Chapter 11

Corporate Performance, Governance, and Business Ethics

STRATEGIC MANAGEMENT

Lecture 11

Dr. John Kraft

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Opening Case

❖ The Fall of John Thain

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The Causes of Poor Performance

❖ Poor management
- Sheer incompetence
- Neglect of core business
- Insufficient number of good managers
- Dominant, autocratic chief executive with passion for empire-building
- Autocratic manager who tries to do it all in the face of complexity and change

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The Causes of Poor Performance

❖ Poor management (cont'd)
- Lack of balanced expertise at the top
- Lack of strong middle management
- Lack of succession planning
- Failure by board to monitor strategic decisions
- Unethical behavior

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The Causes of Poor Performance (cont'd)

❖ High cost structure
- Low labor productivity
- Low capital productivity
- Inadequate financial controls

❖ Inadequate differentiation
- Poor product quality
- Lack of compelling product attributes

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The Causes of Poor Performance (cont'd)

❖ Overexpansion
- Empire-building that adds little value
- Loss of control
- Declining profitability

❖ Structural shifts in demand and new competitors
- Technology
- Economic or political conditions
- Social and cultural norms

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The Causes of Poor Performance (cont'd)

- ❖Organizational inertia
  - Distribution of power and influence in the organization
  - Organization culture
  - Preconceptions about the appropriate business model

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Strategic Change: Improving Performance

- ❖Changing the leadership
  - New leader is often from outside the company
  - New leader must make difficult decisions, motivate, listen, and delegate
- ❖Changing the strategy
  - Redefine strategic focus
  - Divest unwanted assets
  - Improve profitability
  - Make acquisitions

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Stakeholders and Corporate Performance

Stakeholders are individuals or groups with an interest, claim, or stake in the company, what it does, and how well it performs.

Stakeholders are in an exchange relationship with the company

- **Contributions:** they supply the organization with important resources
- **Inducements:** in exchange they expect their interests to by satisfied

Companies should pursue strategies that maximize long-run shareholder value and *must also behave in an ethical and socially responsible manner.*

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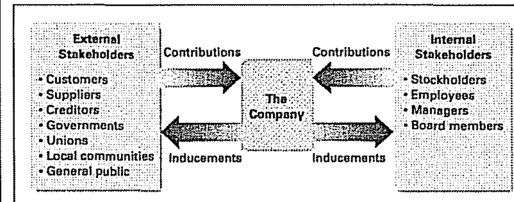
Stakeholders and the Enterprise



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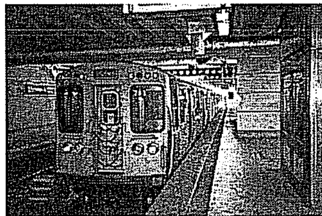
Strategy in Action

- ❖Bill Agee at Morrison Knudsen



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Strategy in Action

- ❖Price Fixing at Sotheby's and Christie's

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The Challenge for Principals

Confronted with agency problems, the challenge for principals is to:

1. Shape the behavior of agents so that they act in accordance with goals set by principals
2. Reduce information asymmetry between agents and principals
3. Develop mechanisms for removing agents who do not act in accordance with goals and principals

Principals try to deal with these challenges through a series of governance mechanisms.

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Agency Theory

- Problems can arise in a business relationship when one person delegates decision making authority to another
- Principal-agent relationships
  - Agency relationship: when one party delegates decision-making authority to another
  - Principal: person delegating authority
  - Agent: person to whom authority is delegated

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The Agency Problem

- Agents and principals may have different goals
- Agents may pursue goals that are not in the best interests of their principals
  - Information asymmetry: Agents almost always have more information
- Difficult for principals to measure performance
- Trust
  - On-the-job consumption
  - Empire building

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Strategy in Action

- Nike Sweatshop Debate

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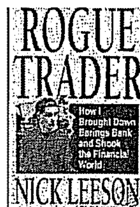
Strategy in Action

- The Agency Problem and the Collapse of Barings Bank



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Real World

- "The Jack-in-the-Box Poisonings – Questionable Ethics?"

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Closing Case

- ❖ **Working Conditions at Wal-Mart**

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Closing Case

- ❖Chainsaw Al Gets the Ax

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Strategy in Action

- ❖**Self Dealing at Computer Associates**

Computer Associates

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Real World

- ❖**"Body Shop International"**

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Closing Case

- ❖The Rise and Fall of Dennis Kowalski

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End of Lecture 11

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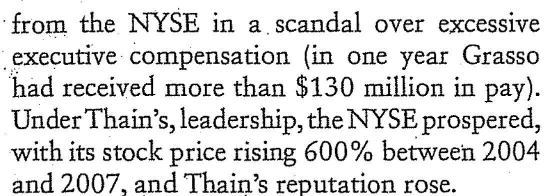
The Fall of John Thain

When John Thain arrived as the new CEO at the beleaguered investment bank Merrill Lynch in November 2007, he was viewed as a potential savior.

Merrill Lynch was staggering under enormous losses related to America's mortgage crisis. The company had a large portfolio of collateralized debt obligations (CDOs), which are complex financial derivatives that were created to insure bonds backed by home mortgages against the possibility of default. The former CEO, Stan O'Neal, had taken Merrill Lynch into the CDOs when trading these instruments was very profitable. But as real estate prices collapsed in America and mortgage defaults soared, their value could not be accurately determined; they could not be resold, and companies like Merrill Lynch had to write billions off their balance sheets. O'Neal was fired by the board of directors and replaced by Thain.

Thain was recruited from the New York Stock Exchange, which he had led since 2004. At the NYSE, Thain followed hot on the heels of Richard Grasso, who had been dismissed

OPENING CASE



from the NYSE in a scandal over excessive executive compensation (in one year Grasso had received more than $130 million in pay). Under Thain's, leadership, the NYSE prospered, with its stock price rising 600% between 2004 and 2007, and Thain's reputation rose.

