg of the *Wall Street Journal* puts it, the performance evaluation system in a company reveals more about the company than it does about those being evaluated.

Performance evaluation systems and employee cynicism about them could be a function of ethics. There are some basic ethical values that could improve the evaluation process.

1. Is the evaluation honest? Employees explain that they just want to know where they stand. One factor that contributes to the perception of dishonesty is that there is too little communication throughout the year about goals, progress, and issues that have developed. For example, a loan officer's volume could be affected by new lending standards at the bank, not because of a lack of hustle on her part. A discussion of those changed standards during the year prevents a "does not meet expectations" at the end of the year.

   In some situations, the annual review focuses on issues not really addressed in the original performance plan so that there is a sudden shift from what the employee thought were the goals and the achievement standards. If professionalism and personal metrics are not part of the evaluation process until the end, the employee has had no chance to work on them.

   In forced ranking systems, the employees must be grouped, and those groupings may not really reflect the work and effort of employees, but the numbers have to be met. Under these systems, the last-minute scramble to meet assigned rankings finds that the performance may have been good, but the ranking does not reflect that performance. The disconnect is perceived as dishonest.

   Finally, the employee deserves honest feedback during the evaluation process. If coworkers are having difficulty working with an employee, that employee deserves to know that and is entitled to concrete examples. "Difficult to work with" does not provide much information. "Will not cover the front office for others when we need help" is the type of information the employee being evaluated needs to have.
2. Are the evaluation standards and terms clear? The lion's share of the work on performance evaluations should be done in setting up the employee's work plan for the year. Employees need to understand what "You are not doing your job" means. Tardiness, customer complaints, missed deadlines, and mistakes are the kinds of substantive examples that fill in the details for employees. "Meets expectations" requires a list of expectations at the beginning of the year and feedback during the year so that this nebulous standard has measurable metrics. For example, a company had as one measurement for managers, "Emphasizes ethics and ethical culture in the company." The measurable standards were whether the manager had 100 percent participation by employees in ethics training, whether the manager discussed an ethical issue with employees during the year, whether ethical issues raised by employees were addressed, and whether employees all had a copy of the code of ethics.
3. Is everyone taking responsibility for the effects of performance evaluations? If a manager tells an employee that there are problems with the employee's performance, then the manager has the responsibility to work with that employee to help with improvement. Part of evaluation is direction: tell the employee how to get better. If the employee has made mistakes, determine why those mistakes occur. Is it a need for more training? Is the employee responsible for too many areas or assignments? Is there a lack of support in the employee's job function?

Perhaps the performance evaluation process could take an ethical turn if those conducting the evaluations would remember the following:

1. Have I told the employee the truth?
2. Is the rating I have assigned consistent with the truth?
3. Are the standards for performance clear, and have I given examples?
4. Have I figured out the whys of performance and offered insights for improvement?

Discussion Questions

1. Why are managers less than truthful in performance evaluations?
2. Is "being nice" easier than offering candid evaluations?
3. What are some example of ambiguous evaluation criteria?

Case 7.26

Ann Hopkins and Price Waterhouse

Ann Hopkins was a senior manager in the Management Advisory Services division of the Price Waterhouse Office of Government Services (OGS) in Washington, D.C. After earning undergraduate and graduate degrees in mathematics, she taught mathematics at her alma mater, Hollins College, and worked for IBM, NASA, Touche Ross, and American Management Systems before beginning her career with Price Waterhouse in 1977.[138] She became the firm's specialist in large-scale computer system design and operations for the federal government. Although salaries in the accounting profession are not published, estimates put her salary as a senior manager at about $65,000.

At that time, Price Waterhouse was known as one of the "Big 8," or one of the top public accounting firms in the United States.[139] A senior manager became a candidate for partnership when the partners in her office submitted her name for partnership status. In August 1982, at the end of a nomination process that began in June, the partners in Hopkins's office proposed her as a candidate for partner for the 1983 class of partners. Of the eighty-eight candidates who were submitted for consideration, Hopkins was the only woman. At that time, Price Waterhouse had 662 partners, 7 of whom were women.[140] Hopkins was, however, a stellar performer and was often called a "rainmaker." She was responsible for bringing to Price Waterhouse a two-year, $25 million contract with the U.S. Department of State, the largest contract ever obtained by the firm.[141] Being a partner would not only bring Hopkins status. Her earnings would increase substantially. Estimates of the increase in salary were that she would earn almost double, or $125,000 annually, on average (1980 figures).

The partner process was a collaborative one. All of the firm's partners were invited to submit written comments regarding each candidate, on either "long" or "short" evaluation forms. Partners chose a form according to their exposure to the candidate. All partners were invited to submit comments, but not every partner did so. Of the thirty-two partners who submitted comments on Hopkins, one stated that "none of the other partnership candidates at Price Waterhouse that year [has] a comparable record in terms of successfully procuring major contracts for the partnership."[142] In addition, Hopkins' billable hours were impressive, with 2,442 in 1982 and 2,507 in 1981, amounts that none of the other partnership candidates' billable hours even approached.

After reviewing the comments, the firm's Admissions Committee made recommendations about the partnership candidates to the Price Waterhouse Policy Board. The recommendations consisted of accepting the candidate, denying the promotion, or putting the application on hold. The Policy Board then decided whether to submit the candidate to a vote, reject the candidate, or hold the candidacy. There were no limits on the number of persons to whom partnership could be awarded and no guidelines for evaluating positive and negative comments about candidates. Price Waterhouse offered forty-seven partnerships to the eighty-eight candidates in the 1983 round; another twenty-seven were denied partnerships; and twenty, including Ms. Hopkins, were put on hold. Ms. Hopkins had received more "no" votes than any other candidate for

[138] Reports conflict in regard to her starting date at Price Waterhouse. Some reports indicate 1977, and some indicate 1978.

[139] Price Waterhouse no longer exists, having merged into PriceWaterhouseCoopers, and the "Big 8" is now the "Big 4" due to the collapse of Arthur Andersen and the mergers of most of the other firms.

[140] There are factual disputes over the number. Hopkins maintains that there were only six female partners at the time.

[141] Ann Hopkins, "Price Waterhouse v. Hopkins: A Personal Account of a Sexual Discrimination Plaintiff," 22 *Hofstra Lab. & Emp. L.J.* 357 (2005).

[142] *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989).

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partnership, with most of those votes coming from members of the partnership committee outside the firm's government services unit.

The comments on Hopkins were extensive and telling. Thirteen of the thirty-two partners who submitted comments on Hopkins supported her, three recommended putting her on hold, eight said they did not have enough information, and eight recommended denial. The partners in Hopkins's office praised her character as well as her accomplishments, describing her in their joint statement as "an outstanding professional" who had a "deft touch," a "strong character, independence, and integrity." Clients appear to have agreed with these assessments. One official from the State Department described her as "extremely competent, intelligent," "strong and forthright, very productive, energetic, and creative." Another high-ranking official praised Hopkins's decisiveness, broad-mindedness, and "intellectual clarity"; she was, in his words, "a stimulating conversationalist."[143] Hopkins "had no difficulty dealing with clients and her clients appear to have been very pleased with her work."[144] She "was generally viewed as a highly competent project leader who worked long hours, pushed vigorously to meet deadlines, and demanded much from the multidisciplinary staffs with which she worked."[145]

On too many occasions, however, Hopkins's aggressiveness apparently spilled over into abrasiveness. Staff members seem to have borne the brunt of Hopkins's brusqueness. Long before her bid for partnership, partners evaluating her work had counseled her to improve her relations with staff members. Although later evaluations indicate an improvement, Hopkins's perceived shortcomings in this important area eventually doomed her bid for partnership. Virtually all of the partners' negative remarks about Hopkins—even those of partners who supported her—concerned her "interpersonal skills." Both "[s]upporters and opponents of her candidacy indicated that she was sometimes overly aggressive, unduly harsh, difficult to work with, and impatient with staff."[146]

Another partner testified at trial that he had questioned her billing records and was left with concern because he found her answers unsatisfying:

> I was informed by Ann that the project had been completed on sked within budget. My subsequent review indicated a significant discrepancy of approximately $35,000 between the proposed fees, billed fees [and] actuals in the WIPS. I discussed this matter with Ann who attempted to try and explain away or play down the discrepancy. She insisted there had not been a discrepancy in the amount of the underrealization. Unsatisfied with her responses, I continued to question the matter until she admitted there was a problem but I should discuss it with Krulwich [a partner at OGS]. My subsequent discussion with Lew indicated that the discrepancy was a result of 500 additional hours being charged to the job (at the request of Bill Devaney … agreed to by Krulwich) after it was determined that Linda Pegues, a senior consultant from the Houston office working on the project had been instructed by Ann to work 12–14 hrs per day during the project but only to charge 8 hours per day. The entire incident left me questioning Ann's staff management methods and the honesty of her responses to my questions.[147]

Clear signs indicated, though, that some of the partners reacted negatively to Hopkins's personality because she was a woman. One partner described her as "macho," whereas another suggested that she "overcompensated for being a woman," and a third advised her to take "a course at charm school."[148] One partner wrote that

[143] *Id.*, p. 234.

[144] *Id.*

[145] *Id.*

[146] *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989), p. 235.

[147] Appellant's brief, *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989).

[148] *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989), p. 235.

Hopkins was "universally disliked."[149] Several partners criticized her use of profanity. In response, one partner suggested that those partners objected to her swearing only "because it[']s a lady using foul language."[150] Another supporter explained that Hopkins "ha[d] matured from a tough-talking somewhat masculine hardnosed manager to an authoritative, formidable, but much more appealing lady partner candidate."[151] In order for Hopkins to improve her chances for partnership, Thomas Beyer, a partner who supervised Hopkins at OGS, suggested that she "walk more femininely, talk more femininely, dress more femininely, wear make-up, have her hair styled, and wear jewelry."[152] Ms. Hopkins said she could not apply makeup because that would require removing her trifocals and she would not be able to see. Also, her allergy to cosmetics made it difficult for her to find appropriate makeup. Mr. Beyer also suggested that she should not carry a briefcase, should stop smoking, and should not drink beer at luncheon meetings. Dr. Susan Fiske, a social psychologist and associate professor of psychology at Carnegie-Mellon University who would testify for Hopkins in her suit against Price Waterhouse, reviewed the Price Waterhouse selection process and concluded that it was likely influenced by sex stereotyping. Dr. Fiske indicated that some of the partners' comments were gender biased, and even those comments that were gender neutral were intensely critical and made by partners who barely knew Hopkins. Dr. Fiske concluded that the subjectivity of the evaluations and their sharply critical nature were probably the result of sex stereotyping.[153]

However, there were numerous comments such as the following that voiced concerns about nongender issues:

> In July/Aug 82 Ann assisted the St. Louis MAS practice in preparing an extensive proposal to the Farmers Home Admin (the proposal inc 2800 pgs for $3.1 mil in fees/expenses & 65,000 hrs of work). The proposal was completed over a 4 wk period with approx 2000 plus staff/ptr hrs required based on my participation in the proposal effort & sub discussions with St. L MAS staff involved. Ann's mgmt style of using "trial & error techniques" (ie, sending staff assigned off to prepare portions of the proposal with little or no guidance from her & then her subsequent rejection of the products developed) caused a complete alienation of the staff towards Ann & a fear that they would have to work with Ann if we won the project. In addition, Ann's manner of dealing with our staff & with the Houston sr consultant on the BIA project, raises questions in my mind about her ability to develop & motivate our staff as a ptr. (No) [indicates partner's vote][154]
>
> I worked with Ann in the early stages of the 1st State Whelan Dept proposal. I found her to be a) singularly dedicated, b) rather unpleasant. I wonder whether her 4 yrs with us have really demonstrated ptr qualities or whether we have simply taken advantage of "workaholic" tendencies. Note that she has held 6 jobs in the last 15 yrs, all with outstanding companies. I'm also troubled about her being (having been) married to a ptr of a serious competitor.[155] (Insuff—but favor hold, at a minimum)
>
> Ann's exposure to me was on the Farmers Home Admin Blythe proposal. Despite many negative comments from other people involved I think she did a great job and turned out a first class proposal. Great intellectual capacity but very abrasive in her dealings with staff. I suggest we hold, counsel her and if she makes progress with her interpersonal skills, then admit next year. (Hold)[156]

[149] Hopkins, "Price Waterhouse v. Hopkins."

[150] *Id.*

[151] *Id.*

[152] *Id.*

[153] Cynthia Cohen, "Perils of Partnership Reviews: Lessons from Price Waterhouse v. Hopkins, "*Labor Law Journal* (October 1991): 677–82.

[154] *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989).

[155] Ms. Hopkins left Deloitte Touche when her husband was made a partner there and firm policy prohibited partners' spouses from working for the company.

[156] *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989).

Although Hopkins and nineteen others were put on hold for the following year, her future looked dim. Later, two partners withdrew their support for Hopkins, and she was informed that she would not be reconsidered the following year. Hopkins, who maintains that she was told after the second nomination cycle that she would never be a partner, then resigned and filed a discrimination complaint with the Equal Employment Opportunity Commission (EEOC).[157]

The EEOC did not find a violation of Title VII of the Civil Rights Act of 1964 (which prohibits discrimination in employment practices) because of the following: (1) Hopkins had resigned and not been terminated; and (2) at that time, the law was not clear, and the assumption was that Title VII did not apply to partnership decisions in companies. With the EEOC refusing to take action, Hopkins filed suit against Price Waterhouse. She has stated she filed the suit to find out why Price Waterhouse made "such a bad business decision."[158] After a lengthy trial and numerous complex appeals through the federal system, the Supreme Court found that Ms. Hopkins did indeed have a cause of action for discrimination in the partnership decision.

Hopkins was an important employment discrimination case because the Supreme Court recognized stereotyping as a way of establishing discrimination. However, the case is also known for its clarification of the law in situations in which employers take action against employees for both lawful and unlawful reasons. Known as *mixed-motive cases*, these cases involved forms of discrimination that shift the burden of proof to the employer to establish that it would have made the same decision if using only the lawful considerations and in spite of unlawful considerations that entered into the process. The "same-decision" defense requires employers to establish sufficient grounds for termination or other actions taken against employees that are independent of the unlawful considerations.

In 1990, on remand, Ms. Hopkins was awarded her partnership[159] and damages. She was awarded back pay plus interest, and although the exact amount of the award is unclear, Hopkins later verified that she paid $300,000 in taxes on her award that year and also paid her attorneys the $500,000 due to them. Ms. Hopkins was also awarded her partnership and rejoined Price Waterhouse as a partner in 1991.

In accounting firms generally, the number of female principals has grown from 1 percent in 1983 to 18 percent today. Ms. Hopkins retired from PriceWaterhouseCoopers in 2002, and she has written a book about her experience as a litigant.

Discussion Questions

1. What ethical problems do you see with the Price Waterhouse partnership evaluation system?
2. Suppose that you were a partner and a member of either the admissions committee or the policy board. What objections, if any, would you have made to any of the comments by the partners? What would have made it difficult for you to object? How might your being a female partner in that position have made objection more difficult?
3. In what ways, if any, do you find the subjectivity of the evaluation troublesome? What aspects of the evaluation would you change?
4. To what extent did the partners' comments reflect mixed motives (i.e., to what extent did their points express legal factors while at the same time expressing illegal ones)?
5. Ms. Hopkins listed three factors to help companies avoid what happened to her: (1) clear direction from the top of the enterprise, (2) diversity in management, and (3) specificity in evaluation criteria. Give examples of how a company could implement these factors.

[157] *Id.*, p. 233.

[158] M. Jennings, Interview with Ann Hopkins, June 18, 1993.

[159] Technically, Ms. Hopkins was made a principal, a title reserved for those reaching partner status who do not hold CPA licenses.

Compare & Contrast

Ms. Hopkins described her interactions with and reactions to Kay Oberly, the lawyer who argued Price Waterhouse's case before the U.S. Supreme Court:

> In the years since she argued the firm's case before the Supreme Court, I have had the pleasure of meeting Kay Oberly on several occasions.
>
> "Nothing personal. Litigation polarizes," she said when we were first introduced. The warmth of her smile and the sincerity that radiated from troubled eyes banished any recollection I had of her at the arguments. I gave her a ride to the airport once. I was driving to work and noticed her unsuccessfully trying to hail a cab. We chatted about being single parents and the trauma of divorce proceedings, matters that we had in common. I like Kay. "Nothing personal. Litigation polarizes." I'm sure it wasn't personal to her, but it was to me. Discrimination cases tend to get very personal, very fast. My life became a matter of public record. Attorneys pored over my tax returns. People testified about expletives I used, people I chewed out, work I reviewed and criticized, and they did so with the most negative spin they could come up with. I'm no angel, but I'm not as totally lacking in interpersonal skills as the firm's attorneys made me out to be.[160]

Offer your thoughts on personal feelings, personal ethics, and litigation. Why did some partners evaluate Ms. Hopkins on the basis of work issues such as billing discrepancies and staff relationships whereas other partners focused on Ms. Hopkins' appearance? What role does fairness play in the differences in approaches by the partners?

Case 7.27

The Glowing Recommendation[161]

Randi W. was a 13-year-old minor who attended the Livingston Middle School where Robert Gadams served as vice principal. On February 1, 1992, while Randi was in Gadams's office, Gadams sexually molested Randi.

Gadams had previously been employed at the Mendota Unified School District (from 1985 to 1988). During his time of employment there, Gadams had been investigated and reprimanded for improper conduct with female junior high students, including giving them back massages, making sexual remarks to them, and being involved in "sexual situations" with them.

Gilbert Rossette, an official with Mendota, provided a letter of recommendation for Gadams in May 1990. The letter was part of Gadams's placement file at Fresno Pacific College, where he had received his teaching credentials. The recommendation was extensive and referred to Gadams's "genuine concern" for students and his "outstanding rapport" with everyone, and concluded, "I wouldn't hesitate to recommend Mr. Gadams for any position."

Gadams had also previously been employed at the Tranquility High School District and Golden Plains Unified District (1987–1990). Richard Cole, an administrator at Golden Plains, also provided a letter of recommendation for the Fresno placement file that listed Gadams's "favorable" qualities and concluded that Cole "would recommend him for almost any administrative position he wishes to pursue." Cole knew at the time he provided the recommendation that Gadams had been the subject of various parents' complaints, including that he "led a panty raid, made sexual overtures to students, [and made] sexual remarks to students." Cole also knew that Gadams had resigned under pressure because of these sexual misconduct charges.

[160] *Id.*, p. 366.

[161] Adapted from *Randi W. v. Muroc Joint Unified School District*, 929 P.2d 582 (Cal. 1997).

Gadams's last place of employment (1990–1991) before Livingston was Muroc Unified School District, where disciplinary actions were taken against him for sexual harassment. When allegations of "sexual touching" of female students were made, Gadams was forced to resign from Muroc. Nonetheless, Gary Rice and David Malcolm, officials at Muroc, provided a letter of recommendation for Gadams that described him as "an upbeat, enthusiastic administrator who relates well to the students" and who was responsible "in large part" for making Boron Junior High School (located in Muroc) "a safe, orderly and clean environment for students and staff." The letter concluded that they recommended Gadams "for an assistant principalship or equivalent position without reservation."

All of the letters provided by previous administrators of Gadams were sent in on forms that included a disclosure that the information provided "will be sent to prospective employers."

Through her guardian, Randi W. filed suit against the districts, alleging that her injuries from Gadams's sexual touching were proximately caused by their failure to provide full and accurate information about Gadams to the placement service.

Discussion Questions

1. If you were a former administrator to whom Gadams reported, what kind of recommendation would you give?
2. Should the previous administrators have done something about Gadams prior to being placed in this dilemma?
3. Do administrators owe their loyalty to employees? To students? To the school district? To the parents?
4. Is this type of recommendation commonly given to get rid of employees?
5. Should friendship have a higher value than honesty?
6. Why do you think the administrators said nothing?

SECTION **F**

Workplace and the Environment

Case 7.28

Exxon and Alaska

On March 24, 1989, the Exxon *Valdez* ran aground on Bligh Reef, south of Valdez, Alaska, and spilled nearly 11 million gallons of oil into Prince William Sound. The captain of the tanker was Joseph Hazelwood.

The Spill

The Ninth Circuit Court of Appeals offered the following description of the accident in its review of the federal district court's award of damages against Exxon:

> The vessel left the port of Valdez at night. In March, it is still dark at night in Valdez, the white nights of the summer solstice being three months away. There is an established sea lane that takes vessels well to the west of Bligh Reef, but Captain Hazelwood prudently took the vessel east of the shipping lanes to avoid a heavy concentration of ice in the shipping lane, which is a serious hazard. Plaintiffs have not claimed that Captain Hazelwood violated any law or regulation by traveling outside the sea lane. The problem with being outside the sea lane was that the ship's course was directly toward Bligh Reef.
>
> Bligh Reef was not hard to avoid. All that needed to be done was to bear west about the time the ship got abeam of the navigation light at Busby Island, which is visible even at night, some distance north of the reef. The real puzzle of this case was how the ship managed to run aground on this known and foreseen hazard.
>
> There was less than a mile between the ice in the water, visible at night only on radar, and the reef. Captain Michael Clark, an expert witness for the plaintiffs, testified that an oil tanker is hard to turn, more like a car on glare ice than a car on asphalt:
>
> Q: Let's talk a minute about how you turn one of these vessels. Now, this we're talking about a vessel here that's in excess of 900 feet long, all right? Over three football fields. What's it like to turn one of these?
>
> *A: Well, it's not like turning a car or a fishing boat or something. There is a—as you are traveling in one direction and you put the rudder over, even though the head of the vessel will turn, your actual direction of travel keeps going in the old direction. Sort of like you're steering a car on ice; you turn the wheel and you just keep going in the same direction. Eventually you'll start to turn and move in the direction you're headed for.*
>
> Q: Okay. Is it just as easy as turning a car?
>
> *A: No.*
>
> Q: And does it make any sense to try to compare changing course in one of these vessels fully laden to that of turning a corner with a car?
>
> *A: No.*
>
> Q: To make it turn on a vessel, there has to be a rudder command given?
>
> *A: Yes.*

> **Q:** And once you give that rudder command, is that the end of the turn?
>
> *A: No. No, you have to watch and make sure that the rudder command is made as you ordered it and to make sure that it's having the desired effect.*
>
> **Q:** Is there anything else that has to be done in order to put it on the course that you want it on?
>
> *A: Yes, you usually have to give counter rudder to slow the turn down.*
>
> Considering the ice in the water, the darkness, the importance of turning the vessel away from Bligh Reef before hitting it, and the tricky nature of turning this behemoth, one would expect an experienced captain of the ship to manage this critical turn.
>
> But Captain Hazelwood left the bridge. He went downstairs to his cabin, he said, to do some paperwork. A special license is needed to navigate the oil tanker in this part of Prince William Sound, and Captain Hazelwood was the only person on board with the license. There was testimony that captains simply do not leave the bridge during maneuvers such as this one and that there is no good reason for the captain to go to his cabin to do paperwork at such a time. Captain Hazelwood left the bridge just two minutes before the turn needed to be commenced, which makes it all the more strange that he left at all.
>
> Before leaving, Captain Hazelwood added to the complexity of the maneuver that needed to be made: he put the vessel on autopilot, which is not usually done when a vessel is out of the shipping lanes, and the autopilot program sped the vessel up, making it approach the reef faster and reducing the time during which error could be corrected. As Captain Hazelwood left, he told [Gregory] Cousins, the third mate, to turn back into the shipping lane once the ship was abeam of Busby Light. Though this sounds plain enough, expert witnesses testified that it was a great deal less clear and precise than it sounds.
>
> There are supposed to be two officers on the bridge, but after Hazelwood left, there was only one. The bridge was left to the fatigued third mate, Gregory Cousins, a man in the habit of drinking sixteen cups of coffee per day to keep awake. Cousins was not supposed to be on watch—his watch was ending and he was supposed to be able to go to sleep—but his relief had not shown up, and Cousins felt that it was his responsibility not to abandon the bridge. He was assisted only by the helmsman, Robert Kagan. Kagan, meanwhile, had forgotten his jacket, ran back to his cabin for it, and returned to the bridge a couple of minutes before the time the turn had to be initiated. Cousins and Kagan thought they had conducted the maneuver, but evidently they had not. When Cousins realized that the vessel was not turning, he directed an emergency maneuver that did not work.[162]

Hazelwood had a history of drinking problems and had lost his New York driver's license after two drunken-driving convictions. The court described the problem as follows:

> Captain Hazelwood s departure from the bridge, though unusual, was not inexplicable. The explanation put before the jury was that his judgment was impaired by alcohol. He was an alcoholic. He had been treated medically, in a 28 day residential program, but had dropped out of the rehabilitation program and fallen off the wagon. He had joined Alcoholics Anonymous, but had quit going to meetings and resumed drinking. Testimony established that prior to boarding his ship, he drank at least five doubles (about fifteen ounces of 80 proof alcohol) in waterfront bars in Valdez. The jury could have concluded from the evidence before them that leaving the bridge was an extraordinary lapse of judgment caused by Captain Hazelwood's intoxication. There was also testimony that the highest executives in Exxon Shipping knew Hazelwood had an alcohol problem, knew he had been treated for it, and knew that he had fallen off the wagon and was drinking on board their ships and in waterfront bars.[163]

Hazelwood had joined a twenty-eight-day alcohol rehabilitation program mentioned in 1985. Almost a week after the Prince William Sound accident, Exxon revealed that

[162] From *In re Exxon Valdez*, 270 F.3d 1215 (9th Cir. 2002).

[163] 270F.3d 1222.

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Hazelwood's blood-alcohol reading was 0.061 in a test taken ten and a half hours after the spill occurred—a level that would indicate intoxication. Exxon also announced it had fired Hazelwood.

Actions Taken ... on All Sides

The magnitude of the spill seemed almost incomprehensible. Then–U.S. Interior Secretary Manual Lujan called the spill the oil industry's "Three Mile Island." After ten days, the spill covered 1,000 square miles and leaked out of Prince William Sound onto beaches along the Gulf of Alaska and Cook Inlet. A cleanup army of 12,000 was sent in with hot water and oil-eating microbes. The workers found more than 1,000 dead otters, 34,400 dead seabirds, and 151 bald eagles that had died from eating the oil-contaminated remains of seabirds.

By September 15, Exxon pulled out of the cleanup efforts after having spent $2 billion but recovering only 5 to 9 percent of the oil spilled. Alaskan officials said about 20 to 40 percent of the oil had evaporated. This meant that 50 to 75 percent of the oil was either on the ocean floor or on the beaches.

Hazelwood was indicted by the State of Alaska on several charges, including criminal mischief, operating a watercraft while intoxicated, reckless endangerment, and negligent discharge of oil. He was found innocent of all charges except the negligent discharge of oil, fined $50,000, and required to spend 1,000 hours helping with the cleanup of the beaches. Exxon paid Hazelwood's legal fees. Hazelwood now works as a maritime consultant for a New York City law firm and still holds a valid sea license.

When the *Valdez* was being repaired, ship workers observed that Hazelwood and his crew had kept the tanker from sinking by quickly sealing off the hatches to the ship's tank, thus making a bubble that helped stabilize the ship. Citing incredible seamanship, the workers noted that an 11-million-gallon spill was preferable to a 60-million one—the tanker's load.

Continuing Contention with Exxon

Following the spill, critics of Exxon maintained that the company's huge personnel cutbacks during the 1980s affected the safety and maintenance levels aboard its tankers. Later hearings revealed that the crew of the *Valdez* was overburdened with demands for speed and efficiency. The crew worked ten- to twelve-hour days and often had their sleep interrupted. Lookouts frequently were not properly posted, and junior officers were permitted to control the bridge without the required supervision. Robert LeResche, oil-spill coordinator for Alaska, said, "It wasn't Captain Ahab on the bridge. It was Larry and Curly in the Exxon boardroom."[164] In response to critics, Exxon's CEO Lawrence Rawl stated,

> And we say, "We're sorry, and we're doing all we can." There were 30 million birds that went through the sound last summer, and only 30,000 carcasses have been recovered. Just look at how many ducks were killed in the Mississippi Delta in one hunting day in December! People have come up to me and said, "This is worse than Bhopal." I say, "Hell, Bhopal killed more than 3,000 people and injured 200,000 others!" Then they say, "Well, if you leave the people out, it was worse than Bhopal."[165]

On January 1, 1990, a second Exxon oil spill occurred when a pipeline under the Arthur Kill waterway between Staten Island and New Jersey burst and spilled 567,000 gallons of heating oil. New York and New Jersey officials criticized Exxon, citing shoddy

[164] *In re Exxon Valdez*, 296 F.Supp.2d 1071 (D. Mask. 2004).

[165] Jay Mathews, "Problems Preceded Oil Spill," *Washington Post*, May 18, 1989, pp. A1, A18.

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equipment and poor maintenance. It was six hours after an alarm from the pipeline safety system went off before Exxon workers shut down the pipeline. Albert Appleton, New York City Commissioner on the Environment, said, "Exxon has a corporate philosophy that the environment is some kind of nuisance problem and a distraction from the real business of moving oil around."[166]

Late in February 1990, Exxon was indicted on federal felony charges of violating maritime safety and antipollution laws in the *Valdez* spill. The charges were brought after Exxon and the Justice Department failed to reach a settlement. The oil company also faced state criminal charges. Alaska and the Justice Department also brought civil suits against Exxon for the costs of cleaning up the spill. Approximately 150 other civil suits were filed by fishing and tour boat operators whose incomes were eliminated by the spill. At the time of the federal indictment, Exxon had paid out $180 million to 13,000 fishermen and other claimants.

The Cleanups and the Pay-Outs

By May 1990, Exxon had renewed its cleanup efforts at targeted sites with 110 employees. Twice during 1991, Exxon reached a plea agreement with the federal government and the state on the criminal charges. After Alaska disagreed with the terms of the first, a second agreement was reached in which Exxon consented to plead guilty to three misdemeanors and pay a $1.15 billion fine. The civil litigation was settled when Exxon agreed to pay $900 million to both Alaska and the federal government over ten years.

The plea agreement with the governments did not address the civil suits pending against Exxon. At the end of 1991, an Alaska jury awarded sixteen fishers more than $2.5 million in damages and established a payout formula for similar plaintiffs in future litigation against Exxon. As of September 1994, Exxon had spent $2 billion to clean up shores in Alaska.

Exxon has had a stream of payouts since 1991—a total of $3.4 billion of its $5.7 billion in profits for that period. Payouts included the following:

- $20 million to 3,500 native Alaskans for damages to their villages
- $287 million to 10,000 fishers
- $1.5 billion for damages to wildlife
- $9.7 million for damages to Native American land

In September 1994, a federal jury awarded an additional $5 billion in punitive damages against Exxon for the suits filed since 1991. The original verdict of Exxon's recklessness and the resulting damage awards were made by a jury following a trial that ended in 1994. The damage award was the largest in history at that time. Exxon's stock fell two and five-eighths points following the verdict. Exxon appealed the verdict to the Ninth Circuit.

In 1996, during a court review of the distribution of an award in an Alaskan case, a *Wall Street Journal* article revealed that Exxon had reached secret agreements with fish processors that would require them to refund the punitive damages awarded by juries. Apparently, some type of high–low settlement was reached with the plaintiffs prior to trial, but the jury trial proceeded without disclosure of the settlement and potential refund by the plaintiffs. Under a high–low settlement, the parties agree to a ceiling and a floor on the amount of damages that can be awarded. If the parties reach a $1 million–$5 million high–low agreement, they mean that $5 million will be the maximum damage award (including punitive damages and lawyers' fees) and $1 million will be the minimum award, regardless of the jury's actual verdict. The parties are guaranteed an

[166] Chris Welles, "Exxon's Future: What Has Larry Rawl Wrought?" *Business Week*, April 2, 1990, pp. 72–76.

outcome they can live with regardless of what the jury comes back with as a verdict. Often companies reach high–low verdicts because they need a court decision in order to take issues up on appeal, but they are concerned about their exposure in allowing a jury carte blanche on their liability. Further, even without an appeal, a verdict can bring a certain finality as well as precedent to what could be a number of cases or cases that will be brought in the future. Some believe that in the Exxon high-low agreement, there was a refund provision that required the plaintiffs to return or refund part of the settlement if the verdict came in at a lower range.

U.S. District Judge H. Russel Holland learned of the high-low agreements and called them an "astonishing ruse" to "mislead" the jury. Judge Holland set aside the agreements and allowed punitive damages to stand.

By November 1, 1996, Exxon had settled all of the *Valdez* cases and settled with its insurers for its claims. Exxon recovered $780 million of its $2.5 billion in costs, including attorney fees, from its insurers. Exxon had been in litigation with its insurers over coverage. Eugene Anderson, a lawyer who represents corporations in insurance actions, noted that insurance companies virtually always deny all large claims because "they pay lawyers much less each year in these cases than they earn in interest."[167]

In November 2001, the U.S. Court of Appeals for the Ninth Circuit ruled that the $5 billion verdict in the Exxon *Valdez* case for punitive damages was excessive. The case was remanded to the federal district court for a redetermination of that damage figure.[168] 4.5 billion.[169]

Exxon has since publicly admitted responsibility for the spill and has paid in excess of $3 billion to clean up the area along the Alaska coastline that has been a prime fishing area and an economic base for people of the area.[170]

The $287 million verdict for the fishermen, awarded as compensatory damages for the loss of their fishing rights during the cleanup, was upheld by the Ninth Circuit.

The Impact of Exxon's Valdez

Congress passed the Oil Spill Act in response to the *Valdez* disaster, as well as other provisions that effectively preclude the *Valdez* from ever entering Prince William Sound again.[171]

After the ten-year anniversary of the spill, many scientists undertook studies of Prince William Sound and reached conclusions along the lines of the following, taken from a website that archives summaries of all the papers presented at the conference on the ten-year anniversary of the *Valdez* spill:

> Natural interannual variability in the structure of the biological infaunal communities is the largest and most consistent signal observed in this study, not any residual effects of the oil spill. The results of statistical analyses of the data (ANCOVA) showed no indication of continuing oiling effects in 1998.[172]

The scientists also noted a natural weathering process that appears to dissipate the oil and diminish its toxicity through the effects of weather and water, even before the oil disappears.

[167] Barbara Rudolph, "Exxon's Attitude Problem," *Time*, January 22, 1990, p. 51.

