The Business Communication Casebook

2e

A Notre Dame Collection

James S. O'Rourke, IV

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James S. O'Rourke, IV
University of Notre Dame
Mendoza College of Business

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The Casebook for Business Communication:
A Notre Dame Collection, 2/e

South-Western College Publishing (2007)
James S. O'Rourke, IV, editor

INTRODUCTION

This book is by no means unique. People have gathered case studies together and published them for many years. After all, the value of case studies--particularly in the education of young managers and executives-in-training – is well known. Cases provide both the instructor and the learner with an opportunity examine authentic, real-world problems in a careful and detailed way. The facts of each case are laid out in methodical, if sometimes incomplete, fashion for the student of management to examine.

"What should the manager do?" you ask. "What's the best strategy in this case?" More to the point, good problem-solvers always ask: "What do I *not* know about this situation that would be helpful to know?" And, "Is there any way I can gather missing information that seems important?" What about assumptions? "What do I believe to be true that I can't actually prove? How do I know that my view of the facts in this instance is accurate, fair, or complete?"

Good questions. And, for the most part, that's what case study is about: asking good questions and seeking the answers on behalf of the stakeholders. Case studies are never about identifying heros and villains, nor are they written for the purpose of highlighting either the inept or skillful handling of an administrative situation. They are always written for the purpose of gathering information that will help to begin a discussion about how management can make better decisions.

Good case studies provide as much accurate, current, and relevant information as possible about an incident, a problem, an event, or an opportunity. No two such problems, events, or opportunities are ever *precisely* the same, so knowing what happened in one will only be partially helpful in deciding what to do in the next. Times change, circumstances differ, stakeholder interests shift. Knowing how to summarize the central events of a case, identify and rank order the critical issues, identify and analyze the interests of various stakeholders, and then outline options for managerial action are skills that will be essential to a successful career in business. This collection of case studies can help.

While this book is not unique, it is different in an important way. Each of the cases in this collection is about communication. Each explores some aspect of the communication process that is so vital to the success of a business. Some cases involves more than one aspect of that process: multiple issues involving separate messages for more than one audience. These cases will require communication skill from the reader – skill in organizing, supporting, and expressing those messages. They will require that students begin to apply theories of communication and integrate them with the management strategies they are learning as students of business.

Each of these cases was written by second-year graduate students in the Mendoza College of Business at the University of Notre Dame. Most were pursuing a Master of Business Administration degree. Others were enrolled in the Master of Nonprofit Administration or Master of Science in Accountancy programs. All were members of small teams of two or three who chose to pursue a case topic in great detail for at least fifteen weeks.

The details contained in the 36 cases you're about to read have come, in part, from public sources such as *The Wall Street Journal*, *The New York Times*, *The Financial Times*, *The Economist*, or similar publications. Other bits of information come from corporate websites and

Internet press rooms. Still others come from professional news-gathering organizations such as the Associated Press, Reuters, Bloomberg, or networks such as MSNBC or CNN. Many of these cases, however, contain information which came from sources inside the organizations being examined – from personal interviews with employees, managers, executives, and shareholders. In some instances, the views of government regulators or civic officials have been sought out and included in the text. In all instances, every effort was made to verify, confirm, and identify the source of each fact, each quote, and each piece of information. Where disagreement exists, the case authors identify that. Where uncertainty exists, that, too, is flagged for the reader's attention.

In each instance, case authors have given competing factions, including companies in crisis, an opportunity to read a preliminary draft of the case study, and to either comment or respond. Many firms responded in a thoughtful and cooperative fashion. Others, perhaps fearful of saying the wrong thing or uncertain of what to say, simply did not respond.

In a few instances – each clearly noted – the authors promised anonymity to sources in exchange for their views of the events they were researching. In a few instances, we have chosen to identify them only as "employees close to the situation." For a few others, we have selected a pseudonym to disguise the identity of the manager or executive involved. In every instance, case authors and their editor had at least two independent sources for every fact, assertion, or assumption included in the case.

Keep in mind as you examine each case that your own knowledge of the events involved may color your response to the questions your instructor will ask. Even though you may know (or think you know) what actually happened in a particular instance, please remember that particular outcome was just one of many that could have occurred, had the executives or managers chosen a different path. What actually happened may not have been the best of all possible outcomes. Think carefully about what you might do differently if faced with similar circumstances.

Finally, a few acknowledgments. First, to the men and women of Notre Dame who wrote these cases: congratulations on a job well done. These are interesting, current, well-crafted stories of organizations facing crisis or change. The money from the sale of this book (such as it is), will help to fund the education of future students. Second, to the hundreds of managers and executives who cooperated in the interviews which were indispensable to the completion of each of these cases, thanks. The stories wouldn't have been as rich, accurate, or complete without your help.

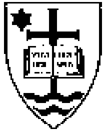
To Taney Wilkins and the staff of South-Western College Publishing, my thanks for your belief in the project, your patience with me, and your help in getting it done. To my own research assistants, Elisa Norris and Theresa Bishop, thanks a thousand times for flagging a sentence that made no sense, chasing down a footnote that seemed incomplete, or grappling with a phalanx of balky paragraphs and format-resistant pages. To my colleagues, Sandra Collins, Sondra Byrnes, Cynthia Maciejczyk, and Carol Jambor-Smith: thank you for your inspiration, assistance, and ideas. And thanks for your friendship. No man could ask to work with better friends.

And to my family: Pam, Colleen, Molly, and Kathleen. Thanks is insufficient for the inspiration, patience, and encouragement. As ever, you are the reason I do this.

James S. O'Rourke, IV
Notre Dame, Indiana
Summer 2006

American Girl: A Protest Over Corporate Philanthropy
Murphy, K.; Halvorsen-Ganepola, M.; O'Rourke, J. S. (Editor)

In November 2005, just prior to the Christmas shopping season, the Pro-Life Action League and the American Family Association announced a boycott of the popular doll line American Girl®, citing outrage at American Girl's charitable support of Girls, Inc., which they accuse of supporting abortion and promoting lesbianism. The two special interest groups staged the boycott after failed attempts during the month preceding it to influence American Girl to cut the "I CAN" promotion. This promotion, centered on a girl's purchasing of an "I CAN" bracelet and making the "I CAN" promise to herself, supported programs of the 150-year-old charity, although the proceeds were earmarked for programs that were not linked to the issues to which the special interest groups objected. The groups felt that the company would respond to the challenge of the campaign because they claimed to be representative of the primary consumer segments of the American Girl dolls, with which they historically held shared family values. The boycott lasted through the Christmas season, and the "I CAN" promotion ended the day after Christmas, as scheduled. 6 pp. Case #06-16 (2006).



Eugene D. Fanning Center for Business Communication **06-16**
Mendoza College of Business
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American Girl:
A Protest Over Corporate Philanthropy (A)

Introduction

Eric Scheidler, communications director for the Pro-Life Action League based in Chicago, Illinois, was dismayed when he received an e-mail from a concerned mother in early October 2005. The woman wrote to inform the Pro-Life Action League headquarters about American Girl's support of a national girls' club, Girls Inc. According to the writer, Girls Inc. supported abortion and lesbianism and she wanted the Pro-Life Action League to get involved to protest this relationship. Eric, a father of seven, has daughters who were regular patrons of the American Girl Place store in Chicago, and did not want to believe this accusation. He spent the next few hours researching the press release from American Girl announcing its "I CAN" campaign, and Girls Inc.'s policies and activism statements. He found evidence that he believed would support the concerned mother's claim, and took the issue to the next board meeting for review.[1]

Ann Scheidler, executive director for the Pro-Life Action League, and a grandmother to Eric's children who took them to American Girl Place Chicago often, was also disheartened by the news, but decided that the league had to take action. She called American Girl to inquire about their knowledge of the controversial Girls Inc. positions. Both the Pro-Life Action League and the American Family Association, led by Donald E. Wildmon issued statements encouraging people to e-mail and call Ellen Brothers, the president of American Girl asking the company to renounce its partnership with Girls Inc.

American Girl

Pleasant T. Rowland founded the Pleasant Company in 1985 in Middleton, Wisconsin.[2] Rowland, a former teacher and publisher, took a vacation to Colonial Williamsburg in 1984 with her husband. The ambiance inspired her, and she realized that the American education system

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This case was prepared by Research Assistants Marie Halvorsen-Ganepola and Katie Murphy under the direction of James S. O'Rourke, concurrent professor of management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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was not doing enough to make history come alive for children. The next Christmas, Rowland was unimpressed with the choices of dolls available to purchase for her nieces, including Cabbage Patch Kids and Barbie. These experiences moved Rowland to develop a concept for a line of dolls that reflected different periods of American history.[3]

The Pleasant Company, funded entirely by Rowland's previous textbook royalties, began as she developed ideas for the dolls and the books to accompany them. In a matter of weeks, Rowland and a friend located a doll manufacturer in Germany, Gotz Puppenfabrik, to produce the dolls. The books are printed in the United States, and the doll accessories are manufactured in China. The American Girl line went public via mail-order catalogs for Christmas 1986. In the third quarter of 1986, the Pleasant Company sold $1.7 million in dolls and accessories.[4]

Over the next eight years, American Girl sales grew to $300 million a year.[5] American Girl's first line of historical figurines was targeted to reach girls between the ages of 7 and 12.[6] Kaya®, Felicity®, Jesfina®, Kirsten®, Addy®, Samantha®, Kit®, and Molly® each provided the target audience with a view of a different period of American history through the eyes and experiences of the nine-year-old characters.[7] In 1992, American Girl published the first issue of its magazine directed at a young audience, addressing topics of self-esteem, creativity, and the achievements of girls.[8] The success of the magazine's appeal to today's issues for girls led American Girl to release a new line of dolls in the Just Like You® series that captured the diversity of the American public.[9] A line of Bitty Baby® dolls also debuted to reach girls in the 3-to-6 age group.[10]

In 1998, Mattel, Inc. purchased the Pleasant Company and the American Girl line of dolls[11] for $700 million, but American Girl still functions independently from Middleton, Wisconsin.[12] Pleasant T. Rowland continued as president until 2000 when Ellen L. Brothers succeeded her as president of American Girl and executive vice president of Mattel.[13]

The first retail store, American Girl Place Chicago opened its doors in November 1998. Since then, American Girl Place New York opened in 2003, and a Los Angeles location opened in the spring of 2006. These retail outlets offer the doll product lines, but also include a café, and a theater that performs live musical reviews.[14]

Girls Inc.

Girls Inc. recognizes its history as dating back to 1864 during the Industrial Revolution, serving young women and girls who migrated from rural communities to seek employment in the new mills and factories of larger cities. The association grew more formally beginning in 1945 when 19 organizations from across the country joined ranks to form Girls Clubs of America with Rachel Harris Johnson as the founding president. In its formative years, the organization's goals were to share information that was important for girls and to open new centers. Today Girls Inc. is run by Joyce Roche who serves as the president and CEO.[15] Girls Inc. has positioned itself as a national network of 1,000 sites focusing on research, education, and advocacy for girls ages 6 to 18. The Girls Inc. mission is "to inspire all girls to be strong, smart, and bold,"[16]and to do this they have established the *Girls' Bill of Rights*.

Girls' Bill of Rights

"Girls have the right to be themselves and to resist gender stereotypes. Girls have the right to express themselves with originality and enthusiasm. Girls have the

right to take risks, to strive freely, and to take pride in success. Girls have the right to accept and appreciate their bodies. Girls have the right to have confidence in themselves and to be safe in the world. Girls have the right to prepare for interesting work and economic independence."[17]

In light of the *Girls' Bill of Rights*, Girls Inc. has aligned its advocacy statements surrounding each line in an effort to show its "commitment to social change, change that is required for girls to exercise their rights freely and fully."[18] These statements reflect the Girls Inc. pledge to support girls in all of the challenges they face and to embrace their differences in an effort to help them all succeed. Title IX of the United States Code, which provides equal opportunities for girls in sports in comparison to boys, is one of the key legislative focal points of the organization and its advocacy initiatives.[19] The organization stresses taking responsibility for one's own actions, and making educated decisions especially in terms of drugs, alcohol, and sexual activity. Within the advocacy statements, Girls Inc. does pledge support for girls dealing with issues of sexual orientation, pregnancy, and matters of choice.[20]

The programs Girls Inc. offers girls in the community include Operation SMART which is aimed at opening more doors in science, math, and technology for girls to spark their interest.[21] Preventing Adolescent Pregnancy is a program focusing on abstinence but also offering access to medical attention and contraception, if girls choose to be sexually active.[22] Another Girls Inc. program focuses on positive peer pressure to prevent drug and alcohol abuse and stresses positive body image.[23] Programs offered at Girls Inc. also focus on sports, understanding money, understanding the media, and leadership.