At Merrill Lynch, Thain found himself confronted by enormous challenges. Thain was able to raise additional capital for Merrill Lynch, helping to stave off bankruptcy. He also cut costs, laying off thousands of employees and exiting several businesses. To the employees that remained, he preached the virtues of tight cost control, telling them that miscellaneous personal expenses had to be reduced to a minimum. Ultimately, though, Thain recognized that Merrill Lynch could not survive as an independent entity. Although the federal government had already committed $10 billion in additional capital as part of its financial rescues package for the banking sector, Merrill Lynch needed more. In the fall of 2008, he engineered the sale of the company to Bank of America. The acquisition was to close in early 2009. For all of these actions, Thain received overwhelmingly positive press. Under the acquisition agreement, Thain was to continue working at Bank of America, reporting directly to CEO Ken Lewis. It was at this point that things started to go terribly wrong for him.

First, it was revealed that at the same time he was cutting jobs and preaching the virtues of cost controls, Thain also personally authorized spending of $1.2 million to redecorate his office at Merrill Lynch. He spent $800,000 to hire a well-known designer, $87,000 on an area rug, four pairs of curtains for $28,000, a pair of guest chairs for $87,000, and so on. If that was not bad enough, it was soon discovered that he had accelerated 2008 bonus payments at Merrill Lynch by several weeks, thereby allowing executives to collect bonuses *before* the acquisition by Bank of American closed. Many wondered why Merrill Lynch was granting any bonuses, given that the firm was booking large losses, the stock had lost over 80% of its value, and the government was lending $10 billion to the troubled company. Compensation and benefits at Merrill Lynch totaled $15 billion in 2008, including $2 billion in bonuses. The total compensation was down only 6% from the prior year. How, some asked, could this possibly be justified given the enormous destruction of stockholder wealth at Merrill Lynch? Moreover, newspapers were reporting that Thain had personally lobbied the compensation committee of the board of directors for a multimillion bonus for 2008, arguing that he had effectively saved the company by engineering a sale and should be rewarded for it. When this information became public, an embarrassed Thain quickly switched his position and stated that he would take no bonus for 2008.

Things came to a head in December 2008 when Thain revealed to Ken Lewis that Merrill Lynch's losses in the fourth quarter would be much bigger than previously thought, totaling some $15.3 billion. Lewis, who was reportedly furious at being misled, almost scuttled the buyout but was pressured to proceed by the federal government, which had already loaned money to Bank of America, and now committed another $20 billion in capital to help it with Merrill Lynch's losses. Three weeks after the deal closed, however, Bank of America announced that Thain would leave the company. Effectively, he had been fired.[1]

Strategy in Action 11.1

Bill Agee at Morrison Knudsen

Bill Agee made his name as a whiz kid who became the chief financial officer of paper maker Boise Cascade during the 1970s while he was in his early thirties. He left Boise Cascade after the company was forced to write down its profits by $250 million because of earlier overstatements of the value of timberland sales. At the time, the write-downs were the largest in corporate history, but this did not stop Agee from being appointed CEO of defense contractor Bendix in 1976 when he was only thirty-eight years old. At Bendix, Agee became involved in a famous corporate soap opera that began when he promoted a young manager, Mary Cunningham, to a senior post over the heads of many other more experienced executives. At the time, many felt the promotion occurred because the two were romantically involved. Both denied this, but in 1982 Agee divorced his wife and married Cunningham, who by this time had left Bendix.

In 1988, Agee became CEO of Idaho-based Morrison Knudsen (MK), a seventy-five-year-old construction company that had made its name as the prime contractor on a number of large western construction projects, including the Hoover Dam and the Trans Alaska pipeline. By the time Agee joined the company, MK was perceived as a venerable institution that wasn't quite living up to its performance potential. Agee's strategy for improving performance was to sell off certain of MK's assets and invest the proceeds in the securities of other companies. At the same time, he pushed MK to pursue large construction projects aggressively and to develop its rail car manufacturing business. At one time, the rail car manufacturing business had been a major success story at MK, but it had fallen on hard times, unable to hold its own in the face of aggressive competition.

On the surface, MK appeared to be prospering under Agee's leadership. In 1993, MK earned $35.8 million, and Agee proclaimed it a "banner year" and a "watershed period" for the company's drive into railroad and mass transit industries. Underneath the surface, however, things were unraveling for Bill Agee. For one thing, 62 percent of MK's profits in 1993 came from Agee's financial plays in securities trading and capital gains on asset sales. Strip out these one-time gains, and it was clear that the operating performance of MK was poor. A prime reason seems to have been Agee's insistence that, in order to win new business, MK should be the low bidder on large contracts. For instance, when MK bid on a contract to build eighty transit cars for the Bay Area Rapid Transit District (BART) in Oakland, California, Agee knocked down the bid to $142 million. According to one insider, the result was that "we were looking at a $14 million loss on the contract the day we won it." In the second quarter of 1994, MK announced a $40.5 million loss after taking a $59.4 million charge for underbidding various transit car contracts. Similarly, in the third quarter of 1994, MK took a $9.2 million charge against profits for underbidding on a $100 million contract to rebuild locomotives for Southern Pacific.

To compound matters, there had been significant employee opposition to Agee's leadership. An anonymous letter sent to MK's board in November 1994 by a group of MK executives calling themselves the MK Committee for Excellence leveled a large number of charges at Agee. They claimed that Agee irked subordinates immediately by removing the portrait of MK's founder from the headquarters and replacing it with a nearly life-sized portrait of himself and his wife, Mary Cunningham, paid for by the company. Agee further estranged insiders by quietly moving the CEO's office to his Pebble Beach estate in California and by scoffing at the company's engineering-oriented culture. Several old-hand MK engineering executives, who had top reputations in their field, were fired, usually after crossing swords with Agee over his policies.

There was also the matter of Agee's pay and perks. At $2.4 million, Agee's 1993 compensation was equal to 6.8 percent of MK's net income, more than any other CEO of a company with earnings in that range, according to a *Forbes* magazine list. According to insiders, MK paid $4 million a year for a corporate jet for Agee, equal to 13 percent of the company's general and administrative budget. The company also paid for landscaping services at Agee's Pebble Beach estate.

Things came to a head on February 1, 1995, when MK's board announced that the company would record a large loss for 1994. The board also announced that Agee would be stepping down as CEO, although initial indications were that he would stay on as chairman of the board. Preliminary figures suggested that MK would have to take a $179.6 million pretax charge in its 1994 fourth quarter, which would result in a net loss of $141 million

for the quarter. At the same time, Standard & Poor's downgraded MK's long-term debt to junk bond rating, signaling that a significant risk of default existed.