[168] Joseph B. Treaster, "With Insurers' Payment, Exxon Says Valdez Case Is Ended," *New York Times*, November 1, 1996, p. C3.

[169] *In re Exxon*, 270 F.3d 1215 (9th Cir. 2001).

[170] "$5 B Exxon Verdict Is Tossed Out," *National Law Journal,* November 19, 2001–November 26, 2001, A6. See also http://www.exxon.com.

[171] 33 U.S.C. §2732 (2001).

[172] http://www.valdezscience.com/page/index.html (as accessed in original research).

The 1991 settlement had a loophole that allowed the government (either federal or state) to claim up to $100 million in additional damages for a fifteen-year period. On Thursday, June 2, 2006, the State of Alaska and the Justice Department, relying on the loophole, demanded an additional $92 million in damages. The amount is needed, according to the exercise of the clause in the agreement, because of oil still present along the beaches.

Exxon argued that there is $145 million still left in the trust fund and that if there were any ongoing damage or concerns, the trustees had the responsibility to fix it with those funds. After three remands of the case, a federal district judge entered an award of $4.5 billion in punitive damages against Exxon. Exxon appealed the punitive damage awards as excessive and the U.S. Supreme Court agreed in *Exxon Shipping Co. v. Baker*, 128 S.Ct. 2605 (2008), holding that maritime cases limited the amount of punitive damages. The court reduced the punitive damages to the amount of the compensatory damages, or $507.5 million.

Discussion Questions

1. Evaluate Exxon's "attitude" with regard to the spill. Following the explosion and resulting ninety-day oil spill at BP's Deepwater Horizon well in the Gulf, Exxon took on the mantle of a responsible corporate citizen (see Case 7.5. Why the change? Is the concept of a socially responsible company a fluid one?
2. Why did the company cut back on staff and maintenance expenditures?
3. What are the risks of a company becoming too cost conscious? Complacent on safety? Complacent because of accolades for its actions? How do these types of budget decisions differ from decisions made by persons ranging in authority from employees to supervisors to violate safety rules?
4. Would Exxon make the same decisions about Hazelwood and cost cutting given the costs of the spill?
5. Evaluate the ethics in Exxon's secret deal on punitive damages.
6. Evaluate the ethics of the insurers in denying large claims in order to earn the interest while litigation over the claim is pending.
7. Why do you think the court held that the punitive damage verdict was excessive? Is there another social issue regarding litigation here?

Compare & Contrast

What are the differences among environmental policy and approaches at Herman Miller (Case 3.23) as compared to Exxon and to BP's handling of the Deepwater Horizon spill (Case 7.5)? Does the Exxon spill seem irrelevant now?

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Case 7.29

Biofuels and Hunger in Guatemala

In both Europe and the United States, government incentives for production and regulatory mandates of biofuels have resulted in an increasing percentage of corn crops being used for biofuel production. In the United States, 40 percent of the corn crop is used for biofuels. With incentives, it is difficult for farmers to simply sell their corn as food. And the mandates and profitability have an impact in agricultural production and sales around the world. For example, in Guatemala, the fields that were once used by families for growing their own food are no longer available. The result is that you can find families farming the small slivers of land on the medians in the highway because that is the only land they can find that has not been taken over by biofuel producers.

Further, the increasing sales of corn to biofeul producers has resulted in low supply of corn for tortillas. The food chain impact is also felt by Guatemalan families because corn is used for chicken feed, and they now find that eggs have tripled in price. Three years ago, one quetzal (15 cents in USD) would get you eight tortillas. In 2013, the same quetzal will net you only four tortillas.[173] Before the biofuel price impacts, Guatemalans spent about two-thirds of their budgets on food. With the price spikes, the families are fortunate if they have enough money to buy the food they need to see them through until the next job. With little land available, they have lost the ability to grow their own food, with the resulting increased costs for acquired already grown food.

Guatemala's situation is particularly acute because both Europe and the United States are moving into Central America for the purpose of farming for biofuels. The biofuels industry does provide jobs and there is economic development as a result of the busy corn farms. However, Guatemala and other similar countries do not have the infrastrcuture that will allow for the economic development that would find families turning from their own farming to a more urban lifestyle and the purchase of food. Further, with so much of the land dedicated to biofuels production, farms that produce food for sale continue to dwindle in numbers.

Discussion Questions

1. One businessman noted, "There are pros and cons to biofuels." Based on what you just read, explain what he means.
2. Why will jobs in biofuel farms and production not help all the people of Guatemala?
3. If you were a biofuel producer, what steps would you take in Guatemala to prevent the hunger problems that continue to increase? What if the government there supported your efforts to produce biofuel?
4. How would you decide on wages for those who work the fields and biofuel production in your Guatemalan operations?

[173] Elisabeth Rosenthal, "As Biofuel Demand Grows, So Do Guatemalans' Hunger Pangs," *New York Times*, January 6, 2013, p. A6.

Ethics and Products

UNIT EIGHT

Marketing and innovation produce results: All the rest are costs.

—Peter Drucker

In the hour when an individual is brought before the heavenly court for judgment, the person is asked: Did you conduct your business affairs honestly?

—Babylonian Talmud, Shabbat 31a

Products are points of pressure. There is pressure to get those products out there on the market. There is the pressure to sell, sell, sell those products. Even buyers, on occasion, feel the pressure to buy, buy, buy. And there is even the pressure that comes when problems with a product arise—to recall or not to recall, that is the question. Or is it?

SECTION A

Advertising Content

Ads sell products. But how much can the truth be stretched? Are ads ever irresponsible by encouraging harmful behavior?

Case 8.1

Skechers and the Muscle-Building Shoes

Skechers' ads for its Shape-Up athletic shoes touted, "Get in shape without setting a foot in a gym!" "Shape up while you walk!" Kim Kardashian was featured in a Super Bowl ad that showed her firing her personal trainer. Brooke Burke appeared in another ad talking about how the shoes burned calories. The ads promised stronger and toned muscles. These shoes could result in weight loss and cardiovascular health.[1] Other ads touted "clinical studies" that established various benefits to the shoe; one stated that chiropractors recommended them. However, the ad did not disclose that the chiropractor who conducted the study of other chiropractors was married to a marketing executive for Skechers. The studies claimed "activation rates" of 85 percent for the muscles that affect posture.

Skechers sold the Shape-Up shoes for $100 per pair and the Resistance Runner, Toners, and Tone-ups for $60 to $100 per pair. By the end of 2010, total sales topped $1 billion.

In May 2012, Skechers settled Federal Trade Commission (FTC) charges of consumer deception by agreeing to pay a $40 million fine and ceasing:

- claims about strengthening;
- claims about weight loss; and
- claims about any other health or fitness-related benefits from toning shoes, including claims regarding caloric expenditure, calorie burn, blood circulation, aerobic conditioning, muscle tone, and muscle activation.

The settlement also bars Skechers from misrepresenting any tests, studies, or research results regarding toning shoes.[2]

Discussion Questions

1. Were these statements just puffing, or were they statements of fact?
2. Does the presence of Kim Kardashian in the ads negate any factual promises? Should consumers have known better? What do the sales figures tell you about the ad campaign?
3. Evaluate the ethics of the marketing executive who used her husband to come up with the study and discuss the nondisclosure of his identity.

[1] "Skechers Will Pay $40 Million to Settle FTC Charges That It Deceived Consumers with Ads for 'Toning Shoes,'" FTC website, http://www.ftc.gov/opa/2012/05/consumerrefund.shtm.

[2] Skechers Settlement, May 26, 2012, http://www.ftc.gov/opa/2012/05/consumerrefund.shtm.

Case 8.2

Joe Camel: The Cartoon Character Who Sold Cigarettes and Nearly Felled an Industry

Introduction and History of Joe Camel

Old Joe Camel, originally a member of a circus that passed through Winston-Salem, North Carolina, each year, was adopted by R. J. Reynolds (RJR) marketers in 1913 as the symbol for a brand being changed from "Red Kamel" to "Camel." In the late 1980s, RJR revived Old Joe with a new look in the form of a cartoon. He became the camel with a "Top Gun" flier jacket, sunglasses, a smirk, and a lot of appeal to young people.

How Effective Is Joe? The Studies

In December 1991, the *Journal of the American Medical Association* (JAMA) published three surveys that found that the cartoon character Joe Camel reached children very effectively. Of children between the ages of 3 and 6 who were surveyed, 51.1 percent recognized Joe Camel as being associated with Camel cigarettes.[3] The 6-year-olds were as familiar with Joe Camel as they were with the Mickey Mouse logo for the Disney Channel. The surveys also established that 97.7 percent of students between the ages of 12 and 19 had seen Old Joe, and 58 percent thought the ads he was used in were cool. Camel was identified by 33 percent of the students who smoke as their favorite brand.[4]

Before the survey results appeared in *JAMA*, the American Cancer Society, the American Heart Association, and the American Lung Association had petitioned the Federal Trade Commission (FTC) to ban the ads as "one of the most egregious examples in recent history of tobacco advertising that targets children."[5]

In 1990, Camel shipments rose 11.3 percent. Joe Camel helped RJR take its Camel cigarettes from 2.7 to 3.1 percent of the market.[6]

Michael Pertschuk, former FTC head and codirector of the Advocacy Institute, an antismoking group, said, "These are the first studies to give us hard evidence, proving what everybody already knows is true: These ads target kids. I think this will add impetus to the movement to further limit tobacco advertising.[7] Joe Tye, founder of Stop Teenage Addictions to Tobacco, stated, "There is a growing body of evidence that teen smoking is increasing. And it's 100 percent related to Camel."[8]

A researcher who worked on the December 1991 *JAMA* study, Dr. Joseph R. DiFranza, stated, "We're hoping this information leads to a complete ban of cigarette advertising."[9] Dr. John Richards summarized the study as follows: "The fact is that the ad is reaching kids, and it is changing their behavior."[10]

RJR spokesman David Fishel responded to the allegations with sales evidence: "We can track 98 percent of Camel sales; and they're not going to youngsters. It's simply not in our best interest for young people to smoke, because that opens the door for the

[3] Kathleen Deveny, "Joe Camel Ads Reach Children, Research Finds," *Wall Street Journal*, December 11, 1991, p. B1.

[4] Walecia Konrad, "I'd Toddle a Mile for a Camel," *BusinessWeek*, December 23, 1991, p. 34. Although the studies and their methodology have been questioned, their impact was made before the challenges and questions were raised.

[5] Deveny, "Joe Camel Ads Reach Children," p. B1.

[6] Konrad, "I'd Toddle a Mile for a Camel," p. 34.

[7] Deveny, "Joe Camel Ads Reach Children," p. B6.

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[9] Konrad, "I'd Toddle a Mile for a Camel," p. 34.

[10] "Camels for Kids," *Time*, December 23, 1991, p. 52.

government to interfere with our product."[11] At the time the survey results were published, RJR, along with other manufacturers and the Tobacco Institute, began a multimillion-dollar campaign with billboards and bumper stickers to discourage children from smoking but announced it had no intention of abandoning Joe Camel. The Tobacco Institute publishes a free popular pamphlet called "Tobacco: Helping Youth Say No."

Calls for Joe's Demise, Smoker Demographics, and Popularity

Former U.S. Surgeon General Antonia Novello was very vocal in her desire to change alcohol and cigarette advertising. In March 1992, she called for the withdrawal of the Joe Camel ad campaign: "In years past, R. J. Reynolds would have us walk a mile for a Camel. Today it's time that we invite old Joe Camel himself to take a hike."[12] The American Medical Association's executive vice president, Dr. James S. Todd, concurred:

> This is an industry that kills 400,000 per year, and they have got to pick up new customers. We believe the company is directing its ads to the children who are 3, 6 and 9 years old.[13]

Cigarette sales are, in fact, declining 3 percent per year in the United States.

The average Camel smoker is 35 years old, responded an RJR spokeswoman: "Just because children can identify our logo doesn't mean they will use our product."[14] Since the introduction of Joe Camel, however, Camel's share of the under-18 market has climbed to 33 percent from 5 percent. Among 18- to 25-year-olds, Camel's market share has climbed to 7.9 percent from 4.4 percent.

The Centers for Disease Control reported in March 1992 that smokers between the ages of 12 and 18 prefer Marlboro, Newport, or Camel cigarettes, the three brands with the most extensive advertising.[15]

Teenagers throughout the country were wearing Joe Camel T-shirts. Brown & Williamson, the producer of Kool cigarettes, began testing a cartoon character for its ads, a penguin wearing sunglasses and Day-Glo sneakers. Company spokesman Joseph Helewicz stated that the ads are geared to smokers between 21 and 35 years old. Helewicz added that cartoon advertisements for adults are not new and cited the Pillsbury Doughboy and the Pink Panther as effective advertising images.

Regulatory Attention on Joe Camel

In mid-1992, then–Surgeon General Novello, along with the American Medical Association, began a campaign called "Dump the Hump" to pressure the tobacco industry to stop ad campaigns that teach kids to smoke. In 1993, the FTC staff recommended a ban on the Joe Camel ads. In 1994, then–Surgeon General Joycelyn Elders blamed the tobacco industry's $4 billion in ads for increased smoking rates among teens. RJR's tobacco division chief, James W. Johnston, responded, "I'll be damned if I'll pull the ads."[16] RJR put together a team of lawyers and others it referred to as in-house censors to control Joe's influence. A campaign to have Joe wear a bandana was nixed, as was one for a punker Joe with pink hair.[17]

[11] *Id.*

[12] William Chesire, "Don't Shoot: It's Only Joe Camel," *(Phoenix) Arizona Republic*, March 15, 1992, p. C1.

[13] *Id.*

[14] Konrad, "I'd Toddle a Mile for a Camel," p. 34.

[15] "Selling Death," *Mesa (Arizona) Tribune*, March 16, 1992, p. A8.

[16] Anna White, "Joe Camel's World Tour," *New York Times*, April 23, 1997, p. A21.

[17] Melanie Wells and Chris Woodyard, "FTC Says Joe Camel Tobacco Icon Targeted Young," *USA Today*, May 29, 1991, p. 1A.

In 1994, RJR CEO James Johnston testified before a congressional panel on the Joe Camel controversy and stated, "We do not market to children and will not," and added, "We do not survey anyone under the age of 18."[18]

As health issues related to smokers continued to expand, along with product liability litigation and state attorneys general's pursuit of compensation for their states' health system costs of smokers, more information about the Joe Camel campaign was discovered. Lawyers in a California suit against RJR discovered charts from a presentation at a September 30, 1974, Hilton Head, South Carolina, retreat of RJR top executives and board.[19] The charts offered the following information:

Company	Brand	Share of 14- to 24-Year-Old Market (%)
Philip Morris	Marlboro	33
Brown & Williamson	Kool	17
Reynolds	Winston	14
Reynolds	Salem	9[20]

RJR's then–vice president of marketing, C. A. Tucker, said, "As this 14–24 age group matures, they will account for a key share of total cigarette volume for at least the next 25 years."[21] The meeting then produced a plan for increasing RJR's presence among the under-35 age group, which included sponsoring NASCAR auto racing. Another memo described plans to study "the demographics and smoking behavior of 14- to 17-year-olds."[22]

Internal documents that discussed targeting young people were damaging. A 1981 RJR internal memo on marketing surveys cautioned research personnel to tally underage smokers as "age 18."[23] A 1981 Philip Morris internal document indicated information about smoking habits in children as young as age 15 was important because "today's teenager is tomorrow's potential regular customer."[24] Other Philip Morris documents from the 1980s expressed concerns that Marlboro sales would soon decline because teenage smoking rates were falling.[25]

A 1987 marketing survey in France and Canada by RJR before it launched the Joe Camel campaign showed that the cartoon image with its fun and humor attracted attention. One 1987 internal document uses the phrase "young adult smokers"[26] and notes a target campaign to the competition's "male Marlboro smokers ages 13–24."[27]

[18] Milo Geyelin, "Reynolds Aimed Specially to Lure Young Smokers Years Ago Data Suggest," *Wall Street Journal*, January 15, 1998, p. A4.

[19] Doug Levy and Melanie Wells, "Papers: RJR Did Court Teens," *USA Today*, January 15, 1998, pp. 1A, 1B.

[20] Eben Shapiro, "FTC Staff Recommends Ban of Joe Camel Campaign," *Wall Street Journal*, August 11, 1994, pp. B1, B8.

[21] Bruce Horovitz and Doug Levy, "Tobacco Firms Try to Sow Seeds of Self-Regulation," *USA Today*, May 16, 1996, pp. 1B, 2B.

[22] Bruce Ingersoll, "Joe Camel Ads Illegally Target Kids, FTC Says," *Wall Street Journal*, May 29, 1997, pp. B1, B8.

[23] Geyelin, "Reynolds Aimed Specifically to Lure Young Smokers Years Ago," p. A4.

[24] Suein L. Hwang, Timothy Noah, and Laurie McGinley, "Philip Morris Has Its Own Youth-Smoking Plan," *Wall Street Journal*, May 16, 1996, pp. B1, B4.

[25] Barry Meier, "Tobacco Executives Wax Penitent before House Panel in Hopes of Preserving Accord," *New York Times*, January 30, 1998, p. A15.

[26] Wells and Woodyard, "FTC Says Joe Camel Tobacco Icon Targeted Young," p. 1A.

[27] *Id.*

A 1997 survey of 534 teens by *USA Today* revealed the following:

Ad	Have Seen Ad (%)	Liked Ad (%)
Joe Camel	95	65[28]
Marlboro Man	94	44[29]
Budweiser Frogs	99	92

In 1987, Camels were the cigarette of choice for 3 percent of teenagers when Joe Camel debuted. By 1993, the share had climbed to 16 percent.[30]

Joe Camel Is Phased Out

In early 1990, the FTC began an investigation of RJR and its Joe Camel ads to determine whether underage smokers were illegally targeted by the ten-year Joe Camel Campaign.[31] The FTC had dismissed a complaint in 1994, but did not have the benefits of the newly discovered internal memos.[32]

By late 1997, RJR began phasing out Joe Camel.[33] New Camel ads feature men and women in their twenties, with a healthy look, in clubs and swimming pools with just a dromedary logo somewhere in the ad. Joe continued as a youth icon. A "Save Joe Camel" website developed, and Joe Camel paraphernalia brought top dollar. A Joe Camel shower curtain sold for $200. RJR also vowed not to feature the Joe Camel character on nontobacco items such as T-shirts. The cost of the abandonment was estimated at $250 million.[34]

Philip Morris proposed its own plan to halt youth smoking in 1996, which includes no vending machine ads, no billboard ads, no tobacco ads in magazines with 15 percent or more of youth subscribers, and limits on sponsorships of events (rodeos, motor sports) to those in which at least 75 percent of attendees are adults.[35]

The Tobacco Settlement

It was also in 1997 that the combined pressure from Congress, the state attorneys general, and ongoing class action suits produced what came to be known as "the tobacco settlement." The tobacco settlement in all of its various forms bars outdoor advertising, the use of human images (Marlboro man) and cartoon characters, and vending-machine sales. This portion of the settlement was advocated by those who were concerned that teenagers would be attracted to cigarette smoking via these ads and that cigarettes were readily available in machines.[36]

[28] "Joe Camel Shills to Kids," *USA Today*, June 2, 1997, p. 12A.

[29] *Id.*

[30] Alan Kline, "Joe Camel Is One Species the Government Wants Extinct," *Washington Times*, June 8, 1997, p. 10.

[31] Doug Levy, "Blowing Smoke?" *USA Today*, January 15, 1998, pp. 1B, 2B.

[32] Shapiro, "FTC Staff Recommends Ban of Joe Camel Campaign," pp. B1, B8.

[33] "Smokin' Joe Camel Near His Last Gasp," *Time*, June 9, 1997, p. 47.

[34] Maria Mallory, "That's One Angry Camel," *BusinessWeek*, March 7, 1994, pp. 94, 95.

[35] Horovitz and Levy, "Tobacco Firms Try to Sow Seeds of Self-Regulation," pp. 1B, 2B; and Gary Rausch, "Tobacco Firms Unite to Curb Teen Smoking," *Mesa Tribune*, June 24, 1991, pp. B1, B6.

[36] Meier, "Tobacco Executives Wax Penitent before House Panel," *New York Times*, January 30, 1998, p. A15.

Although the governmental suits were settled, those suits focused simply on reimbursement for government program costs in treating smokers for their health issues related to smoking. Private litigation resulted in a $144 billion settlement that the tobacco companies paid in proportion to market share.

Post-Tobacco Settlement Events: Self-Extinguishing Cigarettes

Since the time of the tobacco settlement and the Joe Camel ad campaign, the industry has changed in some ways, but in other ways remains unbowed by the events described here. For example, in 2002, Philip Morris was poised to introduce a new cigarette that was designed to save lives. If left unattended, the cigarette would extinguish itself, thus eliminating the tremendous fire risk that results from smokers falling asleep while their cigarettes are still burning. Nonextinguished cigarettes are the leading cause of fire fatalities in the United States. The cigarette was to be released under the company's Merit brand.

However, a company scientist, Michael Lee Watkins, told his superiors that the cigarettes were, in fact, a greater fire risk than conventional cigarettes because chunks of them fell off onto smokers and nearby objects. He was fired, and Philip Morris released the Merit cigarette with special advertising emphasizing its safety. The U.S. Justice Department got wind, as it were, of the problem from Dr. Watkins, and filed suit against Morris and other tobacco companies for deception as well as for the safety issues related to the cigarettes. Dr. Watkins served as a witness for the government.

Philip Morris indicates that Dr. Watkins was fired for failing to attend meetings, for speaking negatively of his colleagues, and for failing to document his research.

Philip Morris says that Dr. Watkins was correct in that chunks of the Merit safety cigarette did tend to fall off, thereby creating a different fire hazard, but the company fixed that problem by substituting a different paper before Merit was released to the market.

New Forms of Cigarette Regulation

Regulation of smoking and cigarettes has continued. At the city level, no-smoking ordinances have taken effect across the country, from New York City to Mesa, Arizona. Many national chain hotels, such as Marriott, and restaurants are completely nonsmoking environments. At the state level, safety legislation took hold. For example, New York passed a statute that requires that cigarettes sold in the state be "self-extinguishing" according to rules and guidelines contained in the statute. Twenty-one other states, including California, Illinois, North Carolina, Massachusetts, and Vermont have similar legislation, with the issue reemerging that there are accidental deaths from fires caused by a smoker falling asleep with a lighted cigarette.[37] Canadian and EU health authorities are also working on fire-safe cigarette requirements.

In the summer of 2004, Philip Morris launched a massive ad campaign directed at children and teens, warning them not to begin smoking. The company ran radio and television ads directing kids and parents to a website for help on peer pressure, smoking, and talking about the dangers of smoking. The company also inserted multipage glossy pamphlet inserts, titled "Raising Kids Who Don't Smoke: Peer Pressure & Smoking," in major magazines. The pamphlets tell parents, "Talk to your kids about not smoking. They'll listen."

[37] These states' self-extinguishing requirements were all in effect by the end of 2009.

Discussion Questions

1. Suppose you were the executive in charge of marketing for R. J. Reynolds. Would you have recommended an alternative to the Joe Camel character? What if RJR insisted on the Joe Camel ad despite your reservations?
2. Suppose you work with a pension fund that has a large investment in RJR. Would you consider selling your RJR holdings?
3. Do you agree with the statement that identification of the logo does not equate with smoking or with smoking Camels? Do regulators agree? Did the Joe Camel ads generate market growth?
4. Antitobacco activist Alan Blum said, "This business of saying 'Oh, my God, they went after kids' is ex post facto rationalization for not having done anything. It's not as if we on the do-good side didn't know that." Is he right?
5. What do you make of RJR's new antismoking ad campaign targeted at children and teens? Is it significant that the company with the highest percentage of the youth market undertook the campaign to prevent kids from smoking?
6. Internationally, the tobacco companies are doing well in developing economies. What lessons learned here should be applied as the tobacco companies expand into other countries?

Compare & Contrast

Philip Morris is a company known for a phenomenal atmosphere of diversity. Government regulators in the EEOC often point to Philip Morris and its programs as an example of how companies should structure their diversity programs to make them effective. The company culture is known for being warm, accepting, and supportive. What can we learn from this aspect of the company versus its strategic policies on marketing?

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Case 8.3

Cereal Claims of Health, Better Grades, Immunity, and Sugar Content

Cheerios and Hearts

The Food and Drug Administration (FDA) warned General Mills about the content of its ads for Cheerios. The warning letter that the agency sent to General Mills focused on the company's claims that its cereal, Cheerios, was "clinically proven to help lower cholesterol." The ads also claimed that the cereal could reduce bad cholesterol by 4 percent in six weeks. General Mills indicated that it has used the claim in its ads for more than two years and that the clinical study supporting the claim is very strong.

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However, the FDA says that government regulations prohibit such claims for anything other than drugs and that Cheerios would have to be approved as a drug in order to make the claims. The FDA indicated that it wants to keep a bright line between what companies can say about a product versus what it can say about a drug. The FDA and Federal Trade Commission (FTC) also pointed to the following analysis of the studies that were used as the basis for the General Mills claims:

> But the average LDL ("bad") cholesterol of the Cheerios eaters fell by only 7 points (from 160 to 153). In fact, a 7-point fall would be a decent drop from just one food, but it was actually three servings of one food. On average, participants ate 450 calories' worth of cereal a day (3 cups of Cheerios plus 1½ cups of fat-free milk). That's a big chunk of the average American's 2,200-calorie diet, especially for such a modest payoff.
>
> And it would take even more than 450 calories to get the same LDL drop from Honey Nut or Berry Burst Cheerios (both of which contain less soluble fiber and more sugar than regular Cheerios).[38]

The General Mills ads features Cheerios eaters who appear to be celebrating more than just a 7-point drop in cholesterol. One commentator commented wryly that those in the ads appear to have conquered heart disease.

Other companies have been facing the same increasing scrutiny on their health benefit ads claims. For example, the FTC reached one settlement with Kellogg's Cereals for its claim that Frosted Mini-Wheats improve children's attentiveness by 20 percent and another for claiming that Rice Krispies bolstered immunity. The Rice Krispies boxes claimed, "Now helps support your child's immunity with 25 percent daily value of antioxidants and nutrients—vitamins A, B, C, and E." Kellogg's said it stood behind its research but agreed to remove the claims related to health from its boxes.[39] Kellogg's also agreed to change its boxes for Frosted Mini-Wheats to remove the claim that this cereal would "increase your child's attentiveness by 20 percent."

Kraft, Barney Rubble, and Shrek

Kraft Foods has decided to ban certain food ads from children's websites for Kraft Foods. Kraft has created a group of outside independent advisers who analyzed the company websites and were disturbed by the sites' games for children, which involved Barney Rubble and Shrek and led the kids on chases for Kraft products such as ChipsAhoy, Lunchables, and Kool-Aid. Professor Ellen Wartella, dean of the College of Communications at University of Texas at Austin, called the web ads "indefensible." Kraft agreed to pull the ads from the web. The ads were placed there as a sort of loophole to its longstanding policy (since the 1980s) of not advertising its products on children's TV and radio programs. Kraft does market "healthier" products to children between the ages of 6 and 12. Kraft also uses cartoon characters on its products, such as Sponge Bob on its crackers and Dora the Explorer on Teddy Grahams cookies.

About eighteen months after Kraft heeded the advice of this advisory board and made changes, eleven U.S. companies, including Kraft, announced that they would put stricter controls on their advertisements for products for children. The companies that participated in the voluntary initiative are as follows:

Kraft
McDonald's
PepsiCo
Coca-Cola

[38] David Schardt, "Hook, Line, and Cheerios," *Nutrition Action Newsletter*, October 5, 2005, accessed June 10, 2010, from http://findarticles.com/p/articles/mi_m0813/is_8_32/ai_n15691320.

[39] Susan Carey, "Snap, Crackle, Slap: FTC Forbids Rice Krispies' Claim," *Wall Street Journal*, June 4, 2010, p. B1.

General Mills
Campbell's
Cadbury Adam's
Kellogg's
Hershey's
Mars
Unilever

The companies all took a pledge to impose stricter controls on their ads directed at children. The controls take different forms. For example, PepsiCo and Coke will eliminate ads at elementary schools. PepsiCo is also eliminating ads at middle schools. Cadbury Adam's will stop advertising its Bubblicious to children under 12.

Margo Wootan, the head of the Center for Science in the Public Interest, praised the group. However, members of Congress indicated that the media outlets, including the Cartoon Network and Nickelodeon, also needed to step forward with voluntary steps on running ads from companies that were not part of the group.[40]

In 2012, Walt Disney Company agreed not to accept ads for foods that did not comply with strict nutritional standards, and other networks were targeted for adoption of a similar posture by 2015. In 2013, Nickelodeon, Disney's major competitor, announced it would continue to accept ads for products such as Trix and Cocoa Puffs. Nickelodeon issued an explanation, "As an entertainment company, Nickelodeon's primary mission is to make the highest quality entertainment content in the world for kids. That is our expertise. We believe strongly that we must leave the science of nutrition to the experts."[41] Ms. Wootan announced a study that found that 69 percent of Nickelodeon's ads were for foods her center has deemed to be unhealthy. Ms. Wootan indicated that Nickelodeon need not have "a Ph.D. in nutrition to [know] that Airheads candy are unhealthy."[42]

There were some signs that food producers were beginning to shoulder the nutrition burden by developing alternatives. In 2013, Kellogg's launched Scooby Doo cereal, a cereal with just six grams of cereal per serving. Ms. Wootan praised Kellogg's and other companies for their voluntary actions in making these cereals, which appeal to children, healthier.

Discussion Questions

1. Are the cereal health claim ads misleading?
2. What are the companies trying to accomplish with their health claims?

   Perhaps the cereals could help consumers if the companies could get the word out about the benefits. The website for Cheerios still includes the following:

   > Good news for your heart!
   >
   > As part of a heart healthy diet, the soluble fiber in Cheerios and Honey Nut Cheerios can help lower cholesterol and reduce the risk of heart disease.[43]

   In addition, Cheerios has the seal of approval of the American Heart Association, and the following language appears on the Cheerios boxes, along with the seal of the AHA: "Products displaying the heart-check mark meet American Heart Association food criteria for saturated fat and cholesterol for healthy people over the age of 2."[44]
3. Are the actions of General Mills in using this language and displaying the seal acts of civil disobedience? Or is the company just not using the claim in its ads? Is a website an ad? Is this a gray area?

[40] "McDonald's, Kraft Tighten Advertising Policies," ChicagoBusiness.com, July 19, 2007, accessed June 10, 2010, from www.chicagobusiness.com/article/20070718/NEWS07/200025703/mcdonalds-kraft-tighten-advertising-policies.

[41] Brooks Barnes and Brian Stelter, "Nickelodeon Resists Critics of Food Ads," *New York Times*, June 19, 2013, p. A1.

[42] *Id.*

[43] http://www.cheerios.com. Accessed June 10, 2010.

[44] www.heartcheckmark.org. Accessed June 10, 2010.

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Is this puffing, or do the medical claims move the ad content from salesmanship to factual claims?

4. Michele Simon, a food activist at Eat Drink Politics says, "From an ethical and legal standpoint, it is immoral to market to children, because children do not understand advertising."[45] Is she correct in her ethical analysis? Is it possible to have a nondeceptive ad for children?
5. Describe Nickelodeon's position on social responsibility given its decision to continue to accept ads from all food companies.
6. What relationship does the regulatory cycle have with the Kraft decision and the follow-up actions by the other ten companies? With Disney's and Kellogg's actions on the ads and cereal content?

Compare & Contrast

1. Refer back to the Joe Camel case (Case 8.2), and consider why Kraft and the other ten companies made their decision to self-regulate when they did with respect to the actions of RJR and the timing.
2. The claims about cholesterol reduction and immunity bolstering appear to be at least marginally true, but regulation prohibits the companies from using those claims in advertising. Some actions are *malum in se*; that is, they are ethically and morally wrong (murder). Other actions are *malum prohibitum*, or wrong because they have been prohibited. Which are the ad claims? Is this distinction important in ethical analysis?

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www.ftc.gov

www.fda.gov

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Case 8.4

Eminem vs. Audi

Chrysler ran an ad featuring Eminem during the Super Bowl in February 2011, and the ad was rated as one of the best for the game. In May 2011, Audi ran an ad at a German auto show that had the "feel" of the Eminem Chrysler "Lose Yourself" ad. Subsequently, the German auto show ad made its way onto the Internet.

The German ad caught the attention of Eminem and 8 Mile, Eminem's publishing company. They notified Audi that the ad constituted an unauthorized use of their intellectual property and then obtained injunctions in several European countries that stopped the ad from airing. A spokesperson for 8 Mile said that the Audi ad "copied the look and feel of the Imported From Detroit commercial." Audi then entered into a settlement with Eminem and 8 Mile that involved Audi making an undisclosed amount of donations to Detroit charities. Chrysler was not part of any of the legal actions or settlement.

Discussion Questions

1. Is copying the "look and feel" of an ad ethical?
2. Was there a likelihood of confusion between a Chrysler and an Audi?
3. Evaluate this comment from someone who viewed the two videos. "I am So Glad Eminem and his company forced Audi to do the right thing. I played both of the commercials; the copying was apparent! How COULD they think they would get away with this?? The world is a small place, and in this case IMITATION IS NOT THE SINCEREST FORM OF FLATTERY … it's ILLEGAL!"
4. Is the writer correct? Is this illegal? What is the difference between an illegal act and a civil wrong that is settled as in this case?

[45] "Should Scooby Do Be Allowed to Advertise to Children?" *Corporate Crime Reporter*, March 4, 2013, http://www.corporatecrimereporter.com/news/200/scoobydoo0304203/.

5. Think about this reader's comments:

> I thought things like this fell under the parody law or something? I guess it wasn't a parody, but did Audi not know the laws here? I think the whole Imported From Detroit ad campaign was terrible, and Eminem is completely overrated, always has been!

Is it possible that Audi was doing a parody? Is a parody act ethical? Does it matter that the ad ran in Germany only and just made its way onto the Internet?

SECTION B

Product Safety

A bad reputation is like a hangover. It takes a while to get rid of and it makes everything else hurt.

—James Preston, former CEO, Avon

Quality, safety, service, and social responsibility—customers want these elements in a product and a company. Does the profit motive interfere with these traits?