Pro-Life Action League

Joseph M. Scheidler founded the Pro-Life Action League in 1980 "with the aim of saving unborn children through non-violent direct action."[24] Some of the League's activities include: being a presence at abortion clinics, including holding prayer vigils and sidewalk counseling; public protest, including marches, pickets, prayer vigils, and "Face the Truth" tours; confronting abortionists, such as at pro-abortion events; promoting and defending activism, including fighting court battles "to defend [the] right to peacefully protest abortion"[25]; broadcasting the pro-life message, through seminars, conferences, debates, and press releases; and youth outreach, especially its "Generations for Life" program.[26]

Joseph Scheidler, recognized by many as having "defined pro-life direct action,"[27] founded the Pro-Life Action league and serves as its director. Columnist Patrick Buchanan claims Scheidler is "the Green Beret of the pro-life movement." Scheidler is an author, video producer, frequent guest of radio and television programs, guest newspaper columnist, and prolific speaker around the country and internationally on the subject of abortion and the merits of direct action. Mr. Scheidler portrays himself as an expert on sidewalk counseling, fetal experimentation, and battling his opponents in the courts.[28] Most notably on the latter subject, Mr. Scheidler was the principal defendant in a RICO lawsuit, *NOW v. Scheidler* in 1986, which alleged violations of the Sherman-Clayton anti-trust laws.[29]

American Family Association

According to its website, "America's Largest Pro-Family Action Site,"[30] the American Family Association is "for people who are tired of cursing the darkness and who are ready to light a bonfire."[31] Founded in 1977 by its current Chairman, ordained United Methodist minister Donald E. Wildmon, the AFA largely focuses its efforts on the influence on society of the media, including television. The Association is a sponsor of many activist movements, including the promotion of Pornography Awareness Week; a "war on divorce," launched in 1994; and the removal of pornographic magazines from the 43 federal prisons.[32] The AFA mission statement explains that "the American Family Association exists to motivate and equip citizens to change the culture to reflect Biblical truth."[33]

The American Family Association explicitly states that, despite some of AFA's activities, it neither supports censorship ("Censorship, by definition, is government imposed."[34]) nor does it "hate homosexuals" ("Absolutely not!").[35] The Association exhorts its supporters to pray daily for their ministry and country; to join their mailing lists; and to consider donating a financial gift to their cause.[36]

The Boycott

In August 2005, American Girl announced a partnership with the non-profit group Girls, Inc. American Girl would sell "I CAN" wristbands for $1.00, and ask girls purchasing the wristbands to sign the "I CAN" promise.

American Girl "I CAN" Promise

I can be myself, follow my dreams, and
always do my best. I can reach for the stars,
lend a hand to others, and be a good friend.
I can make a difference! I promise to try[37]

The project debuted in September and was scheduled to run through December 2005. Proceeds from the sale of the "I CAN" bands would benefit Girls, Inc., along with a donation from American Girl. The proceeds from the campaign were earmarked for three specific programs: building girls' skills in science and math, developing leadership skills, and encouraging athletic skills and team spirit.[38]

Activist groups, including The Pro-Life Action League and The American Family Association, began their letter writing and phone campaigns to American Girl on October 12, 2005, requesting that American Girl discontinue support of Girls Inc. On October 14, 2005, American Girl released a statement saying, "We are profoundly disappointed that certain groups have chosen to misconstrue American Girl's purely altruistic efforts and turn them into a broader political statement on issues that we, as a corporation, have no position."[39] Commenting to the media on the progress of the campaign, Ann Scheidler declared, "American Girl, maker of American Girl Dolls, must be receiving enough calls and e-mails to cause them considerable consternation." Ultimately, the activists' campaign did not elicit its desired response.

On November 1, 2005, a Roman Catholic school in Brookfield, Wisconsin, canceled an American Girl sponsored fashion show fundraiser that included having children dress up as

American Girl dolls. As a spokesman for the school, Fr. Frank Malloy stated, “It’s a bargain we’ll just have to pass up. The cost is too high. Our integrity isn’t for sale.”[40]

After waiting a month, Ann Scheidler determined that she had no choice, and called for a boycott of American Girl products through the 2005 Christmas season. The American Family Association joined the Pro-Life Action League in the boycott, which began in early November 2005.

What Is Next for American Girl?

As Ellen Brothers, American Girl president, and Julie Parks, public relations director, sat around the table in Middleton, Wisconsin, they pondered the impending repercussions of the boycott on American Girl’s sales figures and reputation during the upcoming Christmas season.

Discussion Questions

1. Does American Girl appear to have sound policies rooted in the public interest?

2. Who are the key stakeholders in this case? What are their interests?

3. Who is American Girl’s target customer base?

4. What are the critical issues of the case?

5. Did American Girl choose to support an appropriate community outreach program that aligns with its values?

6. Going forward, should American Girl establish a set of procedures and review committee for choosing which community outreach programs to support?

7. What actions (if any) should American Girl take in response to the boycott?

8. Should American Girl involve Mattel in the response?

9. Does American Girl as the subordinate brand exist with sufficient autonomy to protect its brand name outside of Mattel’s influence?

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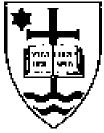
BP America, Inc.: The Prudhoe Bay Oil Spill and a Commitment to "Being Green"
Hermo, J. And O'Rourke, J. S. (editor)

On March 2, 2006, as work crews shoveled through the heavy snow blanketing the Prudhoe Bay oil fields of northern Alaska, they spotted a small hole of no more than a quarter of an inch along the pipeline. As BP America, the company in charge of the oil fields, quickly learned, this tiny hole would prove to be the source of the worst oil spill ever – some 270,000 gallons of crude oil – on the North Slope of Alaska. As BP America and their parent company, BP, soon discovered that their enormous re-branding efforts and carefully cultivated image for being environmentally friendly would be challenged by the reality of extracting petroleum in Alaska's harsh northern environment. 8 pp. #06-14. (2006)



Eugene D. Fanning Center for Business Communication **06-14**
Mendoza College of Business
University of Notre Dame

BP America, Inc.:
The Prudhoe Bay Oil Spill and a Commitment to "Being Green"

On March 2, 2006, as work crews shoveled through the heavy snow blanketing the Prudhoe Bay oil fields of northern Alaska, a small hole of no more than ¼ of an inch in diameter was spotted along the oil pipeline. Unbeknownst to British Petroleum (BP), the oil company in charge of the Prudhoe Bay oil fields, this tiny hole would prove to be the source of what is being considered the worst oil spillage ever on the North Slope of Alaska. During the incident, somewhere between 200,000 and 270,000 gallons of crude oil spilled out into the frozen tundra over a five-day period.[1] The March 2nd spill along BP's pipelines is second in severity within the United States only to the highly publicized 1989 Exxon Valdez disaster, which dumped upwards of 11 million gallons of crude oil into the Prince William Sound in the southern part of Alaska.[2]

BP, the United Kingdom's leading energy superpower, has long been known for its commitment to environmental protection, eco-friendly practices, and innovative solutions in the field of alternative energy. However, BP now finds itself under investigation by the Environmental Protection Agency (EPA) and the United States Congress as a result of the recent Prudhoe Bay spill. Concerns regarding the cause of the spill, as well as BP's pipeline maintenance and overall employment practices, have put the oil company's previously untarnished reputation under the media's magnifying glass.

The History of British Petroleum

British Petroleum took its first steps toward becoming a crude oil superpower in 1901, when a wealthy Englishman named William Knox D'Arcy obtained a concession for the Shah of Persia to explore and exploit Persia's oil resources. While several years passed without much success, commercial quantities of crude oil were discovered in 1908 after D'Arcy's resources were supplemented by outside financial assistance. The Anglo-Persian Oil Company, as BP was first known, was formed in 1909.[3] In 1914, shortly before the outbreak of World War I, Anglo-Persian Oil entered an agreement with the British government in an effort to avoid falling under

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This case was prepared by Research Assistant Jessica Hermo under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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control of the current market dominator, Royal Dutch-Shell. In return for a £2 million capital investment and a majority shareholder interest, Anglo-Persian would be responsible for providing fuel oil supplies to the Royal Navy. Government shareholding added an unusual political dimension to the oil company, and it wasn't until 1987 that the British Admiralty ceased to hold any shares in the company. Anglo-Persian used its capital injection from the British government to develop an international chain of marine bunkering stations and in 1926 began to market aviation fuel. Anglo-Persian also opened new refineries in Australia, Canada, South America, Africa, Papua New Guinea, and Europe. In 1935, Anglo-Persian Oil was renamed the Anglo-Iranian Oil Company.[4]

The post-World War II reconstruction era of Europe increased the demand for oil and allowed Anglo-Iranian Oil to reach record operating levels in the late 1940s. It was at this time that the company entered the field of petrochemicals. As the Iranian nationalization crisis loomed on the horizon, Anglo-Iranian Oil was forced to broaden its operations and to pursue crude oil production in Kuwait and Iraq. Additional new refineries were built in Europe and Australia. In 1954, Anglo-Iranian Oil began marketing Europe's first multi-grade oil named BP Visco-Static.

In 1951, the Iranian government nationalized all Iranian oil, halting Anglo-Iranian Oil's efforts in the country. After three years of intense negotiations, Anglo-Iranian Oil became part of a consortium of oil companies which restarted the Iranian oil industry in 1954. It was at this time that Anglo-Iranian Oil became the British Petroleum Company, which controlled 40% of the Iranian consortium.[5]

In early 1959, BP discovered hydrocarbons under the North Sea and under Alaska's permafrost. In 1965, BP found the West Sole gas field, the first oil exploration success in British waters. This discovery was followed by the 1970 discovery of the Forties oil field, the first major commercial find in the United Kingdom sector. In 1969, BP announced its major oil discovery in Prudhoe Bay on the North Slope of Alaska's tundra. BP contracted the refining and marketing of its Alaskan oil fields to the Standard Oil Company of Ohio, which was formerly known as John D. Rockefeller Standard Oil. Through this deal, Standard Oil took over BP's leases at Prudhoe Bay in exchange for 25% of Standard Oil's equity.

The two great oil price shocks in 1973 and 1979/1980 shook BP and the world's economies. BP, as well as many of its competitors, lost direct access to most OPEC oil supplies, as the OPEC countries took control of oil production and pricing. The Iranian Revolution of the late 1970s caused oil prices to spike for the second time that decade, and BP suffered even further in 1979 when its assets in Nigeria were nationalized and Kuwaiti oil supplies were cut back. BP's luck took a turn for the better in areas outside of the Middle East. The construction of the 800-mile Trans-Alaska Pipeline System allowed the Prudhoe Bay oilfield to come on stream in 1977.

BP's sizeable investments outside of the Middle East are what allowed the company to stay afloat during treacherous times, and BP is currently involved in oil production in Abu Dhabi, Australia, Colombia, Norway, and Papua New Guinea.

The year 1987 proved to be pivotal for British Petroleum. For £4.7 billion, BP acquired the remaining 45% of Standard Oil which it did not already own.[6] Following this acquisition, BP combined its US oil interests with Standard Oil's operations to form BP America, which today holds approximately one-third of BP's fixed assets. In October of 1987, the British government decided to sell off its 31.5% stake in BP, which attracted the eye of the Kuwait Investment Office. KIO built up a 21.6% stake in BP; however, BP was later required to buy back and

cancel 790 million of these shares because of monopoly and antitrust concerns.[7] BP also undertook a bid for Britoil in 1987 and completed the £2.8 billion acquisition during the following year.[8]

BP and the Environment

Today, BP's focus has shifted away from the Middle East and is centered in areas previously unexplored, such as Columbia, the republics of the former Soviet Union, and the Gulf of Mexico. Throughout its history, British Petroleum has made health, safety, and environmental standards the pinnacle of its operations. In 2005 alone, BP had several notable achievements in the area of social responsibility and environmental friendliness.

> *BP Alternative Energy:* Launched in November of 2005, this new business line plans to invest $8 billion over 10 years to generate and market low-carbon power from solar, wind, hydrogen and natural gas sources.
>
> *Supplying affordable liquefied petroleum gas (LPG) in South Africa and India:* In an effort to create local job opportunities and provide products for low-income customers, this pilot program plans to reach 3 million households by 2008.
>
> *Improving pipeline gas delivery to Georgia and Turkey:* In addition to the development of the South Caucasus Pipeline, which aims to bring a new source of natural gas from the Shah Deniz oil field in Azerbaijan to Georgia and Turkey, BP is playing a part in upgrading the existing gas pipeline network in Georgia, which currently leaks approximately 5% of the crude oil that passes through it.[9]
>
> *Revised environmentally sound principles:* As described corporate spokesmen, the new principles created in 2005 were created to "address the need for heightened environmental vigilance as our industry accesses increasingly remote and sensitive areas to meet the world's growing demand for oil and natural gas."[10] Measures include increased outside consultation and screening, as well as increased regulation of current operations.