The announcement gave rise to a blizzard of shareholder lawsuits and criticism, not only of Agee, but also of MK's board for acting so slowly. Many commentators wondered why it took a huge loss and an anonymous letter from MK employees to prod the board into action. Privately, several board members, most of whom were appointees and long-time friends of Agee, indicated that they were led astray by Agee, who repeatedly urged them not to worry about poor results. Still, many felt that the audit committee of the board of directors had not done a good job of vetting MK's financial accounts under Agee's leadership. Stung by this criticism, the growing evidence of financial mismanagement under Agee's leadership, and the downgrade of MK's debt by Standard & Poor's, the board reversed its earlier position and decided to strip Agee of all posts at MK.

The shareholder lawsuits were settled in September 1995. Under the agreement, MK was to pay out $63 million in cash and stock to shareholders. The settlement also required the company to strengthen its board by adding seven new directors over the next two years. As part of the settlement, Agee agreed to relinquish rights to about $3 million in severance pay and to a cut in his MK pension from $303,000 a year for life to $99,750 a year for life.[a]

Strategy in Action 11.2

Price Fixing at Sotheby's and Christie's

Sotheby's and Christie's are the two largest fine art auction houses in the world. In the mid 1990s, the two companies controlled 90 percent of the fine art auction market, which at the time was worth some $4 billion a year. Traditionally, auction houses make their profit by the commission they charge on auction sales. In good times, these commissions can range as high as 10 percent on some items, but in the early 1990s, the auction business was in a slump, with the supply of art for auction drying up. With Sotheby's and Christie's desperate for works of art, sellers played the two houses off against each other, driving commissions down to 2 percent or even lower.

To try to control this situation, Sotheby's CEO, Dede Brooks, met with her opposite number at Christie's, Christopher Davidge, in a series of clandestine meetings held in car parking lots that began in 1993. Brooks claims that she was acting on behalf of her boss, Alfred Taubman, the chairman and controlling shareholder of Sotheby's. According to Brooks, Taubman had agreed with the chairman of Christie's, Anthony Tennant, to work together in the weak auction market and limit price competition. In their meetings, Brooks and Davidge agreed to a fixed and nonnegotiable commission structure. Based on a sliding scale, the commission structure would range

from 10 percent on a $100,000 item to 2 percent on a $5 million item. In effect, Brooks and Davidge were agreeing to eliminate price competition between them, thereby guaranteeing both auction houses higher profits. The price-fixing agreement started in 1993 and continued unabated for six years until federal investigators uncovered the arrangement and brought charges against Sotheby's and Christie's.

With the deal out in the open, lawyers filed several class action lawsuits on behalf of sellers who had been defrauded by Sotheby's and Christie's. Ultimately, some 100,000 sellers signed on to the class action lawsuits, which the auction houses settled with a $512 million payment. The auction houses also pleaded guilty to price fixing and paid $45 million in fines to U.S. antitrust authorities. As for the key players, the chairman of Christie's, as a British subject, was able to avoid prosecution in the United States (price fixing is not an offense for which someone can be extradited). Christie's CEO, Davidge, struck a deal with prosecutors and in return for amnesty handed over incriminating documents to the authorities. Brooks also cooperated with federal prosecutors and avoided jail (in April 2002 she was sentenced to three years' probation, six months' home detention, 1,000 hours of community service, and a $350,000 fine). Taubman, ultimately isolated by all his former co-conspirators, was sentenced to a year in jail and fined $7.5 million.[b]

Opening Case

Nike: The Sweatshop Debate

Nike is in many ways the quintessential global corporation. Established in 1972 by former University of Oregon track star Phil Knight, Nike is now one of the leading marketers of athletic shoes and apparel in the world. By 2004 the company had more than $12 billion in annual revenues, had a return on invested capital of 17.5 percent, and sold its products in some 140 countries. Nike does not do any manufacturing. Rather, it designs and markets its products and contracts for their manufacture from a global network of 600 factories owned by subcontractors scattered around the globe that together employ some 550,000 people. This huge corporation has made founder Phil Knight into one of the richest people in America. Nike's marketing phrase, "Just Do It!" has become as recognizable in popular culture as its "swoosh" logo or the faces of its celebrity sponsors, such as Tiger Woods.

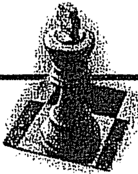
For all of its successes, the company has been dogged for more than a decade by repeated and persistent accusations that its products are made in "sweatshops" where workers, many of them children, slave away in hazardous conditions for wages that are below subsistence level. Nike's wealth, its detractors claim, has been built upon the backs of the world's poor. Many see Nike as a symbol of the evils of globalization: a rich Western corporation exploiting the world's poor to provide expensive shoes and apparel to the pampered consumers of the developed world. Nike's "Niketown" stores have become standard targets for antiglobalization protestors. Several nongovernmental organizations, such as San Francisco–based Global Exchange, a human rights organization dedicated to promoting environmental, political, and social justice around the world, have targeted Nike for repeated criticism and protests. News organizations such as CBS's *48 Hours*, hosted by Dan Rather, have run exposés on working conditions in foreign factories that supply Nike. And students on the campuses of several major U.S. universities with which Nike has lucrative sponsorship deals have protested against those deals, citing Nike's use of sweatshop labor.

Typical of the allegations were those detailed in the CBS news program *48 Hours* in 1996. The report painted a picture of young women at a Vietnamese subcontractor who worked six days a week, in poor working conditions with toxic materials, for only 20 cents an hour. The report also stated that a living wage in Vietnam was at least $3 a day, an income that could not be achieved without working substantial overtime. Nike was not breaking any laws, and nor were its subcontractors, but this report and others like it raised questions about the ethics of using "sweatshop labor" to make what were essentially fashion accessories. It may have been legal, it may have helped the company to increase its profitability, but was it ethical to use subcontractors who by Western standards clearly exploited their work force? Nike's critics thought

not, and the company found itself the focus of a wave of demonstrations and consumer boycotts.