When is a product safe enough for sale? What happens if the product develops problems after it has been sold? What if a product cannot be made safe?

Reading 8.5

From Shunning to Anonymity

When someone purchased the butter churner or the wagon wheel from a neighbor in the era of wagons and churning, there was no need for the Restatement of the Law of Torts. If the churner or the wheel was defective, the neighbor simply made good on the product or risked the mighty shunning that the community would dish out for those who dared to be less than virtuous, forthright, and in a relationship of good rapport with one's fellow village dwellers. When neighbor manufactured for neighbor, the rule of law was *caveat vendor*, which, loosely translated, meant, "If you want to continue living here, you had better take care of the problem with the crooked wagon wheel."

The birth of the industrialized society changed the community dynamic so that some communities made wheels; some made churners; and those in other communities purchased those goods even as they sold their specialties that they produced. The result was that buyers knew the merchant who sold them the wheel or the churn, but had no idea who really put together either, and in many cases were not even sure which community produced either. The one-to-one process of implementing product quality and guarantees disappeared. Even the ads for the wheels and churns were written by some copy writer far, far away who was a subcontractor of an advertising agency working for the manufacturing companies of these products. The physical and production distance between seller and buyer meant that the one-on-one confrontation and shunning methods were no longer effective. The law shifted from *caveat vendor* to *caveat emptor*, which, translated, means "Buyer beware." Now the buyer had to be on guard, ever vigilant in inspecting goods before buying, and had to investigate the company doing the selling so he or she could at least be sure of the company's reputation. The greater these physical and supply chain distances, the less likely the buyer was to have any information about the company, the product, or the history of either. And it was even less likely that the buyer could count on a seller repairing or replacing defective goods. Anonymity created a marketplace in which there were few or no buyer remedies.

Ralph Nader and Unsafe at Any Speed

During the 1960s, the law began to whittle away at the anonymity protections and immunity that manufacturers and sellers enjoyed when they sold their wares. In 1965, Ralph Nader published *Unsafe at Any Speed: The Designed-In Dangers of the American Automobile*, a book that was directed in its specific analysis at General Motors' Corvair but that urged liability for auto manufacturers for their failure to research and implement product safety standards in their automobiles. Because of the stir the book created, a U.S. Senate subcommittee asked the CEOs of the automakers to testify about their commitment to auto safety research. Then–U.S. Senator Robert Kennedy had the following exchanges with James Roche, then-CEO, and Frederic Donner, then-chairman of the board, of General Motors:

Kennedy: What was the profit of General Motors last year?

Roche: I don't think that has anything to do—

Kennedy: I would like to have that answer if I may. I think I am entitled to know that figure. I think it has been published. You spend a million and a quarter dollars, as I understand it, on this aspect of safety. I would like to know what the profit is.

Donner: The aspect we are talking about is safety.

Kennedy: What was the profit of General Motors last year?

Donner: I would have to ask one of my associates.

Kennedy: Could you, please?

Roche: $1,700,000,000.

Kennedy: What?

Donner: About a billion and a half, I think.

Kennedy: About a billion and a half?

Donner: Yes.

Kennedy: Or $1.7 billion, you made $1.7 billion last year?

Donner: That is correct.

Kennedy: And you spent $1 million on this?

Donner: In this particular facet we are talking about....

Kennedy: If you gave just 1 percent of your profits, that is $17 million.

The drama of the moment was historically significant. From that point forward, the nature of seller and manufacturer liability, in the auto industry and consumer products generally, changed. The message was clear: part of the cost of manufacturing consumer products is ensuring their safety. Within the decade, we would see the first appellate court decision that held Johns-Manville responsible for the damage to workers' lungs from asbestos exposure. Strict liability, or full accountability for one's products akin to the days of one-on-one sales, had returned.

The Legal Basis for Product Liability

Product liability has two foundations in law. The first is in contract, found in the Uniform Commercial Code. An **express warranty** as provided in the Uniform Commercial Code (UCC) is an express promise (oral or written) by the seller as to the quality, abilities, or performance of a product (UCC § 2-313). The seller need not use the words *promise* or *guarantee* to make an express warranty. A sample, a model, or just a description of the goods is a warranty. Promises of what the goods will do are also express warranties. "22 mpg" is an express warranty, which is why the claim is always followed by "Your mileage may vary." Other examples of express warranties are "These goods are 100 percent wool," "This tire cannot be punctured," and "These jeans will not shrink."

Any statements made by the seller to the buyer before the sale is actually made that are part of the basis of the sale or bargain are express warranties. Also, the information included on the product packaging constitutes an express warranty if those are statements of fact or promises of performance. So, ads count as warranties. Statements by salespeople count as warranties.

The **implied warranty of merchantability** (UCC § 2-314) is given in every sale of goods by a merchant seller. Merchants are those sellers who are engaged in the business of selling the good(s) that are the subject of the contract. This warranty requires that goods sold by a merchant "(c) are fit for the ordinary purposes for which goods of that description are used." This warranty means that food items are not contaminated and that cars' steering wheels do not break apart. Basketballs bounce, mobile homes do not leak when it rains, and brakes on cars do not fail.

The **implied warranty of fitness for a particular purpose** (UCC § 2-315) is the salesperson's warranty. If a buyer asks the owner of a nursery what weed killer would work in his garden, and the nursery owner makes a recommendation that proves to kill the roses, the nursery owner has breached this warranty and has liability to the rose gardener. An exercise enthusiast who relies on an athletic shoe store owner for advice on which particular shoe is appropriate for aerobics also gets the protection of this warranty.

The second basis for product liability lies in tort law. Under the **Restatement of Torts (Section 402A)**, anyone who manufactures or sells a product is liable to the buyer if the product is in a defective condition that makes it unreasonably dangerous. A product can be defective by design, the allegation that Mr. Nader made against GM for its Corvair when he stated that the position of the engine in the rear of the car made it dangerous for the occupants of the car. A product can also be dangerous because of shoddy manufacturing, as when there is a forgotten bolt or a failure to attach a part correctly. Finally, a product can be defective because the instructions or warnings are inadequate. "Do not stand on the top of the ladder," "Do not use this hair dryer near water," and "Not suitable for children under the age of 3" are all examples of warnings that are given to prevent injuries through use of the product.

Tort liability exists even when the manufacturer or seller is not aware of the problem. For example, a prescription drug may cause a reaction in adults who take aspirin. The manufacturer may not have been aware of this side effect, but the manufacturer is still responsible for the harm caused to those who have the reaction. The idea behind strict liability rests in the Senate hearings exchange: manufacturers need to devote enough resources to product development and research to determine that their products are made safely and that risks are discovered and disclosed before consumers are harmed.

The expansion of product liability from just UCC/contract law to tort law also meant that the traditional notion of "privity of contract" was no longer required. *Privity of contract* is a direct contract relationship between parties. Prior to the restatement standard, a buyer would not have a remedy against a manufacturer for its defective product and certainly could not go back to the bolt supplier or to the manufacturer if the bolt in a product turned out to be defective. The effect of strict tort liability is to hold sellers and manufacturers fully accountable for products up and down the supply chain. The defect may begin with a supplier, but the manufacturer and seller are not excused from liability because "someone else did it." Under strict tort liability standards, all companies associated with the design, production, and sale of defective products have responsibility for damages and injuries caused by that product.

Discussion Questions

1. Who are the stakeholders in the question of who should bear the costs of defective products?
2. Relate the discussion of the development of product liability theories for recovery to the regulatory cycle (Reading 3.12).

Case 8.6

Peanut Corporation of America: Salmonella and Indicted Leaders

The Peanut Corporation of America was a supplier of processed peanuts to some of the largest food-production companies in the United States, including ConAgra, a major producer of peanut butter. The company was founded by Hugh Parnell Sr. when he was selling ice cream vending machines in the 1960s. When he was restocking a machine, he noticed that the peanuts on the Nutty Buddy ice cream cones came from a plant in the North. He decided to begin a company that processed peanuts in the South, where they were grown. The company grew with plants in Virginia, Georgia, and Texas. Stewart Parnell entered the business in the 1970s, when he complained to his father that those in his major, oceanography, often ended up working on oil rigs. His father offered him a job, and Stewart left college to begin work in the Virginia facilities. The company's sales grew, and in 1995 the Parnells sold the company to Morvan Partners LLP. Stewart worked as a consultant for the new buyer but bought back the company in 2000.

Peanut Corporation's base was sold to its customers for use in peanut butter, ice cream, cookies, and crackers. Peanut Corporation was known for its cost cutting. When a prospective customer came back with a bid from another peanut product company that was lower, Stewart Parnell, the CEO of Peanut Corporation, would always cut the price by a few cents in order to win over the potential customer.

The price cuts were possible because of cost cutting at the plant. Peanut Corporation paid low wages to temporary workers and offered few benefits programs. E-mails reflect Parnell's concerns about costs. When a salmonella test was positive, Peanut Corporation was required to hold off shipment for a retest. However, in response, Parnell wrote in an e-mail, "We need to discuss this. Beside the cost, this time lapse is costing us $$$$ and causing us obviously a huge lapse from the time when we pick up the peanuts until the time we can invoice."[46] When he was informed that the test results for salmonella were not complete, he also wrote, "Turn them loose."[47] When the FDA made the connection between Peanut Corporation and the salmonella poisonings, Mr. Parnell wrote, "Obviously we are not shipping any peanut butter products affected by the recall but desperately at least need to turn the raw peanuts on the floor into money."[48]

Following the discovery of Peanut Corporation as the source of salmonella in peanut products that were sickening customers in forty-four states, Congress held hearings into Peanut Corporation's operations. Stewart Parnell took the Fifth Amendment when members of the Commerce Committee in the House of Representatives asked him questions about his company.

The peanut product caused 700 illnesses in forty-four states and resulted in nine deaths because of the salmonella that then made its way into peanut butter, peanut butter crackers, and other products that use a peanut base. The company declared Chapter 7 bankruptcy on February 13, 2009.

In 2013, the Department of Justice filed a seventy-six-page indictment against Mr. Parnell, three former managers and a food broker with charges of criminal fraud. The indictment names Mr. Parnell, the former owner of Peanut Corporation; his brother, a former supervisor at the company, who was a food broker at the time

[46] Jane Zhang and Julie Jargon, "Peanut Corp. Emails Cast Harsh Light on Executive," *Wall Street Journal*, February 12, 2009, p. A3.

[47] *Id.*

[48] *Id.*

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salmonella was found in the product; Samuel Lightsey, a plant operator at the company; and the company's former quality-assurance manager, Mary Wilkerson. The indictment alleges that the four engaged in a conspiracy to hide the fact that tests showed the presence of salmonella in the peanut meal, or peanut base, the company's product. The indictment makes the stunning allegation that the group worked together to fabricate test results to show salmonella-free product when salmonella was present.

Experts note that criminal charges in food-poisoning cases are rare because the proof of intent, or *mens rea*, is difficult or impossible to demonstrate when there is a one-time problem. However, as the indictment notes, Mr. Parnell was being notified by customers that his company's product was testing positive, and yet he still continued production without cleaning up the plant. The indictment also alleges that the four who are charged misled FDA inspectors in January 2009, conduct that added obstruction of justice to the charges in the indictment.

Mr. Parnell's lawyer vows to fight the charges and to demonstrate that Mr. Parnell and the others never intentionally shipped tainted product.[49] However, one portion of the indictment includes an e-mail from an employee that the peanut meal containers at the plant (in 2007) were covered with dust and rat feces. Mr. Parnell responded to the employee, "Clean 'em all up and ship them."[50]

Discussion Questions

1. Discuss the theories for imposing liability on Peanut Corp.
2. Are the e-mails admissible as evidence?
3. Mr. Parnell's father, Hugh Parnell Sr. said, "He's being railroaded. Why would anybody send something out that would ruin his own company? It's like an auto dealer sending a car out with no brakes."[51] What defense is he raising for his son?

Sources

Schmidt, Julie, "Peanut President Refuses to Testify," *USA Today*, February 12, 2009, p. 2B.

Zhang, Jane, "Peanut Corp. for Bankruptcy," *Wall Street Journal*, February 14–15, 2009, p. A3.

Case 8.7

Tylenol: The Swing in Product Safety

The Chicago Capsule Poisonings

In 1982, 23-year-old Diane Elsroth died after taking a Tylenol capsule laced with cyanide. Within five days of her death, seven more people died from taking tainted Tylenol purchased from stores in the Chicago area.

At that time, Tylenol generated $525 million per year for McNeil Consumer Products, Inc., a subsidiary of Johnson & Johnson. The capsule form of the pain reliever represented 30 percent of Tylenol sales. McNeil's marketing studies indicated that consumers found the capsules easy to swallow and believed, without substantiation, that Tylenol in capsule form worked faster than Tylenol tablets.

The capsule's design, however, meant they could be taken apart, tainted, and then restored to the packaging without evidence of tampering. After the Chicago poisonings, which were never solved, McNeil and Johnson & Johnson executives were told at a

[49] Sabrina Tavernise, "Charges Filed in Peanut Salmonella Case," *New York Times*, February 22, 2013, p. B6.

[50] From the indictment, http://www.justice.gov/opa/pr/2013/February/13-civ-220.html.

[51] Ilan Bray and Julie Jargon, "Career in Peanuts Began as a Detour From Oceanography," *Wall Street Journal*, Feb. 19, 2009, p. A6.

meeting that processes for sealing the capsules had been greatly improved, but no one could give the assurance that they were tamperproof.

The executives realized that abandoning the capsule would give their competitors, Bristol-Myers (Excedrin) and American Home Products (Anacin), a market advantage, plus the cost would be $150 million just for 1982. Jim Burke, then-CEO of Johnson & Johnson, told the others that without a tamperproof package for the capsules, they would risk the survival of not only Tylenol but also Johnson & Johnson. The executives decided to abandon the capsule.

Frank Young, a Food and Drug Administration (FDA) commissioner, stated at the time, "This is a matter of Johnson & Johnson's own business judgment, and represents a responsible action under tough circumstances."[52]

Johnson & Johnson quickly developed "caplets"—tablets in the shape of a capsule—and then offered consumers a coupon for a bottle of the new caplets if they turned in their capsules. Within five days of the announcement of the capsule recall and caplets offer, 200,000 consumers had responded. Johnson & Johnson had eliminated a key product in its line—one that customers clearly preferred—in the interest of safety. Otto Lerbinger of Boston University's College of Communication cited Johnson & Johnson as a "model of corporate social responsibility for its actions."[53]

President Ronald Reagan, addressing a group of business executives, said, "Jim Burke, of Johnson & Johnson, you have our deepest admiration. In recent days you have lived up to the very highest ideals of corporate responsibility and grace under pressure."[54]

Within one year of the Tylenol poisonings, Johnson & Johnson regained its 40 percent market share for Tylenol. Although many attribute the regain of market share to tamperproof packaging, the other companies had moved to that form as well. However, it is interesting to note that McNeil was able to have its new product and packaging on the shelves within weeks of the fatal incidents. There had been some preparation for the change prior to the fatalities, but the tragedy was the motivation for the change to safer packaging and product forms.

McNeil has continued to enjoy the goodwill from its rapid response to the poisonings as well as its willingness to take the financial hit for what experts believed was a very small risk that more cyanide-laced Tylenol was out on the shelves. In fact, the recall was so indelibly etched in the public's mind and in the minds of those in the field of business ethics that McNeil, Johnson & Johnson, and Tylenol itself were often given free passes on conduct that did pose safety risks to customers. As new issues with Tylenol have developed, McNeil seems to be given the benefit of the doubt because of the goodwill and reputational capital it purchased with the capsule recalls.[55]

Tylenol and Liver Damage

On December 21, 1994, the *Journal of the American Medical Association* (*JAMA*) published the results of a five-and-a-half-year study showing that moderate overdoses of acetaminophen (known most widely by the brand name Tylenol) led to liver damage in 10 patients.[56] The damage occurred even in patients who did not drink and was most pronounced in those who did drink or had not been eating. Further, the study by

[52] "Drug Firm Pulls All Its Capsules off the Market," *(Phoenix) Arizona Republic*, February 18, 1986, p. A2.

[53] Pat Guy and Clifford Glickman, "J & J Uses Candor in Crisis," *USA Today*, February 12, 1986, p. 2B.

[54] "The Tylenol Rescue," *Newsweek*, March 3, 1986, p. 52.

[55] "Legacy of Tampering," *Arizona Republic*, September 29, 1992, p. A1.

[56] "Acetaminophen Overdoses Linked to Liver Damage," *Mesa (Arizona) Tribune*, December 21, 1994, p. A12; and Doug Levy, "Acetaminophen Overuse Can Lead to Liver Damage," *USA Today*, December 22, 1994, p. 1D.

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Dr. David Whitcomb at the University of Pittsburgh Medical School found that taking one pill of acetaminophen per day for a year may double the risk of kidney failure.[57] By 2001, 450 deaths resulted from liver failure due to Tylenol overdoses.

At that time, the American Association of Poison Control Centers called acetaminophen poisonings the most common of all reported poisonings.[58] The number of pediatric poisonings from overdoses of acetaminophen has more than tripled since 1996. As a result, the FDA adjusted the adult and pediatric doses that were acceptable in 2009. However, adult deaths from overexposure are more likely to be the result of suicidal ingestion.

Tylenol is a stunning source of revenue for McNeil and Johnson & Johnson, with revenue totals growing at double-digit rates as Tylenol expands market presence into 5,000 convenience stores with new and smaller packaging of its product and its new formulas, such as Tylenol PM.[59]

Tylenol users who claimed they were victims of overdose and liver damage and the lack of effective warnings have not been successful against Johnson & Johnson.[60] McNeil has modified the recommended dosages, the ad claims, and language on its labels. The product labels before current modification read, "Gentle on an infant's stomach," and Tylenol's ad slogan was "Nothing's safer." That language has been removed, and McNeil added to its infant Tylenol label: "Taking more than the recommended dose … could cause serious health risks" because of liver damage in children.[61]

McNeil also responded to data that showed patients who combine Tylenol with alcohol have produced 200 cases of liver damage in the past twenty years, with fatality in 20 percent of those cases. The level of alcohol use by patients among these cases was multiple drinks every day. McNeil modified its labels to include bold warnings about alcohol use and the dangers of combining Tylenol with any drinking.

Despite the extensive coverage of the issues surrounding Infant Tylenol, Tylenol overdoses, and issues with liver damage from combining alcohol and Tylenol, the company did not experience any loss of market share or even extensive negative media coverage. The goodwill from Tylenol's earlier recall appeared to see it through these crises. However, others issues were emerging.

The Tylenol Quality Control Program

In May 2010, the FDA was considering bringing criminal charges against McNeil for a pattern of violations in its quality control in the production of children's Tylenol. The charges would spring from the April 30, 2010, recall by McNeil of 136 million bottles of liquid pediatric Tylenol, Motrin, Benadryl, and Zyrtec because the medicines contained too much metal debris or too much of the necessary active ingredient in these over-the-counter drugs. Because of the presence of metal debris, the medicine batches failed FDA testing. However, prior to the FDA testing and the recall, there was evidence that McNeil was aware of the developing problem but took no public action. A purchase order that the company turned over to congressional investigators indicated that McNeil had hired a contractor in 2009 to visit 5,000 stores and buy Motrin from the shelves. The contractor's PowerPoint materials instructed employees to act like any other customer

[57] "Second Tylenol Study Links Heavy Use to Kidney Risk," *(Phoenix) Arizona Republic*, December 22, 1994, p. A6.

[58] www.aapcc.com. Accessed June 10, 2010.

[59] Thomas Easton and Stephan Herrera, "J&J's Dirty Little Secret," *Forbes*, January 12, 1998, 42–44.

[60] Deborah Sharp, "Alcohol-Tylenol Death Goes to Trial in Florida," *USA Today*, March 24, 1997, p. 3A.

[61] Richard Cole, "Tylenol Agrees to Warning on Labels of Risk to Children," *Arizona Republic*, October 19, 1997, p. A5.

and make "no mention of this being a recall when making a purchase."[62] McNeil indicated to congressional investigators that "The Motrin Purchase Project" was created by a McNeil subcontractor without its knowledge and approval. McNeil said it notified the FDA about two Motrin lots that did not dissolve properly and that it was removing the Motrin from the shelves.

The evidence submitted for the hearings showed that McNeil had received forty-six complaints from consumers about black particles in Tylenol and other McNeil products. However, McNeil did not notify the FDA, nor did it recall the medicines. The inaction in the face of customer harm represented the straw that broke the FDA's back of tolerance, because the company, at that point, was finishing two years of an ongoing tussle with regulators over quality control. At one plant that manufactured Children's Tylenol, seven batches of product were released after testing revealed problems in three batches. The agency's frustration in dealing with the plants and managers for inaction and ongoing violations led to the review of the company for possible criminal charges.

The surreptitious removal of Motrin from retail stores because McNeil had discovered quality-control problems with that product was referred to by the FDA as, in effect, an unannounced, or "phantom," recall.[63] Also in 2008, McNeil failed to notify the FDA that it had received complaints from customers about a moldy smell in some of the products made in its Puerto Rican production facilities and, at the same time, failed to disclose complaints from customers about stomach problems experienced after they had used the "moldy" products. McNeil tested the products and found no problems, but the complaints continued through 2009. Further testing showed that the medicine had been contaminated by a chemical used in the plant for the treatment of wooden shipping pallets. One member of Congress noted that the recall on the "smell" issue took one year and that it should have taken three days. At another plant, the FDA found that the company "knowingly" used an ingredient that was tainted with *Burkholderia cepacia*, a bacteria that most healthy people can handle, but that can cause serious infections in those with chronic illnesses such as cystic fibrosis.[64] Another member of Congress said of the congressional inquiry, "We are not getting the kind of information and cooperation from Johnson that I would like."[65]

As consumers purchased generic brands to substitute for the recalled Tylenol products, McNeil's sales of Tylenol dropped 55 percent, a loss of $1.4 billion in sales. Its market share dropped to number eight after being at number two, behind only Advil prior to the public disclosure of the issues and the lack of a recall.[66] The FDA and Johnson & Johnson entered into a consent decree that required McNeil to correct the problems that had been discovered in several of the company's plants, including revamping the production and testing requirements that would require independent verification. McNeil terminated several executives, including its vice president for OTC drugs, and restructured the management team as well as the supervisory teams at many of its production facilities.

As a result of the Tylenol issues, the FDA began inspections of other OTC manufacturers that resulted in forty-three letters being sent to OTC drug factories for their failure to correct "shoddy manufacturing practices that may have exposed patients to health

[62] Natasha Singer, "Johnson & Johnson Seen as Uncooperative on Recall Inquiry," *New York Times*, June 11, 2010, pp. B1, B4.

[63] Natasha Singer, "F.D.A. Weighs More Penalties In Drug Recall," *New York Times*, May 28, 2010, p. A1.

[64] Alison Young, "Plant in Recall Had Other Violations," *USA Today*, May 27, 2010, p. 3A.

[65] Natasha Singer, "Johnson & Johnson Seen as Uncooperative on Recall Inquiry," *New York Times*, June 11, 2010, p. B1.

[66] Jonathan D. Rockoff, "J & J Recalls Infants' Tylenol," *Wall Street Journal*, February 18–19, 2012, p. B1.

risks."[67] The letters indicated that FDA inspectors had found insects in equipment and ingredients, improper testing, failure to conduct required tests, and disregard for customer complaints. More than half of the plants inspected had violations, even if those violations did not rise to the level of receiving the agency's letter warning.

In congressional hearings on the issues discovered at McNeil, the House Committee on Oversight and Government Reform chastised McNeil executives: "The information I've seen during the course of our investigation raises questions about the integrity of the company. It paints a picture of a company that is deceptive, dishonest, and has risked the health of many of our children."[68]

In 2012, McNeil suffered another setback when it had to issue a recall for 574,000 bottles of Infant Tylenol due to design defects in the bottles. The recall came shortly after the company had met standards and returned the infant Tylenol to the market. One expert on pharmaceutical marketing noted that restoring consumer confidence is difficult and, "Now, they have another uphill battle."[69]

Discussion Questions

1. Were the shareholders' interests ignored in the decision to take a $150 million write-off and a possible loss of $525 million in annual sales by abandoning the capsules?
2. Suppose that you were a Tylenol competitor. Would you have continued selling your capsules?
3. Was Mr. Burke's action a long-term decision? Did it take into account the interests of all stakeholders? How did Mr. Burke's action help the company with the liver-damage issues? Mr. Burke, who served as Johnson & Johnson's CEO from 1970–1989, died on October 1, 2012. A full-page ad in the *Wall Street Journal* on October 2, 2012, read, "What you taught us will live on, In fond memory of James E. Burke."[70] Have Burke's teachings survived?
4. What can you conclude from the quick development and appearance of the new product line?
5. Following the 2010 misstep, Tylenol's competitors sent out free samples and coupons to Tylenol customers who participated in the Tylenol recall as a way of getting them to try their products. Why would such a campaign at this time result in more sales of their products? What is different about this issue versus the cyanide poisonings? Make a list of the distinctions between the two series of events, including descriptions of company and customer responses.
6. General Robert Wood Johnson, the CEO of Johnson & Johnson from 1932 to 1963, wrote a credo for his company that states the company's first responsibility is to the people who use its products and services; the second responsibility is to its employees; the third, to the community and its environment; and the fourth, to the stockholders.[71] ollow its credo?
7. Why did the company drag its heels on the later recalls? What was the purpose of the phantom contractor and the resulting unannounced recall?
8. Did the company ride the coattails of its recall recognition from the 1987 poisonings for too long? Was hubris involved?
9. A lawyer who represents clients suing McNeil offered the following observations: "It [McNeil] markets itself as a company that takes children's safety very seriously and that's why they can charge a premium price for the Tylenol. People are willing to pay a premium price because of a reputation for safety. Now they're being deceived."[72] Another lawyer who represents companies before the FDA added, "The value of the brand is such that that's got to be the first thought."[73] What thoughts are the lawyers offering on cost analysis in ethical issues through their experiences and observations?

[67] Alison Young, "FDA Warns 43 Drug Manufacturers," *USA Today*, May 27, 2010, p. 3A.

[68] Mina Kimes, "Why J & J's Headache Won't Go Away," *Fortune*, September 6, 2010, p. 100.

[69] *Id.*

[70] *Wall Street Journal*, October 2, 2012, p. A7.

[71] "Brief History of Johnson & Johnson," company pamphlet, 1992.

[72] Carrie Levine, "Tylenol's Growing Headache," *National Law Journal*, June 7, 2010, p.A1.

[73] *Id.*

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Case 8.8

Merck and Vioxx

A Company with a Rich History and Excellent Reputation

Merck was founded as a chemical manufacturer in Germany in 1668. Run by the Merck family for generations, the company moved to the United States in 1891 under the direction of George Merck. George Merck Jr. once said, "We try never to forget that medicine is for the people. It is not for the profits. The profits follow, and if we have remembered that, they have never failed to appear."

Merck continued as a chemical manufacturer until the 1930s, when it began to do research and development (R&D) in pharmaceuticals. Two mergers, one in 1953 with Sharp & Dohme, a pharmaceutical firm, and another with Medco, a prescription benefits management company, found Merck leaving its chemical production roots and moving exclusively to producing and selling pharmaceuticals.

With this focus, Merck—still headquartered in New York, where George Merck originally located the German chemical company after coming to the United States—has 100,000 employees in ninety-six plants in 120 countries. A merger with Schering-Plough increased the number of employees from 73,000 in 2008 to the 100,000 figure at the end of 2009. There are thirty-one Merck pharmaceutical factories around the world, and Merck sells its drugs in over 200 countries.

Merck has long been known as a responsible and generous corporation. Merck was named one of *Fortunes* "Most Admired Companies in America" for seven years during the 1980s. In 2004, *Business Ethics* named Merck one of its Top 100 Most Ethical Companies in America. Merck has donated billions in AIDS and river blindness drugs, particularly in Africa. Its scientists have focused on R&D related to disease and prevention in undeveloped countries. Its name carries tremendous goodwill around the world. Its drugs for treating high cholesterol levels, osteoporosis, and hypertension have proven to be lifesavers for billions around the world.

The Lackluster Performance and New Drug with Promise and Perils

Despite, however, Merck's excellent philanthropic reputation, analysts were disgruntled during the 1990s over Merck, its performance, and its promise. One analyst concluded, "Merck is living in the past."[74] Merck had launched six new drugs, but its patent exclusivity had expired on five of its drugs. Another analyst expressed dismay that such a grand company had slipped so far from its once impeccable gold standard of achievement in sales and R&D.

In 1994, Merck's R&D program discovered Vioxx (its generic name is rofecoxib), one of a group of COX-2 inhibitors. COX-2 inhibitors include over-the-counter (OTC) medications such as Advil (ibuprofen) and Aleve (naproxen) that serve to reduce both pain and inflammation. COX-2 inhibitors are particularly effective for arthritis pain relief without the side effects that come with the use of steroids for treatment of the aches, pains, stiffness, and swelling of arthritis. Other nonsteroidal medications for these symptoms produce the undesirable side effects of gastrointestinal bleeding and stomach ulcers. Vioxx actually helped with stomach ulcers and curbed intestinal bleeding.

From 1994 through 1999, Merck navigated the Food and Drug Administration (FDA) approval process, one that has incremental steps for approval. The Phase 1 test for an experimental drug requires that the medication be given to 20 to 100 patients and be

[74] "Merck: Will They Survive Vioxx?" *Fortune*, November 1, 2004, pp. 91, 92, 94.

administered over a period of months. This basic and limited testing is for safety issues, and about 70 percent of all drugs make it through the Phase 1 test. Once the initial test is complete, Phase 2 begins. Phase 2 is testing for the effectiveness of the drug, as well as its safety. The number of patients in Phase 2 is 200 to 300, and a Phase 2 screening can take months or up to two years. About 33 percent of the drugs that make it to Phase 2 pass. The final phase, Phase 3, requires 300 to 5,000 patients in a process that will run from one to four years, depending upon the nature of the drug and the type of medical issue it addresses.[75] Phase 3 tests for dosage as well as safety and effectiveness. Only 25 to 30 percent of the drugs that go through Phase 3 make it through for approval for sale to the public. During the Phase 3 trial, in 1997, Dr. Alise Reicin, a Merck physician and scientist, wrote in an e-mail to a fellow Merck scientist on her discovery of "C.V. events" (cardiovascular effects of Vioxx) and her concern about a setback, "I just can't wait to be the one to present those results to senior management." Those study results were not disclosed to the FDA. The FDA would not become aware of them until 2001.

Vioxx made it through all of the phases, and in May 1999 sales of Vioxx began in the United States, complete with ads featuring former Olympic ice skater Peggy Fleming, who endorsed the product as effective for her arthritis pain. Vioxx had competition from Pfizer's Celebrex and Bextra, as well as OTC products such as Advil and Tylenol, Arthritic Formula.

Questions Arise

In 2001, then–Merck CEO Ray Gilmartin received an eight-page letter from the FDA about a Vioxx study and the FDA's concerns about Merck's lack of disclosure of the information from the studies to the public (through its media campaigns for the drug) and to doctors prescribing the drug.[76] A study that would come to be referred to as "the Cleveland study" concluded that Vioxx users were at five times greater risk for a heart attack than those who used just naproxen (Aleve being the OTC example). An excerpt from the letter appears below:

> Additionally, your claim in the press release that "Vioxx has a favorable cardiovascular safety profile," is simply incomprehensible, given the rate of MI [myocardial infarction, or heart attack] and serious cardiovascular events compared to naproxen.[77]

The press release referenced in the FDA letter was one made by Merck after the Cleveland studies went public and was titled "Merck Confirms Favorable Cardiovascular Safety Profile of Vioxx." Merck described Vioxx as "heart protective."

After the Cleveland study became public in 2001, several class action lawsuits were filed on behalf of Vioxx users around the country. The plaintiffs in the cases were surviving relatives of Vioxx patients who had experienced fatal heart attacks or patients who were suffering from heart disease or recovering from heart attacks.

Following the release of the 2001 study, Merck's sales force began to experience questions about Vioxx and cardiovascular events (CVEs). The following are excerpts from Merck's training materials for its sales force:

- "Obstacles": reference for negative CVE data on Vioxx; used in videotaped sales training for Merck sales reps
- "Dodgeball": term used to describe what sales reps should do when asked questions about CVEs and Vioxx and medical data

[75] With chronic illness drugs, such as anticancer drugs, the tests run longer because of issues of relapse.

[76] Barbara Martinez, "Vioxx Lawsuits May Focus on FDA Warning in 2001," *Wall Street Journal*, October 5, 2004, pp. B1 and B4.

[77] *Id.*

In April 2002, Merck added to its Vioxx bottle labels that warned of a risk of cardiovascular and stroke events. All scientists agreed that there was no elevated risk until patients took Vioxx for at least eighteen months.[78]

By 2000, with Vioxx taking off with its approval and fast first sales, Merck's stock would peak at $95 per share. By 2003, Vioxx had proved to be a winner. Vioxx sales totaled $2.5 billion, or 11 percent of the company's total revenue. Vioxx's contribution to net income was $1.2 billion, or 18 percent.

However, after the Vioxx approval in 1999, Merck realized, in early 2000, that Vioxx might have other potential uses. Merck commissioned a study to determine whether Vioxx had additional efficacy in treating colon polyps. The study was monitored by a safety committee of Merck employees as well as outside scientists, which one Merck scientist described as "50% scientific need and 50% appearance."[79] Two of the outside scientists on the committee had continuing consulting arrangements with Merck. The outside committee continued to meet to monitor the polyps study. At the committee meeting in September 2003, the minutes reflect a discussion of the findings of the ongoing studies that concluded that Vioxx users had a 20 percent higher risk of a heart attack or stroke. The study continued, with the numbers climbing to 40 percent, then 80 percent, and finally 120 percent by the data shown to the committee in September 2004.[80]

In May 2004, the medical journal *Circulation* was in the process of preparing an article for publication that highlighted the serious CV effects of Vioxx. One of the authors of the study, Dr. Carolyn C. Cannuscio, was a Merck scientist. Although the editor was unaware of the change, Dr. Cannuscio's name was removed from the study prior to publication of the article. No one at the journal was certain how her name, which was on the paper at the time of its submission for review, was removed from the article during the course of its production, after its acceptance for publication.[81] Merck indicated, through a spokesperson, "Merck disagreed with the conclusions and didn't think it was appropriate to have a Merck author."[82] The study concluded that Vioxx users had an elevated risk of myocardial infarction. Dr. Cannuscio said that she requested that her name be removed because people would conclude, with her name on it, that Merck agreed with the study. One scientist commented that Merck missed the boat on the name removal: "They missed a wonderful opportunity to get some good publicity for the pharmaceutical industry."[83]

When asked about these minutes and numbers, Merck spokeswoman Joan Wainwright would explain in 2004, "Those percentages are based on very small numbers of events."[84] She also indicated that the outside committee had concluded that those numbers were not statistically significant when compared with events in the placebo group. Ms. Wainwright's description is correct according to the minutes of the meetings. Although the committee discussed the numbers, issues, and concerns, no dissent arose in their decision to continue with the testing and do so without disclosure.