The Leak at Prudhoe Bay

The March 2006 oil spill in Prudhoe Bay is the largest ever in the North Slope of Alaska's tundra. An oil transit line operated by BP Exploration, Incorporated leaked crude oil for five days before the leak was discovered. While the results of the spill are still in the investigatory phases, a primary hypothesis as to the cause of the spill is internal pipe corrosion. Next year, the main pipeline which stretches from Prudhoe Bay in the North Slope down to Valdez in the Prince William Sound will be 30 years old. John Devens, the executive director of the Prince William Sound Regional Citizens' Advisory Council is quoted by the Associated Press as saying, "I think many of us are seriously concerned about the aging and deterioration of the pipeline and the facilities."[11] In recent months, concerns over corrosion in the aging oil supply system have been expressed by several parties, and the Prudhoe Bay spill further emphasizes the

potential danger a system-wide deterioration could create. The Alyeska Pipeline Service Company is responsible for maintaining and operating the Trans-Alaska Pipeline System. The company's annual budget of $300 million for operations and maintenance and an additional $100 million for capital projects has been identified by Alyeska spokesman Mike Heatwole as sufficient funding for their responsibilities.[12]

As oil exploitation has become more and more frequent in the North Slope, the quality of oil has significantly declined. This means that a coarser and heavier crude oil is flowing through the pipe system, causing stress on the pipes. While BP has increased the size of its corrosion inspection budget for the North Slope from $50 million in 2004 to $71 million in 2006, more work may still need to be done.[13] BP company spokesman Darren Beaudo suggests that the corrosion could have been due to water and sediment that is carried in the thicker oil. Meanwhile, Alaskan state environmental regulators and BP Exploration, Inc. president Steve Marshall both agree that a possible contributor to the pipe corrosion was an emulsion-breaking additive in the line. [14] This additive is used to reduce water and silt in the oil. Ultrasonic tests conducted in the fall of 2005 showed increasing corrosion in the pipeline, which resulted in an increased frequency of pipeline inspections.[15] These precautions, however, were not enough to prevent the recent Prudhoe Bay oil spill. Ultrasonic tests were not performed in the direct location of the leak, which occurred where the pipe was buried underground to provide an area for caribou crossing. The leak site was not accessible to direct visual inspection.

How the Prudhoe Bay Spill Measures Up

While the spill in Prudhoe Bay is being heralded as the worst ever in the North Slope of Alaska, it pales in comparison to other major oil spills throughout history. In 1978, the Amoco Cadiz drifted off the coast of Brittany, France where its ship bottom and storage tanks were torn open, spilling 230,000 tons of crude oil into the English Channel. The oil spill polluted hundreds of miles of coastline, destroying fisheries, seaweed beds, and wildlife habitats.[16] In July of 1988, an explosion occurred on the oil and gas production platform Piper Alpha of Occidental Petroleum Ltd. and Texaco in the North Sea. Tartan, a nearby platform, continued to pump gas into the upstream pipelines of Piper Alpha after the explosion because the crew did not have the authority to shut down production, even when the Piper Alpha caught fire. The released gas caused a second explosion and the fire increased in size and intensity, resulting in the deaths of over 160 people. An inquiry launched in November of 1988 found Occidental guilty of inadequate maintenance procedures aboard the Piper Alpha, which directly caused the initial explosion.[17] While both the Amoco and Occidental spills were more serious than the recent Prudhoe Bay spill, the Exxon Valdez disaster of 1989 far exceeds all the others in magnitude and severity. When the oil tanker struck Bligh Reef on the Prince William Sound in Alaska, more than 11 million gallons of crude oil were dumped into the water. Exxon paid upwards of $3.5 billion in connection with the accident, and today the region still suffers from the ecological and environmental ramifications of the spill.[18]

In light of these incidents, the Prudhoe Bay spill is comparatively less of a disaster. While the damage caused by the spill falls well short of that caused by other incidents, the leaking pipelines may be indicative of a larger, system-wide problem. Now, many are speculating that this leak is just the beginning for the North Slope, as the aging pipelines continue to deteriorate with time. It is now up to BP to decide what steps need to be taken to ensure its Prudhoe Bay pipelines stay intact.

Investigations Underway: What's in Store for BP

BP, the world's second-largest oil firm based on market value, is now under the watchful eye of the Environmental Protection Agency (EPA) of the United States government and the US Congress. According to *The Wall Street Journal*, an investigation conducted by the EPA has already been underway for several months (EPA spokesperson Dale Kemery from the state of Washington has neither confirmed nor denied the existence of any type of investigation, in accordance with agency policy).[19] EPA officials were present at the spillage site during clean-up efforts, but BP has not yet announced the commencement of an official investigation by the agency.

Democratic representatives John Dingell of Michigan and George Miller of California were sent to the North Slope during the second week of April 2006, on the recommendation of Christopher Knauer, the minority investigator of the US House Committee on Energy and Commerce.[20] Dingell and Miller have focused a majority of their investigation on the causes of corrosion in the pipeline and the sufficiency of corrosion testing throughout the Trans-Alaska Pipeline System. While the US Congress does not have the power to prosecute, any evidence found during the investigation will be surrendered to the US Department of Justice.

At this point in time, BP has been entirely compliant with all investigations into the cause of the approximately 270,000 gallon oil spill.

What the Prudhoe Bay Spill Means for BP

BP has announced an internal investigation of the Prudhoe Bay incident to be conducted in conjunction with Alaskan state governmental regulators. BP could face state-imposed fines as high as $2.1 million, depending on the conclusions of this investigation.[21] A spokesperson for BP's unit in Alaska stated he did not yet know whether or not BP would be the target of a criminal investigation.

In March of 2006, the Office of Pipeline Safety invoked a rarely-used provision against BP for the leak in Prudhoe Bay. The Office of Pipeline Safety has mandated that BP conduct thorough investigations and repairs of the western segment of the Prudhoe Bay pipeline that caused the spill. BP must then report back to the federal agency and receive approval before the pipeline can be put back into service.[22]

The March 2, 2006 spill is just one of two issues that have proven challenging for the administration of BP. In 2005, an explosion at a BP oil refinery in Texas City, Texas resulted in 15 deaths and more than 170 injuries. BP has pledged $700 million in compensation to victims and their families, but still faces wrongful death suits and an FBI investigation.[23] At the refinery, the Department of Labor's Occupational Safety and Health Administration (also referred to as OSHA) found more than 300 violations and fined BP $21 million.[24] These two incidents may have the potential to undermine BP's efforts to portray the company as "green," meaning the oil group is synonymous with environmentally friendly practices.

Discussion Questions

1. Regardless of the spill's cause(s), what does this situation do to BP's corporate image?

2. Throughout the events involved in the leak incident, who are the key stakeholders?

3. What can BP do in the way of public relations damage control?

4. What are the financial ramifications of these investigations? If BP is found liable for pipe corrosion and the spill, how will it affect the company financially?

5. In your opinion, is this oil spill indicative of a larger, systematic problem in BP's Alaskan pipelines and oil fields? If so, what can BP do about it, from a public relations standpoint?

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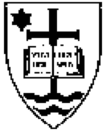
A Philosophy of Dress: Rebuilding Trust in the Brooks Brothers Brand
Johnson, J.; Stevenson, C.; and O'Rourke, J. S. (editor)

Founded by Henry Sands Brooks in 1818, Brooks Brothers' business was built on relationships maintained over generations with employees, suppliers, and customers. Once the most admired retailer in the country, Brooks Brothers lost its corporate identity and consequently, broke the trust of one of America's most loyal bases of customers. During the 1980s and 1990s three companies took ownership of the nation's oldest, and for much of its history, most profitable men's retailer. In 2001 Brooks Brothers was sold to Retail Brand Alliance for $225 million. RBA CEO Claudio Del Vecchio was determined to turnaround and save Brooks Brothers. Mr. Del Vecchio tailored a turnaround plan stitched with a communication strategy for Brooks Brothers' stakeholders. (A) Case: 8 pp. (B) Case: 7 pp. #06-09. (2006).



Eugene D. Fanning Center for Business Communication
Mendoza College of Business
University of Notre Dame

06-09 (A)

Brooks Brothers

A Philosophy of Dress (A)

Introduction

On the largest shopping day of 2001, Claudio Del Vecchio, CEO of Retail Brand Alliance, read the headlines of major newspapers from the U.S. and his native Europe which stated that his company had just acquired Brooks Brothers from the struggling discount retailer Marks & Spencer. As a long-time customer who grew up wearing Brooks Brothers suits, Del Vecchio knew that the company had lost its identity during a series of takeovers in the 1980s. For over a century and a half, Brooks Brothers was the most profitable menswear retailer in the U.S., and many industry experts now questioned whether the firm would survive. As Del Vecchio reviewed the morning papers, he pondered how he could recapture the trust of customers by restoring the core Brooks values of quality, great value, and exceptional customer service and position the company for strong future growth.

The Making of a Dynasty

In 1977 the *Washington Post* wrote, "The Brooks look is a moral trust maintained from one decade to the next, because generation after generation has trusted the company with an unquestioning faith that they give to virtually no other institution in modern life."[1] Since its inception in 1818, Brooks Brothers has conducted business built on a philosophy of dress that captures the American ideals of upward mobility, accomplishment, and class. The company captured this idea in a 1980s advertisement that stated Brooks Brothers is not for the rich but for the successful.[2]

This case was prepared by Research Assistants Jared M. Johnson and Christopher C. Stevenson under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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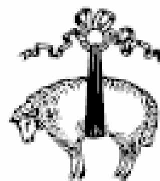
Brooks Brothers' monumental success is attributed to its foundational attributes of quality, value and customer service. As a vertically integrated company, management held the view that by controlling all aspects of the production process, Brooks was able to provide value to the customer by producing a superior quality product at a price others would charge for an inferior good.

In a sense, the retailer's commitment to the customer is legendary. Historically, Brooks never had a design team. Management made merchandising decisions based on the input of the sales associates because they knew the customers best. The friendship, as Brooks would describe it, between the customer and the sales associate was the key reason that customers made Brooks Brothers *their* store and made Brooks a staple at every major event (or daily activity) including weddings, job interviews, and Presidential Inaugurations.

Sworn Symbol of Style

Brooks Brothers adopted the symbol of the Golden Fleece in 1850. The symbol has endured and continues to signify Brooks' quality and heritage. The birth of the Golden Fleece symbol came on January 10, 1430 when Philip the Good, Duke of Burgundy, established an order of Knighthood in honor of his bride, Isabella of Portugal. The Knighthood was named The Order of the Golden Fleece. In homage to Isabella, 31 Knights of the Order took an oath to guard the Church and the glory of the saints. "The Lamb of God, suspended at each Knight's heart, symbolized at once both gentle humility and the woolen fabrics to which so much of Burgundian wealth was owed. Since the days of chivalry, a ram or lamb, suspended by a ribbon, has often been the symbol of the woolen trades." These natty Knights set the European medieval standard for chivalric style.[3] This is the style and substance that Brooks Brothers embodied in selecting the Golden Fleece emblem. The sanctity of the Brooks' symbol has swayed with the whims of corporate steering, yet has not snapped.



The Early Years

Henry Sands Brooks opened his first store on April 7, 1818 on Cherry Street in New York City at the age of 46. His mission was "to make and deal only in merchandise of the best quality, to sell it at a fair profit only, and to deal only with people who seek and are capable of appreciating such merchandise." Before his death in 1833, Mr. Brooks' sons were taught the ways of the business and they subsequently named it "Brooks Brothers."[4]

Brooks was one of the first clothing manufactures to sell "off the rack" merchandise. Traditionally, people had their fine clothing custom produced. The rich had a personal tailor that could complete a garment relatively quickly. Those without such resources had limited wardrobes made of coarse materials for durability. Off the rack clothing was less expensive to produce than custom clothing, thus affording a greater number of people access to comfortable, quality clothing. This merchandise was frequently displayed inside-out to showcase quality

workmanship. Soon Brooks developed a reputation for excellent customer service and quality menswear. Like Americans, many immigrants that arrived in New York knew the road to opportunity was traveled much easier in an original Brooks Brothers suit.[5]

To assure that the best fabrics were used in the merchandise, Brooks Brothers developed strong relationships with a select group of cotton and wool producers in Britain. In the late nineteenth century, the cotton used in the classic oxford was originally purchased in England then processed at mills in Scotland. From there, the fabric was transported to New York where Brooks constructed its clothing.[6]

Brooks prided itself on bringing innovation in an array of offerings to the market. Some of the American classics that can be credited to Brooks Brothers include:

Sack Suit: First introduced in 1900, this suit has undergone very little change in the last 50 years. Known for its comfortable features such as the natural shoulders and straight lines, *The New Yorker* boldly labeled the classic American suit a "philosophy in dress."[7]

Seersucker: Introduced to the American public in 1830, this lightweight, breathable cotton has been a perennial summer staple ever since.[8]

Button-down Polo Shirt: The classic button collar dress shirt was introduced to the American market after John Brooks watched a British polo match. During the event, he noticed that buttons were used to prevent the riders' collars from flapping in the wind. Soon after, Brooks introduced a dress shirt with a soft collar and buttons and the creation became one of the greatest success stories in U.S. fashion.[9]

Repp Tie: "The traditional ties of the American businessman" hit the U.S. market in the 18th century after being discovered in England. Originally, the regimental rep was designed to represent whatever British regiment a gentlemen served in, and each had its own distinctive stripe and coloration.[10] Because of strict standards of quality, Brooks only used the finest silk and all ties were hand-sewn with a special slip stitch. This guaranteed durability and allowed the tie to relax under the pressure of the knot, so it would lie flat.[11]

BrooksEase: As business required greater travel, customers demanded a cool suit that would still look sharp after being in a garment bag or wedged in an economy class seat. Brooks exceeded expectations by offering suit separates. The company not only created a technologically advanced fabric that resisted wrinkles but also developed a system of dying fabrics that guaranteed customers exact color matches.[12]

A Company that Knows Adversity

World War II posed considerable challenges for Brooks as the government drafted laws limiting the availability of materials for clothing and shoes. For example, pants could be neither cuffed nor pleated and double-breasted suits were not allowed because the excess fabric could be used

for military uniforms and bandages. In addition, the vastly limited trans-Atlantic trade prevented Brooks from carrying much of its customary British fabrics.[13]