Adding fuel to the fire, in November 1997 Global Exchange obtained and leaked a confidential report by Ernst & Young of an audit that Nike had commissioned of a Vietnam factory owned by a Nike subcontractor. The factory had 9,200 workers and made 400,000 pairs of shoes a month. The Ernst & Young report painted a dismal picture of thousands of young women, most under age twenty-five, laboring ten and a half hours a day, six days a week, in excessive heat and noise and foul air, for slightly more than $10 a week. The report also found that workers with skin or breathing problems had not been transferred to departments free of chemicals. More than half the workers who dealt with dangerous chemicals did not wear protective masks or gloves. The report stated that in parts of the plant workers were exposed to carcinogens that exceeded local legal standards by 177 times and that 77 percent of the employees suffered from respiratory problems.

These exposés surrounding Nike's use of subcontractors forced the company to reexamine its policies. Realizing that its subcontracting policies were perceived as unethical, Nike's management took a number of steps. These included establishing a code of conduct for Nike subcontractors and setting up a scheme whereby all subcontractors would be monitored annually by independent auditors. Nike's code of conduct required that all employees at footwear factories be at least eighteen years old and that exposure to potentially toxic materials would not exceed the permissible exposure limits established by the U.S. Occupational Safety and Health Administration (OSHA) for workers in the United States. In short, Nike concluded that behaving ethically required going beyond the requirements of the law. It required the establishment and enforcement of rules that adhere to accepted moral principles of right and wrong.[1]



Strategy in Action 11.3

The Agency Problem and the Collapse of Barings Bank

In February 1995, the world was shaken by the revelation that unauthorized derivatives trading by a twenty-seven-year-old Englishman, Nick Leeson, employed at the Singapore Office of Britain's oldest bank, Barings Plc, had amassed losses that amounted to $1.33 billion. The debacle resulted in the collapse of Barings and its purchase, for one pound sterling, by a Dutch bank, ING. So ended the history of a 233-year-old bank whose clients at the time of its collapse included Queen Elizabeth II of England.

Despite his youth, Leeson had been a highly successful trader for Barings in Asia and was viewed as the senior Barings trader in Singapore. In September 1994, he started to speculate on the volatility of Japan's Nikkei 255 stock index. His motives were to maximize the size of his

bonus, which could have easily run into seven figures had his strategy been successful, and solidify his position as a major trader. His strategy involved simultaneously writing uncovered put and call options on Nikkei 255 futures. This procedure will make money for the option writer provided that the market stays within a relatively narrow trading range. When Leeson began his trades, the Nikkei was trading at around 19,000. Leeson's strategy made Barings money so long as the Nikkei stayed between 18,500 and 19,500. Once the Nikkei went outside this range, Barings started to lose large amounts of money: about $70 million for every 1 percent move above or below these limits. The loss was exacerbated by Leeson's aggressive use of leverage: he was writing the options using borrowed money.

At first, the strategy worked. Leeson may have earned as much as $150 million for Barings from this strategy by the end of 1994. However, the strategy started to fall apart when the Kobe earthquake struck on January 17, 1995. Following the earthquake, the Nikkei fell below 18,500. In an attempt to push the market back above 18,500, Leeson purchased Nikkei futures, again using borrowed money, and increasing the size of his bet. It didn't work. Leeson's position deteriorated further on January 23 when the Nikkei fell 1,000 points to under 17,800. Increasingly desperate, Leeson responded to the crisis by borrowing more money to continue purchasing Nikkei futures in what was to prove to be a futile attempt to prop up the Nikkei index. By late February 1995, Barings had accumulated index positions that effectively amounted to a $7 billion highly leveraged bet that the Nikkei index would recover—a bet that was wrong.

Leeson's actions did not go unnoticed by other traders in Singapore or executives at Barings Bank in London. However, Barings executives and other traders were under the impression that Leeson was acting on behalf of a major client—perhaps a big hedge fund. No one could conceive that the positions belonged to Barings. As for the cash required to purchase Nikkei futures, apparently much of this came from an account for a fictitious client that Leeson had set up as early as 1992. Into this account went some of Barings's own cash, along with all of the proceeds of Leeson's option sales, and some fictitious profits from falsified arbitrage deals. He then used this fictitious account to pay the costs of borrowing money to finance his trading positions. When the account was exhausted, Leeson turned to Barings in London, saying that he was executing trades on behalf of a major client who would settle up in a few days. Barings proved willing to send more money to their star trader in Singapore.

Bolstered by the arrival of additional funds from London, Leeson kept up the charade until February 23 when the cash flowing out to cover borrowing costs exceeded Barings's preset limits. With the Nikkei continuing to decline, Leeson realized that he could no longer carry on with the game. He hurriedly faxed a letter to Barings in London tendering his resignation, adding that he was sorry for the trouble he had caused, and along with his wife boarded a plane out of Singapore. The next day, shocked Barings executives informed the Bank of England that they were technically bankrupt. The liabilities from Leeson's trades already exceeded $800 million and were growing by the hour as the Nikkei index continued to tumble.

The collapse of Barings had much to do with a lack of internal management controls, which allowed Leeson to speculate on a massive scale using borrowed money. Leeson was able to get away with this because of the poor monitoring of his activities by Barings's senior managers in England. In July 1995, the Bank of England issued a report on the collapse of Barings. According to the bank, "Significant amounts were regularly remitted to BFS without any clear understanding on the part of Barings' management on whose behalf these monies were to be applied, and without any real demur." The Bank of England's report also cited a number of senior managers at Barings for failing to apply proper controls.

Leeson was later tracked down, arrested in Malaysia, and ultimately sentenced to a four-year jail term for fraud. In an interview he gave to the BBC from his jail cell, Leeson gave more insight into the collapse of Barings. Leeson said that he got away with his trading for so long because of the failure of key executives at Barings's London headquarters to understand the business he was engaged in and to look more closely into his activities: "The first day that I asked for funding there should have been massive alarm bells ringing. But senior people in London that were arranging these payments didn't understand the basic administration of futures and options. . . . They wanted to believe in the profits being reported, and therefore they weren't willing to question."

In a spectacular example of the agency problem, Leeson exploited the information asymmetry that existed between himself and senior managers to pursue his own interests, placing risky bets on the Nikkei stock market index that could have netted Leeson millions but in the event plunged Barings into bankruptcy and sent Leeson to jail.