When the conduct of the safety committee was reviewed, outside scientists felt that the committee was just doing what scientists do in these clinical trials. "Sometimes you see something significant, and then it goes away," so disclosure is delayed.[85]

[78] Andrea Peterson, "Putting Side Effects in Perspective," *Wall Street Journal*, October 5, 2004, p. D1.

[79] *Id.*

[80] *Id.*

[81] Thomas M. Burton, "Merck Takes Author's Name off Study," *Wall Street Journal*, May 18, 2004, p. B1.

[82] *Id.*

[83] *Id.*

[84] *Id.*

[85] *Id.*

Dr. David Bjorkman, one of the outside scientists on the committee, indicated that he had received, at most, $20,000 as a Merck consultant. Cardiologist Dr. Martin Konstam, another scientist on the panel, had conducted research with Merck employees on CVEs and Vioxx and was the lead author on an article that appeared in the medical journal *Circulation.* The article, which had been published in 2001, concluded that there was "no evidence for an excess of cardiovascular effects of Vioxx."[86] The article was critical of a study that had appeared two months earlier in the *Journal of the American Medical Association* (*JAMA*) that warned of the CVEs of Vioxx.

When the number 120 percent appeared at the September 2004 safety committee meeting, the committee warned the company, and the company stopped selling Vioxx and issued a recall of the drug.[87] R&D head Dr. Peter Kim said, "I am proud that we did the right thing."[88]

The Impact of Vioxx CV Effects

Upon the announcement of the Vioxx recall, Merck's shares dropped from $45.07 to $33 in one day.[89] Even after the recall, Moody's and Standard & Poor's kept Merck's Triple-A bond rating. Analysts estimate that Merck has, easily, $10 billion in highly liquid assets, more than enough to manage the crisis.[90] Most analysts place the final tally for the litigation at $10 billion.

The estimate of fatal and nonfatal heart attacks in Vioxx users since 1999 is 140,000. By the time of the recall, 20 million Americans had used Vioxx. In early 2005, Merck announced the creation of a $675 million reserve for handling both the recall-refund program and the pending litigation.[91] There were 625 lawsuits, including class action suits, filed against the company by February 2005. Also in February 2005, the SEC announced that it was opening an investigation into Merck's disclosures about Vioxx and its safety in the company's 10-K's and periodic filings. The Justice Department subpoenaed company records on the handling of the warnings and disclosures related to Vioxx. Congress opened hearings in February 2005 into the role of the FDA in the Vioxx issues. In May 2005, the Merck board replaced CEO Gilmartin with Richard Clark.[92] At the time, its stock price had dipped below $25.

The jury verdicts in the cases have been split—50 percent finding for Merck, and 50 percent for the plaintiffs. Verdicts in four of the eight cases decided through November 2007 totaled $39.75 million. Merck's strategy for the suits was to ensure that the suits were not grouped together as one class action. Merck's lawyers reasoned that, because the Vioxx users were so different in age, health, and heart conditions, there would be different verdicts because not all of the health issues or deaths could be attributed to Vioxx. Merck achieved a major victory in September 2007 when the New Jersey Supreme Court ruled that a group of Vioxx plaintiffs could not be certified for purposes of a consumer fraud class action.[93] The judge found, as Merck had reasoned, that the plaintiffs

[86] *Id.*

[87] Barnaby J. Feder, "Merck's Actions on Vioxx Face Scrutiny," *New York Times*, February 15, 2005, p. C1.

[88] "Merck: Will They Survive Vioxx?" pp. 91, 92.

[89] David Henry, "Market Lessons from Merck's Decline," *BusinessWeek*, October 18, 2004.

[90] "Merck: Will They Survive Vioxx?" pp. 91, 92.

[91] Feder, "Merck's Actions on Vioxx Face Scrutiny," pp. C1, C4.

[92] Barbara Martinez and Joann A. Lublin, "Merck Replaces Embattled CEO with Insider Richard Clark," *Wall Street Journal*, May 6, 2005, p. A1.

[93] *International Union of Operating Engineers Local No. 68 Welfare Fund v. Merck & Co., Inc.*, 929 A.2d 1076 (N.J. 2007)

were very different in age, in health, and in terms of preexisting health conditions. However, the case-by-case strategy proved expensive, and the legal bills remained steep.

In November 2007, Merck was able to settle the lawsuits brought against it by patients who used Vioxx. Merck pulled the antiarthritis drug completely from the market in September 2004 after evidence surfaced that use of the drug was tied to a higher risk of heart attack and stroke. At the time, 26,600 cases were pending against Merck. The cases had not been consolidated into one class action.

Merck's legal strategy had been one of fighting each of the cases independently. Merck announced a $1.9 billion set aside for defending the legal cases, and, as of November 2007, had spent $1.2 billion of that amount. With litigation costs mounting, Merck made the decision to settle the cases. The biggest problem with such massive settlements is the ability of plaintiffs to opt out of the settlement and pursue litigation. Merck was trying to avoid what happened to Wyeth when it settled its suits on the diet drug fen-phen. The suits were settled for $3.75 billion, but so many fen-phen users opted out that Wyeth ended up with a total payout of $21 billion. Merck negotiated limits on who could opt out, especially with regard to statutes of limitation for suits by those who opt out.

Merck's share price climbed 2.1 percent, or $1.13, when, in 2007, the settlement of $4.85 billion was announced.[94]

Discussion Questions

1. Applying the background on the law for product liability, why do you think some jurors found Merck liable? Applying the law again, why do you think some found the company not liable?
2. List the facts that work in Merck's favor in terms of being forthright. List the facts that work against Merck. Compare the lists, and offer suggestions on what Merck might have done differently in handling Vioxx issues.
3. Describe other ethical issues you see arising peripherally in this case.

Compare & Contrast

Since the Merck Vioxx experience, several pharmaceutical firms have voluntarily withdrawn many of their drugs when the smallest question arises, even just a negative reaction in one patient. Why the quick reaction by these companies? What analyses are they performing that are perhaps different from the one Merck performed with Vioxx? What general lessons could pharmaceutical firms take from the Vioxx experience?

Case 8.9

Ford and Its Pinto and GM and Its Malibu: The Repeating Exploding Gas Tank Problem

The Ford Pinto

In 1968, Ford began designing a subcompact automobile that ultimately became the Pinto. Lee Iacocca, then a Ford vice president, conceived the idea of a subcompact car and was its moving force. Ford's objective was to build a car weighing 2,000 pounds or less to sell for no more than $2,000. At that time, prices for gasoline were increasing, and

[94] Heather Won Tesoriero, Sarah Rubenstein, and Jamie Heller, "Vioxx Settlement for $4.85 Billion Large Vindicates Merck's Tactics," *Wall Street Journal*, November 10–11, 2007, pp. Al, A5; Alex Berenson, "Analysts See Merck Victory in Vioxx Deal," *New York Times*, November 10, 2007, pp. A1, Al2; and "Merck Agrees to $4.85B Settlement over Vioxx," *National Law Journal*, September 12, 2007, p. 3.

the American auto industry was losing competitive ground to the small vehicles of Japanese and German manufacturers.

The Rushed Project

The Pinto was a rush project. Ordinarily, auto manufacturers work to blend the engineering concerns with the style preferences of consumers that they determine from marketing surveys. As a result, the placement of the Pinto fuel tank was dictated by style, not engineering. The preferred practice in Europe and Japan was to locate the gas tank over the rear axle in subcompacts because a small vehicle has less “crush space” between the rear axle and the bumper than larger cars.[95] The Pinto’s styling, however, required the tank to be placed behind the rear axle, leaving only nine to ten inches of “crush space”—far less than in any other American automobile or Ford overseas subcompact. In addition, the Pinto’s bumper was little more than a chrome strip, less substantial than the bumper of any other American car produced then or later. The Pinto’s rear structure also lacked reinforcing longitudinal side members, known as “hat sections,” and horizontal cross members running between them, such as those in larger cars produced by Ford. The result of these style-driven changes was that the Pinto was less crush-resistant than other vehicles. An additional problem was that the Pinto’s differential housing had an exposed flange and bolt heads. These resulting protrusions meant that a gas tank driven forward against the differential by a rear impact would be punctured.[96]

Pinto prototypes were built and tested. Ford tested these prototypes, as well as two production Pintos, to determine the integrity of the fuel system in rear-end accidents. It also tested to see whether the Pinto would meet a proposed federal regulation requiring all automobiles manufactured in 1972 to be able to withstand a 20-mile-per-hour fixed-barrier impact and those made after January 1, 1973, to withstand a 30-mile-per-hour fixed-barrier impact without significant fuel spillage.[97]

The crash tests revealed that the Pinto’s fuel system as designed could not meet the proposed 20-mile-per-hour standard. When mechanical prototypes were struck from the rear with a moving barrier at 21 miles per hour, the fuel tanks were driven forward and punctured, causing fuel leakage in excess of the proposed regulation standard. A production Pinto crashing at 21 miles per hour into a fixed barrier resulted in the fuel neck being torn from the gas tank and the tank being punctured by a bolt head on the differential housing. In at least one test, spilled fuel entered the driver’s compartment through gaps resulting from the separation of the seams joining the rear wheel wells to the floor pan.

Other vehicles Ford tested, including modified or reinforced mechanical Pinto prototypes, proved safe at speeds at which the Pinto failed. Vehicles in which rubber bladders had been installed in the tank and were then crashed into fixed barriers at 21 miles per hour had no leakage from punctures in the gas tank. Vehicles with fuel tanks installed above rather than behind the rear axle passed the fuel system integrity test at 31 miles per hour against a fixed barrier. A Pinto with two longitudinal hat sections added to firm up the rear structure passed a 20-mile-per-hour fixed-barrier test with no fuel leakage.[98]

[95] Rachel Dardis and Claudia Zent, “The Economics of the Pinto Recall,” *Journal of Consumer Affairs* (Winter 1982), pp. 261–277.

[96] *Id.*

[97] *Id.*

[98] *Grimshaw v. Ford Motor Co.*, 174 Cal. Rptr. 378 (1981).

The vulnerability of the Pinto's fuel tank at speeds of 20 and 30 miles per hour in fixed-barrier tests could have been remedied inexpensively, but Ford produced and sold the Pinto without doing anything to fix the defects. Among the design changes that could have been made were side and cross members at $2.40 and $1.80 per car, respectively; a shock-absorbent "flak suit" to protect the tank at $4; a tank within a tank and placement of the tank over the axle at $5.08 to $5.79; a nylon bladder within the tank at $5.25 to $8; placement of the tank over the axle surrounded with a protective barrier at $9.59 per car; imposition of a protective shield between the differential housing and the tank at $2.35; improvement and reinforcement of the bumper at $2.60; and addition of eight inches of crush space at a cost of $6.40. Equipping the car with a reinforced rear structure, smooth axle, improved bumper, and additional crush space at a total of $15.30 would have made the fuel tank safe when hit from the rear by a vehicle the size of a Ford Galaxy. If, in addition, a bladder or tank within a tank had been used or if the tank had been protected with a shield, the tank would have been safe in a rear-end collision of 40 to 45 miles per hour. If the tank had been located over the rear axle, it would have been safe in a rear impact at 50 miles per hour or more.[99]

Engineering Doubts

As the Pinto approached actual production, the engineers responsible for the components of the project "signed off" to their immediate supervisors, who in turn "signed off" to their superiors, and so on up the chain of command until the entire project was approved for release by the lead engineers, and ultimately, Iacocca. These decision makers knew the Pinto crash test results when they decided to go forward with production.

At an April 1971 product review meeting, a report by Ford engineers on the financial impact of a proposed federal standard on fuel-system integrity and the cost savings that would accrue from deferring even minimal "fixes" of the Pinto was discussed.

In 1969, the chief assistant research engineer in charge of cost-weight evaluation of the Pinto and the chief chassis engineer in charge of crash testing the early prototype both expressed concern about the integrity of the Pinto's fuel system and complained about management's unwillingness to deviate from the design if the change would cost money.

J. C. Echold, Ford's director of automotive safety, studied the issue of gas-tank design in anticipation of government regulations requiring modification. His study, "Fatalities Associated with Crash Induced Fuel Leakage and Fires," included the following cost-benefit analysis:

> The total benefit is shown to be just under $50 million, while the associated cost is $137 million. Thus, the cost is almost three times the benefits, even using a number of highly favorable benefit assumptions.[100]
>
> **Benefits**
>
> Savings—180 burn deaths, 180 serious burn injuries, 2,100 burned vehicles Unit cost—$200,000 per death, $67,000 per injury, $700 per vehicle Total benefits—(180 × $200,000) + (180 × $67,000) + (2,100 × $700) = $49.15 million Costs
>
> - Sales—11 million cars, 1.5 million light trucks
> - Unit cost—$11 per car, $11 per truck
> - Total costs—(11,000,000 x $11) + (1,500,000 x $11) = $137 million

[99] *Id.*

[100] Ralph Drayton, "One Manufacturer's Approach to Automobile Safety Standards," *CTLA News*, February 8, 1968, p. 11.

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TABLE 8.1

Ford's Unit Cost of $200,000 for One Life

Component	1971 Costs ($)
Future productivity losses	
Direct	132,000
Indirect	41,300
Medical costs	
Hospital	700
Other	425
Property damage	1,500
Insurance administration	4,700
Legal and court	3,000
Employer losses	1,000
Victim's pain and suffering	10,000
Funeral	900
Assets (lost consumption)	5,000
Miscellaneous accident cost	200
Total per family	$200,725

Source: Mark Dowie, "Pinto Madness," *Mother Jones,* September/October 1977, p. 28.

Ford's unit cost of $200,000 for one life was based on a National Highway Traffic Safety Administration calculation developed as shown in Table 8.1.

Despite the concerns of the engineers and the above report, Ford went forward with production of the Pinto without any design change or any of the proposed modifications. Shortly after the release of the car, significant mechanical issues were recurring, with complaints by vehicle owners, as well as a number of fiery rear-end collisions. One of the most public cases happened in 1971, when the Gray family purchased a 1972 Pinto hatchback (the 1972 models were made available in the fall of 1971) manufactured by Ford in October 1971. The Grays had trouble with the car from the outset. During the first few months of ownership, they had to return the car to the dealer for repairs a number of times. The problems included excessive gas and oil consumption, downshifting of the automatic transmission, lack of power, and occasional stalling. It was later learned that the stalling and excessive fuel consumption were caused by a heavy carburetor float.

The Accidents and Injuries

On May 28, 1972, Mrs. Gray, accompanied by 13-year-old Richard Grimshaw, set out in the Pinto from Anaheim, California, for Barstow to meet Mr. Gray. The Pinto was then 6 months old and had been driven approximately 3,000 miles. Mrs. Gray stopped in San Bernardino for gasoline, then got back onto Interstate 15 and proceeded toward Barstow at 60 to 65 miles per hour. As she approached the Route 30 off-ramp where traffic was congested, she moved from the outside fast lane into the middle lane. The

Pinto then suddenly stalled and coasted to a halt. It was later established that the carburetor float had become so saturated with gasoline that it sank, opening the float chamber and causing the engine to flood. The driver of the vehicle immediately behind Mrs. Gray's car was able to swerve and pass it, but the driver of a 1962 Ford Galaxy was unable to avoid hitting the Pinto. The Galaxy had been traveling from 50 to 55 miles per hour but had slowed to between 28 and 37 miles per hour at the time of impact.[101]

The Pinto burst into flames that engulfed its interior. According to one expert, the impact of the Galaxy had driven the Pinto's gas tank forward and caused it to be punctured by the flange or one of the bolts on the differential housing so that fuel sprayed from the punctured tank and entered the passenger compartment through gaps opening between the rear wheel well sections and the floor pan. By the time the Pinto came to rest after the collision, both occupants had been seriously burned. When they emerged from the vehicle, their clothing was almost completely burned off. Mrs. Gray died a few days later of congestive heart failure as a result of the burns. Grimshaw survived only through heroic medical measures. He underwent numerous and extensive surgeries and skin grafts, some occurring over the ten years following the collision. He lost parts of several fingers on his left hand and his left ear, and his face required many skin grafts.[102]

As Ford continued to litigate Mrs. Gray's lawsuit and thousands of other rear-impact Pinto suits, damages reaching $6 million had been awarded to plaintiffs by 1980. In 1979, Indiana filed criminal charges against Ford for reckless homicide.

Discussion Questions

1. Calculate the total cost if all the "fixes" for the Pinto gas tank problem had been performed.
2. What was management's position on the fixes?
3. Using the decision models you have learned, list some of the analysis questions and issues management missed in making its decision to go forward with production without any design changes.
4. Don't all automobiles present the potential for injuries? Do we assume risks in driving and buying an automobile?
5. If you had been one of the engineers who were concerned, what would you have done differently? Do you think there was anything you could do? What if you resigned, as Dr. LiCari at Beech-Nut did (Case 4.29)? Could you then notify a government agency?

Compare & Contrast

In 1996, Ford issued a recall on 8.7 million vehicles because a joint investigation with the National Highway Traffic Safety Administration (NHTSA) revealed that the ignition in certain cars could short-circuit and cause a fire. Ford ran full-page ads in major newspapers. The ad from the *Wall Street Journal* (May 8, 1996, p. B7) is reproduced below:

T.J. Wagner Ford Motor Company
Vice President Dearborn, MI 48121

Customer Communication & Satisfaction

To Our Ford, Lincoln and Mercury Owners:

As I am sure you have read, Ford Motor Company recently announced a program to voluntarily recall 8.7 million vehicles to replace ignition switches. You should know that at the time we announced the

[101] "Who Pays for the Damage?" *Time*, January 21, 1980, p. 61.

[102] Adapted from *Grimshaw v. Ford Motor Co.*, 174 Cal. Rptr. 348 (1981).

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> recall, the actual number of complaints which may be related to the ignition switch in question was less than two hundredths of one percent of that total. We regret the inconvenience this has caused the customers who have placed their trust in our products.
>
> Q: What happened?
>
> A: *Following an intensive investigation in cooperation with the U.S. National Highway Traffic Safety Administration and Transport Canada, we determined that the ignition switch in a very small percentage of certain models could develop a short circuit—creating the potential for overheating, smoke, and possibly fire in the steering column of the vehicle. The factors that contribute to this are a manufacturing process change to the ignition switch in combination with the electrical load through the switch.*
>
> Q: What should I do?
>
> A: *If you own one of these vehicles, you will receive a letter from us instructing you to take your vehicle to the Ford or Lincoln/Mercury dealer of your choice and have the switch replaced free of charge. However, you do not have to wait for our letter. You may contact your dealer and arrange to have the switch replaced immediately if you choose, free of charge.*
>
> Q: How long will it take?
>
> A: *The repair procedure should take about one hour. But please contact your dealer in advance to schedule a time that is convenient for you.*
>
> Q: What if I need additional help?
>
> A: *You may contact your dealer anytime, or call our Ford Ignition Switch Recall Customer Information Line at 1-800-323-8400.*
>
> We're in business because people believe in our products. We make improvements because we believe we can make our products better. And at times we'll take a major step like this to make sure that people who buy a Ford, Lincoln or Mercury vehicle know that they bought more than a vehicle, they bought a company and a dealer organization that stands behind the cars and trucks they build and sell. This is our Quality is Job 1 promise to you. Thank you for your patience and support.

What was different about Ford's conduct in this case? Has Ford had an ethical cultural change on product safety? Why did Ford voluntarily agree to fix almost 9 million vehicles?

The Chevrolet [GM] Malibu

On July 9, 1999, a Los Angeles jury awarded Patricia Anderson, her four children, and her friend, Jo Tigner, $107 million in actual damages and $4.8 billion in punitive damages from General Motors in a lawsuit the six brought against GM because they were trapped and burned in their Chevrolet Malibu when it exploded on impact following a rear-end collision.[103]

Jury foreman Coleman Thorton, in explaining the large verdict, said, "GM has no regard for the people in their cars, and they should be held responsible for it." Richard Shapiro, an attorney for GM, said, "We're very disappointed. This was a very sympathetic case. The people who were injured were innocent in this matter. They were the victims of a drunk driver."[104]

The accident occurred on Christmas Eve 1993 and was the result of a drunk driver striking the Andersons' Malibu at 70 miles per hour. The driver's blood alcohol level

[103] Ann W. O'Neill, Henry Weinstein, and Eric Malnic, "Jury Orders GM to Pay Record Sum," *Arizona Republic*, July 10, 1999, pp. A1, A2.

[104] *Id.*

was .20, but the defense lawyers noted they were not permitted to disclose to the jury that the driver of the auto that struck the Malibu was drunk.

The discovery process in the case uncovered a 1973 internal "value analysis" memo on "post-collision fuel-tank fires" written by a low-level GM engineer, Edward C. Ivey, in which he calculated the value of preventing fuel-fed fires. Mr. Ivey used a figure of $200,000 for the cost of a fatality and noted that 500 fatalities occur per year in GM auto-fuel fire accidents. The memo also stated that his analysis must be read in the context of how "it is really impossible to put a value on human life." Mr. Ivey wrote, using an estimate of $200,000 as the value of human life, that the cost of these explosions to GM would be $2.40 per car. After an in-house lawyer discovered the memo in 1981, he wrote,

> Obviously Ivey is not an individual whom we would ever, in any conceivable situation, want identified to the plaintiffs in a post-collision fuel-fed fire case, and the documents he generated are undoubtedly some of the potentially most harmful and most damaging were they ever to be produced.[105]

In the initial cases brought against GM, the company's defense was that the engineer's thinking was his own and did not reflect company policy. However, when the 1981 lawyer commentary was found as part of discovery in a Florida case in 1998, GM lost that line of defense. In the Florida case in which a 13-year-old boy was burned to death in a 1983 Oldsmobile Cutlass station wagon, the jury awarded his family $33 million.

The two documents have become the center of each case. Judge Ernest G. Williams of Los Angeles Superior Court, who upheld the verdict in the $4.9 billion Los Angeles case but reduced the damages, wrote in his opinion,

> The court finds that clear and convincing evidence demonstrated that defendants' fuel tank was placed behind the axle of the automobiles of the make and model here in order to maximize profits—to the disregard of public safety.[106]

As of 2006, class action lawsuits were still pending around the country. The suits center on GM's midsize "A-cars," which include the Malibu, Buick Century, Oldsmobile Cutlass, and Pontiac Grand Prix. Approximately 7.5 million cars are equipped with this gas-tank design. On appeal, the Los Angeles verdict was, as mentioned above, reduced from $4.9 billion (total) to $1.2 billion.[107]

Discussion Questions

1. Why do you think the drunk driver was not held responsible for the Los Angeles accident?
2. If you had found the 1973 memo, what would you have done with it?
3. What happens over time when memos such as this engineer's discussion are concealed?
4. What did the GM managers miss in ignoring the engineer's concerns? Why do you think they said he was acting on his own? If an employee writes a memo about the company's product, is the employee ever acting on his or her own?
5. Offer some general lessons from these two cases for business managers and for yourself when you enter the business world.
6. The National Highway Traffic Safety Administration (NHTSA) asked the Chrysler Corporation in 2013 to recall 2.7 million Jeeps because the vehicles are likely to catch on fire in rear-end

[105] Milo Geyelin, "How an Internal Memo Written 26 Years Ago Is Costing GM Dearly," *Wall Street Journal*, September 29, 1999, pp. A1, A6.

[106] *Id.*

[107] Margaret A. Jacobs, "BMW Decision Used to Whittle Punitive Awards," *Wall Street Journal*, September 13, 1999, p. B2.

collisions. The issue was whether the placement of the fuel tank behind the rear axle makes the Jeep more susceptible to fires in a rear-end crash. The NHTSA studies indicate that the rate of fatal rear-end collisions involving fires was double the rate for other sports utility vehicles.

Initially, Chrysler refused to do the recall and responded as follows:

> These vehicles met and exceeded all applicable requirements of the Federal Motor Vehicle Safety Standards, including FMVSS 301, pertaining to fuel-system integrity. Our analysis shows the incidents, which are the focus of this request, occur less than once for every million years of vehicle operation. This rate is similar to comparable vehicles produced and sold during the time in question.
>
> Chrysler Group stands behind the quality and safety of its vehicles. It conducts voluntary recalls when they are warranted, and in most cases, before any notice or investigation request from NHTSA.[108]

Following a meeting with the NHTSA, Chrysler reversed its position and agreed to a recall of most of the vehicles (1.56 million of the original 2.7 demanded by NHTSA).[109] The recall will involve installing a towing hitch on the cars, something that puts more metal between the back of the car and the gas tank. The proposed fix is much cheaper than other proposals for fixing the gas-tank issue. Why did Chrysler reverse its position?

Case 8.10

E. Coli, Jack-in-the-Box, and Cooking Temperatures

On January 11, 1993, young Michael Nole and his family ate dinner at a Jack-in-the-Box restaurant in Tacoma, Washington, where Michael enjoyed his $2.69 "Kid's Meal." The next day, Michael was admitted to Children's Hospital and Medical Center in Seattle with severe stomach cramps and bloody diarrhea. Several days later, Michael died of kidney and heart failure.[110]

At the same time, 300 other people in Idaho, Nevada, and Washington who had eaten at Jack-in-the-Box restaurants were poisoned with *E. coli* bacteria, the cause of Michael's death. By the end of the outbreak, more than 600 people nationwide were affected.[111]

Jack-in-the-Box, based in San Diego, California, was not in the best financial health, having just restructured $501 million in debt. The outbreak of poisonings came at a difficult time for the company. However, the company was also at the beginning of what was proving to be an effective ad campaign with the introduction of "Jack," the executive with a white, spherelike head and clown features. The company was making inroads in the market shares of Burger King and Wendy's.

Federal guidelines require that meat be cooked to an internal temperature of 140 degrees Fahrenheit. Jack-in-the-Box followed those guidelines. In May 1992 and September 1992, the state of Washington notified all restaurants, including Jack-in-the-Box, of new regulations requiring hamburgers to be cooked to 155 degrees Fahrenheit. The change would increase restaurants' costs because cooking to 155 degrees slows delivery of food to customers and increases energy costs.

[108] "Chrysler Group LLC Responds to NHTSA Recall Letter," June 4, 2013, http://media.chrysler.com/newsrelease.do;jsessionid=77FE163183E69ED0BFEA929E8335D391?&id=14371&mid=2.

[109] Christina Rogers, "Chrysler Recalls 1.56 Million Jeeps," *Wall Street Journal*, June 19, 2013, p. B3.

[110] Catherine Yang and Amy Barrett, "In a Stew over Tainted Meat," *BusinessWeek*, April 12, 1993, p. 36.

[111] Fred Bayles, "Meat Safety," *USA Today*, October 8, 1997, p. 1A.

At a news conference one week after the poisonings, Jack-in-the-Box president Robert J. Nugent criticized state authorities for not notifying the company of the 155-degree rule. A week later, the company found the notifications, which it had misplaced, and issued a statement.

After the Jack-in-the-Box poisonings, the federal government recommended that all states increase their cooking temperature requirements to 155 degrees. Burger King cooks to 160 degrees; Hardee's, Wendy's, and Taco Bell cook to 165 degrees. The U.S. Agriculture Department also changed its meat-inspection standards.[112]

The poisonings cut sales at Jack-in-the-Box by 20 percent.[113] Three store managers were laid off, and the company's plan to build five new restaurants was put on hold until sales picked up. Jack-in-the-Box scrapped 20,000 pounds of hamburger patties produced at meat plants where the bacteria were suspected to have originated. It also changed meat suppliers and added extra meat inspections of its own at an expected cost of $2 million a year.[114]

Consumer groups advocated a 160-degree internal temperature for cooking and a requirement that the meat no longer be pink or red inside.

A class action lawsuit brought by plaintiffs with minor *E. coli* effects was settled for $12 million. Two other suits, brought on behalf of children who went into comas, were settled for $3 million and $15.6 million, respectively.[115] All of the suits were settled by the end of 1997, with most of the settlements coming from a pool of $100 million established by the company's ten insurers.[116]

Discussion Questions

1. In 1993, Jack-in-the-Box adopted tougher standards for its meat suppliers than those required by the federal government so that suppliers test more frequently for *E. coli.* Could Jack-in-the-Box have done more before the outbreak occurred?
2. The link between cooking to a 155-degree internal temperature and the destruction of *E. coli* bacteria had been publicly known for five years at the time of the outbreak. The Centers for Disease Control and Prevention (CDC) tests showed Jack-in-the-Box hamburgers were cooked to 120 degrees. Should Jack-in-the-Box have increased cooking temperatures voluntarily and sooner?
3. What does the misplacement of the state health department notices on cooking temperature say about the culture at Jack-in-the Box?
4. A plaintiff's lawyer praised Jack-in-the-Box, saying, "They paid out in a way that made everybody walking away from the settlement table think they had been treated fairly." What do we learn about the company from this statement?

Case 8.11

Bucky Balls and Safety

Buckyballs and Buckycubes were high-powered, small rare earth magnets that were imported into the United States by Maxfield and Oberton Holdings, LLC, from Ningo Prosperous Imports & Exports in Ningbo City, China. The products, which consist of individual magnets packaged as aggregated masses in different size containers of 10,

[112] Richard Gibson and Scott Kilman, "Tainted Hamburger Incident Heats Up Debate over U.S. Meat-Inspection System," *Wall Street Journal*, February 12, 1993, pp. B1, B7; and Martin Tolchin, "Clinton Orders Hiring of 160 Meat Inspectors," *New York Times*, February 12, 1993, p. A11.

[113] Ronald Grover, Dori Jones Yang, and Laura Holson, "Boxed in at Jack-in-the-Box," *BusinessWeek*, February 15, 1993, p. 40.

[114] Adam Bryant, "Foodmaker Cancels Expansion," *New York Times*, February 15, 1993, p. C3.

[115] Bob Van Voris, "Jack-in-the-Box Ends E-Coli Suits," *National Law Journal*, November 17, 1997, A8.

[116] *Id.*

125, and 216 magnets, became enormously popular, with over 3 million of the products sold within the United States. Initially, ads for Buckyballs compared them to the wildly successful hula hoops and Silly Putty of the 1960s. That comparison brought a new customer base for the product, and by 2009, Buckyballs were being sold as an adult executive toy and/or stress reliever. The price range for Buckyballs was $19.95 to $100.00.

Children under the age of 14 (52 of them) ingested the Buckyballs. Their powerful magnetic force caused the intestinal walls to pinch or create a trap, a condition that resulted in progressive tissue injury. Some children became septic, and removal required endoscopic or surgical procedures that left children with permanent scarring. The greatest danger was that the symptoms began as simply a stomach upset, and treatment was often not pursued, with the result being progressive deterioration of the intestines. Because Buckyballs were such a new and fast-moving phenomenon, many physicians were not aware of the source of the intestinal problems they were trying to diagnose, something that resulted in further delays in treatment.

The only warning that appeared on Buckyballs was this: "Warning: Not intended for children. Swallowing of magnets may cause serious injury and require immediate medical care. Ages 13+" The Consumer Product Safety Commission (CPSC) concluded that the warning was not sufficient to reflect the real danger and consequences of ingestion. In 2010, Buckyballs had new packaging, new warnings, and new instructions, and the old products with the faulty warning were recalled. Despite these efforts, ingestion among children continued, with the most severe cases causing injury to the windpipes and esophagi of young children.

The CPSC issued a safety alert in 2011, but the ingestion continued because children thought that Buckyballs looked like candy, and older children tried to mimic tongue piercing by placing them on their tongues, thereby resulting in accidental swallowing of the magnets.

At that point, the CPSC ruled that warnings could never be effective because once Buckyballs are removed from their packaging, there is no longer any warning about their use. On July 25, 2012, the CPSC issued a mandatory product recall after failing to reach an agreement for a voluntary recall with the product importing company.[117]

Discussion Questions

1. Why wasn't a warning enough with Buckyballs?
2. Explain why Maxfield and Oberton Holdings, the importing company, struggled to keep its product available.
3. Is personal responsibility an issue in product use and product liability?

Case 8.12

Energy Drinks: Healthy or Risky?

The New York Attorney General has been investigating Monster Energy Drinks (Monster Beverage), Pepsi's AMP (PepsiCo), and 5-Hour Energy Drinks (Living Essentials) to determine whether the companies are adequately disclosing the amount of caffeine in their drinks. The investigation focuses on the other ingredients in the drinks, such as black tea extract and guarana; these are disclosed on the labels, but those labels may not reflect the additional caffeine that those ingredients contain, caffeine levels that are not then disclosed in the drinks' labels.

[117] A copy of the order and complaint against the company can be found at http://www.cpsc.gov//PageFiles/131696/maxfield1a.pdf.

The Food and Drug Administration (FDA) has already issued a warning about combining these energy drinks with alcohol consumption because of several resulting deaths. In addition, the Department of Health and Human Services (HHS) has issued a report warning about the negative health impact of excessive caffeine consumption. The report documented reports from emergency room physicians about young people requiring emergency room treatment because of consumption of alcohol and energy drinks. Neither agency has, however, taken any action against the makers of these drinks.

The average amount of caffeine in a 12-ounce soda such as Coca-Cola or Pepsi is 50 milligrams. For a 5-ounce cup of coffee, the amount is 100 milligrams. Energy drinks contain between 80 and 500 milligrams.

Discussion Questions

1. Is it possible that these drinks could be banned? What similarities do you see between Buckyballs and energy drinks? What differences?
2. What voluntary solutions could the energy drink makers undertake? Why would they want to undertake voluntary disclosures? Who wouldn't they want to?

SECTION C

Product Sales

The *way* a company sells is as important as *what* it sells. Good hustle wins sales, but too much hustle can cross ethical and then legal lines.