By the end of the 1940s, Brooks Brothers had escaped an extraordinarily tough retail environment, but not without cost. Winthrop Brooks, the company's president at the time, sold the retailer to Garfinkle & Co. Winthrop was quick to calm the fears of the Brooks loyalists by stating that the Brooks family would still hold key leadership positions and British imports would continue to increase. Moreover, newly appointed CEO John C. Wood was eager to communicate his commitment to quality and innovation. Although not all of Wood's new fashion ideas, such as removing the button from behind the collar of the Polo Shirt, were well received, he was quick to revert back to the classics that created such an affinity for the label.[14]

During the early part of the 1960s Americans had a renewed sense of optimism. President John F. Kennedy, clad in the traditional Brooks Brothers Sack Suit, became the model of the American "can-do" attitude through the introduction of the space program and the avoidance of catastrophe during the Cuban Missile Crisis. As the decade of the 1970s rolled in with its anti-establishment ideologies, fashion trends changed considerably. The traditional wool and cotton classics gave way the polyester leisure suit and the Brooks look was no longer in vogue with America's younger generation. Although Brooks had a history of not selling trend, it had to respond to the demands of its younger clients: the solution was an introductory line aimed at the young executive called Brooksgate. This line of suits featured wider lapels and a lower cut.[15]

Brooks' legacy of being the most profitable menswear provider in history made it a take-over target in the "winner-take-all" mergers and acquisition era of the 1980s. In the early part of the decade, Allied Stores purchased all of Garfinkel's holdings and had the aspirations of rapidly expanding Brooks Brothers. Brooks Brothers CEO, Frank Reilly, who began working at the company in the 1950s, understood the monolithic Brooks' culture that seemingly existed in a "time warp" but also knew the benefits of expansion. Under the leadership of Reilly, the company launched its first women's catalog and continued to have success with the Brooksgate line. As the decade progressed, fashion trends began to turn away from the classics such as the sack suit and aimed for individual expression and masculinity. Italian designers and their "power suits" represented the latest threat to Brooks' strength of "deal[ing] in conservative clothing."[16]

Robert Campeau, a short-lived acquisition icon of the 1980s, purchased Allied Stores in 1984 with a no-money down loan. Concerned with other buy-out targets, Campeau left Brooks alone until he sold it 14 months later to raise an additional $750 million to buy Federated Department stores.[17] The company was sold to Marks & Spencer, a discount retailer based in the United Kingdom.

A Downward Spiral

Marks & Spencer had big dreams for Brooks Brothers. Market analysts believed that the company paid too much for the famed menswear producer. Known for selling high turnover women's wear, Marks & Spencer had little knowledge of the high-end men's market and had no acquisition experience. More to the point, the company's leadership did not subscribe to the idea that a company could be successful by selling to customers who only shopped a couple of times per year.[18] What Marks & Spencer's management forgot was that these individuals would buy a number of suits, shirts, and ties when they visited the store. Clearly, Brooks Brothers was on the verge of a life-or-death battle.

Determined to make the acquisition work and prove dissenting analysts wrong, Marks & Spencer launched a series of new initiatives to modernize the perceived archaic business model of the famed men's retailer. Some of the plans to increase the competitiveness of Brooks Brothers included:

Marketing: Historical Brooks Brothers advertising focused on the firm's heritage, quality products, and innovations in the clothing. Catalogs featured traditionally dressed models sporting a sack suit and Repp tie. In an attempt to attract a younger client base in an age defined by the mantra of "if you've got it, flaunt it," Marks & Spencer's twenty-something models posed with slick hair, a bold shirt, and a slightly arrogant smirk.[19] In addition, Brooks Brothers' ads appeared in trendy magazines such as *GQ* and with pictures that featured models with loosened ties and partially unbuttoned shirts.[20]

Stores: Brooks Brothers was thought of as a store people aspired to shop at, thus the retail space had an intended exclusive feel. To appeal to a wider audience, Marks & Spencer began changing the environment of the stores and started with complete remodeling of the flagship. Inserted in place of the tremendously popular "shirt wall" were escalators. The century-old fixtures and memorabilia were replaced by a more contemporary motif.[21]

Brooks Brothers launched two new series of stores. The first was a smaller mall store that featured an amended variety of main stores' selections. Second, Brooks introduced the outlet concept in 1991. These stores allowed the company to reach a segment of the market that normally would not shop in areas where the major Brooks Brothers were located. In addition, stores and factories had a place to send products that were overproduced.[22]

Inventory Monitoring: Brooks Brothers was admittedly behind in the area of technology. Marks & Spencer implemented its IT infrastructure, which was designed to monitor large volume inventory changes, into all Brooks stores. Consequently, management became more interested in monitoring the number of individual items instead of the cost of these "improvements" (i.e. a reduction of floor personnel who where essential in maintaining relationships with customers).[23]

Trend: Historically, Brooks played the role of the innovator but the 1990s trend of business casual forced the company to compete, for the first time, with other makers from the role of the underdog. In order to make the label trendier, Marks & Spencer hired Brooks' first design team. As Brooks Brothers became more hip to challenge brands such as J. Crew and Banana Republic, its long-time relationships with a loyal customer base became even more fractured.[24] Traditionally, when contemplating new merchandising decisions, management would present ideas found in Britain to sales associates with the question, "Would it sell?" Sales associates, because they best knew the client, had the most input into the company's selection.[25]

Efficiency: The Marks & Spencer business model was built on turnover and low cost. Thus, it was believed that Brooks Brothers had to become more efficient in terms of production and consolidate its offerings to increase profitability. To accomplish this end, Brooks closed its suit production facility, vastly expanded the number of suppliers, outsourced the production of garments, and limited the sizes and varieties of goods. This was a major shift from the traditional model of maintaining long relationships with select suppliers, controlling all aspects of production, and maintaining a healthy selection of goods to fit virtually any man who entered a store.[26]

Innovation: Prior to the acquisition, Brooks Brothers terminated its Brooksgate clothing and was researching a suit separates offering as the new introductory line. Marks & Spencer had already established such a line and was able to refine the technology to meet the Brooks Brothers quality standard. This worsted wool fabric was able to remain virtually wrinkle free whether trapped in economy class on an airplane or packed away in a suitcase.[27]

After spending $750 million on acquiring the legendary retailer and investing over $1 billion into the business, Marks & Spencer put Brooks Brothers up for sale.[28] Although Marks & Spencer made significant contributions to Brooks Brothers such as the development of the BrooksEase suit, many needed improvements in the IT infrastructure, and introducing business casual merchandise, they simply did not understand the Brooks model of business and corporate culture. In November of 2001, Brooks Brothers was acquired by Retail Brand Alliance for $225 million.[29]

Retail Brand Alliance

Privately owned by CEO Claudio Del Vecchio, Retail Brand Alliance is the parent of mid-market professional women's retailers Casual Corner and Petite Sophisticate. Del Vecchio got his business education working under the tutelage of his father who is the founder of the Italian eyewear manufacturer Luxotica. In the early 1980s the younger Del Vecchio moved to the U.S. to run Luxotica's American operations and subsequently bought U.S. Shoe in the 1990s to acquire LensCrafters. The plan was to keep LensCrafters under Luxotica and sell the shoe business and U.S. Shoe's women's clothing business, Casual Corner. Although the shoe company sold with ease, Casual Corner was a struggling business. Del Vecchio decided to purchase Casual Corner from his father, leave Luxotica, and devote his attention to reviving the ailing women's brand. With a hands-on nurturing approach and patience, Del Vecchio rebuilt Casual Corner under the parent company Retail Brand Alliance.[30]

The Day After Thanksgiving

Claudio Del Vecchio is a long-time Brooks Brothers customer. Lamenting about the fact that Brooks Brothers had deteriorated to a commoditized brand competing with Banana Republic and Bachrach, Del Vecchio knew he must rebuild the trust given by so many to the brand. Recalling the days when people aspired to wear Brooks Brothers clothing, he knew that the retailer must return to its core of quality, value, and excellent customer service. The previous owners

completely changed the formula that made Brooks Brothers America's most profitable retailer for so long. Del Vecchio was responsible for developing a plan to return the company to its heritage and prove to the public that Brooks Brothers is worthy of their trust.

Discussion Questions

1. Who are the key stakeholders in Brooks Brothers? How will an attempt to restore the brand to its former glory affect each of these stakeholders?

2. What are the major components of the brand, and how can Brooks Brothers restore these to their former strength?

3. How should Brooks Brothers communicate their new business strategy with the customer? Inside the company? To the public?

4. Do Retail Brand Alliance and Del Vecchio have the experience that it takes to run a high-end luxury retail menswear company? What are the differences between Casual Corner and Brooks Brothers?

5. What should Brooks Brothers do with the changes that Marks and Spencer contributed to the firm? Should Brooks Brothers close down the outlet stores?

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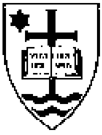
CBS News: Challenging the Authenticity of a News Source
Stevenson, C.; Suhanic, K.

CBS News runs a feature story about President Bush's receiving preferential treatment while in service in the Texas Air National Guard. At the center of the story are photocopies of memos supporting this story. Almost immediately after broadcast, internet "Bloggers" and news sites begin to question the authenticity of these memos. The maelstrom that ensues questions CBS' and Dan Rather's motives, and the role of broadcast media in the internet age. (A) Case, 9 pp. (2004)



Eugene D. Fanning Center for Business Communication
Mendoza College of Business
University of Notre Dame

CBS News:
Challenging the Authenticity of a News Source

It is a rare situation when those reporting the news become the news. Yet on the evening of Tuesday, November 23, 2004, Dan Rather, the veteran CBS News anchor, became the story once again when he announced he would retire the following March. In fact, Mr. Rather had been in the news for several weeks since he became the center of a controversial story on President George W. Bush. The announcement of his retirement, many media observers felt, was the epilogue of the tumultuous story of the Bush National Guard Memos.

In a written statement, Mr. Rather said, "I have always said that I'd know when the time was right to step away from the anchor chair. This past summer, CBS and I decided that the close of the election cycle would be an appropriate time."[1] What Mr. Rather did not say was how the events of September helped influence this decision.

The History of CBS News

The CBS television network traces its roots back to January 27, 1927, when it began as a network of 16 independent radio stations called United Independent Broadcasters, Inc. By September of 1928, the 27-year-old William S. Paley acquired United Independent Broadcasters Inc. Mr. Paley changed the name to the Columbia Broadcast System and became president of the company.[2]

First with Many Firsts

Radio was to the Roaring Twenties what the Internet was to the 1990s. In similar fashion to the founders of Yahoo or Amazon.com, Mr. Paley embarked with his young radio network on many groundbreaking endeavors. One example of this was the November, 1928 CBS Radio coverage

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This case was prepared by Research Assistants Christopher C. Stevenson and Kevin P. Suhanic under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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of the presidential election that pitted Herbert Hoover against Alfred E. Smith. On election night, CBS relied on their announcer, Ted Husing, for live reports on election returns. Husing used a microphone that was set-up in the city room of the *New York World* building. This was the first live coverage of a U.S. presidential election. For its efforts, CBS received 12,000 congratulatory telegrams. This live broadcast set the standard for many future CBS firsts, including the first battlefield broadcast in radio news history during the Spanish Civil War.

On January 8, 1929, Paley made an on-air appearance to announce to his audience that CBS then had the greatest number of radio broadcasting stations ever assembled. In less than four months, Paley had tripled CBS' broadcasting coverage. His burgeoning radio empire included 49 stations in 42 cities, but Paley had his CBS eye on more than radio. He had the foresight to recognize that television would eventually become the American public's principal source of entertainment and news. CBS began its early movement into television on July 21, 1931 when the network broadcast the first regularly scheduled program simulcast on both radio and television.

A Network Empire Built on News

The integrity, quality, and broad public appeal of CBS News laid the foundation on which Paley built his network. 1933 saw CBS News Editor, Paul White, organize the Columbia News Service. This was the first network news operation. Bureaus were established in New York, Washington, Chicago, and Los Angeles. By 1935, CBS had become the nation's largest radio network with 97 stations. News legend Edward R. Murrow joined CBS the same year. On March 13, 1938 CBS broadcast a special report on the events that would eventually lead to WWII. What was truly special about this report was that correspondents from multiple locations across Europe were connected to a central news desk in New York during a daily national broadcast. This daily report became the "World News Roundup," the longest-running news program in the history of broadcasting. The term "anchor" was coined on July 7, 1952 to describe Walter Cronkite's role at the Democratic and Republican National Conventions. This CBS broadcast was the first nationally televised convention coverage.

Cronkite Bridges Historic Murrow to Contemporary Rather

By 1954, CBS News joined the CBS Radio and Television divisions and created the News and Public Affairs department. Yet another first, this news organization would provide content for both the CBS radio and television networks. With the television broadcast becoming ever more important to CBS, on April 16, 1962 Walter Cronkite was named anchor and managing editor of the "CBS Evening News." At different points in his career, Cronkite was a competitor, contemporary, and colleague of Edward R. Murrow, who is still widely seen by historians as the epitome of honesty and integrity in American broadcast journalism. Before the end of his career, Cronkite established himself as an American icon who was often termed "the most trusted man in America."[3] In 1975, Cronkite's eventual successor, Dan Rather, joined Mike Wallace and Morley Safer on *CBS 60 Minutes* as co-editor.