Sources: N. Bray and G. Whitney, "Barings Collapse Tied to Wide Cast," *Wall Street Journal,* July 19, 1995, p. A5. T. Shale, "Why Barings Was Doomed," *Euromoney* (March 1995): 38–41. "A Fallen Star," *Economist,* March 4, 1995, pp. 19–21.

2.4 STRATEGY in ACTION

The Jack-in-the-Box Poisonings—Questionable Ethics?

In January 1993, several hospitals in Seattle started to notice a dramatic increase in the number of cases of E. coli bacterial infections. The E. coli bacteria are found in undercooked meat. The symptoms of infection include severe fever, diarrhea, and vomiting. In the case of young people, the infection can be life threatening. Most of the victims of this outbreak were young, and many were in very serious condition. Epidemiologists quickly found a common element: almost all of the victims had eaten hamburgers at local Jack-in-the-Box restaurants shortly before falling ill.

Foodmaker, the parent company of Jack-in-the-Box, was quick to issue a statement denying that the meat served in its restaurants was undercooked. At the same time, it blamed the outbreak on a batch of bad meat that had been delivered from a supplier. The supplier responded by placing blame on Jack-in-the-Box. While Foodmaker and its supplier traded insults, the number of those infected rose to 200, and several children became seriously ill. Then Washington State health inspectors revealed that local Jack-in-the-Box restaurants were cooking meat at 140 degrees Fahrenheit, 15 degrees below the 155-degree state standard that had been in force since March 1992. Foodmaker responded by claiming that it had never received notification of the increase in standards. When Health Department officials came up with a copy of the notification that had been sent to local Jack-in-the-Box restaurants, Foodmaker changed its position. According to Robert Nugent, president of Jack-in-the-Box, the company had received the notification but the vice president whose responsibility it was to notify local area restaurants hadn't done so. Jack-in-the-Box indicated that it would take disciplinary action against the vice president, whom it refused to name.

Meanwhile the number of children infected had soared to 450, one had died, several were in a coma, and a number of others were listed as being in critical condition. At this stage Jack-in-the-Box offered to pay the hospital costs for those infected. But there was a catch; in return for paying medical costs, the company's lawyers asked the parents of the infected children to sign forms waiving their rights to subsequently file a lawsuit against Jack-in-the-Box. This request was greeted with outrage, and Jack-in-the-Box once more had to shift its position. This time the company agreed to pay the full hospital costs without requiring a waiver.

By February 1993, the worst of the outbreak was over. However, for Foodmaker the impact was only just becoming apparent. Nationwide sales at Jack-in-the-Box restaurants had plunged 35 percent in the first two weeks of February, the company's stock price had lost 30 percent of its value, and the company announced that it had put on hold plans to open eighty-five new Jack-in-the-Box stores in 1993. In the next two years, Foodmaker recorded nine consecutive quarters of losses, totaling $167 million, while revenues dropped 18 percent. It cost the company a reported $44 million to settle lawsuits from angry franchisees, who blamed their falling sales on Foodmaker, and $4 million to settle a stockholder lawsuit. The company also reportedly ended up paying $90 million in damages to victims and their families.

What seems to have hurt Jack-in-the-Box most was not the outbreak itself, but the company's repeated attempts to shift responsibility for the outbreak onto others, and its cynical attempt to link the offer of financial help to victims with lawsuit waivers. As a result, Jack-in-the-Box came out of the crisis with its reputation tarnished and its sales slumping. Compare this to Johnson & Johnson, which came out of the Tylenol crisis with its reputation for ethical behavior enhanced. It should be noted, though, that the lesson was not lost on Foodmaker. The company has completely overhauled its food distribution and preparation system to make sure this kind of thing does not happen again. Now Foodmaker's system is reportedly the best in the industry. Moreover, the company has explicitly recognized that it responded inappropriately to the crisis and has vowed never to make the same mistake again.[64]

Running Case

Working Conditions at Wal-Mart

When Sam Walton founded Wal-Mart, one of his core values was that if you treated employees with respect, tied compensation to the performance of the enterprise, trusted them with important information and decisions, and provided ample opportunities for advancement, they would repay the company with dedication and hard work. For years the formula seemed to work. Employees were called "associates" to reflect their status within the company, even the lowest hourly employee was eligible to participate in profit sharing schemes and could use profit sharing bonuses to purchase company stock at a discount to its market value, and the company made a virtue of promoting from within (two-thirds of managers at Wal-Mart started as hourly employees). At the same time, Walton and his successors always demanded loyalty and hard work from employees. For example, managers were expected to move to a new store on very short notice, and base pay for hourly workers was very low. Still, as long as the upside was there, little grumbling was heard from employees.

In the last ten years, however, the relationship between the company and its employees has been strained by a succession of lawsuits claiming that Wal-Mart pressures hourly employees to work overtime without compensating them, systematically discriminates against women, and knowingly uses contractors who hire undocumented immigrant workers to clean its stores, paying them below minimum wage.

For example, a class action lawsuit in Washington State claims that Wal-Mart routinely (a) pressured hourly employees not to report all their time worked, (b) failed to keep true time records, sometimes shaving hours from employee logs, (c) failed to give employees full rest or meal breaks, (d) threatened to fire or demote employees who would not work off the clock, and (e) required workers to attend unpaid meetings and computer training sessions. Moreover, the suit claims that Wal-Mart has a strict "no overtime" policy, punishing employees who work more than forty hours a week, but that the company also gives employees more work than can be completed in a forty-hour week. The Washington suit is one of more than thirty suits that have been filed around the nation in recent years.

With regard to discrimination against women, complaints date back to 1996, when an assistant manager in a California store, Stephanie Odle, came across the W2 of a male assistant manager who worked in the same store. The W2 showed that he was paid $10,000 more than Odle. When she asked her boss to explain the disparity, she was told that her coworker had "a wife and kids to support." When Odle, who is a single mother, protested, she was asked to submit a personal household budget. She was then granted a $2,080 raise. She was subsequently fired, she claims for speaking up. In 1998 she filed a discrimination suit against the company. Others began to file suits around the same time, and by 2004 the legal action had evolved into a class action suit that covered 1.6 million current and former female employees at Wal-Mart. The suit claims that Wal-Mart did not pay female employees the same as their male counterparts and did not provide them with equal opportunities for promotion.