Case 8.13

Cardinal Health, CVS, and Oxycodone Sales

The Drug Enforcement Administration (DEA) has moved to revoke the controlled medication licenses of two pharmacies because the pharmacies were filling prescriptions for oxycodone (the painkiller) in excess of their monthly allowances for controlled substances. In addition, the DEA alleges that the pharmacies' corporate entities failed to conduct on-site inspections and failed to notice that 42 to 58 percent of all the sales of the substances were cash sales, something that is considered a red flag in the sale and distribution of controlled substances. In addition, the number of prescriptions filled continued to escalate.

The two pharmacies won an injunction against the revocation in federal district court. However, the DEA is hoping to persuade the judge to lift the injunction once it is able to show that the corporations should have known a problem existed. The rate of cash sales at these pharmacies was eight times the national rate for filling prescriptions with cash. Pharmacists at the drug stores, in interviews with the DEA agents, indicated that the customers paying cash for the oxycodone were "shady," and that they suspected that some of the prescriptions were not legitimate. One of the companies adjusted (increased) the levels of shipment of oxycodone to the pharmacies five times. In one on-site visit by a DEA agent, the following information emerged: one of every three cars that came to the drive-thru window had a prescription for oxycodone; many patients living at the same address had the same prescriptions for oxycodone from the same doctor.

Both companies, CVS and Cardinal Health, have indicated in court filings that they have changed their practices and provided training to pharmacy personnel so that they can spot these types of illegal prescriptions and report suspicious activity. Both pharmacy companies have terminated customers, meaning that they will no longer fill prescriptions for those customers. As these cases evolve, Walgreen's agreed to pay a fine of $80 million to settle charges that it too did not have sufficient internal controls in place to stop widespread distribution of this narcotic.[118]

The DEA seeks to hold the corporations responsible because of the lack of on-site presence and the failure to follow the numbers for sales and distribution at the pharmacies. The revocation of a license is a punitive action but does not indicate that a crime has been committed. Managers and corporations can be held liable for the actions of employees through their knowledge of those activities or because they failed to become informed of the operations. They can also be held liable if they are warned about an issue and fail to take appropriate action to stop the violations, action that includes internal controls that monitors the level of oxycodone distribution at their pharmacies. The failure to follow due diligence standards is the basis for the DEA license revocation.

[118] Barry Meier, "Chain to Pay $80 Million in Drug Fine," *New York Times*, June 12, 2013, p. B1

Discussion Questions

1. Why is there responsibility for drug distribution when there is not direct knowledge?
2. Interviews with pharmacy employees indicated that many were aware of a problem and concerned. Consider the following statements and explain why they did not speak up and tell someone at their companies about their concerns.
   - "We have goals for revenue."
   - "This is a busy pharmacy, and I am oversubscribed for my full shift. Who has time to worry about this?"
   - "Who's to know?"
   - "Nobody else seems to see it."
   - "There are lots of orthopedic patients in this area. It's possible."
   - "Not my place. Other people watch for this stuff."
   - "If I say something, they'll get someone else, and I'm unemployed."
3. What should the companies have done to encourage the employees to raise their concerns?

Case 8.14

Pfizer, Pharmas, Fines, and Sales Tactics

Off-label marketing is prohibited by federal law and occurs when a company makes representations about one of its products that are not approved by the Food and Drug Administration (FDA). Prescription drugs are approved for sales only for the FDA-designated uses. Physicians are able to use their discretion in treatment to prescribe drugs for what research may show are beneficial uses, but sales representatives of pharmaceutical (pharma) companies cannot then tout those off-label uses.

Many prescription drugs on the market are approved for one use but are then prescribed by physicians to treat other illnesses for which they have not been approved. The difficulties for pharma companies arise when the sales force is asked about the nonapproved use. The reps are not permitted to make any representations about the nonapproved use, but the line is a fine one between disclosure of nonapproved uses and marketing for that nonapproved use. That fine line has proven to be a challenge for pharma sales representatives.

The Story of Pfizer

Pfizer has agreed to pay what was at that time the largest health care fraud settlement in the history of the United States—$2.3 billion. The criminal portion of the fine, $1,195 billion, is the largest criminal fine ever imposed in any crime or matter in the United States. The remaining $1 billion is being paid to settle civil damages. Pfizer has agreed to pay the civil and criminal penalties because of its practices related to off-label marketing.

The Justice Department referred to Pfizer as a four-time offender. One of those previous violations began when former sales representative, John Kopchinski, questioned Pfizer's marketing of Bextra. Bextra, which has since been removed from the market because of a side effect of a rare but sometimes fatal skin reaction, was approved by the FDA for treating rheumatoid arthritis, osteoarthritis, and menstrual pain. However, doctors were prescribing Bextra for relieving pain following joint replacement, such as knee replacements. When Kopchinski questioned Pfizer's marketing tools and materials, he was fired. He filed a wrongful termination suit. Five other Pfizer employees would also file similar suits, and the six will be splitting $102 million, their take of the fine Pfizer will pay. Mr. Kopchinski will receive $51.5 million of that amount. He has said, "At Pfizer, I was expected to increase profits at all costs, even when sales meant endangering lives."

Mr. Kopchinski also told the BBC, "It's hard to do what's right when everyone around you is following management sales directives." He also referred to his experience as one of "swimming upstream."

At the time Mr. Kopchinski raised his concerns to his managers, he was earning $125,000 per year, and his wife was pregnant with twins. After he was fired, he resorted to living on his retirement pay from the military of $40,000 per year, as a Gulf War veteran. He also depleted his savings from the point at which he was fired in 2003 until the settlement on September 2, 2009. Mr. Kopchinski was a valued Pfizer employee, having been hired by then-CEO Edward Pratt in 1992 after their correspondence during the Gulf War sparked a friendship.

However, Pfizer's record was not clean when the Kopchinski suit emerged. Mr. Kopchinski had been with Pfizer, selling Pfizer's drug Neurontin, when the company was hit with fines and another whistleblower suit in the late 1990s over off-label marketing for Neurontin. Mr. Kopchinski said at the time that he was told by company managers that when physicians asked about the news stories on Neurontin that they were to explain that the litigation was the result of disgruntled former employees seeking revenge. Neurontin was approved as an anticonvulsant for use in treating patients with epilepsy. However, doctors had been prescribing it for psychiatric patients with anxiety as well as for treating the pain associated with shingles. The markets for the nonapproved uses are much larger than the market for anticonvulsants.

In the pharma industry, employees who are terminated and win wrongful termination suits often receive large settlements or verdicts because they are, in effect, blackballed in the industry and are unable to return to their former line of work, no matter which company.

The Story of GlaxoSmithKline

Following the Pfizer case, the FDA would assess its largest penalty in its history against drug maker GlaxoSmithKline for off-label marketing—$3 billion.[119] The penalty was assessed for Glaxo's sales activities related to three drugs: Paxil, Wellbutrin, and Avandia. In the case of Paxil, the settlement indicated that Glaxo had, for six years, promoted the drug for use in patients under the age of 18 when the drug was not approved for such use. The settlement also indicated that Glaxo helped to prepare an article for a journal that concluded the drug was effective for treating depression in children under the age of 18 when the clinical data indicated no such thing. That article was used by sales representatives to promote the use of Paxil to doctors for their patients under the age of 18.

With regard to Wellbutrin, Glaxo used physicians, including Dr. Drew, to promote its use for treatment of obesity and sexual disorders, two nonapproved uses. Dr. Drew was used to "build buzz" for these off-label uses.

Glaxo also settled on charges that it gave physicians trips to Bermuda, hunting trips, spa treatments, ski trips, concert tickets, and pheasant-hunting trips to Europe in order to encourage them to write prescriptions for the three drugs.

Glaxo is under a five-year corporate integrity agreement, which means that the company must avoid any repeat conduct or any new federal violations, or the result is that the corporation becomes a felon, a status that deprives it of receiving any federal contracts, including Medicare and Medicaid business arrangements. Although corporate integrity agreements (CIA) are not unusual in the pharmaceutical and other industries,

[119] Jeanne Whalen, Devlin Barrett, and Peter Loftus, "Glaxo Sets Guilty Plea, $3 Billion Settlement," *Wall Street Journal*, July 3, 2012, p. B1.

this CIA requires Glaxo to change its compensation system because the incentives were a driver in the continuing violations of the sales forces and the management team. The revised compensation program must also include a claw-back provision, which means that Glaxo can take back any bonuses earned through the use of off-label market or other forms of prohibited marketing of prescription drugs.

Discussion Questions

1. Discuss the restrictions the FDA puts on marketing. Do they make it difficult for sale reps? Do they deprive patients of useful drugs? Is it just too difficult for sales reps to draw the line on marketing? For example, Eli Lilly paid a $1.4 billion fine for similar violations of off-bale marketing for its antipsychotic drug Zyprexa. Or is it the case that some good is achieved by letting physicians know that some patients could be helped by the drug even though such use is not FDA approved?
2. Discuss what happens with a corporation convicted of a crime.
3. What are the cultural issues when employees raise questions in a company? Why do some situations require employees to go outside the company to obtain a response to their concerns?
4. Discuss the fine line pharma reps may have to walk when discussing their companies' drugs with physicians who are curious about off-label uses. For example, what if a physician who is accepting payments from a pharma speaks at a conference and discusses the research on off-label use of that pharma's drugs? Could the reps cite the doctor? Could the reps cite the research? Would doctors who accept the payments from a pharma also need to abide by the off-label rules? One doctor has noted that he knew exactly what to say to slip in the off-label use information without violating FDA regulations. Describe this doctor's ethical posture.
5. Given Glaxo's CIA, what cultural drivers do pharmas need to be aware of in order to avoid off-label sales issues?

Source

Rubin, Rita, "Pfizer Fined $2.3B for Illegal Marketing," *USA Today*, September 3, 2009, p. 1B; see also http://www.justice.gov/opa/pr/2009/September/09-civ-900.html accessed September 19, 2013, and www.pharmalot.com accessed September 19, 2013.

Case 8.15

The Mess at Marsh McLennan

Background and Structure

Marsh McLennan (MMC) is a multinational insurance broker that, at its peak in 2004, had 43,000 employees at offices around the world.[120] MMC's revenues were $2 billion more than its closest competitor, Aon Corporation.[121] MMC is actually a conglomerate that consists of Marsh, its risk and insurance division; Putnam Investments, a mutual fund and investment management company; and Mercer, Inc., a human resources consulting company.

Regulatory and Legal Problems Emerge

Following a series of earnings restatements in the 2001 through 2003 period, MMC was hit with additional Securities and Exchange Commission (SEC) investigations on its Putnam

[120] Monica Langley and Ianthe Jeanne Dugan, "How a Top Marsh Employee Turned the Tables on Insurers," *Wall Street Journal*, October 23, 2004, pp. A1, A9. Some put the number of employees at 60,000. Gretchen Morgenson, "Who Loses the Most at Marsh? Its Workers," *New York Times*, October 24, 2004, pp. 3–1 (Sunday Business 1), 9.

[121] Monica Langley and Theo Francis, "Insurers Reel from Bust of a 'Cartel,'" *Wall Street Journal*, October 18, 2004, pp. A1, A14.

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Investments, resulting in suits by Putnam's mutual fund customers, and fines paid to the SEC to settle allegations with that agency. The suits by the mutual fund holders were settled with payouts. In 2003, Putnam was the first of the mutual fund companies charged with showing favoritism to certain customers by allowing them to buy and sell shares at the expense of lesser customers in order to retain the greater customers (larger investors).[122]

Running parallel to the restatements and the mutual fund issues were problems at Mercer. Mercer settled charges related to conflicts of interest that had arisen in trying to retain clients by not making disclosures about its relationships. Also, Mercer was involved with former New York Stock Exchange (NYSE) Chairman Richard Grasso's compensation package, an issue that would later cause Mr. Grasso to lose his position for the failure to disclose the full extent of his compensation, something Mercer was fully aware of but did not discuss with NYSE board members.[123]

The Pay-to-Play Ploy

MMC employees, who were generously rewarded for more clients, had developed a "pay-to-play" format for obtaining bids for insurance coverage that was almost a sure thing. The pay-to-play scheme came into play, as it were, when MMC corporate customers came up for renewal on their policies. MMC, as the world's largest insurance broker, had all of its insurers for its corporate customers agree to just roll over their coverage on renewals. MMC's plan was to eliminate all the nastiness of rebidding and competition among insurers for the renewal. Rolling over is, in many ways, both literally and figuratively easier. For example, if Insurer A were up for renewal with Customer Y, Insurers B and C would submit fake and higher bids for Customer Y that MMC would then take to Customer Y. And the no-brainer for executives at Customer Y was to go with the lowest bidder. Then–New York State Attorney General Eliot Spitzer was able to show that MMC did not even have official bids from the competing insurers in some of these rollover situations. MMC sometimes sent bids forward that had not even been signed by the insurers who were playing along at the higher bid. Of course, those who played along and didn't get the renewal had the others play along when their turn came for renewal with an existing customer. No competitive bidding took place; only a façade existed.

Mr. Spitzer, in filing suit against MMC, referred to it as part of a cartel.[124] In the complaint, Mr. Spitzer quoted this e-mail from an ACE assistant vice president to ACE's vice president of underwriting (ACE is a "competitor" of MMC and American International): "Original quote $990,000…. We were more competitive than AIG in price and terms. MMGB (Marsh McLennan Global Broking) requested we increase the premium to SLIM to be less competitive, so AIG does not lose the business."[125]

Once MMC got the pay-to-play system in place, its insurance revenue was 67.1 percent of its total revenue.[126] Commissions from these rollovers represented one-half of MMC's 2003 income of $1.5 billion.[127] When MMC agreed to drop the system as part of a settlement with Spitzer's office, it reported a 94 percent drop in its third-quarter

[122] Marcia Vickers, "The Secret World of Marsh Mac," *Fortune*, November 1, 2004, pp. 78, 80; and Monica Langley and Ian McDonald, "Marsh Directors Consider Having CEO Step Aside," *Wall Street Journal*, October 23, 2004, pp. A1, A11.

[123] Monica Langley and Ian McDonald, "Marsh's Chief Is Expected to Step Down," *Wall Street Journal*, October 25, 2004, pp. C1, C4.

[124] Alex Berenson, "To Survive the Dance, Marsh Must Follow Spitzer's Lead," *New York Times*, October 25, 2004, pp. C1, C8.

[125] Thor Valdmanis, Adam Shell, and Elliot Blair Smith, "Marsh & McLennan Accused of Price Fixing, Collusion," *USA Today*, October 15, 2004, pp. 1B, 2B.

[126] Langley and Dugan, "How a Top Marsh Employee Turned the Tables on Insurers," pp. A1, A9.

[127] *Id.*

profit for 2004 from 2003. MMC's income for 2003 was $357 million, but for 2004, it was just $21 million.[128]

E-mails show that employees understood that they were violating antitrust laws. In one e-mail quoted in the Spitzer suit, an MMC executive (whose name is redacted) even jokes about the practice of sending a fake emissary to a meeting with a customer who was taking bids for insurance renewal. The e-mail read, "This month's recipient of our Coordinator of the Month Award requests a body at the rescheduled April 23 meeting. He just needs a live body. Anyone from New York office would do. Given recent activities, perhaps you can send someone from your janitorial staff—preferably a recent hire from the U.S. Postal Service."[129] The response to this e-mail, in all capital letters, showed some disgust with the process: "WE DON'T HAVE THE STAFF TO ATTEND MEETING JUST FOR THE SAKE OF BEING A 'BODY' WHILE YOU MAY NEED 'A LIVE BODY,' WE NEED A 'LIVE OPPORTUNITY' WE'LL TAKE A PASS."[130]

An executive at Munich RE, an insurer that worked with MMC, indicated some concerns in another e-mail:

> I am not some Goody Two Shoes who believes that truth is absolute, but I do feel I have a pretty strict ethical code about being truthful and honest. This idea of "throwing the quote" by quoting artificially high numbers in some predetermined arrangement for us to lose is repugnant to me, not so much because I hate to lose, but because it is basically dishonest. And I basically agree with the comments of others that it comes awfully close to collusion and price-fixing.[131]

As MMC's profitability increased under the pay-to-play scheme, it became more and more difficult to meet the past numbers and even increase them, as management was demanding. One branch manager explained, "We had to do our very best to hit our numbers. Each year our goals were more aggressive."[132] Jeff Greenberg, the MMC CEO, frightened even his direct report, Roger Egan, the president and chief operating officer of MMC, who stated to his direct reports in a meeting on the goals and achieving them, "Each time I see Jeff [Greenberg] I feel like I have a bull's eye on my forehead."[133] An accounting employee who was at that meeting provided the information to Mr. Spitzer and agreed to testify if it became necessary. It was never necessary for him to testify because MMC settled the suit, agreeing to pay an $850 million fine.[134] Within two months of the settlement, MMC had cut 5,500 jobs. MMC's share price dropped 28 percent over the same time period. Its revenues dropped 70 percent.[135]

Discussion Questions

1. What cultural issues do you see that affected decisions at MMC?
2. Whose interests were served by the pay-to-play cartel?
3. What thoughts does this case offer for your credo?

[128] Thor Valdmanis, "Marsh & McLennan Lops off 3,000 Jobs," *USA Today*, November 10, 2004, p. 1B.

[129] Alex Berenson, "Once Again, Spitzer Follows E-Mail Trail," *New York Times*, October 18, 2004, pp. C1, C2.

[130] *Id.*, p. C1.

[131] *Id.,* p. C2.

[132] *Id.,* p. C2.

[133] Langley and Dugan, "How a Top Marsh Employee Turned the Tables on Insurers," pp. A1, A9.

[134] Ian McDonald, "Marsh & McLennan Posts Loss, Unveils Dividend and Job Cuts," *Wall Street Journal*, March 2, 2005, p. C3.

[135] Ian McDonald, "Marsh Post 70 percent Drop in Earnings," *Wall Street Journal*, May 4, 2005, p. C3.

Compare & Contrast

Evaluate the thoughts of the insurer who indicates there is no absolute truth. Why did he react differently from the others who were involved in the pay-to-play scheme?

Case 8.16

Selling Your Own Products for Higher Commissions

In banks and investment firms, employees who are guiding customers have a variety of mutual funds product available for those customers. Many banks offer their own mutual funds as potential investments for those customers. In some cases, the performance of those mutual funds is only average; other mutual fund vehicles are available for customers that would bring them greater returns. However, employees at the banks and investment firms earn higher commissions on placing customers in their own company's funds as opposed to placing those funds in the mutual funds managed by other banks and firms. In some cases, the bank or investment firm collects double fees when a customer invests. That is, in addition to the cost of investing in the mutual fund, the bank or investment firm also collects a management fee from the customers. However, in some banks, their fees, even with double-charging, could be less than the fees charged by other mutual funds.

The sales practices at a number of banks and investment firms have been investigated by federal and state authorities, with some settlements resulting.

Discuss the ethical issues involved in the sales of your own company's investment vehicles.

Discussion Questions

1. Discuss the ethical issues involved in the sales of your own company's investment vehicles.
2. Explain how the issue could be resolved with customers.

Case 8.17

Frozen Coke and Burger King and the Richmond Rigging[136]

Tom Moore, president of Coca-Cola's Foodservice and Hospitality Division, was looking at sales in the fountain division, a division responsible for one-third of all of Coke's revenues. The fountain division sells fountain-dispensed soda to restaurants, convenience marts, and theaters. Sales were stagnant, and he knew from feedback from the salespeople that Pepsi was moving aggressively in the area. In 1999, Pepsi had waged a bidding war to try to seize Coke's customers. Coke held about 66 percent of the fountain drink business and 44.3 percent of the soda market overall. Pepsi held 22 percent of the fountain market and 31.4 percent of the overall soda market. The war between the two giants had been reduced to a price war. One might say that Coke's fountain sales were flat.

However, Moore envisioned a potential new product line as he looked at the Frozen Coke products. At that time, Frozen Coke was a convenience store item only. Frozen Coke was still a little-known product, and Moore's team at Coke pitched the idea of having Frozen Coke at Burger King, along with a national advertising push that would push Coke's fountain sales but also increase food sales at Burger King as customers came in to try the newly available product. Their pitch to Burger King was that Frozen Coke would

[136] The author has done consulting work with the Burger King team of Coca-Cola. All information in this case is from public records and/or third-party publications.

draw customers and that the sales of all menu items would increase as a result. Burger King was not ready for a marketing push because it had just lived through two marketing disasters. The first was the failure of the introduction of its new fries, and another was a costly ad campaign to boost sales of the Whopper, with no impact but a great many angry franchise owners who had been required to help pay for the ads. Before Burger King would invest in another ad campaign, it wanted to see some test marketing results. Burger King asked Coke to do a promotion of Frozen Coke in a test market. Burger King chose the Richmond, Virginia, area as a good test market.

If the Richmond market did not show sales during the marketing test, Moore knew that Coke risked not only no more growth in fountain sales, but also loss of Burger King's confidence and perhaps an open door for Pepsi to win Burger King over.

Promotions and the marketing test in Richmond began in February 2000. Initial sales were not good. Burger King executives made what Coke employees called "excoriating" calls to Coke team members about the poor performance. Coke pulled out all the stops and hired mystery shoppers to make sure that Burger King employees were offering the Frozen Coke to customers as had been directed during the promotion. Coke gave T-shirts and other promotional items to Burger King managers to encourage them to promote Coke sales. John Fisher, the Coke executive who had just been given the Burger King account to manage, was getting more nervous the closer Coke got to the end of the Richmond promotion time frame.

The Coke team told its own employees to buy more value meals at Burger King, the menu item that was being promoted with the Frozen Coke. Finally, Robert Bader, the Coke marketing manager who was in charge of the Richmond test, decided to hire a marketing consultant, Ronald Berryman, to get more purchases at Burger King. Mr. Berryman, who had worked with Coke in the past, developed a plan that included working with the Boys & Girls Clubs in the area. Using $9,000 wired to him by Mr. Bader from Mr. Bader's personal Visa card, Berryman gave cash to directors of these clubs and developed a homework reward program: if the kids came to the clubs and did their homework, they could go and buy a value meal at Burger King. The directors at the clubs assumed that the money for the value meals was a donation from either Burger King or Coke.

The result of the Berryman plan was that the Richmond area Burger Kings had a 6 percent increase in sales during the Frozen Coke promotion. Other Burger King stores had only 0 to 2 percent growth during the same period. As a result, Burger King agreed to invest $10 million in an ad program to promote Frozen Coke. Burger King also invested $37 million in equipment, training, and distribution in order to carry the Frozen Coke in its franchises, but sales did not follow the Richmond pattern. Estimates are that Burger King's total investment in the Frozen Coke promotion was $65 million.

Matthew Whitley, who had been with Coke since 1992, was its finance director in 2000. During some routine audit work at Coke, he ran across an expenses claim from Mr. Berryman in the amount of $4,432.01, a claim that was labeled as expenses for the "mystery shop." Mr. Whitley questioned Mr. Bader about this amount and others, what the funds were for, who Mr. Berryman was, and what the "mystery shop" submission label represented. Mr. Bader responded that the methods might be "unconventional," but they were "entrepreneurial." Mr. Fisher wrote in a memo in response:

> I would never have agreed to move forward if I believed I was being asked to commit an ethics code or legal transgression.... We had to deseasonalize the data in order to have an accurate measure. These actions were wrong and inconsistent with values of the Coca-Cola Co. Our relationships with Burger King and all our customers are of the utmost importance to us and should be firmly grounded in only the highest-integrity actions.[137]

[137] Chad Terhune, "How Coke Officials Beefed Up Results of Marketing Test," *Wall Street Journal*, August 20, 2003, pp. A1, A6.

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Mr. Whitley recommended that Mr. Fisher be fired because of the excessive expense and his authorization for it. Coke did not fire Mr. Fisher, but Mr. Moore took away half of his bonus for the year, saying in his memo of explanation to Mr. Fisher, "These actions exposed the Coca-Cola Co. to a risk of damage to its reputation as well as to the relationship with a major customer."[138]

However, Coke did fire Mr. Whitley, who then filed suit for wrongful termination. Coke first told Burger King of the issues the day before Mr. Whitley filed his suit. Mr. Whitley's lawyer had contacted Coke and offered to not file the suit if Coke would pay Mr. Whitley $44.4 million within one week. Coke declined the offer and disclosed the Whitley and Frozen Coke issues to Burger King. The Coca-Cola board hired the law firm of Gibson, Dunn & Crutcher and auditors Deloitte & Touche to investigate Whitley's claim.

Mr. Whitley then filed his suit. The *Wall Street Journal* uncovered the lawsuit in court documents when a reporter was doing some routine checking on Coke and ran a story on August 20, 2003, describing Mr. Whitley's experience and suit.

The reports of the law and audit firms concluded that the employees had acted improperly on the Richmond marketing test. Also, as a result, Coca-Cola issued an earnings restatement of $9 million in its fountain sales.

Burger King's CEO, Brad Blum, was informed of the report following the investigation and calling the actions of the Coke employees "unacceptable," and he issued the following statement:

> We are very disappointed in the actions … confirmed today by the Coca-Cola audit committee. We expect and demand the highest standards of conduct and integrity in all our vendor relationships, and will not tolerate any deviation from these standards.

Coke's president and chief operating officer, Steve Heyer, sent an apology to Mr. Blum:

> These actions were wrong and inconsistent with values of the Coca-Cola Co. Our relationships with Burger King and all our customers are of the utmost importance to us and should be firmly grounded in only the highest-integrity actions.[139]

Coke had to scramble to retain Burger King's business because Burger King threatened to withdraw Coca-Cola products from its restaurants. Burger King is Coke's second largest fountain customer (McDonald's is its largest). The settlement requires Coke to pay $10 million to Burger King and up to $21.2 million to franchisees who will still have the right to determine whether they will continue to carry the Frozen Coke products.

Coke continued with its litigation against Whitley, maintaining that he was "separated" from the company because of a restructuring and that his "separation" had nothing to do with his raising the allegations. However, in October 2003, Coke settled the lawsuit for $540,000: $100,000 in cash, $140,000 in benefits including health insurance, and $300,000 in lawyer's fees. Mr. Whitley said when the settlement was reached, "I have reflected on my relationship with Coca-Cola, a company I still respect and love … the company has taken seriously the issues I raised. That's all I ever wanted."[140]

[138] *Id.*

[139] Chad Terhune, "Coke Employees Acted Improperly in Marketing Test," *Wall Street Journal*, June 18, 2003, pp. A3, A6.

[140] Sherri Day, "Coca-Cola Settles Whistle-Blower Suit for $540,000," *New York Times*, August 26, 2003, pp. C1, C2.

Deval Patrick, then–executive vice president and Coke's general counsel, also issued the following statement when the settlement was reached:

> Mr. Whitley was a diligent employee with a solid record. It is disappointing that he felt he needed to file a lawsuit in order to be heard. We want everyone in this company to bring their issues to the attention of management through appropriate channels.[141]

Mr. Fisher was promoted to a top marketing position in the fountain division at Coke in 2003. However, In April 2003, Coke's internal auditors raised questions with Mr. Fisher about why he exchanged two Disney theme park tickets that had been purchased by the company for Notre Dame football tickets. Mr. Fisher resigned shortly after, but no one at Coke has offered an explanation.

Mr. Bader is still a marketing manager in the fountain division, but he does not work on the Burger King account.

Tom Moore resigned following both the settlements. A spokesperson for Coca-Cola said, "As he reflected on the events, he felt that change was necessary to avoid distractions and move the business forward."[142] Sales of Frozen Coke at Burger King have fallen to half of Coke's original estimates. Burger King has proposed changing the name to Icee.[143] Coke did sign the Subway chain for its fountain beverages, a contract that gave Coke the three largest fountain drink contracts in the country: McDonald's, Burger King, and Subway.[144] Pepsi had previously held the Subway contract.

As a result of the Whitley lawsuit, the SEC and the FBI began investigating Coke. Coke cooperated fully with the government investigations. In 2005, those investigations were closed, with no action taken against the company or any individuals with regard to the marketing scenario or the response to Mr. Whitley's report on the consultant's conduct in the Richmond test market.[145] Coke also settled the channel-stuffing charges in 2005. Although channel-stuffing issues at Coke had emerged in the 1997–1999 time frame, regulatory interest was rekindled when the Burger King issue became public.[146] As part of the settlement, in which Coke neither admitted nor denied the allegations, Coke agreed to put compliance and internal control processes in place and work to ensure an ethical culture. Coke was also able to settle private suits on the channel-stuffing issues.[147] Federal prosecutors investigated the Frozen Coke marketing tests for possible fraud.[148]

Discussion Questions

1. Why did the executives at Coke decide to go forward with the marketing studies? What questions from the models you have studied could they have asked themselves in order to avoid the problems that resulted?
2. Make a list of everyone who was affected by the decision to fix the numbers in the Richmond test market.
3. Make a list of all of the consequences Coke experienced as a result of the Richmond rigging.

[141] *Id.*

[142] Sherri Day, "Coke Executive to Leave His Job after Rigged Test at Burger King," *New York Times*, August 26, 2003, pp. C1, C2.

[143] Terhune, "How Coke Officials Beefed Up Results of Marketing Test," pp. A1, A6.

[144] Sherri Day, "Subway Chain Chooses Coke Displacing Pepsi," *New York Times*, November 27, 2003, pp. C1, C2.

[145] "Coke Settles with SEC," April 19, 2005, accessed June 20, 2010, from http://www.BevNet.Com.

[146] Betsy McKay and Chad Terhune, "Coca-Cola Settles Regulatory Probe," *Wall Street Journal*, April 19, 2005, p. A3.

[147] Sherri Day, "Coke Employees Are Questioned in Fraud Inquiry," *New York Times*, January 31, 2004, pp. B1, B14.

[148] Kenneth N. Gilpin, "Prosecutors Investigating Suit's Claims against Coke, *New York Times*, July 13, 2003, pp. B1, B4; and Chad Terhune, "Coca-Cola Says U.S. Is Probing Fraud Allegations," *Wall Street Journal*, July 14, 2003, p. B3.

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"The initial decision was flawed, and the rest of the problems resulted from that flawed decision," was an observation of an industry expert on the Richmond marketing test. What did the expert mean with this observation?

4. List the total costs to Coke of the Richmond rigging. Be sure to list any costs that you don't have figures for but that Coke would have to pay. Do you think those costs are done and over?
5. What lessons should companies learn from the Whitley firing and lawsuit? What changes do you think Coke has made in its culture to comply with the SEC settlement requirements? Are there some lessons and elements for a credo in the conduct of individuals in this case?

Case 8.18

Slotting: Facilitation, Costs, or Bribery?[149]

Finding "Bearwiches" on the cookie shelf in your grocery store will be a daunting task. Locating some "Frookies," a line of fat-free, sugarless cookies, will take you on a journey through various aisles in the store, and you may find them at knee level in the health foods section. You can find packaged Lee's Ice Cream from Baltimore in Saudi Arabia and South Korea, but it will not be found on the grocery store shelves in Baltimore. The difficulty with finding these items is not that they are not good products. The manufacturers of these products cannot afford to buy shelf space. The shelf space in grocery stores is not awarded on the basis of consumer demand for Bearwiches or Frookies. Shelf space in grocery stores is awarded on the basis of the manufacturer's willingness to pay "slotting" fees. If manufacturers pay, they are given a space on the grocer's shelf. If the slotting fees are not paid, the grocer does not sell the product.

Slotting fees are fees manufacturers pay to retailers in order to obtain retail shelf space.[150] The practice has been common in the retail grocery industry since 1987. The origins of slotting fees are unclear, with different parties in the food chain offering various explanations. Retailers claim manufacturers started slotting, with the fees paid to retailers as an inducement to secure shelf space. Another theory of origin offered by retailers is that manufacturers use slotting fees to curtail market entrants. If a manufacturer buys more space with additional fees, existing marketers can control the market can be controlled by existing manufacturers. Manufacturers claim slotting retail grocers started slotting as a means of covering the bookkeeping and warehousing costs of the introduction of a new product. However, two things are clear. First, the practice of affiliated fees for sale has expanded to other industries. The retail book industry, particularly the large chains, now demands fees from publishers for shelf slots and displays for their books. In malls, developers and landlords now demand sums as large as $50,000 from tenants or prospective tenants before a lease can be negotiated or renegotiated. These fees for a position in the mall are referred to as *key money* or *negative allowances*. In certain areas, home builders are demanding "access fees" or "marketing premiums" from appliance makers and other residential construction suppliers for use of their products in the builders' developments. In the computer software industry, the packaging of software programs with computers ensures sales and requires a fee. Even the display of programs in electronic stores is subject to a fee. The second clearly evolving trend in affiliated fees is that the practice is inconsistent, and the purposes of the fees are unknown. Fees differ from manufacturer to manufacturer, from product to product, and from retailer to retailer.

[149] Portions adapted from Robert J. Aalberts and Marianne M. Jennings, "The Ethics of Slotting: Is This Bribery, Facilitation, Marketing or Just Plain Compensation?" *Journal of Business Ethics* 20 (1999), pp. 207–215. Reprinted with kind permission of Kluwer Academic Publishers.

[150] *Slotting fees* actually pertain to obtaining space in the grocer's warehouse. *Shelf fees*, which are fees for placement on the shelf, are also charged by some grocery retailers.

How Slotting Works

Food manufacturers produce more than 10,000 new products each year. However, store shelf space remains fixed. Because profit margins at grocery stores hover at very narrow levels of only 1 to 2 percent of sales,[151] additional shelf space would not increase profits or produce guaranteed returns from the new products displayed there. In addition, grocers must assume the risk of allocating shelf space to a new product that would not sell at a level sufficient to provide even the narrow margins. Retail grocers must absorb the cost of warehousing the product, accounting for it in inventory, bar coding it, and eventually stocking the shelves with it.[152] In many cases, particularly where the manufacturer is a small company, there has been little or no advertising of the product, and the retail grocer must also incur the cost of advertising the product in some way or offer in-store coupons to entice customer purchases. To the retail grocer, the introduction of a new product and the allocation of precious shelf space is a high-cost risk. There are no guarantees that a new product will garner sales, and there is the downside of the loss of revenue from whatever product is displaced by the new product. To retail grocers, a slotting fee is a means of insulation from the risk of new product introduction and a means of advance recoupment of costs.