Dan Rather

Like Walter Cronkite, Dan Rather grew up in Texas. Daniel Irvin Rather was born October 31, 1931 in Wharton, Texas. By 1953, he received a bachelor's degree in journalism from Sam Houston State Teachers College. The school has since named its journalism and communications building after him.

Rather began his career in 1950 as an Associated Press reporter in Huntsville, Texas. Mr. Rather went on to become a reporter for the United Press International, several Texas radio stations, and the Houston Chronicle. By 1959, he became a television reporter for KTRK-TV in Houston. In 1961, Rather gave live reports from the Galveston seawall as Hurricane Carla battered the Texas coastline. This action impressed the network executives at CBS, as Rather was among the first broadcasters to capture the drama of reporting in dangerous weather. CBS hired him as a news correspondent in 1962, and made him chief of its Southwest bureau in Dallas.[4]

Rather eventually moved to London to become CBS News bureau chief. He was also the White House correspondent during the Johnson and Nixon administrations. After years of progressing through the ranks at CBS, on March 9, 1981, Rather was named Anchor and Managing Editor of the *CBS Evening News*. He would be looked upon to fill the shoes of perhaps the most famous newsman in American broadcast history, Walter Cronkite. Rather also continued work on the CBS news magazine *48 Hours*, made regular contributions to CBS Radio News, and was a full-time correspondent for *CBS 60 Minutes II*. In addition to his various roles and responsibilities at CBS, Rather became a prolific writer. He is the author of such titles as *The American Dream* and *The Camera Never Blinks Twice: The Further Adventures of a Television Journalist*. Rather has often been referred to as, "the hardest working man in broadcast journalism."[5]

Rather Controversial

Even though he has been awarded the highest honors in broadcast journalism, including multiple Emmy Awards and a Peabody Award, Dan Rather has always been a lightning rod for controversy at CBS News. Enter the words "Dan Rather" into the Google search engine and you'll find a series of websites critical of his work, including http://www.ratherbiased.com. Such criticism has been spurred by his run-ins with prominent Republicans, including Richard Nixon and George H.W. Bush. More recently, his February 2003 one-on-one interview with Saddam Hussein was seen as sympathetic to the Iraqi dictator and, therefore, implicitly critical of President George W. Bush's policies.

Rather has been controversial not only for his political views, but has caused controversy within the CBS organization itself. His views about broadcast news led to the infamous "dead air incident" of September 11, 1987, in which Rather walked off the set of the *CBS Evening News* when he suspected a tennis match might preempt his broadcast. The match ended sooner than expected, leaving CBS personnel scrambling to locate Rather. More than 100 CBS broadcast affiliates were left with six minutes of dead air to broadcast. Reacting to Rather's actions, Walter Cronkite told a reporter, "I would have fired him. There's no excuse for it."[6]

Viacom's Insulation

Viacom Corporation, the corporate parent of CBS, had humble beginnings. The company was founded by Sumner Redstone, its current chairman, in the 1950s when he bought a chain of movie theatres. It grew into a media conglomerate, aggregating cable networks, dozens of radio stations, a book publisher, Blockbuster Video, and a movie studio. At one point during the 1990s, Viacom even owned New York's Madison Square Garden.[7]

Viacom acquired CBS for US$50 billion in 1999. While Viacom's U.S. Security and Exchange Commission filings indicate that the television division provided about 31% of operating income for 2003,[8] CBS News provided just one-sixth of the total television division revenues and operating income, according to a company insider.[9] This means that CBS News accounts for approximately 4-to-5 percent of Viacom revenues and operating income. (See Exhibit 8 for a more detailed analysis of CBS News' impact on the Viacom bottom line.)

The sheer size and diversity of Viacom's operations provide significant protection from any fallout at CBS News. Redstone, Viacom's chairman, commented on controversy at CBS, saying "I don't think it could negatively impact the brand." In fact, CBS itself relies much more heavily on its entertainment content, where it was the leader in prime-time ratings during the 2002-2003 and 2003-2004 seasons.[10] The company's news division, which has consistently finished third in national news viewership, has done little for Viacom revenues.[11]

The Growth of Internet and Cable News Sources

Alternative news outlets have dramatically eaten into CBS's audience for news, along with the overall audience for broadcast network news. Cable news has captured much of the audience for major network news, as Fox News Channel (FNC), Cable News Network (CNN and others grew steadily from 2000 through 2004.[12] Fox News is seen by many critics and observers as a more conservative organization, while the traditional broadcast networks are seen as more politically liberal. This is a somewhat self-reinforcing view, as self-described conservatives are more likely to watch FNC and self-described liberals are more likely to watch broadcast news.[13]

These alternative media outlets were originally confined to cable channels, but their ranks have swelled in recent years to include Internet sites and web logs, or "blogs." In 1995, the number of people who said they got news online three or more days a week was just 2 percent of the total audience. By 2004, that figure grew to 29 percent.[14] The frequency of use of Internet news and information sources also grew over the same period. The main sources of news on the Internet are the web sites of broadcast and cable news operations (FoxNews.com, CNN.com, ABCnews.go.com., among others). By 2004, however, non-traditional sources grew dramatically. Especially noteworthy is the growth of news-related blogs.

Blogs are basically personal logs that individuals post on the Internet. They include daily running commentary (some posted solely by the blog owner, while others include postings from readers around the world). They address a wide variety of topics, from working at a particular company to the life of a professional chef. A number of blogs now focus on breaking news, including what some would call the original news blog, *The Drudge Report*, *written* by Matt Drudge. Mr. Drudge's site, along with similar sites, focuses on two main goals: reporting news they feel is glossed over by the mainstream media, and breaking new stories as they happen, in near real-time. These sites do, in fact, often break stories early, but many readers question the accuracy of some claims. In the 2004 presidential election, many of these sites posted

preliminary exit polling data showing John Kerry with a lead in nearly every battleground state, but George W. Bush ended up winning many of those states.[15]

The difficulty with blogs is that they are written by individuals who may indeed have first- hand information, or they may just have an agenda. It can be very difficult to ascertain the accuracy and sources of information reported in blogs, and the sheer volume of bloggers allows people of all sorts to hide in the anonymity of a web name. The explosive growth of these blogs and other Internet news outlets has created a tension between "radical" bloggers and traditional news media. As one CBS executive said, "You couldn't have a starker contrast between the multiple layers of check[s] and balances [at *60 Minutes*] and a guy sitting in his living room in his pajamas writing."[16]

The *60 Minutes II* Feature Story

On Wednesday, September 8, 2004, the *CBS Evening News* broadcast a story as a set-up to that evening's broadcast of *60 Minutes II*. The story was about President George W. Bush's service in the Texas National Guard and it centered on a set of documents that came into the possession of CBS. Known as the Killian Documents, as well as the CBS documents, they were attributed to the late Lieutenant Colonel Jerry B. Killian (see Exhibits 1 through 4). Killian was the Texas Air National Guard Squadron Commander of President George W. Bush. The theme carried throughout the memos was that, then-Lieutenant Bush was lax in his duties in the Texas Air National Guard. They suggested that Bush disobeyed orders, did not meet flight requirements, and tried to use the position and influence of his father in order to receive preferential treatment. The memos spanned 1972 and 1973 and were used by CBS News producer Mary Mapes for the September 8th *60 Minutes II* segment. That segment also included accounts from those who were involved with Bush's unit at the time, but the documents were the foundation for the entire story.

Aftermath of the Feature

Blogs and Internet Sources Question Memos

Almost immediately after the *60 Minutes II* segment aired, rumors began circulating on Internet blogs. The first known post, questioning the authenticity of the memos, was on a blog hosted by http://wwwfreerepublic.com, just before midnight on Wednesday, September 8, just four hours after the documents were shown on the *60 Minutes II* broadcast.[17] Free Republic is a largely conservative Internet news site but, by the next day, the questions had spread to blogs throughout the Internet, and President Bush's statements questioning the memos only added to the doubts about the memos' origins.

Bloggers picked up on several key inconsistencies in the memos. The first was that the characters were not evenly spaced, even though nearly all typewriters of the time spaced letters evenly. The memos exhibited "proportional spacing" which was only available on the newest model IBM Selectric II.. It was doubtful the Texas Air National Guard owned one of these typewriters, as they were new and very expensive. Also of note is that other documents from the same squadron did not exhibit proportional spacing.

The other inconsistency bloggers uncovered was the fact that, in one instance, the document said "111th Fighter Wing." The superscript "th" was highly suspect, as no typewriter

of the time was known to have that capability. Other problems with the memo would later surface, but these two problems led to the story becoming more widespread.

Mainstream Media Pick up the Story

As the more established conservative news sites (Drudge Report, Free Republic) started talking about superscript and proportional spacing, major newspapers and the networks began to take notice. Fox News began reporting that questions had arisen surrounding the source of the documents.

Soon thereafter, the story was picked up by the major media outlets, but only after being published by a series of often anonymous bloggers. *The Washington Post* sought independent experts to review the documents, but they knew they were self-admittedly behind the Internet news sources.[18] The fever-pitch blog postings would reach would eventually lead to sites dedicated to debunking the story, such as http://www.rathergate.com and http://www.ratherbiased.com. Some blogs even posted lists of major Viacom shareholders and urged people to contact them en masse, which some felt bordered on harassment.[19]

CBS/Viacom Response

By the 6:00 p.m. news hour the next day (Thursday, September 9th) reactions to the story on Bush's guard service (or apparent lack thereof) were headline news on most network broadcasts. During the *CBS Evening News*, Dan Rather mentioned that some "Republican Congressmen" had questioned the authenticity of the documents, but he reiterated that CBS believed the story was accurate.

CBS News also released a statement that day, declaring that each one of the documents "was thoroughly vetted by independent experts and we are convinced of their authenticity."[20] CBS also supported the authenticity of the documents by having their reporters talk with unidentified individuals who saw them "at the time they were written."[21] CBS spokeswoman Kelli Edwards declined to respond to questions raised by experts who examined copies of the papers at the request of *The Washington Post*, or to provide the names of the experts CBS consulted.[22] Marjorie Connell, the widow of the documents' alleged author, stated that the documents are "a farce… her husband did not keep files." In addition, she said that her husband considered Bush "an excellent pilot." She also made that statement that she was "livid" at CBS.[23] A CBS reporter contacted her briefly before the on-air release, but did not ask her to authenticate the records.[24] In addition to Lt. Col. Jerry B. Killian's widow, his former secretary, Marian Carr Knox, questioned the authenticity of the documents.[25]

Later that week, Rather traveled to Texas to interview Bill Burkett, a retired National Guard official who some alleged was the source of the documents. Mr. Burkett, however, had strong ties to the Democratic Party, and even reportedly urged Democratic activists to wage "war" against Republican "dirty tricks."[26] This did little to quiet speculation on conservative sites that the "discovery" (perhaps, "creation") of these memos was the product of anti-Bush political elements.

CBS Continues to Follow the Story

It was not until Wednesday, September 15, 2004 that Dan Rather acknowledged for the first time that, "there are serious questions about the authenticity of the documents he used to question President Bush's National Guard record last week on *60 Minutes*."[27] Bob Schieffer, CBS News' chief Washington correspondent, stated that, "I think that this is very, very serious."[28] At the same time, Rather wanted the press to question the Bush administration about the President's service record instead of questioning him about where and how he acquired the documents. With fires all around them, CBS issued a statement (See Exhibit 6) maintaining that the documents were authentic. This statement was to set the stage for that night's broadcast of *60 Minutes II*, one week after the initial story broke.

The Washington Post Reviews the Documents

The Washington Post chose to conduct its own examination of the documents in question. *The Post* investigation discovered inconsistencies in both the format and origin of the documents, concluding that the Killian memos were formatted differently from other Texas Air National Guard documents of that same period. *The Post* brought in William Flynn, a forensic document specialist with 35 years of experience in police crime labs and private practice, who said that "the CBS documents raise suspicions because of their use of proportional spacing techniques."[29] Exhibit 5 highlights Flynn's findings.

CBS News Retracts the Story

On September 20, 2004, CBS news released a statement effectively retracting the story that questioned President Bush's Service. CBS released the following: (See Exhibit 7).

> *Bill Burkett, in a weekend interview with CBS News Anchor and Correspondent Dan Rather, has acknowledged that he provided the now-disputed documents used in the September 8th "60 Minutes Wednesday" report on President Bush's service in the Texas Air National Guard.*
>
> *Burkett, a retired National Guard lieutenant colonel, also admits that he deliberately misled the CBS News producer working on the report, giving her a false account of the documents' origins to protect a promise of confidentiality to the actual source.*
>
> *In light of this and other developments reported by CBS News and other news organizations, CBS News President Andrew Heyward issued the following statement:*
>
> *Based on what we now know, CBS News cannot prove that the documents are authentic, which is the only acceptable journalistic standard to justify using them in the report. We should not have used them. That was a mistake, which we deeply regret. Nothing is more important to us than our credibility and keeping faith with the millions of people who count on us for fair, accurate, reliable, and independent reporting. We will continue to work tirelessly to be worthy of that trust.*[30]

Other Anchors Defend Mr. Rather

Dan Rather, a fixture of network news for more than two decades, was now on the defensive, along with the entire CBS News organization. Other network news figures came to the defense of Mr. Rather, including NBC anchor Tom Brokaw and ABC anchor Peter Jennings. Brokaw was particularly strong in his support of Rather, saying, "There's a political jihad against Dan Rather and CBS." He continued, "We know a mistake was made, but it's been blown out of proportion. It's an attempt to demonize CBS News. It's a demagoguery unleashed on the Internet."[31]

The three titans of broadcast news: Brokaw, Jennings, and Rather appeared together at the New York Public Library on October 2, 2004 to show solidarity during this situation. At that point, CBS News had backed away from the memos, but bloggers and conservative pundits continued to press CBS for details on what checks had been performed on the documents. CBS's own admission that it may not have done enough background checking prior to airing the story led many to question the continuing role of Rather as Managing Editor of the *CBS Evening News*.