In the case of both undocumented overtime and discrimination, Wal-Mart admits to no wrongdoing. The company does recognize that, with some 1.4 million employees, some problems are bound to arise, but it claims that there is no systematic companywide effort to get hourly employees to work without pay or to discriminate against women. Indeed, the company claims that this could not be the case since hiring and promotion decisions are made at the store level.

For their part, critics charge that while the company may have no policies that promote undocumented overtime or discrimination, its hard-driving cost-containment culture has created an environment where abuses can thrive. Store managers, for example, are expected to meet challenging performance goals, and in an effort to do so they may be tempted to pressure subordinates to work additional hours without pay. Similarly, company policy requiring managers to move to new stores at short notice unfairly discriminates against women, who lack the flexibility to uproot their families and move them to another state at short notice.

While the lawsuits are still ongoing and may take years to resolve, Wal-Mart has taken steps to change its employment practices. For example, the company has created a director of diversity and a diversity compliance team, and it has restructured its pay scales to promote equal pay regardless of gender.[d]

Closing Case

Chainsaw Al Gets the Ax

In July 1996, Sunbeam, a troubled maker of small appliances, announced that it had hired Al Dunlap as its chief executive officer. Sunbeam's stock jumped 50 percent on the news to $18 5/8 as investors eagerly anticipated the gains that the legendary "Chainsaw Al" would bring to Sunbeam. Dunlap's reputation was built on a highly successful career as a turnaround specialist. Before joining Sunbeam, he had engineered a tough turnaround at Scott Paper. There he had laid off 31 percent of the workforce, including 70 percent of all upper-level managers. The stock market valuation of Scott tripled during his tenure. After only eighteen months at Scott, Dunlap walked away with $100 million in salary, bonus, stock gains, and perks, a richly deserved reward, he claimed, given the gains that he engineered in the stock of Scott Paper. Now investors hoped that he would work the same magic at Sunbeam.

Upon arrival at Sunbeam, Dunlap quickly fired seven of Sunbeam's top executives. Then he spent three months formulating his strategy, which he unveiled at an analyst meeting in November 1996. It was classic Dunlap: Sunbeam's workforce would be cut in half to just 6,000, eighteen of the company's twenty-six factories would be closed, four divisions would be disposed of, and the number of products Sunbeam offered would be reduced by 81 percent to 1,500. These measures were projected to produce annual savings of $225 million. Dunlap also laid out ambitious growth goals for Sunbeam, including doubling revenues to $2 billion (after divestitures), raising operating profit margins to 20 percent from 2.5 percent, launching at least thirty new products a year, and increasing international sales to $600 million. "Our growth mission," he proclaimed, "is to become the dominant and most profitable small household appliance and outdoor cooking company in North America, with a leading share of Latin American and Asian Pacific markets."

Right from the start, there were questions about the feasibility of this strategy. Several securities analysts that followed Sunbeam wondered how the company could possibly increase revenues given the depth of the cuts in employment and products, particularly since the North American market for small appliances was experiencing no growth. Nevertheless, Sunbeam's initial results seemed to suggest that Dunlap could pull off this trick. Revenues grew by 18 percent in 1997, while operating margins income rose to $109.4 million and the stock price surged to around $50 a share. It looked as if Dunlap was about to prove once again that tough guys finish first.

However, under the surface were problems. To increase revenues, Dunlap was urging Sunbeam's managers to engage in a "bill and hold" strategy with retailers. Under this arrangement, Sunbeam's products were purchased at large discounts and then held at third-party warehouses for delivery later. In effect, Dunlap was shifting sales from future periods into the current period. Although the approach was not illegal, the ethics of the approach were certainly questionable. Later, Dunlap defended the practice, claiming that it was an effort to extend the selling season and better meet surges in demand. Sunbeam's auditors, Arthur Andersen, also insisted that the practice met accounting standards.

In early March 1998, Dunlap announced that Sunbeam would acquire three companies, including Coleman, the manufacturer of outdoor camping stoves. The stock market responded enthusiastically, and the stock hit an all-time high of $53. Some critics wondered, however, if this implied that Sunbeam could not hit its growth goals from internally generated sales. Shortly afterward, Dunlap announced that the company would book a first-quarter loss of $44.6 million. Dunlap blamed the loss on underlings who had offered "stupid, low-margin deals" and insisted that it would "never happen again." To drive home his point, he fired a number of senior managers who, he claimed, were responsible for the "stupid, low-margin deals," including Donald Uzzi, Sunbeam's well-regarded executive vice president for worldwide consumer products. Around the same time, Dunlap announced that he would cut 5,100 more jobs at the acquired companies and at Sunbeam.

Dunlap's layoff announcement did not stop the fall in Sunbeam's stock price, which had been declining ever since the announcement of a first-quarter loss and now stood under $20. The decline in the stock price accelerated in late May 1998, when the highly regarded financial newspaper *Barron's* published a scathing analysis of Sunbeam. In the article, *Barron's* alleged that Dunlap had employed $120 million of artificial profit boosters in 1997, without which Sunbeam would have recorded a loss.

Dunlap was so concerned about the *Barron's* article that he called a special meeting of the company's board of directors on June 9, 1998. The board had been supportive of Dunlap to this point, and he could count several longtime friends among its number. What began as a straightforward meeting rebutting the *Barron's* article took a strange turn when one director asked Sunbeam's chief financial officer, Russ Kersh, if the company would make its next quarter's numbers. Kersh admitted that they were "challenging." At this point, Dunlap asked all of the outside advisers to step out and then told the board that he and the CFO would resign unless they got the right level of support from the board. "I have all of the necessary documents in my briefcase," Dunlap was reported to have said and then stormed out of the room.

Over the next few days, the board members started to dig deeper. One director placed a call to several top executives. He quickly discovered that many had lost confidence in Dunlap, whom they characterized as abusive and unethical. He was also disturbed to hear that not only would Sunbeam miss its growth goals in the coming quarter, but that revenues would probably come in $60 million *below* the $290 million recorded in the same quarter a year earlier.