Within some retail grocery chains, slotting fees represent the net profits for the organization. Similar to the rental car industry in which earnings come from renters' fees for insurance, car seats, and additional driver coverage, some retail grocers' profits come not from the sales of food, but from the fees manufacturers pay for access.

The level and nature of slotting fees vary significantly. Some retailers have a flat fee of $5,000 per product for introduction. Other retailers have a graduated fee schedule tied to the shelf space location. Eye-level slots cost more than the knee- or ground-level slots. The prime spaces at the ends of grocery aisles bring premium slotting fees because those spaces virtually ensure customer attention.[153] Other stores require that a "kill fee" be paid when a product does not sell. One supermarket chain requires $500 just for a manufacturer to make an appointment to present a new product. Some retailers will not accept a new product even with a slotting fee. Small businesses often incur the cost of product development only to be unable to place the product with grocery stores.

Some stores charge a slotting fee, an additional fee if the product is new, and a "failure fee" on new products to cover the losses if the product fails to sell. A new fee, called the *staying fee*, has also developed. A staying fee is an annual rent fee that prevents the retailer from giving a manufacturer's product slot to someone else. Some manufacturers offer to buy out the product in existing space in order to make room for their product. A 1988 survey found that 70 percent of all grocery retailers charge slotting fees, with one retail store disclosing that its $15-per-store per-product slotting fees bring in an additional $50 million in revenue each year.[154] Examples of various slotting fees paid and documented are found in Table 8.2. The most typical slotting fee for a new product to be placed with a grocery retailer was $10,000. Slotting fees do not typically come down over time, even if

[151] Costs in the retail grocery industry are relatively fixed and cannot be readily reduced. Union wages and other unmanageable cost elements preclude effective efforts at increasing profit margins. Further, competition from the "club" stores (e.g., Costco, Sam's Club, and Price Club) is intense.

[152] The cost of shelving is that of the labor and materials involved in simply changing the shelf sign. Shelf fees are typically a minimal amount, such as $50.

[153] Referred to as *prime real estate* in the industry, slotting fees follow a graduated schedule for the locations. Amounts vary according to aisle space. Bread slotting fees are $500 to $1,000 per bread type. Ice cream, with one small segment in frozen foods, brings $25,000 per flavor.

[154] No convenience store chains charge slotting fees. However, convenience stores do not warehouse inventory. Manufacturers deliver directly to the convenience stores (from interviews conducted by the author).

TABLE 8.2
Slotting Fees: Amounts and Terms

Payer	Amount	Terms	Payee
Truzzolino Pizza Roll	$25,000	Chain-wide	
Old Capital Microwave Popcorn	$86,000	Chain-wide for $172,000	ShopRite stores
United Brands	$375,000	Frozen fruit juice bar	New York City–area stores
Apple & Eve	$150,000	Fruit punch product	Limited stores in Northeast
Frookies	50 cents per box Increased price (from $1.79 to $2.29)	Sugar-free cookies	100 stores Various
Frito-Lay	$100,000	New product	Each grocery store chain
Lee's Ice Cream	$25,000 per flavor	Ice cream	Each grocery
Bread	$1,500 per store per bread	Chain-wide cost is $100,000	Chains
General, manufacturers, and producers	$15,000–$30,000 per SKU (item)	New products—chain-wide	Chains[155]

the product sells well. At the retail level for CD-ROM sales, the producers pay a 20 percent fee per shipment, regardless of whether their product is in demand.

The Legal Issues Surrounding Slotting

The chairman of the board of a small food manufacturer in Ohio wrote to his congressman and described slotting fees in this way: "This is nothing but a device to extort money from packers and squeeze all the independent and smaller processors off the shelves and out of business. We believe this is the most flagrant restraint of trade device yet conceived."[156] The Senate Small Business Committee's investigation included a report on an interview with one small manufacturer who said, "I know for a fact that my competition is paying the lease on the buyer's BMW."[157] When the Senate hearings were held, many of the manufacturers appeared behind a screen at the hearing and used voice-altering technology because of their expressed fear of retaliation from distributors and stores for speaking out on the extent of the fees and the problems of under-the-table

[155] Updated from Robert J. Aalberts and Marianne M. Jennings, "The Ethics of Slotting: Is This Bribery, Facilitation, Marketing or Just Plain Compensation?" *20 Journal of Business Ethics* 2007 (1999). A 1997 survey indicates the following: Usual slotting fees: Retailers vary from free to $20,000 per SKU (product). Wholesalers: $500 to 10,000 per SKU. Manufacturers: $500 to 10,000 per SKU. The figures in the chart were updated through May 2001.

[156] Slotting: Fair for Small Business and Consumers? Hearing before the Committee on Small Business, U.S. Senate, 106th Congress, 1999.

[157] Roger K. Lowe, "Stores Demanding Pay to Display Products on Shelves, Panel Told," *Columbus Dispatch*, September 15, 1999, p. 1H.

payments that have sprung from the practice. One manufacturer testified with a grocery bag on his head.

The Federal Trade Commission has investigated both slotting and rebate fees for possible antitrust implications. The American Antitrust Institute notes that there is an "absence of reliable industry-wide information" on slotting fees and a "pervasive secrecy surrounding what actually occurs among the major players."[158] It is possible that a slotting fee might fall under the legally prohibited conduct of commercial bribery. However, for a successful prosecution for payment of a bribe, the conduct required must be that in which a seller pays funds to a buyer solely for the purpose of acquiring a contract or business opportunity (in the case of slotting, a space on the shelf). As noted earlier, however, the reality is that there are costs associated with awarding an item shelf space.

If the funds are simply received by the retailer and used for general operating expenses that include advertising, bookkeeping, and warehousing, then the notion that a slotting fee is commercial bribery does not fit within the *actus reus*, or the required conduct, for criminal prosecution.[159]

Regardless of legalities, the use of slotting fees creates an atmosphere of confusion. It is unclear how slotting payments are made and where the payments are reported. Many small business owners report that the payments they make to grocery retailers must be made in cash. Some owners report that payments are made in cash both to the chain and to individual store managers. The atmospheric result is that large amounts of cash change hands among sellers, managers, and purchasers. The former CEO of Harvest Foods, a food retailer in the South, has been indicted on charges of bribery and other related offenses for the alleged receipt of hundreds of thousands of dollars in cash for slotting fees.

Because slotting fees are nonuniform and even nonuniversal, it is impossible to understand how the fee structure works, how much the fees should be, and whether the fees are actually related to the costs incurred by retailers in getting a new product to the shelf. The secretive and inconsistent nature of slotting fees and their payment in cash create an atmosphere similar to that in the drug trade.[160] Market entry rights are unclear; fees change; not everyone is permitted to buy into the system; and the use and declaration of revenues are unknown. In at least four reports on the practice of slotting fees, parties on both sides referred to slotting as the grocery industry's "dirty little secret." Cost recoupment, the public airing of the fees, and public accounting disclosures are nonexistent for slotting fees. The secrecy of the fees and the industry's unwillingness to discuss or disclose them are problematic for manufacturers.

From the cost figures offered in Table 8.2, it is safe to conclude that slotting fees could make market entry prohibitive for many small companies. In some instances, fees have gone beyond the initial slotting costs, with some grocery chains now demanding up to $40,000 per year for a company to maintain just a square foot of retail space for its product. Even some of the larger companies have difficulty competing because of the large fees. Frito-Lay recently purchased Anheuser-Busch's Eagle Snacks after Anheuser had spent over $500 million trying to increase its 17 percent market share. Frito-Lay now

[158] Aalberts and Jennings, "The Ethics of Slotting," p. 207.

[159] Again, it is important to note that a retailer may also charge an "advertising fee."

[160] The authors could find only three manufacturers willing to discuss their personal experiences with slotting fees or industry practices. Retribution (i.e., denial of retail access) was cited as the reason for their reluctance. These three manufacturers spoke on condition of anonymity. Two other manufacturers, Richard Worth (Frookies) and Scott Garfield (Lee's Ice Cream), have been public in their discussion of slotting fees. Grocery retailers referred all questions to legal counsel or corporate officers, who declined to be interviewed.

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holds 55 percent of the snack market and pays the largest slotting fees in the grocery industry. Borden ended its foray into the snack market in 1995, and barely survived before it did so. Nearly thirty regional snack companies went out of business between 1995 and 1998. A vice president of Clover Club Foods, a Utah-based snack company, believes Frito-Lay's goal is to be the only salted-snack food company in the country. The Independent Baker's Association has described slotting fees as being "out of control."

The following data were obtained from surveys of members of the retail food industry:

- Slotting allowances are a way of penalizing manufacturers for inadequate market tests.
  Fifty-two percent of retailers, 72 percent of wholesalers, and 77 percent of manufacturers said they disagreed or disagreed strongly.
- If a supplier can demonstrate adequate market testing of a new product, slotting fees should not be charged.
  Fifty-four percent of retailers, 50 percent of wholesalers, and 0 percent of manufacturers said they disagreed or disagreed strongly.
- Slotting fees hamper a retailer's ability to maximize the effectiveness of his product assortment.
  Fifty-eight percent of retailers, 54 percent of wholesalers, and 94 percent of manufacturers agreed strongly or agreed somewhat.[161]

A 1997 survey by Supermarket Business found the following:

- At present, some slotting fees are an "under the table" form of payment.
  Eighty-three percent of retailers, 85 percent of wholesalers, and 79 percent of manufacturers strongly agreed or agreed somewhat with the statement.

Slotting and Accounting Issues

Slotting has received additional attention since 2003 because of questions and confusion surrounding the accounting for such fees. For example, if promotional fees are to be paid as part of an arrangement between a manufacturer and a retailer, how are those fees to be carried on the retailer's financial statements? Promotional fees may be paid over time, may be tied to the amount sold, or may be conditioned on certain forms of advertising and results. The flexibility in booking those promotional fee revenues has brought attention to several major retailers, including Royal Ahold N.V. and its U.S. subsidiary, U.S. Foodservice. The *New York Times* ran the following description of the activities and issues that resulted in the U.S. Food Services investigation and accounting restatement:

> Representatives of U.S. Foodservice are rewarded regularly with goodies like Palm hand-held computers, fax machines, vacation travel and even help with college tuition. All they have to do is earn points by persuading their customers to buy more crackers, coffeecake, plastic forks or other products that have made the company's list for intense promotion.
>
> Under the program, known as Points of Focus, U.S. Foodservice sales representatives amass points if they increase their sales of certain brands, which include the company's own labels as well as brands from nationally known "preferred vendors."
>
> The companies that get it have been willing to pay U.S. Foodservice for special treatment. Such payments are not illegal, and many other food companies have similar programs.[162]

[161] Adapted from Robert Aalberts, Marianne Jennings, and Stephen Happel, "The Economics, Legalities and Ethics of Slotting Fees," 21 *Journal of Law and Commerce* 1 (2001).

[162] Constance Hays, "At a Food Distributor, Vendors Often Pay to Play," *New York Times*, March 30, 2003, p. C1.

Every major food distributor, with the exception of Sysco, has been the subject of accounting restatements or SEC investigation for issues related to the booking of revenues.[163] Two former vice presidents of Kmart were indicted on federal charges that they lied to accountants about a payment from a supplier and that they used that payment to supplement earnings for the company. Joseph Hofmeister was a divisional vice president of merchandising in Kmart's drugstore division. Enio Montini was a senior vice president and general manager of the same division. Former CEO Charles Conaway and Chief Financial Officer John McDonald were also charged by the SEC with making materially false financial disclosures about Kmart.[164] They are charged with attributing larger amounts of inventory to seasonable demand (i.e., it was being carried for the Christmas season as opposed to disclosing that sales were down) and with failing to disclose agreements to postpone payments to creditors. Interestingly, a panel used by Kmart's board to arbitrate Conaway's termination found that Mr. Conaway acted in good faith and had not committed any fraud. The panel ruled that Mr. Conaway was entitled to his compensation package. The SEC charges, accusing Mr. Conaway of fraudulent reporting, followed several days later.[165]

The charges center on a payment of $42.4 million from American Greetings in 2001. The payment was called an *allowance* or *rebate*, and covered joint advertising as well as rebates and markdowns.[166] The payment was fully booked for that quarter despite accounting rules that require an examination of possible refunds for those fees. Many argue that the accounting in this case involves a gray area on which experts disagree and that no criminal intent existed. In fact, the area of allowances between manufacturers and retailers is one in which many stores are under SEC investigation. Kmart purchased Sears in November 2004 under new ownership.[167]

Discussion Questions

1. Are slotting fees a means of allocating risk?
2. What possible employee temptations exist?
3. Would a schedule of fees change the ethical and economics issues in slotting fees?
4. Are the perceptions of the industry participants a reflection of their questions about the ethics of slotting?
5. Are the accounting issues the result of the secretive nature of the payments?

Compare & Contrast

Note that Sysco, one of the largest food distributors in the United States, was the only food distributor in the industry that did not have to restate its financials based on the accounting for these types of fees. What made Sysco behave so differently from the rest of the industry? Sysco remains financially sound today and is not involved with SEC charges. Were these long-term factors part of the decision process on its accounting practices?

[163] Constance Hays, "Rules Are Loosely Defined in the Food Service Industry," *New York Times*, March 5, 2003, p. C1.

[164] Lorrie Grant, "K-Mart's Former CEO, CFO Face Charges," *USA Today*, August 24, 2005, p. 1B.

[165] Susan Carey, "K-Mart Ex-CEO Cleared of Wrongdoing," *Wall Street Journal*, August 16, 2005, p. A3.

[166] Lorrie Grant, "Former Kmart Executives Face 3-Count Federal Indictment," *USA Today*, February 27, 2003, p. 1B; Amy Merrick, "U.S. Indicts 2 Ex-Executives of Kmart Corp.," *Wall Street Journal*, February 27, 2003, pp. A3, A14; and Constance L. Hays, "2 Officials at Kmart Face Fraud Charges," *New York Times*, February 27, 2003, pp. C1, C7.

[167] Robert Berner, "The Next Warren Buffett?" *BusinessWeek*, November 22, 2004.

SECTION D

Products and Social Issues

Sometimes the product is legal, the quality is good, and yet the product does have its issues. In this section, the issues are ones of social responsibility.

Case 8.19

The Mommy Doll

Villy Nielsen, APS, a Danish toy company, introduced the Mommy-To-Be doll in the United States. The doll, named Judith, looks like it is pregnant. When its belly is removed, a baby is revealed inside that can be popped out. Once the baby is removed, the doll's original stomach pops into place. The new stomach is flat and instantly restores Judith's youthful figure.

Teenage girls are intrigued by the doll and call it "neat." However, Diane Welsh, the president of the New York chapter of the National Organization for Women, stated, "A doll that magically becomes pregnant and unpregnant is an irresponsible toy. We need to understand having a child is a very serious business. We have enough unwanted children in this world."[168]

Mommy-To-Be comes with Charles, her husband, and baby accessories. An 11-year-old shopper said of the doll, "I don't think she looks like a mommy…. She looks like a teenager."[169] Mattel also had an expectant mother doll, but in the background on the box the doll and baby came in, there was a picture of a father standing by, ready to help.

Discussion Questions

1. Is the doll a socially responsible toy?
2. Would you carry the doll if you owned a toy store?
3. Would you want your children to have the doll?
4. Why did Mattel take a different approach in its packaging?

Case 8.20

Fast-Food Liability

Ashley Pelman, Roberta Pelman, Jazlen Bradley, and Israel Bradley (all youths under the age of 18) brought suit against McDonald's Corporation and several of its franchisees, alleging that in making and selling their products they have engaged in deception and that this deception has caused them to consume McDonald's products to such an extent that they have injured their health. Their health problems include being overweight and diabetic. Three of them also have coronary heart disease, high blood pressure, and elevated cholesterol intake.

[168] "Mommy Doll Makes Birth a Snap," *Mesa Tribune*, May 9, 1992, p. A7.

[169] *Id.*

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The following is an excerpt from the district court decision that dismissed the suit brought by the parents of the young people on their behalf.

Sweet, District Judge

Questions of personal responsibility, common knowledge and public health are presented, and the role of society and the courts in addressing such issues. Laws are created in those situations where individuals are somehow unable to protect themselves and where society needs to provide a buffer between the individual and some other entity—whether herself, another individual or a behemoth corporation that spans the globe. Thus Congress provided that essentially all packaged foods sold at retail shall be appropriately labeled and their contents described. The Nutrition Labeling and Education Act of 1990, Pub. L. 101-535, 104 Stat. 2353 (Nov. 8, 1990) (the "NLEA"), 21 USC § 343(q). Also as a matter of federal regulation, all alcoholic beverages must warn pregnant women against their use. 27 USC. § 215 (forbidding sale of alcohol unless it bears the following statement: "GOVERNMENT WARNING: (1) According to the Surgeon General, women should not drink alcoholic beverages during pregnancy because of the risk of birth defects. . . ."); 27 C.F.R. § 16.21. Congress has gone further and made the possession and consumption of certain products criminal because of their presumed effect on the health of consumers.

This opinion is guided by the principle that legal consequences should not attach to the consumption of hamburgers and other fast-food fare unless consumers are unaware of the dangers of eating such food. . . . [T]his guiding principle comports with the law of products liability under New York law. As Sir Francis Bacon noted, "Nam et ipsa scientia potestas est," or knowledge is power. Following from this aphorism, one important principle in assigning legal responsibility is the common knowledge of consumers. If consumers know (or reasonably should know) the potential ill health effects of eating at McDonald's, they cannot blame McDonald's if they, nonetheless, choose to satiate their appetite with a surfeit of supersized McDonald's products. On the other hand, consumers cannot be expected to protect against a danger that was solely within McDonald's knowledge. Thus, one necessary element of any potentially viable claim must be that McDonald's products involve a danger that is not within the common knowledge of consumers.

McDonald's has also, rightfully, pointed out that this case, the first of its kind to progress far enough along to reach the stage of a dispositive motion, could spawn thousands of similar "McLawsuits" against restaurants. Even if limited to that ilk of fare dubbed "fast food," the potential for lawsuits is great: Americans now spend more than $110 billion on fast food each year, and on any given day in the United States, almost one in four adults visits a fast-food restaurant.[170] The potential for lawsuits is even greater given the numbers of persons who eat food prepared at other restaurants in addition to those serving fast food.

The interplay of these issues and forces has created public interest in this action, ranging from reports and letters to the Court to television satire. Obesity, personal liberty and public accountability affect virtually every American consumer.

… [T]here is no allegation that McDonald's of New York had in its possession any particular knowledge that consumers did not have that would require it to promulgate information about the nutritional contents of the products.

… [T]he plaintiffs only cite two advertising campaigns ("McChicken Everyday!" and "Big N' Tasty Everyday") and to a statement on the McDonald's website that "McDonald's can be part of any balanced diet and lifestyle." These are specific examples of practices, act[s] or advertisements and would survive a motion to dismiss based on lack of specificity. Whether they would survive a motion to dismiss on the substantive issue of whether such practices, act[s] and advertisements are deceptive is less clear. The two campaigns encouraging daily forays to McDonald's and the statement regarding making McDonald's a part of a balanced diet, if read together, may be seen as contradictory—a balanced diet likely does not permit eating at McDonald's everyday. However, the advertisements encouraging persons to eat at

[170] Eric Schlosser, *Fast Food Nation* 3 (2002).

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> McDonald's "everyday!" do not include any indication that doing so is part of a well-balanced diet, and the plaintiffs fail to cite any advertisement where McDonald's asserts that its products may be eaten for every meal of every day without any ill consequences. Merely encouraging consumers to eat its products "everyday" is mere puffery, at most, in the absence of a claim that to do so will result in a specific effect on health. As a result, the claims likely would not be actionable.

As noted, the trial court dismissed the suit. However, the appellate court reversed the decision, and the case continues through the discovery and trial stage.[171]

A significant setback in the case transpired when the trial court declined to grant class action certification for the suit.[172] That denial means that the recovery, if the theory were successful, would be limited. Without class action status, it becomes difficult for a single plaintiff to pursue the fast-food liability theory for recovery. The case seems to be in a stalled status.

Discussion Questions

1. Are the following questions, raised by lawyers for McDonald's, relevant in resolving this situation: What else did the young people eat? How much did they exercise? Is there a family history of the diseases alleged to have been caused by McDonald's products?
2. Why does the court bring up the issue of personal accountability?
3. What would happen if there were a flurry (as it were) of McLawsuits? Is a flurry of lawsuits likely at this point?
4. McDonald's has added a choice of fruit pieces, yogurt, and salads to its menus, with a resulting boost in revenues. What business lessons can be gleaned from this decision?

Case 8.21

Barbie Doesn't Like Math

Federal Judge Alex Kozinski gave a history of the Barbie doll in one of his court opinions on an intellectual property dispute between Mattel, the doll's manufacturer, and MCA Records:

> Barbie was born in Germany in the 1950s as an adult collector's item. Over the years, Mattel transformed her from a doll that resembled a "German street walker," as she originally appeared, into a glamorous, long-legged blonde. Barbie has been labeled both the ideal American woman and a bimbo.
>
> She has survived attacks both psychic (from feminists critical of her fictitious figure) and physical (more than 500 professional makeovers). She remains a symbol of American girlhood, a public figure who graces the aisles of toy stores throughout the country and beyond. With Barbie, Mattel created not just a toy but a cultural icon.[173]

Barbie is a lightning rod for cultural issues. In fact, July 27th each year is known as "National Barbie in a Blender Day," for those who simply cannot abide her presence. When Mattel released a Barbie doll that talked and said, "I hate math," public outcries arose because of the impact such an icon's statement would have on the drive to have more young women enter into engineering and sciences. In 2010, Mattel introduced

[171] The full history of the case is as follows: *Pelman v. McDonald's Corp.* (Pelman III), 396 F.3d 508, 510 (2nd Cir. 2005). *Pelman* was initially dismissed. *Pelman I*, 237 F. Supp. 2d at 543. An amended complaint was refiled and dismissed. *Pelman v. McDonald's Corp.* (*Pelman II*), No. 02 Civ. 7821(RWS), 2003 WL 22052778, at 15 (S.D.N.Y. Sep. 3, 2003). The U.S. Court of Appeals vacated the court's dismissal and remanded the case, see *Pelman III*, 396 F.3d 508, which is pending[0]. See also *Pelman v., McDonald's Corp. (Pelman IV)*, 396 F. Supp. 2d 439, 446 (S.D.N.Y. 2005); *Pelman v. McDonald's Corp. (Pelman V),* 452 F. Supp. 2d 320, 328 (S.D.N.Y. 2006).

[172] *Perlman v. McDonald's Corp.*, 272 F.R.D. 82 (S.D.N.Y. 2010).

[173] *Mattel, Inc. v. MCA Records, Inc.*, 177 F.3d 839 (9th Cir.1999).

Tattooed Barbie, a doll that had her chest and neck tattooed and sported pink hair. Tattooed Barbie's top was off the shoulder so as to reveal the splendor of her tattoos. When parents protested the introduction of Tattooed Barbie as a dangerous role model for young girls, Mattel responded that the doll was simply a collectible for adults. Boycotts always ensue the introduction of a controversial Barbie, but the doll remains a mainstay – a significant portion of Mattel's sales.

Discussion Questions

1. Is the issue with Barbie different from the issues with children's ads?
2. Who are the stakeholders Mattel should consider in determining what types of Barbies to develop and sell?
3. If Tattooed Barbie is a big hit and results in increased sales, would Mattel harm its shareholders by withdrawing the product?

Ethics and Competition

UNIT NINE

Capitalism without failure is like religion without sin.

Irwin M. Stelzer, "Our Hapless Automakers," *The Weekly Standard*, June 16, 2010

I think you just felt a tremendous need to keep up and to play well. You know, it was hot in Texas every day. It was over a hundred degrees. You know, you felt like, without trying to overinvestigate what you're taking, can I have an edge just to get out there and play every day? And that's what it came down to.

Alex Rodriguez, in 2009, acknowledging his use of PED

A business's relations with its competitors can be a sticky wicket. Producing similar products, poaching employees, and pricing all present ethical challenges that are often about as close to the legal line as ethical issues come. The heat of competition often creates dilemmas about what you can take with you to your new job or just how similar your product can be to your competitor's.

SECTION A

Covenants Not to Compete

Reading 9.1

A Primer on Covenants Not to Compete: Are They Valid?[1]

Covenants not to compete take two forms. The first type is found in the sale of a business. To keep the seller of the business from trotting down the street and opening up another business to compete, courts enforce covenants not to compete in these business purchase agreements as long as they are reasonable in length and geographic scope. The questions of time and scope are based in economics; that is, how many dry cleaners can be located within this radius and still find a sufficient customer base?

The second type of covenant not to compete is a bit more testy than those found in the sale of a business. This type of covenant applies to employees. Employers require their new hires, as part of their contractual arrangement, to agree not to compete with their employer should they decide to leave their employ. When an owner sells a business, he or she has the income from the sale as a means of a support. When an employee leaves his or her employ, a banishment from that area of doing business, in other words, from using their skills, can be tantamount to a ban on employment.

In dealing with these covenants, courts strike a balance between employees' right to work and employers' right to protect the trade secrets, training, and so on, that former employees have and then take with them to another company or use to start a business.

Requirements for Noncompete Agreements

The Need for Protection

The laws on noncompete agreements vary from state to state, with California's being the most protective of employees. California's statute in essence prohibits employers from enforcing agreements that prohibit employees from working in their chosen fields.[2] However, across all states, courts are clear in their position that there must first be an underlying need or reason for a noncompete agreement. To be valid, the covenant must apply only to employees who have had access to trade secrets that could help them start a business in competition with the principal or employer.

Reasonableness in Scope

The covenant must also be reasonable in geographic scope and time. These factors depend upon the economic base and the nature of the business. For example, a noncompete in a high-tech employee's contract could be global but must be shorter in duration because technology changes so rapidly. A noncompete for a collection agency could not be global but might be longer in duration because this is the type of business based on relationships.

[1] Adapted from Marianne M. Jennings, *Business: Its Legal, Ethical, and Global Environment*, 9th ed. (2011).

[2] Alabama, Montana, North Dakota, and Oklahoma have statutes similar to California's.

Valid Formation

Noncompete agreements are also subject to the basics of contract law. There must be consideration, and there cannot be duress. For example, one dot-com agreed to give its employees stock options if they would sign a noncompete agreement. Amazon.com offered downsized employees an additional ten weeks' pay plus $500 if they would sign a three-page "separation agreement and general release" in which they promised not to sue Amazon over the layoff or disparage it in any way. Amazon has had employees sign a confidentiality agreement at the beginning of their employment that restricts their use of information and knowledge gained while working at Amazon.

California and other states have provided protection for employees who refuse to sign noncompete agreements by imposing punitive damages on employers that terminate employees who refuse to sign.

Other Theories for Noncompete Enforcement

Some employers have begun to use the tort of tortious interference with contracts as a means of preventing former employees from working for competitors or beginning their own competing business. In those states in which noncompete clauses are unenforceable, interference is used as a means of enjoining the former employee's business activities. For example, in *TruGreen Companies, L.L.C. v. Mower Brothers, Inc.* (199 P.3d 929 Utah 2008), the Utah Supreme Court held that a company whose former employee had gone to work for a competing company and recruited other employees to join him was liable for tortious interference.

Another possible avenue of protection is a confidentiality agreement, one signed with employees that prohibits them from disclosing confidential and proprietary information they learned of during their employment. For example, the information in a sealed bid is proprietary. An employee who takes that information along when hired by a competitor breaches a confidentiality agreement. This type of agreement does not prohibit employment, but it does control the type of work the employee can do at the new company.

Discussion Questions

1. What is the balance in covenants?
2. What types of covenants are enforced?

Case 9.2

Boeing, Lockheed, and the Documents[3]

In 1996, Boeing and Lockheed Martin were in a head-to-head competition for a multibillion-dollar government contract for furnishing the rockets that are used for launching satellites into space (a project referred to in the industry as the Evolved Expendable Launch Vehicle, or EELV). The satellites perform various functions and could be communication or spy satellites.

It was during this competitive time frame (1996) for the rocket launcher project that Kenneth Branch, a space engineer and manager at Lockheed facilities in Florida, traveled to McDonnell Douglas facilities at Huntington Beach, California, for a job interview. McDonnell Douglas was working on the rocket bid at the same time that it was being acquired by Boeing. Boeing's acquisition of McDonnell Douglas had been finalized at the time of the Branch interview, but the logistics of acquisition had not yet been

[3] The author consulted with Boeing following the ethical scandals to help with employee ethics training. The information here was taken from public documents.

completed (it would be completed in August 1997). Boeing's acquisition of McDonnell Douglas and the combination of Lockheed with Martin Marietta meant that in the future the federal government would basically be dealing with two large contractors on all of its projects.

Near the end of his interview at McDonnell Douglas, Branch showed the participants in the interview process a copy of Lockheed's proposed presentation for the government project. Six months after his interview, in January 1997, Branch began work at Boeing on Boeing's rocket project, a $5 billion project. The pressure for Boeing to win the contract became intense at that time. Boeing executive Frank Slazer, the director of business development for the project, encouraged Boeing employees working on EELV to develop "an improved Lockheed Martin EELV competitive assessment." He also encouraged the employees to find former Lockheed employees to get their thoughts and impressions about the project.

Sometime during the first quarter of 1997, Lockheed sent Mr. Branch a letter reminding him of his confidentiality agreement with Lockheed and his duty not to disclose any proprietary information in his new position at Boeing. During this same period, a Boeing employee filed a report that she had seen Mr. Branch in the hallway with a notebook that had the Lockheed logo on the outside. She was reprimanded by Tom Alexiou, Mr. Branch's supervisor, for doing so, and no one took any action with regard to Mr. Branch or the notebook.

Shortly after, the project was awarded in what is called a "leader-follower" contract, in which the two companies compete for the term of the satellite launcher program. Boeing did emerge as the leader in that project and was awarded nineteen of the planned twenty-eight rocket launches, a total contract value of $1.88 billion. Shortly after, there were rumblings around the industry and government agencies about Boeing's conduct and possible possession of proprietary documents during the time of the bids. The government began an investigation into whether proprietary documents had passed from Lockheed to Boeing. Boeing also launched, as it were, an internal investigation and fired Mr. Branch as well as one of his supervisors, William Erskine, because it found that the two were in possession of thousands of pages of proprietary documents that included Lockheed Martin information on specifications and cost. The terminations were reported to the federal government, along with Boeing's assurances that it had dealt with the situation and completed cleansing its own house.

Mr. Branch and Mr. Erskine filed suit against Boeing for wrongful termination, and document production began as part of the discovery process in the suit. Although the suit was dismissed in 2002, the details of Boeing's internal investigation still made their way into the court case, including documents and a memo describing the conduct of Mr. Branch, Mr. Erskine, and Boeing executives. The interest of the Justice Department was piqued, and its investigation into Boeing's conduct also began in 2002. In one telling exchange, a project specialist, Steve Griffin, confronted Mr. Erskine with his conduct related to the EELV project: Mr. Erskine admitted that he had an "under-the-table" arrangement to get Lockheed bid documents from Mr. Branch and that he did ultimately incorporate what he learned into Boeing's bid. The internal investigation revealed this conversation between the two following that disclosure:

Griffin: We just took a Procurement Integrity Law class. I can't believe you did that.
Erskine: I was hired to win … and I was going to do whatever it took to do it.

Mr. Griffin ultimately reported the information to his boss, and the internal investigation resulted.

Boeing and Lockheed had been in a virtual dead heat for military contracts for some time, with Lockheed Martin slightly ahead in 2000 and 2001, and the two nearly tied at

$15 billion each in 2002. There was, as a result, significant bad blood between the two, and each new disclosure led to further investigations by more agencies.

The judge in the Branch and Erskine wrongful termination suit ordered the men to pay Boeing's legal fees, but the two men signed agreements promising not to disclose details about the case or discuss it with the media in exchange for Boeing waiving its rights to collect its legal fees.

At the end of April 2003, Boeing shipped eleven boxes of documents to Lockheed Martin. The documents in the boxes had the Lockheed Martin logo and were stamped "Proprietary." When those documents arrived, the entire sordid history emerged in the press.[4] Boeing did not disclose the issues and investigations surrounding EELV in its SEC documents until May 2003, after a *Wall Street Journal* report on the investigations and litigation appeared. Jim Albaugh, CEO of the Defense Systems Division, indicated that management had not really focused on the inquiries and investigations until that public disclosure.[5]

The scandal then reached Congress, where concerns about government contracts with Boeing arose.[6] Pending at the time of the erupting investigation into the EELV contracts was an $18 billion contract with the U.S. Air Force for the delivery of Boeing 767 tankers, aircraft used to refuel fighter jets in midair. Congress held hearings on the Defense Department's decision to award a tanker contract to Boeing because CEO Albaugh had called Air Force Assistant Secretary Marvin Sambur for help in closing the deal. Mr. Sambur did step in to help, and congressional wrath resulted. U.S. Senator John McCain (R-Ariz.) noted, "It's astonishing. Even in light of serious allegations, they [Boeing] continued to push to railroad the [tanker] deal through, and they still are."[7]

The public relations fallout from the tankers issue not only created a negative reaction in Congress but also created public perception problems. In order to win back public favor and attempt to refute the charges, Boeing ran a series of one-page ads in newspapers around the country, including the *Wall Street Journal.*[8]

Continuing ethical lapses (see Case 7.13) Boeing's recruitment while bids were pending of a government official who had not recused herself) forced a shake-up in Boeing, with the termination of its chief financial officer (CFO), Michael Sears.[9] On July 24, 2003, the USAF suspended the space launch services business and the three former employees from receiving government contracts for an indefinite period because of Boeing's possession of the Lockheed Martin information during the EELV source selection in 1998. The USAF also terminated seven out of twenty-one contracts from Boeing as a penalty for its conduct with the Lockheed documents.[10] The USAF also disqualified the launch services business from competing for three additional launches under a follow-on

[4] Anne Marie Squeo and Andy Pasztor, "U.S. Probes Whether Boeing Misused a Rival's Documents," *Wall Street Journal*, May 5, 2003, pp. A1, A7.

[5] Anne Marie Squeo, J. Lynn Lunsford, and Andy Pasztor, "Boeing's Plan to Smooth Bumps of Jet Market Hits Turbulence," *Wall Street Journal*, August 25, 2003, pp. A1, A6.