Many who saw or read about Brokaw's comments accused him of bias in his support of Rather. For his part, Jennings displayed a somewhat wider perspective, and made one of the best received remarks when he shared his thoughts on the situation, "You never judge a man by one event in his career." Jennings added, "I think the attack on CBS is an attack on mainstream media, an attack on the so-called 'liberal media.' To me, when you make a mistake, you apologize. You go back and review your standards."[32]

Pressure on Dan Rather and the CBS Television Network

After retracting their story on President Bush's service record, both CBS and Dan Rather were placed under considerable scrutiny. The question that loomed over both CBS News and Mr. Rather was why CBS did not catch the problems with their sources before broadcasting the story. Any chance that the media firestorm surrounding these documents would die off after the retraction quickly evaporated, as bloggers and conservative web sites felt emboldened by their apparent "victory" over the media giant.

Hard questions were being asked by outlets ranging from cable broadcasters to Internet weblogs. Dan Rather was, in effect, indicted by the alternative news media, and the questioning did not subside. Was there an agenda or bias in the way they reported on this story? Independent readers on the Internet had poked holes in the CBS story within 24 hours of its broadcast, yet none were noticed prior to running the story. How were CBS and Rather so easily misled, or did they turn a blind eye? CBS was asked these questions repeatedly, yet had no easy answers.

Rather Announces His Retirement

On November 23, 2004, in a written statement, Mr. Rather said, "I have always said that I'd know when the time was right to step away from the anchor chair. This past summer, CBS and I decided that the close of the election cycle would be an appropriate time."[33] This announcement meant that the face of CBS News for nearly 24 years would be gone by the end of March. The strain of the previous three months showed clearly on Rather's face, and few doubted that the

scandal had taken a toll on the veteran newsman. Rather would sign-off as anchor and managing editor on March 9, 2005, some 24 years to the day after he took the position. While he planned to eventually return to a contributing role on *CBS 60 Minutes*, there was no doubt that the face of CBS News had changed, first metaphorically and then literally.

Where does CBS go from here?

CBS Television launched an inquiry into what led to the allegedly forged memos reaching the airwaves. They have appointed Richard Thornburgh, who ran the Justice Department during parts of the Reagan and George H.W. Bush administrations, and Louis D. Boccardi, who retired as chief executive of the Associated Press.[34] "It's a journalistic challenge to look at the handling of the story, what was done, what was not done and see what lessons we can derive for CBS News," Mr. Boccardi said.[35] The investigation's findings were slated for release in early 2005.

CBS News has been defined by great newsmen: Murrow, Cronkite and Rather. Dan Rather's dual role as anchor and managing editor would have to be filled, yet no obvious successor existed. CBS News gradually lost market share, and witnessed the overall market for broadcast news dwindle each year from the late 1990s. Internet and 24-hour cable news continued to attract viewers, and, in this case at least, proved to be more accurate than CBS's reporting. With dwindling viewership, accusations of bias and shoddy reporting, and a long-time anchor and managing editor set to leave, CBS and Viacom management began planning the future direction of CBS News.

Discussion Questions

What duties does CBS news have to verify the accuracy of its news stories?

Internet news sources have the ability to reach people instantaneously and segment the news market along many demographics. How can CBS News compete with a single program produced for a national audience?

CBS News has been defined by the great men who have sat behind the news desk. How should CBS fill the void left after Mr. Rather leaves the anchor desk?

CBS News is unique in that the anchor is also the managing editor. What advantages does this provide? What are the potential drawbacks?

CBS News faces a credibility crisis, yet its figurehead will be stepping down in a few months. What steps should CBS take to regain credibility in the news market?

Is there a place for national news in the future? How will the newscast evolve as more media outlets are created? What repercussions will there be for other network anchors who supported Dan Rather?

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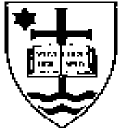
The Chicago Sun-Times: When Truth-Tellers Lie

Morales, S. M.; and O'Rourke, J. S. (editor)

While conducting an internal audit, David Cruickshank, the newly-hired publisher of *The Chicago Sun-Times*, was faced with a chilling reality about how his newspaper was operating. Cruickshank uncovered data proving that the Sun-Times circulation figures – the lifeline of the paper's advertising revenues – had been inflated for nine years. The credibility of one of the nation's top publications was on the line, and Cruickshank needed to decide how to communicate this to his staff and, more importantly, to the world. 7 pp. Case #05-07. (2005).



The Chicago Sun-Times:
When Truth-Tellers Lie

In June 2004, David Cruickshank, Publisher of *The Chicago Sun-Times*, conducted an audit to review the paper's circulation numbers after a recent price hike. To his surprise, he was soon faced with a chilling reality about how his newspaper was operating. Cruickshank uncovered data proving that the Sun-Times circulation figures – the lifeline of the paper's advertising revenues – had been inflated since 1995. The credibility of one of the nation's top publications was on the line, and Cruickshank needed to decide how to communicate this to his staff and, more importantly, to the world.

Hollinger International

The Hollinger Gold Mine, the discovery of prospector Benny Hollinger, was founded in 1909 in Timmins, Ontario. The Hollinger mine was once the richest gold producer in the Western Hemisphere, with a total production of $400 million, at one-tenth of today's prices. After decades of production, Conrad Black of Argen Holdings acquired a control block of Hollinger Mines and created Hollinger Argus Limited. The organization was later renamed Labmin Resources Limited and finally formed itself into Hollinger Inc. As part of its growth strategy, the corporation began to acquire newspapers in 1985. Today known as Hollinger International, the once gold mine is now a multinational publisher of English language periodicals in North America, the United Kingdom, and Israel, in addition to other media holdings and real estate investments. Popular Hollinger publications include *The Daily Telegraph* (UK), *The Jerusalem Post* (Israel), *La República* (Costa Rica), and *The Chicago Sun-Times*.[1] Not a stranger to scandals and public relations problems, Hollinger International's former CEO, Conrad Black, was brought to court for unethical compensation practices in late 2003 after robbing the company of nearly $390 million. Gordon Paris stepped into the Hollinger International Interim CEO position in fall 2003.[2]

The Chicago Sun-Times

The 21st highest circulated newspaper in the United States[3], *The Chicago Sun-Times* is Hollinger International's largest North American periodical. *The Sun-Times* boasts eight Pulitzer Prize winners and is home to high-profile journalists Robert Novak, Rick Telander, and film critic Roger Ebert. Also available in Chicago suburbs and outside neighborhoods, *The Sun-Times* is the long-time rival of the *Chicago Tribune*, one of the nation's most highly-circulated newspapers.

The current Publisher at *The Sun-Times* is David Cruickshank, part of a new wave of senior leadership at the paper, appointed in November 2003.

Audit Bureau of Circulations (ABC)

The first and largest circulations bureau in the world, ABC is a not-for-profit, third party auditing organization located in Schaumburg, Illinois, a Chicago suburb. The organization's purpose is to govern how circulation audits are conducted and how publications are reporting their respective circulation figures. The ABC Board of Directors, a group of 36 publishers and advertisers, set auditing rules, and aim to set the standard for integrity, objectivity, and accuracy. The ABC also releases annual circulation rankings, which are commonly used by publications as a benchmark for setting advertising rates.[4]

What Happened?

After an April 1, 2004 price hike on single-copy issues of *The Sun-Times*, new leadership at the paper, led by Publisher David Cruickshank, began to focus on ensuring the accuracy of the paper's circulation figures. While conducting an internal audit, Cruickshank was surprised to find that circulation figures and revenue did not match following the price increase.[5] *The Sun-Times*' circulation figures were inflated, and Cruickshank needed to determine how this happened – and for how long.

After further research, Cruickshank discovered that *The Sun-Times*' circulation figures had been inflated for years – as far back as 1995, under the direction of former Publisher David Radler. Circulation figure inflation was apparently stepped-up once the paper began to experience printing complications which delayed delivery times. Radler had depended on current VP of Circulation Stephen Hastings and Mark Hornung, who held the circulation position from 1995-2001, to take any measures necessary to keep circulation from falling.

Hornung and Radler adopted three different methods to raise circulation numbers:

- Set up fake accounts at *Sun-Times*-owned delivery agencies to boost distribution figures in the Chicago area. Officials would then tell agencies to trash unwanted papers after delivery – as many as 30,000 issues of *The Sun-Times* were trashed per day. Of these 30,000, all were written off as "sold" and were included in the paper's circulation numbers.[1]

- Because ABC rules allow publishers to eliminate circulation numbers on certain days from figures reported to the ABC, *The Sun-Times* took advantage of what is commonly referred to as "elimination days." *The Sun-Times* would shift returned paper numbers rather than record them on the days that papers were actually returned. The paper's internal records were also modified in an effort to make it look like certain days qualified as elimination days when they really didn't.

- *The Sun-Times* redirected recycling proceeds due to *the organization* to be deposited into a charitable trust that was created for the purpose of purchasing and distributing newspapers in local schools. *The Sun-Times* was buying their own newspapers and including these numbers into their overall circulation.[6]

Hornung left the circulation position to serve as president and publisher of Hollinger-owned paper *The Daily Southtown*, in 2001[7]. Hornung was no stranger to ethical problems – while serving as an editorial page editor of *The Sun-Times* in the early 1990's, he was ousted from his position for plagiarism after copying content from an article in *The Washington Post*.[8]

Cruickshank's Response

Immediately upon learning of the situation, Cruickshank met with his staff and wrote an internal memo to be distributed to all *Sun-Times* employees. Cruickshank also formed an internal Audit Committee to scan the accuracy of the circulation figures of Hollinger's other media holdings.

Determined to identify responsible parties and to correct the situation before relevant stakeholders, Cruickshank revealed *The Sun-Times* inflation of circulation figures on a page three article of the June 15, 2004 edition of *The Sun-Times*. A press release on the issue was also posted on Hollinger International's web site. In the article, Cruickshank explained how the circulation errors took place, how long it had been going on for, and announced that internal agencies, Gardner Carton & Douglas LLP and the Forensic Services practice of Deloitte & Touche LLP, had been hired to help in the correction of the problem.[9] Finally, Cruickshank announced the resignation of Hastings, as well as the administrative leave of Hornung as the *Sun-Times* internal investigation continued.

Cruickshank was also determined to ensure the public that the issue was a shock to him, as well as the vast majority of the *Sun-Times* staff. "This is something that was held very closely," Cruickshank told reporters. "Very few people knew. Very few people were involved."

Within one month of his initial announcement, Cruickshank restated its single-copy circulation numbers. The Audit Committee determined that the paper had inflated their single-copy circulation numbers by a staggering 23 percent, roughly 72,000 copies per day. The Committee determined that for ABC reports beginning in 1998, single-copy circulation figures for *the paper's* weekday and Sunday issues were inflated. Saturday editions were not overstated. Single-copy circulation inflation began slowly and gained speed over time. The average overstatement over the twelve-month period ending March 1997, as reported by ABC, was 2,814 copies per day during the week, and 672 copies on Sundays. Inflation at the paper continued and increased during the most recent twelvemonth period ending March 28, 2004 (see Appendix A). Inflated numbers were also detected at other Hollinger-owned papers: Chicago-based *The Daily Southtown* and *The Star*, as well as *The Jerusalem Post*.[10]

A Violation of Trust

Cruickshank's June 14 announcement shocked stakeholders, including journalists and advertisers. A rival paper, *The Chicago Tribune*, saw the scandal as an opportunity to win more readers and broke a front-page story with the headline, "Newspaper reveals sales at newsstands lower than claimed; upset advertisers may seek refund." The headline was placed under the Tribune masthead, which featured a full-color American flag. The *Tribune* then ran a second-day Business Section story on the scandal, outlining how *The Sun-Times* struggled to keep circulation numbers up.[11]

Advertisers grew furious at the announcement, as the ad rates they regularly paid to *The Sun-Times* were apparently higher than they should have been. Reporters began claiming that

rebates to *Sun-Times* advertisers could cost Hollinger millions of dollars. "It's a form of theft," industry insider John Morton said to *The Washington Post*. "Your ad rates are keyed to your circulation. You can sue to get refunds." In response to the announcement, key *Sun-Times* ad accounts, including Central Furniture, Inc. and The Professional Weight Clinic, filed lawsuits against the paper, charging fraud, deceptive trade practices and unjust enrichment.[12] Final Audit Committee results projected that $27 million would be rebated to advertisers as a result of the scandals.[13]

The investor community also voiced concerns following the announcement, predicting that *The Sun-Times* may not be alone. Rich Fine of Merrill Lynch announced that "there is more concern that more companies will step forward with disclosures, especially in view of Sarbanes-Oxley," a recently-passed federal law which requires publicly traded companies to provide more financial disclosures.