Armed with this information, the board convened a second meeting on June 13. At that meeting, the directors all agreed that Dunlap had to go. Most of the directors were friends of Dunlap, but they felt betrayed by him, misled about the company's financial condition, its second-quarter earnings, and its yearly numbers. That day they placed a call to Dunlap and told him that he had been dismissed. Three days later, the board also fired Russ Kersh, the CFO. Commenting on Dunlap's demise, the CEO of a competitor to Sunbeam stated that Dunlap "is the logical extreme of an executive who has no values, no loyalty, no honor, no ethics. And yet he was held up as a corporate god in our culture. It greatly bothers me." A former plant manager whom Dunlap had fired remarked, "I guess the house of cards came tumbling down. When you reduce your workforce by 50 percent, you lose your ability to manage. You can survive like that for months, not years." Following the announcement that Dunlap had been fired, Sunbeam stock fell to under $8 a share, lower than it had been before Dunlap joined the company.

Case Discussion Questions

1. In whose best interests was Al Dunlap acting? Do you think he was honestly trying to discharge his obligation to key stakeholder groups, such as stockholders, employees, and customers?
2. Do you think the Sunbeam board exercised its fiduciary duty? What does this tell you about how boards can work?
3. In retrospect, what might Al Dunlap have done differently to engineer a turnaround at Sunbeam?

Sources: John Byrne, "How Al Dunlap Self-Destructed," *Business Week*, July 6, 1998, p. 58. G. DeGeorge, "Al Dunlap Revs Up His Chainsaw," *Business Week*, November 25, 1996, p. 37. "Exit Bad Guy," *Economist*, June 20, 1998, p. 70. Ellen Pollock and Martha Brannigan, "Mixed Grill: The Sunbeam Shuffle," *Wall Street Journal*, August 19, 1998, p. A1.

11.2 STRATEGY IN ACTION

Self-Dealing at Computer Associates

Computer Associates is one of the world's largest software companies. During the 1990s, its stock price appreciated at a rapid rate, driven in large part by surging revenues and a commensurate rise in profits. Because its revenues were growing more rapidly than those of rivals during the late 1990s, investors assumed that the company was gaining market share and that high profitability would follow, so they bid up the price of the company's stock. The senior managers of Computer Associates were major beneficiaries of this process. Under a generous incentive program given to the company's three top managers by the board of directors—Charles Wang, then CEO and chairman of the board, Sanjay Kumar, the chief operating officer, and Russell Artzt, the chief technology officer—if the stock price stayed above $53.13 for 60 days, they would receive a special incentive stock award amounting to some 20 million shares. In May 1998, Kumar announced that Computer Associates had "record" revenues and earnings for the quarter. The stock price surged over the $53.13 trigger and stayed there long enough for all three to receive the special incentive stock award, then valued at $1.1 billion.

In late July 1998, after all three had received the award, Kumar announced that the effect of Asian economic turmoil and the year 2000 bug "leads us to believe that our revenue and earnings growth will slow over the next few quarters." The stock price promptly fell from the high 50s to less than $40 a share. What followed was a series of class action lawsuits, undertaken on behalf of stockholders, who claimed management had misled stockholders to enrich themselves. As a result of the lawsuits, the three were compelled to give back some of their gains, and the size of the award was reduced to 4.5 million shares. Wang stepped down as CEO, although he retained his position as chairman of the board, and Kumar became the CEO.

This was not the end of matters, however, for Computer Associates had attracted the attention of both the Justice Department and the SEC, which launched a joint investigation into the company's accounting practices. By 2002, they were reportedly focusing on a little-noticed action the company had taken in May 2000 to reduce its revenues by 10%, or $1.76 billion, below what it had previously reported for the three fiscal years that ended March 2000. The downward revisions, detailed in the company's 10-K filings with the SEC, retroactively took hundreds of millions of dollars away from the top line in the 14 months preceding the May 1998 stock award to senior managers, including some $513 million for the year ending March 1998. According to the company, earnings were unaffected by the revision because the lost revenue was offset by a commensurate downward revision of expenses. The downward revision reportedly came at the urging of auditor KPMG, which replaced Ernst & Young as the company's accountant in June 1999.

The implication that some observers were drawing was that Computer Associates deliberately overstated its revenues in the period prior to May 1998 to enrich the three top managers. The losers in this process were stockholders who purchased shares at the inflated price and longer-term shareholders who saw the value of their holdings diluted by the stock awarded to Wang, Kumar, and Artzt. In a statement issued after a report of the ongoing investigation was published in the *Wall Street Journal*, Computer Associates stated that it changed how it classified revenue and expenses at the advice of its auditors. "We continue to believe CA has acted appropriately," the company spokesperson said. "This change in presentation had no impact on reported earnings, earnings per share, or cash flows."

By 2004, it was clear that Computer Associates had been acting anything but appropriately. According to the SEC investigation, between 1998 and 2000, the company adopted a policy of backdating contracts to boost revenues. For example, in January 2000, Computer Associates negotiated a $300 million contract with a customer but backdated the contract so that the revenues appeared in 1999. Although initially this may have been done to help secure the $1.1 billion special stock award, by 2000 the practice represented an increasingly desperate attempt to meet financial projects that the company was routinely missing. Under increasing pressure, in 2002 Charles Wang stepped down as chairman, and in 2004 Kumar was forced to resign as CEO by the board of Computer Associates, which had belatedly come to recognize that the company's financial statements were fraudulent. In late 2004, in a deal with federal regulators, the company admitted to $2.2 billion in fraud. As part of the deal, Kumar was indicted by federal prosecutors on charges of obstruction of justice and securities fraud. In November 2006, Kumar was sentenced to 12 years in jail for his part in the fraud.

Sources: J. Guidera, "Probe of Computer Associates Centers on Firm's Revenues," *Wall Street Journal*, May 20, 2002, A3, 15; Ronna Abramson, "Computer Associates Probe Focus on 1998, 1999 Revenue," *The Street.Com*, May 20, 2002; C. Forelle, M. Maremont, and G. Fields, "U.S. Indicts Sanjay Kumar for Fraud, Lies," *Wall Street Journal*, September 23, 2004, N. Varchaver, "Long Island Confidential", *Fortune*, November 27, 2006, 172–178.