[6] Stanley Holmes, "Boeing: Caught in Its Own Turbulence," *BusinessWeek*, December 8, 2003, p. 37.

[7] Byron Acohido, "Boeing's Call for Help from Air Force Raise More Questions," *USA Today*, December 8, 2003, p. 3B.

[8] *Wall Street Journal,* May 4, 2004, p. A7.

[9] Ironically, Mr. Sears's book *Soaring through Turbulence* was scheduled for release from the publisher at the same time; Julie Creswell, "Boeing Plays Defense," *Fortune,* April 19, 2004, p. 91. Its publication was delayed indefinitely; Del Jones, "Fired Boeing Executive Encounters Book Turbulence," *USA Today*, November 28, 2003, p. 2B. Some quotes from the book: "Corporate leaders need a model that will keep them clear of impropriety and the appearance of impropriety," and "Either you are ethical or you are not. You have to make that decision; all of us do. And there is no in between."

[10] J. Lynn Lunsford and Anne Marie Squeo, "Boeing CEO Condit Resigns in Shake-Up at Aerospace Titan," *Wall Street Journal*, December 2, 2003, pp. A1, A12.

procurement. Air Force Undersecretary Peter Teets released the following statement in making the announcement:

> We do not tolerate breaches of procurement integrity, and we hold industry accountable for the actions of their employees.[11]

Just prior to the Air Force announcement, Boeing had issued its own announcement that the expected revenues from commercial satellites and rocket launchers had been greatly overestimated by that division. Boeing took a $1.1 billion charge to reflect the fact that those revenues had already been overestimated.[12] Two of Boeing's former executives were indicted for their role in the documents scandal. The fallout from the problems at Boeing has caused the contract for the tankers to go back and forth several times, with the Air Force ultimately, in 2009, suspending the bidding and ordering a new process of bidding for those planes. The bidding did not close until November 2010.

Lockheed filed suit against Boeing for the appropriation of the documents. CEO Philip Condit had fired CFO Sears, saying, "Boeing must and will live by the highest standards of ethical conduct."[13] However, Condit departed abruptly on December 1, 2003.[14] When Condit resigned, analysts, observers, employees, and others took stock of Boeing and what had gone wrong. One wrote, "Under Condit, engineering skills and ethics seemed to lose sway over senior management." Condit's four marriages, two to Boeing employees, one of whom was pink-slipped during her relationship with Condit, created a culture that ran contra to the conservative traditions of Boeing. When Condit moved into the Four Seasons Olympic Hotel in Seattle and had the suite remodeled at company expense, even the board members became nervous, quietly saying among themselves that they had "another Clinton" on their hands.[15]

As the culture of the company deteriorated, Boeing missed strategic opportunities. Doubting the ability of Airbus to bring the A380 555-passenger jet to market, Boeing opted out of that jumbo-jet market. Airbus won 120 orders for the super jumbo jet and seized Boeing's market for large jetliners. Shareholders were in revolt. Boeing did develop the Dreamliner 7E7 jetliner following its withdrawal from the jumbo-jet competition with Airbus, but its commercial production has been delayed numerous times for both design flaws and supplier issues. Boeing was scheduled to deliver fifty of the new aircraft to All Nippon Airways, for a total contract price of $6 billion in 2008, but the jet was not unveiled in Everett, Washington, until July 8, 2007. And its maiden public flight did not occur until 2009.

After the management shake-up and all the fallout from the documents and the defense employee recruitment, Boeing worked toward a culture change. However, the issues continued to arise. In April 2004, the U.S. Attorney's Office in Los Angeles expanded its investigation of the Lockheed Martin document case into Boeing work for NASA and the possibility that other Lockheed documents were used on NASA projects. The documents are different and involve different managers, but the pattern of abuse is the same.[16]

[11] Edward Iwata, "Air Force Punishes Boeing by Taking 7 Contracts," *USA Today*, July 25, 2003, p. 1B.

[12] Squeo, Lunsford, and Pasztor, "Boeing's Plan to Smooth Bumps of Jet Market Hits Turbulence," pp. A1, A6.

[13] Gary Strauss, Byron Acohido, Elliot Blaire Smith, and Marilyn Adams, "Boeing CEO Abruptly Quits after Controversy," *USA Today*, December 2, 2003, p. 1B.

[14] Stanley Holmes, "Boeing: What Really Happened," *BusinessWeek*, December 15, 2003. p. 33.

[15] *Id.*

[16] Andy Pasztor and Jonathan Karp, "Federal Officials Widen Probe into Boeing's Use of Rival's Data," *Wall Street Journal*, April 27, 2004, pp. A7, A10.

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In 2003, the U.S. Navy selected Boeing to deliver up to 210 F/A 18 fighter jets for a total contract price of $9.6 billion.[17] In June 2004, the Navy awarded a $23 billion contract to Boeing to convert 737 jets into antisubmarine aircraft, a contract that replaces plans that had been supplied by Lockheed Martin originally.[18] The contract was awarded even as the government investigation on the EELV was still ongoing. When former CEO Harry Stonecipher returned from retirement to reassume his role following Mr. Condit's resignation, he told the business press, "We're cleaning up our own house."[19] When asked if he could provide assurance to investors and customers that the scandals were behind Boeing, Mr. Stonecipher said, "Well, as in definitely behind us, they'll never be definitely behind us until all the lawsuits are finished. Rather than trying to convince people that it's all behind us, I have convinced them that we have a process and a will to deal with it, vigorously and summarily."[20] In 2005, the federal government lifted the sanctions against Boeing that had banished it from the line of defense contracts that were related to the Lockheed documents.[21]

In 2005, Mr. Stonecipher was removed as CEO after an internal investigation revealed that he had had an affair with one of the company executives. The affair was uncovered by an employee responsible for monitoring e-mails, and Mr. Stonecipher's e-mails to the executive demonstrated not only an affair but also poor judgment in the use of company e-mail. The employee reported anonymously the content of the e-mails, including information about the affair and other "graphic content," to an ethics officer.[22] The ethics officer investigated the concern and then turned over the findings to general counsel, who then took the information to the Boeing board. When confronted with the issue, even Mr. Stonecipher agreed that he was no longer the right person to lead the company in its recommitment to ethics, "We set—hell, I set—a higher standard here. I violated my own standards. I used poor judgment."[23] Mr. Stonecipher's departure was announced within ten days following the employee's anonymous tip. The board found that he had violated the following provisions of Boeing's code of ethics:

> In conducting its business, integrity must underlie all company relationships, including those with customers, suppliers, communities, and other employees.
>
> Employees will not engage in conduct or activity that may raise questions about the company's honesty, impartiality, [or] reputation or otherwise cause embarrassment to the company.

Lou Platt, chairman of the board, said that Mr. Stonecipher's "poor judgment … impaired his ability to lead."[24]

On May 15, 2006, Boeing announced that it had settled the charges with the federal government that were related to the federal contracts and the Darlene Druyun matter (Case 7.11). Boeing agreed to pay a $615 million fine, but the government did not require the company to admit any wrongdoing and acknowledged that employees had acted without "authority and against company policy."[25]

[17] "Closing Bell," *BusinessWeek*, January 12, 2004, p. 42.

[18] Leslie Wayen, "Boeing Wins Navy Contract to Replace Sub Chasers," *New York Times*, June 15, 2004, pp. C1, C9.

[19] Ron Insana, "We're Cleaning Up Our Own House," *USA Today*, January 5, 2004, p. 4B.

[20] Laura Rich, "A Boeing Stalwart, War or Peace," *New York Times*, July 18, 2004, p. BU4.

[21] Floyd Norris, "Moving from Scandal to Scandal, Boeing Finds Its Road to Redemption Paved with Affairs, Great and Small," *New York Times*, March 8, 2005, p. C5.

[22] J. Lynn Lunsford, Andy Pasztor, and JoAnn S. Lublin, "Boeing CEO Forced to Resign over His Affair with an Employee," *Wall Street Journal*, March 8, 2005, pp. A1, A8.

[23] *Id.*

[24] Bryan Acohido and Jayne O'Donnell, "Extramarital Affair Topples Boeing CEO," *USA Today*, March 8, 2005, p. B1.

[25] "Boeing Pays a Biggie," *BusinessWeek*, May 29, 2006, p. 30.

Discussion Questions

1. What made the engineers and executives want the Lockheed documents and then use them? Do you have some ideas for lines for your credo that come from seeing what happened with the engineers and the executives who were complicit?
2. List the long-term costs and consequences of Boeing's use of the documents. Consider others you may see that are not called out in the case.
3. Do you think the fact that Boeing continued to receive contracts is evidence that ethics don't matter?
4. One analyst has said that the problem with Boeing is that it cannot admit that the problems were internal but always seeks to blame the problems on a "few bad apples." Is this statement valid?
5. List the categories of ethical breaches that you see in this scenario.

Compare & Contrast

When Mr. Stonecipher left the company, analysts disagreed on whether his ouster was appropriate. One analyst said, "The board has done the right thing inasmuch as the firm still needs a moral rudder to return to its storied reputation."[26] Another analyst added, "It's a board that's become overly sensitized by all the negative publicity about Boeing employees and their ethics, and they reacted more strongly than I think was appropriate."[27] Discuss the two views, and using what you have learned, determine what was best for the company. Why did they reach different conclusions? Can you draw any additional lines for conduct in business based on this case?

Case 9.3

Starwood, Hilton, and the Suspiciously Similar New Hotel Designs

The Hotel Setup and Background

Starwood and Hilton are direct, head-to-head competitors. In 2007, the Blackstone Group, a private equity firm, acquired Hilton for over $20 billion in a top-of-the-market, highly leveraged buyout. Financial analysts suggested that because Blackstone had paid a super-premium price for Hilton, the hotel chain would be under intense pressure to deliver immediate results. Ross Klein and Amar Lalvani were president and senior vice president, respectively, of Starwood's Luxury Brands Group. Both were intimately involved in and aware of the strategy and planned future development of Starwood's lifestyle and luxury hotel brands: the St. Regis, W Hotels, and The Luxury Collection. Both Messrs. Klein and Lalvani had access to strategic development plans, and both had signed written confidentiality agreements with Starwood.

Hilton Recruits from Starwood

In February 2008 Christopher Nassetta, Hilton's President and Chief Executive Officer, began recruiting Mr. Klein to join Hilton. Mr. Klein then began requesting large volumes of confidential information from Starwood employees, which he took home and loaded onto a personal laptop computer and/or forwarded to a personal e-mail account, before joining Hilton. After Mr. Klein obtained a severance payment of more than $600,000 from Starwood, he joined Hilton and used the information there in the development of a new Hilton high-scale hotel known as Denizen.

[26] Dave Carpenter, "Boeing Chief Ousted over Affair with Employee," *The Tribune*, March 8, 2005, pp. B1, B2.

[27] *Id.*

In March 2008, Steven Goldman, Hilton's President of Global Development and Real Estate, began recruiting Mr. Lalvani to join Hilton. Goldman told Lalvani that Hilton was a "clean slate" and "you're the first guy on my list." Mr. Lalvani provided Mr. Goldman with his ideas for Hilton, including the following from an e-mail: "Other idea is bring over the core W team which has created an enormous amount of value and is very loyal to me to build a new brand for you guys. Not sure your appetite but I know I could make that happen as well."[28] Before joining Mr. Goldman at Hilton, Mr. Lalvani also secretly downloaded large quantities of confidential Starwood documents, which he brought with him and used at Hilton.

By June 2008, Messrs. Klein and Lalvani were both at Hilton as Hilton's Global Head of Luxury & Lifestyle Brands and Global Head of Luxury & Lifestyle Brand Development, respectively.

Hilton's press release included the following statement upon the arrival of the two:

> These new hires will help advance Hilton's strategic goal of further developing its presence in the luxury and lifestyle sectors. At Hilton, Mr. Klein will oversee the company's global luxury and lifestyle brand portfolio, including Waldorf-Astoria, the Waldorf-Astoria Collection and Conrad, and will spearhead the company's entry into the lifestyle segment. Mr. Lalvani will lead the global development of Hilton's luxury and lifestyle segments?[29]

The Paper Hiring Bonus

Between the two men, they brought along to Hilton over 100,000 electronic Starwood documents that contained proprietary information that Hilton then used in creating its new Denizen hotel chain. The documents included the following:

Starwood's Forward-Looking Strategic Development Plans

- Starwood's Principal Term Prioritization Worksheets, containing Starwood's highly confidential and proprietary current and prospective negotiation strategies with owners, ranked by importance to Starwood for numerous deal terms.
- Starwood's Property Improvement Plan templates for how to create "the Ultimate W Experience" in conversion properties, providing step-by-step details for how to convert a hotel property to a W-branded hotel.
- Starwood's confidential computer files containing the names, addresses, and other nonpublic information for its Luxury Brands Group owners, developers, and designers compiled by Starwood.
- Recent presentations to Starwood's executive leadership team, containing current and prospective financial, branding, and marketing information for Starwood's lifestyle and luxury brands.
- Starwood's site-specific Project Approval Requests, which set out in detail highly sensitive and competitively useful information for Starwood properties and targeted properties around the world.
- Confidential and proprietary marketing and demographic studies for which Starwood paid third parties over $1 million.
- Starwood's W Residential Guidelines 2008, containing Starwood's strategies and proprietary toolkits for residential development in or at W hotels.
- Starwood's W Hotels "Brand in a Box" modules and training materials, containing Starwood's proprietary training, operational materials, and procedures for opening a new lifestyle hotel.
- A board presentation on future strategies for the chain.
- Starwood's Luxury Brands Group "Brand Bibles," brand handbooks, brand immersion materials, and brand marketing plans.

[28] *Starwood Hotels & Resorts Worldwide, Inc. v. Hilton Hotels Corporation*, Klein, & Levine, trial pleading, 2009 WL 1025597 (S.D.N.Y.)

[29] *Id.*

The Recruiting Raids

Upon their arrival at Hilton, Messrs. Klein and Lalvani also recruited additional Starwood employees to join them at Hilton and to bring with them to Hilton additional confidential, competitively sensitive Starwood information. A list appears below:

Individual	Former Starwood Position	Current Hilton Position
Christopher Kochuba	Vice President, Development Planning & Design Management, Luxury Brands Group	Vice President, Planning and Programming, Global Luxury and Lifestyle Brands
Erin Shaffer	Senior Manager, Brand Marketing, Luxury Brands Group	Senior Director, Communications and Partnerships
Jeff Darnell	General Manager, W Hotel Los Angeles	Vice President, Brand Operations
Stephanie Heer	Marketing Manager, W Hotel Los Angeles	Brand Marketing Manager, Conrad Hotels
Erin Green	Director, W Development, Europe, Africa, and Middle East	Senior Development Director, Luxury and Lifestyle (Europe and Africa)
Elie Younes	Senior Director, Acquisitions & Development, Europe, Africa, and Middle East	Vice President, Development (Middle East)
Leah Corradino	Marketing Manager, W Hotel San Diego	Brand Marketing Manager, Waldorf Astoria and Waldorf Astoria Collection
Susan Manrao	Senior Manager, Interior Style & Design Standards	Senior Director of Design and Brand Experience[30]

The Arbitration and Truth Percolates

Because of the ongoing poaching, Starwood brought and commenced an arbitration action against Mr. Klein in November 2008 to enforce the nonsolicitation provisions in his employment contract and his separation agreement with Starwood.

In February 2009, pursuant to a Starwood discovery request of Hilton, Hilton delivered eight large boxes of computer hard drives, zip drives, thumb drives, and paper records containing the information listed above. Hilton also acknowledged that the former employees had additional Starwood materials "at home." However, Hilton took no action against Mr. Klein or any of the other former Starwood employees.

Hilton's general counsel said in a cover letter included with the eight boxes of documents that he did not think the information was proprietary or confidential but that he was sending them back as a precaution.

However, Starwood noted that files that had been taken included its development plans for its "zen den" that it was going to put in its upscale W hotels. Hilton's development plans for Denizen referred to it as their "den of zen."

Hilton and Starwood settled their suit in 2010, with Hilton agreeing not to create a luxury "lifestyle" hotel until 2012. In addition, Hilton was banned from ever using its Denizen brand and was required to have a court-appointed monitor to review its

[30] *Id.*

marketing and branding materials to be sure that nothing it was doing resulted from its access to the Starwood documents. Damages were also part of the settlement, with Hilton paying Starwood an unspecified amount of damages.[31] Individuals within the companies disclosed that the payment was $75 million.[32] The settlement mirrored the temporary injunction that the court had put into place prior to trial that placed the same restrictions on Hilton. Messrs. Klein and Lalvani were prohibited under the agreement from working with certain hotel chains for two years.

Following a criminal investigation, the U.S. Attorney declined to bring charges against Hilton, but investigations into the conduct of individual employees has continued.

Discussion Questions

1. In developing a concept for a new chain (Denizen is geared at the high-end market), companies spend years and millions of dollars on studying consumer needs and preferences, social trends, lighting, costs, food choices, and even fabrics and designs. What ethical category does the conduct of the former Starwood executives fall into beyond just the breach of their employment contract covenants?
2. The following clause appears in the former Starwood employees' contracts:

   [Employee] acknowledges that during the course of his/her employment with [Starwood], Employee will receive, and will have access to, "Confidential Information" … of [Starwood] and that such information is a special, valuable and unique asset belonging to [Starwood] … All [Documents (broadly defined)] which from time to time may be in Employee's possession … relating, directly or indirectly, to the business of [Starwood] shall be and remain the property of [Starwood] and shall be delivered by Employee to [Starwood] immediately upon request, and in any event promptly upon termination of Employee's employment, and Employee shall not make or keep any copies or extracts of the Documents. … Employee shall not disclose to any third person any information concerning the business of [Starwood], including, without limitation, any trade secrets, customer lists and details of contracts with or requirements of customers, the identity of any owner of a managed hotel, information relating to any current, past or prospective management agreement or joint venture, information pertaining to business methods, sales plans, design plans and strategies, management organization, computer systems and software, operating policies or manuals … financial records or other financial, commercial, business or technical information relating to the company.

   Is this an enforceable provision? Do you believe the employees violated this provision by their conduct?
3. What components of a personal credo would have helped in this situation?
4. Where does "fair play" fit into ethics? Competition? Law?

[31] Alexandra Berson, "Hilton Settles Spy Suit," *Wall Street Journal*, December 23, 2010, p. B1

[32] Peter Lattman, "2 Big Hotel Chains Settle a Theft Suit," *New York Times*, December 23, 2010, p. B1.

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SECTION B

All's Fair, or Is It?

We all look for that angle, that piece of information, that extra effort that gives us a winning moment financially. But ethical issues arise in how we obtain that one piece of information and how we use it.

Reading 9.4

Adam Smith: An Excerpt from The Theory of Moral Sentiments

How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it.

1.1.27

Philosophers have, of late years, considered chiefly the tendency of affections, and have given little attention to the relation which they stand in to the cause which excites them. In common life, however, when we judge of any person's conduct, and of the sentiments which directed it, we constantly consider them under both these aspects. When we blame in another man the excesses of love, of grief, of resentment, we not only consider the ruinous effects which they tend to produce, but the little occasion which was given for them. The merit of his favourite, we say, is not so great, his misfortune is not so dreadful, his provocation is not so extraordinary, as to justify so violent a passion. We should have indulged, we say; perhaps, have approved of the violence of his emotion, had the cause been in any respect proportioned to it.

1.1.28

When we judge in this manner of any affection, as proportioned or disproportioned to the cause which excites it, it is scarce possible that we should make use of any other rule or canon but the correspondent affection in ourselves. If, upon bringing the case home to our own breast, we find that the sentiments which it gives occasion to, coincide and tally with our own, we necessarily approve of them as proportioned and suitable to their objects; if otherwise, we necessarily disapprove of them, as extravagant and out of proportion.

Every faculty in one man is the measure by which he judges of the like faculty in another. I judge of your sight by my sight, of your ear by my ear, of your reason by my reason, of your resentment by my resentment, of your love by my love. I neither have, nor can have, any other way of judging about them.

The man who, by some sudden revolution of fortune, is lifted up all at once into a condition of life, greatly above what he had formerly lived in, may be assured that the congratulations of his best friends are not all of them perfectly sincere. An upstart, though of the greatest merit, is generally disagreeable, and a sentiment of envy commonly prevents us from heartily sympathizing with his joy. If he has any judgment, he is sensible of this, and instead of appearing to be elated with his good fortune, he endeavours, as much as he can, to smother his joy, and keep down that elevation of mind with which his new circumstances naturally inspire him. He affects the same plainness of dress, and the same modesty of behaviour, which became him in his former station. He redoubles his attention to his old friends, and endeavours more than ever to be humble, assiduous, and complaisant. And this is the behaviour which in his situation we most approve of; because we expect, it seems, that he should have more sympathy with our envy and aversion to his happiness, than we have with his happiness. It is seldom that with all this he succeeds. We suspect the sincerity of his humility, and he grows weary of this constraint. In a little time, therefore, he generally leaves all his old friends behind him, some of the meanest of them excepted, who may, perhaps, condescend to become his dependents: nor does he always acquire any new ones; the pride of his new connections is as much affronted at finding him their equal, as that of his old ones had been by his becoming their superior: and it requires the most obstinate and persevering modesty to atone for this mortification to either. He generally grows weary too soon, and is provoked, by the sullen and suspicious pride of the one, and by the saucy contempt of the other, to treat the first with neglect, and the second with petulance, till at last he grows habitually insolent, and forfeits the esteem of all. If the chief part of human happiness arises from the consciousness of being beloved, as I believe it does, those sudden changes of fortune seldom contribute much to happiness. He is happiest who advances more gradually to greatness, whom the public destines to every step of his preferment long before he arrives at it, in whom, upon that account, when it comes, it can excite no extravagant joy, and with regard to whom it cannot reasonably create either any jealousy in those he overtakes, or any envy in those he leaves behind.

Discussion Questions

1. How do we relate to and judge others? Why?
2. How do we determine when someone's behavior is wrong?
3. What happens to our relationships with those who enjoy success very quickly?

Case 9.5

Sabotaging Your Employer's Information Lists before You Leave to Work for a Competitor

Eagle Gate College hired an admission consultant from Stevens-Henager College (Janna Miller). After she was hired, Ms. Miller hired other employees from Steven-Henager, and some of those employees had access to a confidential database at Steven-Henager that included leads for recruiting students. Before leaving Stevens-Henager, the employees went into the college's database on leads and altered the information on the individuals in the list in such a way that it impeded or prevented Stevens-Henager's ability to contact those leads. One Stevens-Henager official said, "We continue to use any leads that come into the college from time to time, and with the loss of adequate phone numbers ... it became difficult, if not impossible, to use our own leads. …"[33]

Discussion Questions

1. Evaluate the ethics of Ms. Miller in her recruitment efforts. What about the ethics of the employees in altering the database so that it could no longer be used?
2. Are there any prevention tools that might have helped the colleges from becoming involved in the resulting litigation?

[33] *Stevens-Henager College v. Eagle Gate College*, 248 P.3d 1025 at 1028 (Utah App. 2011).

Source

Stevens-Henager College v. Eagle Gate College, 248 P.3d 1025 (Utah 2011).

Case 9.6

Bad-Mouthing the Competition: Where's the Line?

When the competition is stiff, the product, service, and price may not be the deciding factor. What the buyer believes about the competitor may be controlling. The following are statements made by contractors as they were in the process of trying to win a remodeling contract with a homeowner:

- "You could go with them—they do good work, but they use illegal immigrants on their jobs."
- "Be sure to get a time frame from them before you make a decision. Sometimes they can be slow."
- "You need to be careful with X Company because I have heard that they are close to bankruptcy."
- "Check the registrar of contractors at the state level—they have had all kinds of complaints filed against them."
- "The Better Business Bureau has not given them a very good rating."
- "I can give you a list of people they've done work for and I have had to go in and clean up the mess they have made."
- "You can go with low price, but you get what you pay for."

Discussion Questions

1. Evaluate each of the statements from an ethical perspective.
2. Which of the statements would you feel comfortable using?

Case 9.7

Online Pricing Differentials and Customer Questions

The *Wall Street Journal* investigated online pricing and discovered that your price may vary indeed.[34] Using your zip code, online retailers determine the price of your stapler, your saw, or even your language program, based on whether that retailer has competition in the area (whether there is a Staples and an OfficeMax near your home) as well as other factors such as the costs of rent, labor, and other economic factors in your area. According to the *Journal*, Staples, Rosetta Stone, and Home Depot consistently adjust prices on items based on information these companies obtain about you, the online buyer. Some of the online retailers even vary the types of items available to you online based on your zip code. The study found the strongest lower price correlation with the distance from where the buyer is to competitors. So, someone 10 miles away from you may pay more for a set of markers because the online seller assumes that it would not be worth the drive for that buyer to go to the competitor's retail store. However, there are some price differences that appear to be unrelated to geographic proximity to competitors but may truly be due to economic factors. For example, you are going to pay more for your office supplies if you order from your zip code in Manhattan or Staten Island and less if your zip code happens to be in Brooklyn or Queens.

The products are the same. For example, prices on a simple Swingline stapler varied by $1.50 in a 10-mile area, even though the staplers shipped to the geographically

[34] Jennifer Valentino-DeVries, Jeremy Singer-Vine, and Ashkan Soltani, "Online Retailers Vary Prices Based on a User's Location," *Wall Street Journal*, December 24, 2012, p. A1.

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different customers are the same. Rosetta Stone customers buying multiple levels of language lessons from the United States receive a 20 percent discount, but buyers from the United Kingdom and Argentina never see the 20 percent special. Home Depot has six different prices for a 250-foot spool of wiring. And the wire is most expensive in New York and least expensive in Ashtabula, Ohio.

Even credit card offers vary by geographic location. Discover offers special credit card rates to consumers in Denver, Kansas City, and Dallas. But consumers in Scranton, Pennsylvania, and Los Angeles, California, will not see those special credit card offers popping up on their screens. Known as part of credit card companies' acquisition strategies, the companies are mum on why they target certain areas and not others in soliciting new users.

There is no violation of the Robinson–Patman Act and its prohibitions on price discrimination as long as the retailers can show that they are pricing to meet the competition or according to differences in costs (such as labor and rent). The interesting question that the practice presents is that these are online prices so that the differences in cost may not actually exist. That is, the shipping may well be the same regardless of retail store costs in that area. However, the connection between the location of a competitor and the online price then falls into the protected area of price differentials to meet the competition.

Discussion Questions

1. Do pricing differentials help or hinder competition?
2. Should the online retailers disclose the pricing differentials?

Case 9.8

Brighton Collectibles: Terminating Distributors for Discounting Prices

Leegin Creative Leather Products, Inc. (Leegin), designs, manufactures, and distributes leather goods and accessories under the brand name Brighton. The Brighton brand has now expanded into a full line of women's fashion accessories and is sold across the United States in over 5,000 retail stores. PSKS, Inc. (PSKS) runs Kay's Kloset, a Brighton retailer in Lewisville, Texas, that carried about seventy-five different product lines, but was known as the place to go for Brighton products. Kay's ran Brighton ads and had Brighton days in its store.

Leegin's president, Jerry Kohl, who also has an interest in about seventy stores that sell Brighton products, believes that small retailers treat customers better, provide customers more services, and make their shopping experience more satisfactory than do larger, often impersonal retailers. In 1997, Kohl released a new strategic refocus for Brighton by explaining: "[W]e want the consumers to get a different experience than they get in Sam's Club or in Wal-Mart. And you can't get that kind of experience or support or customer service from a store like Wal-Mart." As a result, Leegin instituted the "Brighton Retail Pricing and Promotion Policy," which banished retailers that discounted Brighton goods below suggested prices. The policy had an exception for products not selling well that the retailer did not plan on reordering. The established prices gave its retailers sufficient margins to provide customers with the quality service central to Brighton's strategy.

In December 2002, Leegin discovered Kay's Kloset had been marking down Brighton's entire line by 20 percent. Kay's Kloset said it did so to compete with nearby retailers who also were undercutting Leegin's suggested prices. Leegin, nonetheless, requested that Kay's Kloset cease discounting. Its request refused, Leegin stopped selling to the store. The loss of the Brighton brand had a considerable negative impact on the store's revenue from sales (about 40 percent to 50 percent of its profits were from Brighton).

Discussion Questions

1. Is it fair for some stores to carry Brighton products at a discount but not provide the service and ambience that the company is seeking for its products?
2. Do deep discounters benefit from the services and information provided at stores that do not do the deep discounting?
3. What is the role of the customer as stakeholder in your ethical analysis?

Source

Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

Case 9.9

Electronic Books and the Amazon War

The U.S. Department of Justice (DOJ) has filed an antitrust suit against Apple and five of the largest publishers in the United States (Simon & Schuster, HarperCollins, Hachette, Penguin, and Macmillan), alleging that Apple conspired with the five to battle Amazon, the market leader on e-book sales, by agreeing ahead of the release of the iPad tablet and iBook to raise prices for e-books. The move by the publishers would thus force Amazon, if it wanted the books in electronic form, to raise its prices. Amazon has traditionally charged $9.99 for its e-books, a price that other publishers could not compete with.

Simon & Schuster, HarperCollins, and Hachette have already settled the suit with the DOJ. The government's complaint alleges that because of the agreement, e-book prices climbed $2 to $3 per book in early 2010 when the iPad was released. The complaint also outlines the communication among the CEOs of Apple and the publishing houses. During December 2009 and January 2010, the U.S. chief executives of the publisher defendants placed at least 56 phone calls to one another.

Apple has explained its actions through its business model—it carries books and music with a revenue-sharing model. For example, a seller would agree to accept 70 percent of the revenue from the sale of a song or film through Apple, and Apple would retain the 30 percent. Apple's position is that the pricing model moves the publishers to higher prices because of the revenue sharing. The difficulty Apple has with the defense is that the publishers all moved to a certain price at the same time. That the publishers settled the antitrust charges also creates problems for Apple. However, Apple argues, and many in the business and legal communities have advanced the same argument, that the companies gave consumers more choices as opposed to relying on Amazon only.

Discussion Questions

1. Is it ethical to fix prices? Is it ethical if the prices fixed drive a competitor out of business?
2. Is it ethical for Amazon to price its books so that publishers cannot profit?

Case 9.10

Mattel and the Bratz Doll

Mattel, Inc., is the world's largest manufacturer and marketer of toys, dolls, games, and stuffed toys and animals. Mattel employed Carter Bryant as a product designer from September 1995 through April 1998 and from January 1999 through October 2000. Upon starting his second term of employment in 1999, Bryant signed an Employee Confidential Information and Inventions Agreement, in which he agreed not to "engage in any employment or business other than for [Mattel], or invest or assist (in any manner) any business competitive with the business or future business plans of [Mattel]." Also, Bryant assigned to Mattel all rights, title, and interest in the "inventions" he conceived of, or reduced to practice, during his employment.

Bryant also completed Mattel's Conflict of Interest Questionnaire and certified that he had not worked for any of Mattel's competitors in the prior twelve months and had not engaged in any business dealings creating a conflict of interest. Bryant agreed to notify Mattel of any future events raising a conflict of interest.[35]

A July 18, 2003, *Wall Street Journal* article suggested Bryant had copied a scrapped Mattel project, known as "Toon Teens," in creating the Bratz. The story reported that MGA said that the Bratz were designed by Carter Bryant, a former member of Mattel's Barbie team. Bryant didn't work on the line that Mattel scrapped in 1998, but most Barbie designers had seen the prototypes. Although the doll line that was scrapped wasn't exactly like the Bratz, they were remarkably similar, with the Bratz's oversized heads, their pursed lips, cartoonish eyes, and big feet were similar to the dolls the Barbie team had created. Lily Martinez, a designer who still works at Mattel, came up with the idea for the big doll heads and posted her sketch on her cubicle where anyone could see them.[36]

By 2003, MGA's revenues were about $800 million, with 65 percent of that coming from the Bratz doll line.

After investigating the situation reported in the *Wall Street Journal,* Mattel discovered in November 2003 that Bryant had secretly entered into an agreement with MGA Entertainment, Inc., a competitor, during the time that he was employed by Mattel, to receive royalties for "works for hire." In an agreement signed September 18, 2000, Bryant agreed to provide product design services for MGA's line of Bratz dolls in exchange for $5,500 per month for the first six months and $5,000 per month for the next three months, as well as a 3 percent royalty on the Bratz he worked on. Mattel filed its copyright registration for the Toon Teens drawings on November 28, 2003, four years after the drawings were created.

Bryant's last day of employment at Mattel was October 20, 2000. Bryant went through the usual Mattel checkout. The checkout form used for Bryant misquoted Bryant's Inventions Agreement, which did not expressly assign to Mattel Bryant's interest in his ideas. This error may have resulted from the fact that prior versions of Mattel's Inventions Agreement expressly assigned the contracting employee's interest in his ideas. Bryant's agreement identifies "discoveries, improvements, processes, developments, designs, know-how, data computer programs and formulae, whether patentable or unpatentable," language that was not in prior versions.

Mattel filed suit against Bryant for (1) breach of contract, (2) breach of fiduciary duty, (3) breach of duty of loyalty, (4) unjust enrichment, and (5) conversion.[37] MGA Entertainment intervened in that case. Mattel settled with Bryant but amended its complaint against MGA alleging intentional interference with contract; aiding and abetting breach of fiduciary duty, aiding and abetting breach of duty of loyalty, conversion, unfair competition, and copyright infringement.[38] However, MGA counterclaimed against Mattel for appropriation of trade secrets. MGA's counterclaim arose out of the activities of Mattel's Market Intelligence Group, a collection of employees dispatched to international toy fairs and directed to gather information from the private showrooms of Mattel's

[35] Mattel, Inc. v. Bryant, 441 F. Supp. 2d 1081 (C.D. Cal. 2005).

[36] Maureen Tkacik, "Dolled Up: To Lure Older Girls, Mattel Brings in Hip-Hop Crowd; It Sees Stalwart Barbie Lose Market Share, So 'Flayas' Will Take on the 'Bratz,'" *Wall Street Journal*, July 18, 2003, at A1.

[37] The case has a fascinating history of procedural questions, including an issue of diversity of jurisdiction that resulted in an appellate decision. *Mattel, Inc. v. Brandt*, 446 F.3d 1011 (9th Cir. 2006).