The Plot Thickens

Fine's predictions were correct. Just two days after Cruickshank's initial announcement, rival Tribune Co., owner of *The Chicago Tribune*, announced that two of its papers, *Newsday* and Spanish-language paper *Hoy*, also inflated their circulation figures. The Tribune Company placed *Newsday's* vice president of circulation on administrative leave and vowed to reevaluate its circulation practices.[14]

On July 12, 2004, a shocked ABC Board unanimously imposed harsh sanctions on the *Sun-Times, Newsday,* and *Hoy*, for circumvention of ABC's bylaws and rules. The publications were now required to submit circulation claims for more frequent audits – every six months, rather than annually. Additionally, their circulation claims were to be excluded from ABC's FAS-FAX, the semi-annual report of "top-line" publisher circulation claims. The publications were also now required to submit a plan to correct their past practices. "The relationship between publisher and advertiser is based upon trust," stated ABC Board Chairman Robert Troutbeck. "Each member of the ABC Board agrees that we, as an industry, do not tolerate rules circumvention, to say nothing of fraud, and will do whatever is necessary to preserve the trust between publishers and advertisers that all sides value so highly."[15]

An Industry in Trouble

Journalists began to question the public's perception of the newspaper industry – one which was once known for its credibility. Circulation scandals, coupled with reporter dishonesty at the *New York Times* (Jayson Blair), and *USA Today* (Jack Kelley), were changing the face of the media. Reporter Al Swanson asked his readers "is an industry that historically has prided itself on protecting the public trust in truth, justice, and the American way in jeopardy? The deception is rattling news consumers who again wonder how much you can believe of what you read in the newspaper."

The scandals continued to surface. Several weeks after Hollinger International and Tribune Co. revealed their inflated figures, The Belo Corp., another media organization, announced its inflation of Circulation numbers at *The Dallas Morning News* by 1.5 percent on Mon-Fri and by 5 percent on Sunday. More lawsuits are sure to be filed at all three companies, with more executives set to lose their jobs due to their dishonesty.[16] With these events in mind, other media companies, including Knight Ridder and The New York Times Company developed

and implemented plans to transparently reassure advertisers that their metrics were honest and real. These companies scrambled to create the plans prior to November 1 – the date when ABC will release circulation figures for March – September 2004.[17]

What's Next?

With Hollinger International and other penalized publications now dealing with rebates to advertisers, they are also trying to regain the trust of their advertisers, employees, readers, and competitors. Cruickshank was transparent in his handling of the scandal at the Sun-Times, but could he have done a better job of protecting the paper's image? What action plan should *The Sun-Times*, as well as other newspapers and media companies, implement to prevent such crises from reoccurring? How should Cruickshank train his sales staff to communicate these issues with current and potential advertisers? What steps should the newspaper and media industry take to improve its now damaged image?

Appendix

Daily and Sunday Circulation Overstatement[1]

	Daily			Sunday		
Publication Date[2]	ABC Reported Average Circulation	Total Overstated Sales per Day	Total Overstated Sales as a Percent of Reported Circulation	ABC Reported Average Circulation	Total Overstated Sales per Day	Total Overstated Sales as a Percent of Reported Circulation
April 1998	493,998	2,814	0.57%	440,696	672	0.15%
April 1999	488,909	3,768	0.77%	427,662	3,164	0.74%
April 2000	481,685	9,106	1.89%	408,915	8,987	2.20%
April 2001	474,533	16,667	3.51%	402,779	6,043	1.50%
April 2002	477,354	28,746	6.02%	385,649	10,702	2.77%
April 2003	481,980	33,517	6.95%	377,640	12,321	3.26%
April 2004	482,421	50,191	10.40%	376,401	17,318	4.60%

Source: "Hollinger International Announces Findings of Internal Review at the Chicago Sun-Times," http://www.gcd.com/db30/cgi-in/pubs/HollingerAnnouncementOct2004.pdf

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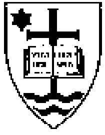
De Beers Ltd.: Polishing Up Its Brand For the U.S. Market
Davgun, A.; McDaniel, H.; Thomas, M.; and O'Rourke, J. S. (editor)

In order to be permitted to enter the United States retail market, De Beers Ltd. is expected to plead guilty to a lawsuit accusing them of price fixing. While trying to present themselves as the conscientious leader of an otherwise sordid, often dangerous diamond business, they find themselves facing the daunting task of balancing an admission of guilt and the negative media attention they may draw with an unpredictable American diamond consumer. 20 pp. Case #04-07. (2004)



De Beers, Ltd. (A)

Polishing Up Its Brand Image for the U.S. Market

Nicky Oppenheimer clicked off his phone, leaned back in his chair and sighed. As Chairman of De Beers, the world's foremost diamond company, he had chosen to plead guilty to a 10-year-old criminal price-fixing charge in a United States court, and the proceedings were moving slowly. The case was only one of Oppenheimer's headaches. The diamond industry was rapidly changing, and De Beers needed to transform itself from a diamond cartel into a respected, socially responsible luxury goods company. Resolving the case was a necessary step to achieve this goal, and to fulfill the company's current objective: to establish a retail presence in the U.S.

Although the United States remains De Beers's biggest market for diamond jewelry worldwide, the South African-based company has historically sold to the U.S. only through intermediaries. De Beers pulled out of the U.S. market shortly after World War II after the Justice Department alleged it had fixed the price of industrial diamonds. Federal antitrust enforcers again filed criminal charges against De Beers in 1994, but had trouble prosecuting the elusive De Beers executives, who avoided U.S. soil for fear of detention.[1] Now, with plans to develop a direct presence in the U.S. and implement several new global brand-building initiatives, De Beers had to confront the U.S. charges.

Antitrust issues were not the only obstacles De Beers would encounter in the U.S. Federal officials have been reluctant to facilitate De Beers's entry into the U.S. due to the company's history of harsh labor conditions and support for South Africa's apartheid regime; De Beers's earlier attempts to have the U.S. price-fixing charges dropped were unsuccessful with both the Clinton administration and the Bush administrations.[2] The company would likely face additional private lawsuits and antitrust enforcement once established in the U.S. Additionally, negative publicity surrounding a European Union investigation into De Beers's new "Supplier of Choice" system meant the company was under even closer scrutiny.[3]

Most significantly, De Beers would have to carefully manage its image in the eyes of the American public. The diamond industry had become a target for activist groups worldwide due to the unchecked illegal mining and trading of "blood diamonds." Blood diamonds, a term used for diamonds illegally traded to finance rebel factions and terrorist activities, had caused the death, maiming or displacement of millions of South Africans, and were a pressing global concern. Though De Beers had undertaken steps to filter out any blood diamonds from their own

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This case was prepared by Research Assistants Marie Halvorsen-Ganepola and Katie Murphy under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.
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stockpile, their methods were not foolproof. Certain human rights groups claimed that De Beers, due to their size and power, were responsible for the proliferation of the blood diamond trade.[4] How could De Beers prove their commitment to helping eradicate the blood diamond trade, and keep their brand from being tarnished by associations with war-torn Africa and terrorist regimes? As Oppenheimer contemplated the strategy for entering the U.S. retail market, he thought back to De Beers' first retail store opening in London.

The London Store Opening

De Beers's London store, which had been scheduled to open December 3, 2002, experienced a number of troubling delays. The store failing to meet its set grand opening date was the least of the corporate heads' worries. The official reason for the delayed opening: an insufficient number of diamonds to display in the cases and storefront, an ironic state of affairs for the diamond giant. Fortunately, De Beers had the power to remedy the situation.[5]

Of more pressing concern: the human rights activists who had used the store opening as an opportunity to make some very bold – and damning – statements about the dark side of the diamond industry. A group known as Survival International had thwarted De Beers's plans to have a ribbon cutting ceremony for this, their first store. The group replaced the huge billboard of Iman (the representative supermodel for De Beers) at the London store with an equally huge billboard of a woman from the Bushmen group. The Iman billboard was capped with the tagline "A diamond is forever," while the Bushmen billboard answered with, "The Bushmen aren't forever."[6]

The allusion to the Bushmen was a call to remember the many indigenous peoples that had been removed from their native lands for the sake of diamond mining. Following the incident, both De Beers and the Botswana government (which owns the mines in a 50/50 partnership with De Beers) denied that diamonds had anything to do with the Bushmen evictions, though Bushmen had allegedly been told by government officials that, "If diamonds are found somewhere, the people have to be chased away."[7]

Despite the London store's delayed opening, De Beers held a store opening party on November 21, 2002. Conspicuously absent from the party was De Beers spokesmodel, Iman, though De Beers reported that her absence was due for "family reasons" and not because of any break with the company over the Bushmen incident.[8] At the time, Stephen Corry, director of Survival International told the *New York Times*, "The campaign will not end until the Bushmen's land has been returned to them."[9] Though it is unclear whether a U.S. store opening would attract similar protests, it is certainly likely.

The History of De Beers

Founded by Cecil Rhodes in 1888, and subsequently purchased by Sir Ernest Oppenheimer, De Beers is the largest diamond company in the world today. In 1902, Sir Ernest arrived in South Africa as a representative of a diamond buying company, and stayed to found and build his diamond empire. Though the company has changed leadership over the years, this leadership has always remained within the Oppenheimer family, each heir seamlessly and effectively building upon the previous leader's efforts.

The family business has historically been passed from father to son and is currently being prepared for the transition to the leadership of Jonathan Oppenheimer, the only child of Nicholas

Oppenheimer (Sir Ernest's grandson). The company has weathered many major transitions through tumultuous times in South Africa, the most recent being Nicholas's decision to pay $17.6 billion to once again take the company private in 2001(it had previously been controlled by Anglo American, an investor-owned company). The current ownership structure is such that the family owns 45%, Anglo American owns 45%, and Debswana (a company owned jointly by the Oppenheimers and the government of Botswana) owns the remaining 10%. The shift back to private ownership effectively reasserted family control over De Beers, alleviating investor pressures the company had faced while under the control of Anglo American.[10]

The Diamond Industry

Diamonds are the crystalline form of carbon. They are created in molten rock, 75 to 120 miles below the earth's surface, and then transported to the surface in volcanic eruptions.[11] The diamond crystals must cool quickly and near the surface in order to remain a diamond, and not turn into graphite or carbon dioxide. The most recent such volcanic eruption occurred approximately 53 million years ago. According to the San Diego Natural History Museum, most diamonds are over three billion years old, two-thirds the age of the earth; younger diamonds are only 100 million years old.[12] Though diamonds are most often thought of as sparkling jewelry pieces, only 20 percent of mined diamonds are suitable for use as gems; the other 80 percent are used in industry.

Diamonds are currently mined in 25 countries, and on every continent except Europe and Antarctica.[13] Antarctica is believed to be a rich source of diamonds, but international accords prohibit mining in the region. Among the major producing countries are Botswana, South Africa, Namibia, Angola, Sierra Leone, Congo, Australia, Russia and Canada. The United States has only one diamond mine, located in Arkansas. Major diamond trading centers include Antwerp, Tel Aviv, Bombay, London and Moscow.

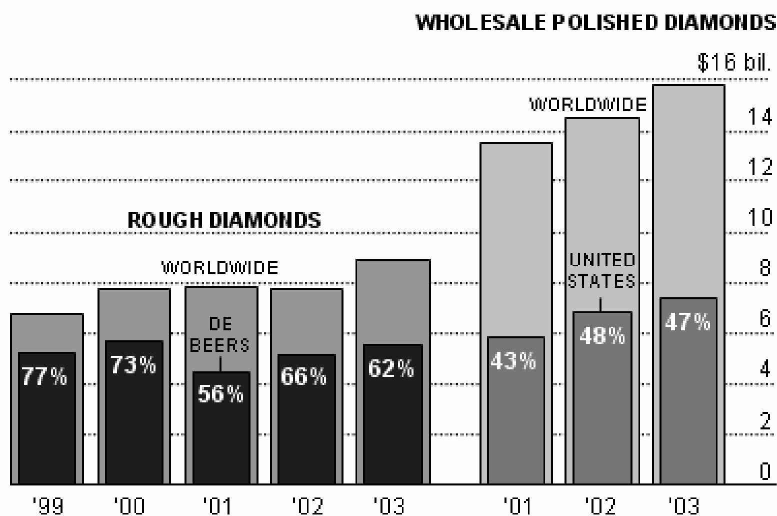
De Beers is the world leader in diamond exploration, mining, recovery, sorting, valuation and marketing.[14] While De Beers has historically maintained tight control on the entire industry, the diamond trade is experiencing a number of rapid and fundamental changes: vertical integration within the diamond pipeline, increased focus on branding and conflict diamonds, and shifting power among key players.[15] Recent improvements in synthetic diamond production have proved promising, and represent a significant threat to traditional mining companies. As of 2002, the world diamond market was estimated to be $56 billion dollars. Forecasts for future sales of diamond jewelry remain strong.