CLOSING CASE

Body Shop International

THE BRITISH-BASED RETAILER, Body Shop International, is often viewed as a prime example of a company commited to being ethical and socially responsible in its business dealings. The company's founder and CEO, Anita Roddick, has become an energetic spokesperson for the importance of ethics and social responsibility. Body Shop competes in the international cosmetics and toiletries market but offers unique products derived from natural ingredients. The company has based its success on the claim that none of its products is tested on animals, contains artificial ingredients, or is elaborately packaged. The products appeal to consumers who are concerned about animal rights and the environment. Under a program called "Trade not Aid," Body Shop claims to purchase many of the ingredients for its products from Third World producers, and the company maintains that it pays its suppliers well. It also makes a point of plowing money back into the communities where its suppliers are based to support a variety of health and educational projects. This commitment to social responsibility helped propel Body Shop from a single store in 1976 to a global enterprise with 1,100 stores in forty-five countries and annual revenues of more than $700 million in 1995. According to Roddick,

> You can run a business differently from the way most businesses are run, you can share your prosperity with employees, and empower them without being in fear of them. You can rewrite the book in terms of how a company interacts with the community, on third world trade, global responsibility, and the role of educating customers and shareholders, and you can do all this and still play the game according to the City [the British version of Wall Street], still raise money, delight the Institutions and give shareholders a wondrous return on their investment.

Roddick's philosophy helped turn Body Shop into the darling of the business ethics community. However, the good feeling was rudely shattered in the fall of 1994 when a journalist, Jon Entine, published an article highly critical of Body Shop in the *Business Ethics* magazine. Among other things, Entine made the following claims:

- Body Shop uses many outdated, off-the-shelf product formulas filled with nonrenewable petrochemicals.
- Many of its products are contaminated and contain formaldehyde, an artificial ingredient.
- Body Shop has used ingredients in its products that have been tested on animals.
- Contrary to its claims, Body Shop sources only a tiny amount of ingredients through its Trade not Aid program. Moreover, Body Shop does not pay "first world wages for third world products," as it claims in its publicity.
- The company's charitable contributions and progressive environmental standards fall short of it's claims. Until 1994, the company never contributed more than 1.24 percent of its pretax profits to charitable organizations.
- The company invented stories about the exotic origins of some of its products.

Entine's article drew a vigorous response from Gordon Roddick, the chairman of Body Shop International. In a ten-page letter sent to all subscribers of *Business Ethics* magazine, Roddick claimed that Entine's article was filled with "many lies, distortions, and gross inaccuracies. . . . I am at a loss to find anything balanced or fair in this article." Roddick went on in the letter to give a detailed rebuttal of Entine's charges. For example, with regard to the Trade not Aid program, Roddick observed that Entine's article

> goes after our Trade not Aid program, building its attack around an utterly irrelevant statistic—the percentage of our ingredients that come from Trade not Aid projects. What is this number supposed to reveal? It certainly tells us nothing about the effectiveness of our efforts. Or the amount of time we have put into nurturing these projects. Or the obstacles we have had to overcome due to the lack of infrastructure in disenfranchised Third World communities. . . . One single ingredient, such as Brazil nut oil or cocoa butter, may take two years or more to source and develop. Believe me, there are much easier ways to do business than by taking on the problems of such projects. . . . We do it because we are asked to help by the disenfranchised communities themselves. The only significant measure of our success is the number of people who are directly beneficially affected by our activities. That is a number, I am proud to say, that runs into the thousands.

Body Shop followed up Entine's attack by commissioning an independent "ethics audit" by the New Economics Foundation, a London-based ethics business consultant. Issued in January 1996, the audit reported that

93 percent of Body Shop's employees feel the company lives up to its mission to be socially and environmentally responsible and that the purchases from suppliers in developing countries or poor communities increased by more than 30 percent during 1995. The audit also noted that less than 2 percent of the company's raw material inputs came from the Trade not Aid program in 1995, although about 17.8 percent of the accessories sold in Body Shop stores—such as brushes and sponges—came from the program. The company donated 2.3 percent of its pretax profits to charity in 1995.[70]

Case Discussion Questions

1. Is Anita Roddick correct when she claims that it is possible to run a business in a very ethical and socially responsible manner and still "give shareholders a wondrous return on their investment"?
2. Is the percentage of ingredients that come from Trade not Aid projects an irrelevant statistic, as Gordon Roddick claims?
3. In light of the ethics audit report, evaluate Body Shop's claims to be ethically responsible.

Strategy in Action

The Agency Problem at Tyco

Under the leadership of Dennis Kozlowski, who became CEO of Tyco in 1990, the company's revenues expanded from $3.1 billion in 1992 to $38 billion in 2001. Most of this growth was due to a series of acquisitions that took Tyco into a diverse range of unrelated businesses. Tyco financed these acquisitions by taking on significant debt commitments, which by 2002 exceeded $23 billion. As Tyco expanded, some questioned Tyco's ability to service its debt commitments and claimed that the company was engaging in "accounting tricks" to pad its books and make the company appear more profitable than it actually was. These criticisms, which were ignored for several years, were finally shown to have some validity in 2002, when Kozlowski was forced out by the board and subsequently charged with tax evasion by federal authorities.

Among other charges, federal authorities claimed that Kozlowski treated Tyco as his personal treasury, drawing on company funds to purchase an expensive Manhattan apartment and a world-class art collection that he obviously thought were befitting the CEO of a major corporation. Kozlowski even used company funds to help pay for an expensive birthday party for his wife, an extravaganza that featured toga-clad ladies, gladiators, a naked-woman-with-exploding-breasts birthday cake, and a version of Michelangelo's David that peed vodka! Kozlowski was replaced by a company outsider, Edward Breen. In 2003 Tyco took a $1.5 billion charge against earnings for accounting errors made during the Kozlowski era (that is, Tyco's profits had been overstated by $1.5 billion during Kozlowski's tenure). Breen also set about dismantling parts of the empire that Kozlowski had built, divesting the company of several businesses.

After a lengthy criminal trial, in June 2005 Dennis Kozlowski and Mark Swartz, the former chief financial officer of Tyco, were convicted of twenty-three counts of grand larceny, conspiracy, securities fraud, and falsifying business records in connection with what prosecutors described as the systematic looting of millions of dollars from the conglomerate (Kozlowski was found guilty of looting $90 million from Tyco). Both were set to serve significant jail time.[a]