[38] *Mattel, Inc. v. MGA Entertainment, Inc.*, 782 F. Supp. 2d 911 (C.D. Cal. 2011).

competitors through the use of false pretenses. Allegations in the counterclaim stated that the employees had made copies of identification credentials in order to gain access to the private showrooms, showrooms that were intended for buyers to be able to see what was available for purchase from MGA in the future.

A jury found for Mattel on all counts, concluding that Bryant conceived the idea for the name Bratz and created the concept drawings and sculpt for the Bratz dolls during his second term of employment with Mattel (January 4, 1999, to October 4, 2000). The federal district court placed the Bratz trademarks in a constructive trust and enjoined MGA from continuing to sell dolls. MGA appealed, and the case was remanded for a new trial. Upon remand, both companies moved for summary judgment on various issues. The court denied summary judgment on some issues but required a trial for others, including MGA's counterclaims on Mattel's market intelligence group.[39]

Following approximately two weeks of deliberations, the jury found that Mattel had misappropriated twenty-six trade secrets owned by MGA, and awarded MGA $3.4 million in damages for each act of misappropriation, reaching a total award of $88.5 million. The jury also found that Mattel's misappropriation had been willful and malicious, thus entitling MGA to exemplary damages under Cal. Civ. Code § 3426.3, for a total verdict of $177.5 million, followed by an award by the court of $2.52 million in attorneys' fees and costs to MGA.[40] However, that decision, including the determination of attorney's fees, was reversed and is now back in federal district court.[41]

Discussion Questions

1. One expert commented that the litigation "killed" the Bratz line and nearly destroyed MGA as a competitor. Were the competitors killing each other?
2. Should Mattel have done more to protect its trade secrets? Is an agreement with an employer necessary in order to keep you from taking trade secrets to your next employer?

[39] *Mattel, Inc. v, MGA Entertainment, Inc.*, 2011 WL 3420571 (C.D. Cal.).

[40] *Mattel, Inc. v, MGA Entertainment, Inc.*, 801 F. Supp. 2d 950 (C.D. Cal. 2011).

[41] *Mattel, Inc. v, MGA Entertainment, Inc.*, 705 F.3d 1108 (9th Cir. 2013).

SECTION C

Intellectual Property and Ethics

When does an idea belong to someone else? Laws on patents and copyrights afford protection in some cases, but other situations are too close to call—or are they?

Case 9.11

Tiffany, Louis Vuitton, eBay, Landlords, and Knock-Offs

The luxury goods industry has gone global. Cartier watches, Louis Vuitton bags, and anything Gucci are among the most popular items. However, where there is high demand for brand-name goods, there are also the "knock-off merchants," those who sell fake designer goods. You can find knock-off merchants on the Internet, on the streets of New York City, in strip malls, and in beauty parlors. These are the businesspeople who produce goods that look like the luxury brand items but sell for between $12 and $25 to beauty parlors, street vendors, and Internet sellers. Consumers pay up to $250 for the Cartier watches, for example, especially those who buy the watches over the Internet. A real Cartier watch starts at $1,800.

The global market gives those in China, the main area for production of counterfeit goods, increased access to view the designer goods and make the replications more authentic. The Internet allows the posting of photos of the real thing and the selling of knock-offs.

The profit margins in counterfeit goods are phenomenal—better than other forms of illegal activity. Profit in cocaine sales is 100 percent. Profit in the sale of Microsoft counterfeit products is 900 percent.[42] Further, those profits have become a source of revenue for terrorist groups. Interpol (the international police organization based in Lyon, France) has connected Hezbollah to a ring of auto parts counterfeiters in Germany that resulted in a seizure of $1.2 million in brake pads.[43]

The annual revenue from counterfeit goods is about $540 billion and, according to Interpol, is the main source of income for terrorist groups such as Hezbollah as well as the Chinese triad.

One private investigator who works for brand-name companies says that handbag counterfeiters can make as much money as someone who sells cocaine. Profits are estimated at $10 for every $1 invested. Those margins are significantly higher than those for the drug trade. One businessman had watch components imported from China, assembled them in the United States, and slapped on fake Cartier labels—all for a cost of 27 cents. He then sold them for between $12 and $20.

To cut back on the increasing problem, countries are taking different steps. France has passed a new law making it a crime for someone to buy or carry a knock-off bag. A violation carries up to a three-year sentence in France. In the United States, a first-time violation of counterfeit laws carries up to a ten-year sentence and a $2 million

[42] Zachary Pollinger, "Counterfeit Goods and Their Potential Financing of International Terrorism," *Michigan Journal of Business* 1 (2008), p. 85.

[43] *Id.*, p. 89.

fine. Enforcement has increased, and U.S. Customs seized the following amounts of counterfeit goods in the years noted here:

Year	Amount Seized
2000	$40 million
2001	$53 million
2002	$95 million
2003	$80 million
2004	$130 million
2009	$260 million[44]
2009	$606 million
2010	$1.04 billion
2011	$1.11 billion
2012	$1.26 billion
2013 to June	$1.58 billion[45]

The counterfeiters are a tough group to rein in, but the trademark owners have become diligent in their pursuit up and down the economic chain—they are going after those who own the shops and the Internet sites that sell counterfeit merchandise.

Tiffany and eBay

Tiffany & Co. and eBay have been in litigation in San Francisco for several years. The litigation culminated in a weeklong bench trial in December 2007. Tiffany accused eBay of being, in effect, a distributor of goods that infringe Tiffany's trademarks and copyrights. Tiffany has established that eBay sellers are selling counterfeit and knock-off Tiffany items and that eBay is facilitating the exchanges. eBay counters that it simply provides a marketplace and cannot police every item that is sold via its network of buyers and sellers. eBay's lawyers maintain that as a marketplace they never take possession of any of the goods so that it would be impossible for the company to check for the authenticity of the goods being bought and sold.

However, Tiffany lawyers have argued that eBay benefits from the transactions because it advertises the availability of Tiffany jewelry through its marketplace and thereby profits from these counterfeit sales.

Flea markets and retail stores have been held responsible for determining the authenticity of their goods. The question is whether such a vicarious duty applies to eBay.

Tiffany did notify eBay of the counterfeit problems on the site in 2003, but eBay elected not to look into the problem. Tiffany maintains that eBay could police the situation simply by requiring sellers to provide proof of authenticity such as a receipt from a Tiffany's store. Tiffany has tried to chase down the counterfeit sellers but finds phantom sites and disappearing and changing identities. Tiffany would shut down one site only to

[44] From press release, accessed September 4, 2013, from www.cbp.gov. Go to newsroom and search seizure statistics. http://www.cbp.gov/linkhandler/cgov/trade/priority_trade/ipr/seizure/ipr_seizures_fy2011.ctt/ipr_seizure_fy2011.pdf.

[45] "US Seizes Counterfeit Goods Worth $1.26 Billion in 2012," World Intellectual Property Review, January 22, 2012. Go to www.cbp.gov; go to newsroom, and search seizure statistics. http://www.worldipreview.com/news/us-seizes-counterfeit-goods-worth-1-26-billion-in-2012.

have another site appear under a different name within a matter of days. "We were chasing ourselves," was the comment of Michael J. Kowalski, Tiffany's chairman.[46]

The eventual outcome of the case was that eBay did nothing wrong by having the Tiffany logo on its site with links to buy Tiffany merchandise. In addition, the court held that eBay could not be held responsible for infringement activity by eBay users. In short, Tiffany must continue to police the sellers on eBay through its own efforts.[47]

eBay has not fared as well in Europe. A French court has ordered eBay Inc. to pay several luxury brand manufacturers €40 million, or about US$63.2 million for its failure to take steps to ensure that the goods being sold through the Internet auction site were not counterfeit. Louis Vuitton and Christian Dior had brought suit against the online retailer because of the large numbers of fake and unauthorized products of the two companies that were being sold at the site. In addition, the judge found that eBay had permitted the unauthorized sales of certain perfumes manufactured by the two companies. The perfumes that were sold were indeed authentic. However, the two companies have exclusive deal arrangements with retailers, and the perfumes can only be sold at department stores and other specialized retail outlets.

The French court decision means that online retailers cannot assume a passive role in allowing the sale of goods. They must undertake some form of screening to eliminate the obvious forms of infringement and the selling of counterfeit items.

eBay is appealing the court's decision. The company says that it has 2,000 employees and a $20 million per annum budget devoted to ferreting out counterfeit goods but that the task is so large that there are some items that slip through the oversight system.

This decision is not the first from the EU:

- eBay was ordered by a French court last year to pay Hermes €20,000 for the sale of fake products.
- A German court ordered eBay to do more to stop the sale of counterfeit Rolex watches.

Louis Vuitton and the Web

Two web-hosting companies had a verdict of $32 million entered against them by a California jury for contributory trademark infringement. The case is *Louis Vuitton v. Akanoc Solutions, Inc.*, and the jury returned the verdict against the web-hosting companies for "contributory trademark infringement."

The lawyers for Louis Vuitton—and the company employs forty of them each year—were able to put their case together from internal e-mails obtained through discovery from Akanac Solutions and Managed Solutions Group, two web-hosting companies owned by Steven Chen. The e-mails indicated that employees at both companies were aware that there were counterfeit Vuitton bags and merchandise being sold by others using their service, but they took no steps to warn or stop the sales. Louis Vuitton also employs 250 investigators at a cost of $20 million per year to track down the fake goods, which, in this case, are almost identical to the company's actual products.[48]

Although the courts have held that it is primarily the responsibility of the trademark holder to enforce against counterfeiters and the eBay case was decided prior to this one, there are an increasing number of decisions holding websites liable on the grounds that they cannot turn a blind eye when they are aware that there is infringement occurring using their websites, such as when the sellers advertise "fake designer handbags" or "No one will know they are not the original Louis Vuitton purse."

[46] Katie Hafner, "Tiffany and eBay in Fight Over Fakes," *New York Times*, November 27, 2007, pp. C1, C9.

[47] *Tiffany (NJ) Inc. v. eBay Inc.*, 600 F.3d 93 (2nd Cir. 2010). Tiffany's appealed to the U.S. Supreme Court, but *certiorari* was denied. 131 S.Ct. 647 (2010).

[48] *Id.*

Landlords, Louis Vuitton, and Liability for Counterfeit Tenants

Buyers of counterfeit goods are not prosecuted in the United States, but the goal is to frighten them away. Also, companies such as Louis Vuitton are turning to landlords, property owners, shippers, credit card companies, and any others in the supply chain, to stop the flow of goods, with suits for vicarious or contributory liability. A settlement in one case found landlords promising to evict tenants who sell fake goods, as well as to hang warning signs permanently. Companies that have joined with Louis Vuitton include Burberry, Gucci, and Prada. They refer to their work with the supply chain as "the Landlord Program." Although a judge has awarded the companies $464 million in one case for infringement by tenants, the companies are unable to collect such a large judgment from these small businesses. The result is the pursuit of the landlords, and landlords are generally larger companies with more funds and less likelihood of having judgment-proof status.

In *Polo Ralph Lauren Corp. v. Chinatown Gift Shop*, 855 F. Supp. 648 (S.D.N.Y. 1994), Polo Ralph Lauren, Rolex Watch USA, and Louis Vuitton brought suit against a landlord who was leasing property to three retailers who were selling goods that infringed on their trademarks for their clothing, watches, and leather goods, respectively. The court held that the landlord could have vicarious liability under federal law for facilitating the infringement by the tenants. In *Habeeba's Dance of the Arts, Ltd. v. Knoblauch*, 430 F. Supp. 2d 709 (Ohio 2006), the court held that the landlord (YWCA) could be held liable for contributory infringement for leasing a portion of its facilities to Habeeba's when it knew that Habeeba's was teaching the Habiba form of dancing, a trademarked method that belonged to Habiba, and that such use was likely to cause confusion about ownership of the dance method.[49]

The bags are still there on Canal Street in New York City, but, as the buyers note, you are taken back into secret rooms through two locked doors. The bags no longer hang out in the open, something that makes everyone vulnerable. The extra steps have not, however, made a dent in the counterfeit trade. The companies estimate that their intense program has cut back on counterfeit sales about 5 percent. Still, the companies continue because they feel that the precedent for third-party liability is their only hope of curbing the huge counterfeit market.

Because of their potential liability, even property owners have joined in to help with enforcement. On New York's Canal Street, owners post signs (furnished by Louis Vuitton) with the following information:

> This retailer is not authorized or licensed to sell Louis Vuitton merchandise. Counterfeiting is criminally and civilly punishable under federal and state law by up to 10 years of imprisonment and $2,000,000 in fines.

Discussion Questions

1. Why should we worry about knock-offs of luxury goods? What ethical issues exist?
2. If you were a landlord, would you turn a blind eye to counterfeit sales? Should landlords be held responsible if they don't know about the sales?
3. Would you, or do you, buy knock-offs? Who is harmed? Make a list of stakeholders.
4. What are the ethical issues in taking no action when someone else is harmed—that is, you know it is happening, but you aren't doing it and you do nothing to stop it?

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[49] This discussion was adapted from Marianne M. Jennings, *Real Estate Law*, 10th ed. (2013), p. 235.

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Case 9.12

The Little Intermittent Windshield Wiper and Its Little Inventor

Robert W. Kearns, a Maryland inventor and former engineering professor at Wayne State University in Detroit, Michigan, obtained a patent for his first intermittent car windshield wiper system in 1967. *People* magazine described the genesis of Kearns's invention as follows:

> The idea for the intermittent windshield wiper popped, as it were, into Robert Kearns' mind on his wedding night in August 1953 when he was opening a bottle of champagne. The cork hit him in the eye and that inability to blink through the incident and see clearly got him to thinking about driving in the rain. The end result was his invention, conceived in a motel and created in his basement.[50]

He installed it in a 1962 Ford Galaxy and then demonstrated it for Ford. Ford installed the wiper system in its cars, beginning in 1969, and did so under its own patents for such a system. During the 1970s, intermittent wiper systems began appearing on the cars of major U.S. and Japanese automakers. Kearns received no money for the use of these systems. The automakers maintained that the idea was an obvious one, and it was only a matter of time before their engineers developed the same type of system. They also claimed that their systems differed from Kearns's in design and function.

Kearns filed suit against Ford, General Motors, Chrysler, Fiat, Toyota, Ferrari, Volvo, Alfa-Romeo, Citroen, Honda, Isuzu, Mitsubishi, Nissan, Maserati, Peugeot, Renault, Rolls Royce, Saab, Toyota, and other Japanese auto manufacturers, for a total of nineteen different defendants. He had planned to open his own firm to supply the intermittent windshield wiper systems to all automakers but was unable to do so after the companies manufactured the systems in-house. Dr. Kearns represented himself in the cases that ran through 1995 until final resolution or settlement. In fact, Kearns set up Kearns and Associates in a building across the street from the federal courthouse in Detroit in order to battle the auto manufacturers. His children worked for the company formed to litigate, and at one point Kearns was ordered to pay sanctions because his son had obtained confidential documents by dating a paralegal who worked at a law firm that was representing one of the auto manufacturers.[51]

In November 1990, Kearns settled his case with Ford Motor Company for $10.2 million, which amounted to 30 cents per car Ford sold with the intermittent wiper systems. He had turned down a $30 million offer from Ford and proceeded with litigation. In June 1992, a jury awarded Kearns $11.3 million in damages from Chrysler, or about 90 cents per car, for Chrysler's infringement of Kearns's patent. Chrysler had sold 12,564,107 vehicles with the device. Kearns had originally asked for damages ranging

[50] Ken Gross, "Wiper Man Robert Kearns Won His Patent Fight with Ford, but That Didn't Mean He Was Out of the Wood," *People*, August 6, 1990.

[51] Mike Hoffman, "'Patent Fending: A Look at Some Famous Legal Battles between Inventors and the Corporations That Stole Their Patented Ideas," *Inc.*, December 1997, http://www.inc.com/magazine/19971201/1374.html.

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from $3 to $30 per car, or $37.7 to $377 million, based on the treble damage provisions of the patent infringement laws.[52] Chrysler appealed what it called the "unreasonable and excessive" verdict; however, the appeal was dismissed by the U.S. Supreme Court.[53] The amount Kearns received from Chrysler, $18.7 million, was far less than he had requested as damages.

Kearns continued to pursue his cases against the other car companies until the U.S. Supreme Court refused to reverse the dismissal of his case. He spent $4 million in legal fees in the Ford case and about $5.5 million on the case against Chrysler. He was represented by four law firms during the course of all the litigation. Dr. Kearns was a colorful figure who wrote an angry letter to the federal judge handling his first trial, when the jury was unable to reach a verdict. After having the letter delivered to the judge, Dr. Kearns disappeared for several days. The jury could not reach a verdict, and the judge declared a mistrial. That case, the Ford case, was eventually settled.

Kearns said his success should be an inspiration for other inventors because it proves they can win against large corporations that have used others' ideas without reimbursement. Others say that Kearns's failed marriage and his near breakdown demonstrate that a refusal to negotiate can be harmful and that most of his money went to paying lawyers in the decades-long litigation.

Dr. Kearns died in February 2005, just after he appeared in *Forbes* magazine along with other inventors who had changed our daily lives by what they developed. Others in the group included Ray Tomlinson, the man who came up with using "@" for e-mail addresses, and Allen Gant Sr., the inventor of pantyhose.

Discussion Questions

1. Is it ethical to use an idea based on the risk analysis that the owner of that idea simply cannot afford to litigate the matter?
2. Why was the intermittent wiper system so important to the automakers?
3. Could Kearns have done anything further to protect himself?
4. If you were an executive with one of the companies still in litigation with Kearns, would you settle the case? Why or why not?
5. Why do you think the auto manufacturers fought Kearns so extensively? Is it possible that their engineers had been working simultaneously on the idea?

Case 9.13

Copyright, Songs, and Charities

Children at camps around the country in the summer of 1996 were not able to dance the "Macarena" except in utter silence. Their usual oldies dances were halted in 1996. The American Society of Composers, Authors & Publishers (ASCAP) notified camps and the organizations that sponsor camps (such as the Boy Scouts of America and the Girls Scouts of the USA) that they would be required to pay the licensing fees if they used any of the 4 million copyrighted songs written or published by any of the 68,000 members of ASCAP.

The fees for use of the songs have exceeded the budgets of many of the camps. One camp that operates only during the day charges its campers $44 per week. ASCAP wanted $591 for the season for the camp's use of songs such as "Edelweiss" (from *The Sound of Music*) and "This Land Is Your Land." ASCAP demanded fees for even singing the songs around the campfire. ASCAP's letters to the camps reminded the directors of

[52] *Kearns v. Ford Motor Co.* 726 F. Supp. 159 (E.D. Mich. 1989); see also "Chrysler Told to Pay Inventor $11.3Million," *New York Times*, June 12, 1992, p. C3.

[53] *Kearns v. Ford Motor Corp.*, 62 F.3d 1430 (C.A.F.C. 1995), *cert. denied,* 516 U.S. 989 (1995).

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the possible penalties of $5,000 and up to six days in jail and threatened lawsuits for any infringement of the rights of ASCAP members. Luckily, “Kumbaya” is not owned by an ASCAP member.

Several camp directors wrote and asked for a special program that would allow their camps a discount for the use of the songs. Many of the camps are not run as for-profit businesses, but rather include camps such as those for children with cancer and AIDS. ASCAP now includes the following frequently asked question on its website (http://www.ascap.com):

> Do I need permission to perform music as part of a presentation in class or at a training seminar?
>
> If the performance is part of face to face teaching activity at a non-profit educational institution, permission is not required. Permission is required when music is used as part of training seminars, conventions, or other commercial or business presentations.

ASCAP has over 100 licensing fee arrangements. The fees range from $200 to $700 per year, but some organizations have negotiated lower fees. The Radio Music License Committee negotiated a $1.7 billion fee arrangement with ASCAP to cover its members through 2009.

In 1999, Congress passed the Fairness in Music Licensing Amendment [17 USC 110 (5)] to provide an exemption for restaurants (such as sports bars) that play radio music or television programs over speakers in their facilities. The law provides that because the radio and television rights have been acquired, restaurants and bars need not pay ASCAP additional fees. ASCAP opposed this change to the copyright laws and has proposed changes to it since 1999.

The issue of public use of popular songs and copyrights surfaced after the September 11, 2001, attacks, when Congress stood on the steps of the Capitol on the evening of September 11, 2001, and sang, “God Bless America.” It was a spontaneous moment, and from that time the song became an integral part of all public functions, including the seventh-inning stretch during the World Series.

Irving Berlin wrote “God Bless America” in 1940. When he did, he pledged all the royalties from the song to benefit youth organizations in the United States, specifically the Girl Scouts and Boy Scouts.

Each time there is a performance of the song, royalties are paid to the trust fund Berlin established for the administration of the royalties for the Scouts. Since that time, just the groups in New York City have received over $6 million from song performances. The annual income from “God Bless America” public performances has been about $200,000. However, the song has become a sort of second national anthem since the time of the September 11, 2001, attacks, with royalties from public performances generating triple income in 2002.

Mr. Berlin died in 1989 at the age of 101, and his daughter, Mrs. Linda Emmett, administers the trust fund. Mrs. Emmett, who shares her father’s commitment to the children of the United States, says that nothing would have pleased her father more than the song’s newfound popularity and the resulting benefits to the Scouts.[54]

Discussion Questions

1. Why does ASCAP work so diligently to enforce its rights and collect the fees for its members’ songs?
2. What risks does ASCAP run if the camps continue to use the songs without payment of the licensing fees?
3. What ethical and social responsibility issues do you see with respect to those camps that are strictly nonprofit operations?

[54] William Glaberson, “Irving Berlin Gave the Scouts a Gift of Song,” *New York Times*, October 14, 2001, p. A21.

4. Can you think of a compromise that would protect ASCAP members' rights but still offer the camps a reasonable chance to use the songs?
5. What would you do if you were an ASCAP member and owned the rights to a song a camp wished to use? Do you think Mr. Berlin's trust has the correct approach? Could his trust not simply donate the use of the song? What problems do you see with that practice?

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The Ethical Common Denominator (ECD) Index

The Common Threads of Business Ethics

OVERALL THEME AREAS	DESCRIPTION	SUBCATEGORIES	CASES	READINGS
Philosophical Foundations	Case/reading affords opportunity for exploring ethical theories	Utilitarianism, moral relativism, egoism, divine command, rights, justice, virtue ethics	Case 1.6 Case 1.13 Case 2.8 Case 2.17 Case 3.8 Case 3.9 Case 3.10 Case 3.22 Case 4.4 Case 4.21 Case 5.7 Case 5.10 Case 6.2 Case 6.9 Case 7.18 Case 8.21 Case 9.6	Reading 1.1 Reading 1.2 Reading 1.3 Reading 2.2 Reading 2.3 Reading 2.5 Reading 3.1 Reading 3.2 Reading 3.3 Reading 3.4 Reading 3.5 Reading 3.6 Reading 3.7
Ethical analysis	Case/reading provides opportunity for logical walk-through of ethical dilemmas and their resolution	Either/or conundrum; models for decision-making	Case 1.12 Case 1.14 Case 1.15 Case 1.16 Case 1.17 Case 1.18 Case 1.19 Case 1.20 Case 2.12 Case 2.17 Case 3.10 Case 4.6 Case 5.11 Case 5.13 Case 6.8	Reading 1.7 Reading 1.9 Reading 1.10 Reading 1.14 Reading 2.1 Reading 2.2 Reading 2.3 Reading 2.6 Reading 2.9

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Culture/organizational behavior	Case/reading provides insight into how the organization and culture overpower ethical reasoning; the bad apple vs. bad barrel syndrome	Compensation systems; enforcement; confrontation; raising ethical issues; fear and silence in organizations	Case 1.17 Case 1.20 Case 2.7 Case 3.8 Case 3.13 Case 3.16 Case 3.17 Case 3.27 Case 4.9 Case 4.10 Case 4.11 Case 4.12 Case 4.15 Case 4.17 Case 4.19 Case 4.22 Case 4.23 Case 4.24 Case 4.25 Case 4.28 Case 4.33 Case 4.35 Case 5.5	Reading 1.2 Reading 2.4 Reading 2.6 Reading 3.3 Reading 4.3 Reading 4.8 Reading 4.9 Reading 4.13 Reading 4.18 Reading 7.24 Reading 7.25 Reading 9.2

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Economic theory	Case/reading provides backdrop for discussion of relationship between ethics and economics	Fair trade; living wage; downsizing; property rights; *laissez-faire*; moral hazard; nature of markets; effects of demand and supply	Case 1.16 Case 2.11 Case 3.13 Case 3.24 Case 4.21 Case 5.6 Case 6.2 Case 6.6 Case 9.9	Reading 1.3 Reading 3.1 Reading 3.5 Reading 3.12 Reading 4.5 Reading 6.1 Reading 9.1 Reading 9.4
Personal introspection; credo	Case/reading provides an opportunity for students to put themselves in the position of those facing the dilemmas; developing tools for resisting pressure	Personal ethics vs. business ethics; the lines you would never cross to get a job, to keep a job, to earn a bonus, to meet goals	Case 1.6 Case 1.12 Case 1.15 Case 1.21 Case 2.4 Case 2.7 Case 2.8 Case 2.14 Case 2.15 Case 3.11 Case 4.6 Case 4.34 Case 5.8 Case 5.9 Case 6.4 Case 7.9 Case 7.23 Case 8.12 Case 8.16 Case 8.7 Case 9.5	Reading 1.1 Reading 1.2 Reading 2.3 Reading 2.4 Reading 3.3 Reading 4.1 Reading 4.2

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Leadership	Case/reading provides an opportunity for understanding the role of managers in company culture and decisions	Tone-at-the-top; example; conduct of managers and supervisors; manager's responses to employee concerns	Case 1.8 Case 2.7 Case 2.17 Case 3.13 Case 3.23 Case 3.16 Case 4.8 Case 4.12 Case 4.22 Case 4.29 Case 5.1 Case 6.12 Case 7.4 Case 7.6 Case 8.13 Case 9.3 Case 9.6	Reading 1.2 Reading 2.3 Reading 2.4 Reading 3.5 Reading 3.18 Reading 4.18 Reading 7.24 Reading 7.25
Corporate governance	Case/reading provides an opportunity for examining the role of the board and corporate processes in culture and ethical analysis and decision-making	Compensation systems; compliance; internal controls	Case 2.11 Case 2.17 Case 4.14 Case 4.15 Case 4.19 Case 4.22 Case 4.24 Case 4.33 Case 4.35 Case 5.5 Case 5.11 Case 6.2 Case 6.12	Reading 4.3 Reading 4.5 Reading 4.9 Reading 4.13 Reading 4.18 Reading 4.26

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OVERALL THEME AREAS	DESCRIPTION	SUBCATEGORIES	CASES	READINGS
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Whistle-blowing	Case/reading examines individual actions in dealing with ethical issues	Speaking up; approaches to raising issues	Case 1.6 Case 1.12 Case 2.17 Case 3.13 Case 4.9 Case 4.12 Case 4.15 Case 4.17 Case 4.19 Case 4.22 Case 4.33 Case 7.20 Case 7.26 Case 8.8 Case 9.2	Reading 4.2 Reading 4.16 Reading 4.26
The Gray Area	Case/reading focuses on Law vs. ethics – can vs. should? The loophole	Regulatory cycle; industry behaviors; slippery slope; gray area	Case 1.8 Case 1.21 Case 2.11 Case 1.12 Case 2.10 Case 2.11 Case 4.20 Case 5.12 Case 7.21 Case 8.14 Case 9.6	Reading 1.7 Reading 1.11 Reading 4.1 Reading 4.18
Categories of ethical dilemmas	Case/reading helps to illustrate where ethical dilemmas exist	Honesty; false impression; balancing ethical issues; conflicts of interest; taking adv.	Case 1.10 Case 2.13 Case 3.10 Case 3.11 Case 4.10 Case 4.28 Case 5.3 Case 5.4 Case 5.8 Case 6.1 Case 6.8 Case 7.3 Case 7.13	Reading 1.4 Reading 1.9 Reading 1.10

OVERALL THEME AREAS	DESCRIPTION	SUBCATEGORIES	CASES	READINGS
			Case 7.17 Case 8.8 Case 8.9 Case 9.3 Case 9.11 Case 9.13	

THE BUSINESS TOPIC AREAS	DESCRIPTION	SUBCATEGORIES	CASES	READINGS
Financial reporting/accounting	Case/reading involves FASB, GAAP issues and interpretation of rules	Red flags; materiality; EBITDA; loading dock behaviors; cookie-jar reserves; spring-loading	Case 2.11 Case 3.13 Case 4.10 Case 4.14 Case 4.19 Case 4.22 Case 4.25 Case 4.27 Case 4.29 Case 4.30 Case 4.31 Case 4.32 Case 4.36 Case 5.7	Reading 4.5 Reading 4.13
Product liability	Case/reading involves decision on product quality/safety	Design defects; recalls; product dumping; risk tolerance; low probability events	Case 3.9 Case 3.19 Case 4.27 Case 5.4 Case 5.11 Case 7.10 Case 8.6 Case 8.7 Case 8.8 Case 8.9 Case 8.10 Case 8.11 Case 8.12 Case 8.20	Reading 8.5
Technology	Case/reading involves ethical dilemmas that arise due to new technologies	Privacy of individuals; privacy of employees; social networking; theft; screening; testing	Case 1.16 Case 2.12 Case 5.2 Case 6.9 Case 7.19	

(Continued)

THE BUSINESS TOPIC AREAS	DESCRIPTION	SUBCATEGORIES	CASES	READINGS
			Case 7.21 Case 7.22 Case 9.7 Case 9.9	
Supply chain	Case/reading involves issues in contracts, relationships with vendors, purchasing managers	Conflicts of interest; commercial bribery; contracts	Case 3.17 Case 3.20 Case 3.21 Case 4.17 Case 4.27 Case 6.6 Case 6.8 Case 7.6 Case 8.6 Case 8.13 Case 8.18 Case 9.11	Reading 8.5
Marketing and sales	Case/reading involves ethical issues in advertising, pricing, product distribution	Antitrust issues; PR; framing issues; psychological tools of marketing; services marketing;	Case 1.21 Case 3.8 Case 3.9 Case 3.14 Case 3.20 Case 3.22 Case 3.23 Case 5.4 Case 5.11 Case 6.5 Case 6.7 Case 6.8 Case 8.1 Case 8.2 Case 8.3 Case 8.4 Case 8.7 Case 8.8 Case 8.14 Case 8.19 Case 8.21 Case 9.3 Case 9.5 Case 9.6 Case 9.7 Case 9.8 Case 9.9	Reading 9.1

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Government activities	Case/reading involves business relationships with and within government	Bribery, conflicts of interest, public issues and debate; PACs; government contracting	Case 2.17 Case 3.13 Case 3.19 Case 3.24 Case 3.25 Case 3.27 Case 4.33 Case 5.1 Case 5.7 Case 5.9 Case 6.4 Case 6.13 Case 7.12	Reading 3.12
Sustainability	Case/reading involves business relationship with environment	Climate issues; pollution; carbon footprints;	Case 1.13 Case 3.19 case 3.20 Case 3.21 Case 3.23 Case 3.24 Case 6.2 Case 6.5 Case 7.5 Case 7.28	Reading 3.1 Reading 3.2 Reading 3.3 Reading 3.4 Reading 3.5 Reading 3.6 Reading 3.7
Discrimination	Case/reading deals with issues in equal opportunity	Affirmative action; sexual harassment; diversity in the workforce; HR policies	Case 3.26 Case 5.3 Case 7.15 Case7.16 Case 7.17 Case 7.18 Case 7.19 Case 7.23 Case 7.26	Reading 7.24 Reading 7.25
Intellectual property	Case/reading deals with ownership of property and competitors' access	Copyrights; trademarks; reverse engineering; anti-compete clauses; downloading; software copies	Case 9.3 Case 9.5 Case 9.10 Case 9.11 Case 9.12 Case 9.13	Reading 9.1
International business	Case/reading covers ethical issues in operating multinationally	FCPA; bribery; product dumping, living wage, factory conditions, geopolitical issues; fair trade; human rights violations; mercenary issues	Case 3.14 Case 3.21 Case 3.22 Case 6.2	Reading 6.1

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THE BUSINESS TOPIC AREAS	DESCRIPTION	SUBCATEGORIES	CASES	READINGS
			Case 6.3 Case 6.4 Case 6.5 Case 6.6 Case 6.7 Case 6.8 Case 6.9 Case 6.10 Case 6.11 Case 6.12 Case 6.13	
Financial markets	Case /reading focuses on issues in the capital markets	Insider trading, short sales, risk; disclosure; hedge funds	Case 1.8 Case 2.7 Case 2.10 Case 3.13 Case 4.14 Case 4.21 Case 5.2	Reading 3.12 Reading 4.5 Reading 4.13 Reading 4.18
Employee rights and responsibilities	Case/reading focuses on employee work and employer supervision	Employee privacy; employee productivity; personal activity (net-surfing); employer monitoring; employer use of social networks	Case 1.12 Case 1.14 Case 4.4 Case 4.27 Case 4.33 Case 6.6 Case 6.7 Case 7.2 Case 7.3 Case 7.4 Case 7.5 Case 7.15 Case 7.16 Case 7.17 Case 7.18 Case 7.19	Reading 4.2 Reading 4.26 Reading 7.1 Reading 7.24 Reading 7.25
Operations	Case/reading focuses on production	Safety; reg compliance; training; work conditions	Case 4.27 Case 5.5 Case 5.11 Case 6.2 Case 6.3 Case 6.7 Case 7.2 Case 7.3 Case 7.4 Case 7.5 Case 7.6	Reading 3.2 Reading 7.1

THE BUSINESS TOPIC AREAS	DESCRIPTION	SUBCATEGORIES	CASES	READINGS
			Case 7.17 Case 7.28 Case 8.6 Case 8.13	
Information systems	Case/reading focuses on data: development; use; access	Stats and interpretation; role of data processing in decision-making	Case 3.13 Case 4.5 Case 4.11 Case 4.30 Case 5.7 Case 5.12 Case 7.13 Case 9.3 Case 9.7	Reading 1.5 Reading 2.3 Reading 7.1
Contract Obligations and performance	Case/reading focuses on legal and ethical obligations under contracts	Performance; damages; breach; interpretation	Case 2.12 Case 2.16 Case 3.25 Case 5.4 Case 5.10 Case 5.13 Case 8.1 Case 8.3 Case 8.17 Case 9.3 Case 9.10	
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