The De Beers Monopoly

Although De Beers is slowly restructuring its buying and selling models, the company first achieved its tremendous success by operating as a monopoly. For more than 60 years, De Beers' Central Selling Organization (CSO) marketed around 80 percent of world production.[16] De Beers' strategy has historically entailed buying and stockpiling rough diamonds, and severely restricting their release into the marketplace. In addition to producing from their own mines in South Africa, De Beers purchases a large percentage of rough diamonds from other countries like Russia, and from other sources outside their network, for marketing through their sales arm, the Diamond Trading Company.[17] In the early 1980's De Beers controlled roughly 85 percent of

both production and global sales of rough diamonds.[18] By 1998, De Beers had accumulated a staggering stockpile of $4.8 billion dollars worth of diamonds.[19]

Once amassed, De Beers sold from its stockpile of diamonds to approximately 125-175 “sightholders” (generally, major diamond cutting firms), the only companies authorized to buy directly from De Beers.[20] The sightholders were invited to attend a “sight” at the CSO in London or Johannesburg approximately 10 times a year. Rough diamonds were not subject to negotiation, and buyers who attempted to speculate were not invited back. Such power has come to De Beers at a cost – allegations of price-fixing, cartel behavior, and encouraging the blood diamond market have accompanied De Beers’ almost absolute control.



Source: Rapaport Research. Used by permission

A New Approach

Due to competitive pressures, De Beers has been slowly transforming its monopolistic practices, and has pledged to alter some of its strict supply control tactics.[21] The change was predicated by a late 1990s strategy review conducted by the U.S. management consultants, Bain & Co.[22] Faced with a declining share of diamond production, and increasing costs in maintaining its stockpile (since reduced from $4.8 billion to $2.7 billion), De Beers was advised to relinquish its role as “industry enforcer” and, instead, focus on strengthening the De Beers brand name. Playing the part of “industry guardian” and “guarantor of prices” was no longer considered a viable strategic option.[23] In the previous five years, De Beers’s market share had fallen from 80 percent to closer to 60 percent, partly because a number of major producers opted to sell directly to the market. Consequently, De Beers’s current selling strategy now focuses on becoming the “Supplier-of-Choice” within the diamond industry.

The Supplier-of-Choice model focuses more on adding value to the current De Beers inventory of diamonds through marketing and branding initiatives. De Beers maintains its relationships with its sightholders, but has set more stringent qualification criteria for each. A Canadian diamond industry publication explains the changes:

> Very strong emphasis will be placed on the sightholders' ability to grow demand for diamond products. Service to clients will be improved and De Beers will provide a full suite of value-added services in training, business planning, market research and information. The company will encourage their sightholder partners to become purveyors of high-end luxury products.[24]

De Beers dropped the title "Central Selling Organization" in favor of the friendlier "Diamond Trading Company." Time will tell what impact this new emphasis on branding has on the diamond industry. Traditionally, the industry has employed a generic marketing approach, largely through De Beers's own *A Diamond is Forever* campaign. Though this campaign will continue, up until now, there has been little or no branding of specific manufacturers' stones, or by cut or producer origin.[25] De Beers believes an advertising push could spur sales by as much as 50 percent over the next ten years. Part of this strategy entails increasing current advertising budgets from approximately 1 percent of sales (the current standard for diamonds) up to 5 or 6 percent of sales, which would be on par with other luxury goods such as watches, perfumes, and jewelry. To complement this effort, De Beers has partnered with the French luxury goods group LVMH (Louis Vitton, Moet, Hennessy) for the opening of stores under the De Beers brand name. Additionally, De Beers has introduced the "Forevermark" to differentiate gems originating from the Diamond Trading Company from other stones. A social responsibility effort geared toward the elimination of blood diamonds was also added to their re-branded identity.

Despite the new branding initiatives and move to a less oppressive selling model, De Beers has not yet relinquished its monopoly position – though others are gaining. Because of De Beers's overall market share, and the fragmentation of its competitors, no one can yet touch its position.[26] Russia, which is the second largest producer at 18%, sells about 40% of its production to De Beers. The young Canadian market, with mines discovered as recently as 1991, has become the third largest producer by value and is expected to deliver 12% of the world's value in the short-term, and as much as 50% of the world's value in the long-term.[27]

Diamonds May Be a Girl's Best Friend, But What Are They Worth?

When valuing a diamond, several factors must be considered. To allow the end-user to evaluate these factors to some degree, De Beers popularized the "4 C's" of diamonds in 1939. The C's refer to cut, carat, clarity and color, and are distinguishable to the human eye.

Cut refers to the shape of a diamond and the manner in which it has been cut. Popular cuts include round, square (princess), pear shaped, and emerald, This does not make one diamond worth more than the next to anyone other than the person who will receive it. It is simply a matter of personal preference. The other aspect of cut refers to the ratio of the crown of the diamond (the top part) to the pavilion (the bottom, slanted part). This ratio will determine the brilliance of the diamond. If it is too small or too large, the light will not bounce off of the facets in the right way, thus producing a dull, less fiery diamond. Cut is the only one of the four C's that can be controlled.

Carat is the weight of the diamond, so named because it is determined by the weight of a carob seed which has a remarkable weight uniformity from one seed to the next. Interestingly, a higher carat weight does not ensure that the diamond will look larger than one of a lesser weight. The reason for this is the cut. A shallow cut diamond will appear to be much larger than a more deeply cut counterpart. About half of the carat weight of a raw diamond has to be chiseled away in order to cut it for brilliance.

Clarity refers to how clear the diamond is, how many inclusions it has, and to what degree they are visible to the human eye. Although a diamond is made solely of carbon, an inclusion is a fracture or deposit of minerals within the diamond that can make it have black specks or appear cloudy. As this is undesirable, a diamond that is lower on the clarity scale will often cost much less than one of lesser carat weight that has no inclusions.

Color, the final C, makes intuitive sense as a perfect diamond will have no color to it. A "clear" diamond can range in color from D to Z, with D having no color and Z exhibiting more of a brownish champagne color. This does not hold true for, vividly colored diamonds (called fancies) that are much more rare and precious than a colorless diamond. Fancy diamonds can take many different colors, but are generally found in pink, blue, green, yellow, orange, brown, and very rarely, red. Fancy diamonds are the rarest of all and therefore are the most coveted and expensive of all stones.[28]

Nearly every bridegroom in America who has endured the painstaking process of engagement ring shopping can recite the four C's, but the question remains: what are diamonds worth? Examining De Beers' history reveals a brilliant operating strategy aimed at supply control, and an equally stunning marketing campaign designed for demand control. It is thought that De Beers has, through "spectacular lighting, beautiful couples, mammoth stones, and urgent violins . . . convinced billions of people to spend months of their salaries on the traditional token of love and commitment."[29] Journalist Greg Campbell believes that De Beers has driven up demand for jewels by "generating and maintaining the myth that diamonds are both rare and necessary for people who fall in love."[30]

Campbell asserts that diamonds are, in fact, not rare; their value is falsely ascribed through De Beers' illegal market practices.[31] The assertion is that diamonds would really only be worth about $30 per carat if De Beers did not fix the market price. Edward J. Epstein's 1982 article, "Have You Ever Tried to Sell a Diamond?" offers an unsettling account of how De Beers carefully and calculatingly embarked on a decades long advertising campaign to convince the American public that tiny bits of carbon were truly an "inseparable part of courtship and married life."[32] Epstein argues that, in order to ensure a stable and lasting market, De Beers needed to create the illusion that diamonds were "forever" in the sense that they should never be resold. A 1938 meeting between Harry Oppenheimer (son of Ernest) and Gerald M. Lauck, president of N.W. Ayers, a leading U.S. advertising agency, yielded the following strategy:

> . . N. W. Ayer suggested that through a well-orchestrated advertising and public relations campaign it could . . . strengthen the association in the public's mind of diamonds with romance. Since "young men buy over 90% of all engagement rings" it would be crucial to inculcate in them the idea that diamonds were a gift of love: the larger and finer the diamond, the greater the expression of love. Similarly, young women had to be encouraged to view diamonds as an integral part of any romantic courtship.[33]

The resulting campaign was considered a tremendous success. The agency's work included the 1947 creation of De Beers's famous slogan, *A Diamond is Forever*. Now firmly embedded in the American lexicon of great campaigns, consumers may not even consider that the only real value in diamonds emanates from the perceived need and scarcity tactics orchestrated largely by De Beers.

De Beers Famous Diamonds

There are many famous diamonds in the world, and a large number of them can be found in the Smithsonian Institute and the Crown Jewels. Obviously, De Beers boasts the discovery of a number of them. Among the most famous of the De Beers diamonds are:

- *Millennium Star*, a proud 777-carat diamond
- *Heart of Eternity*, a vivid blue 27.64 heart-shaped sparkler.
- *Centenary*, a perfect color 599-carat diamond found in the De Beers Premier Mine and cut down to 273.85-carats for De Beers'100th Anniversary.
- *Star of South Africa*, a flawless 47.69-carat, pear-shaped diamond (this represents South Africa's diamond business. Prior to this discovery, diamonds had only been found in India and Brazil).
- *Incomparable*, a 407.48-carat, fancy diamond.
- *De Beers Diamond*, a 234.65-carat soft yellow colored stone found in a De Beers mine shortly after the formation of the De Beers Consolidated Mines in 1888.[34]

Diamond Production

The majority of the diamond rich land in Africa can be found in the southern portion of the continent – in what is now recognized as Sierra Leone, South Africa, Angola, Botswana, the Democratic Republic of Congo, and Liberia. Not all countries that are considered "diamond" nations are diamond producers. Liberia produces relatively few diamonds, but serves as a transit country for the stones, especially those that are smuggled for sale in the black market.[35] Transit countries are those that serve as the purchasing ground for unpolished diamonds to both legitimate and black-market purchasers. There are also a number of countries that are involved in the diamond trade completely through the black market. The Cote d'Ivoire diamond industry closed down in the 1980s, but Belgium – a major distribution country – recorded imports of more than 1.5 million carats[36] from the African country in the mid-90s.[37] The same story can be told of Liberia, which officially produced 100,000 carats, though dealers in Belgium imported nearly 31 million carats from the country in the mid-90s.

Diamonds circulate through a network referred to as "the pipeline" from mines, to dealers, to polishing factories, to jewelers and then to the final consumer. This pipeline can require an investment of one to two years.[38] The pipeline is riddled with numerous inlets, with vast open diamond excavation pits found in the Arctic Circle, the Kalahari's deep underground excavation tunnels, and even the floating mines of the South Atlantic. From these sources, the unpolished stones are sold to any of three main diamond transit markets – Antwerp, Mumbai, and Tel Aviv – where they are cut and polished for distribution. As competition is especially tight in the oligopoly, it is not uncommon for each location to purchase diamonds from questionable sources, even from countries like Cote d'Ivoire, which no longer officially produce the stones.

Rather than funding the growth of many African nations, the diamond profits are funneled out of the continent and into the hands of an elite few. The 120 million carats of rough diamonds extracted globally from the Earth every year weigh a total of just 24 tons, a single truckload, but those 24 tons are sold by the producers for about seven billion dollars. Since they cost less than two billion dollars to extract, the profits are already immense. By the time the diamonds reach the customers waiting in the far end of the pipeline, the truckload, set into approximately 67 billion pieces of jewelry, is worth over 50 billion dollars.[39] Thus, the production of diamonds has become a brutal fight for power and wealth in Africa, as seen by the manner in which various African governments have fought to control the production and sale of the stones.

Conflict Diamonds in Africa

Diamonds have become the symbol of love and eternity thanks to the aggressive marketing campaigns from De Beers, and this allure is often captured almost completely from consumers' perspectives. This is not to say that the natural allure of diamonds is not actively nurtured by those who profit from them. When a gang of thieves with a stolen bulldozer plowed into London's Millennium Dome in November 2000 to steal a 203-carat diamond from a display sponsored by De Beers, Nicky Oppenheimer, De Beers's chairman, hailed the botched heist as wonderful publicity: "If only we could do this once every six months. We could do away with the advertising department altogether."[40]

While Oppenheimer's comments accurately describe the perceived value and demand for the stones, it fails to remain flattering when examined in the context of the conflicts that have arisen in several African nations. The term "conflict" diamond really indicates the true nature of the effects of the industry in Africa. Rebels in the African nations of Sierra Leone, Liberia, Angola, and the Democratic Republic of Congo have long traded diamonds and other minerals to pay for their weaponry. Angola's rebel army, UNITA, earned hundreds of millions of dollars by selling stones to legal traders, especially De Beers. In the late 1990s the United Nations placed sanctions on business relationships with African rebel armies, such as UNITA, which terminated De Beers' relationship with the nation's diamonds.[41]

In Sierra Leone, the conflict diamond trade has an especially alarming association, as the country is credited with collaborating with various terrorist organizations in diamond trafficking. Among the terrorist organizations is Osama bin Laden's al-Queda network – which various intelligence organizations believe has made millions of dollars in recent years by trading the smuggled stones.[42] FBI sources have indicated that only three months before the terrorist attacks of 9/11, al-Queda had laundered millions of dollars by buying untraceable diamonds from the rebels in Sierra Leone. The nation's diamond-fueled civil conflicts received substantial media attention, in part because it served as the transit point for more than half of the rough diamonds that enter Western Europe.

A report issued by the United Nations estimates that the rebel movement in Sierra Leone, the Revolutionary United Front (RUF), which has gained international notoriety for its practice of chopping off the appendages of its victims, deals each year in diamonds worth around $100 million, more than enough to sustain its forces.[43] Over the course of the decade-long war, the rebels have mutilated some 20,000 people, hacking off their arms, legs, lips, and ears with machetes and axes. The RUF used its diamond profits to open foreign bank accounts for rebel leaders and to finance a complicated network of gunrunners who kept the rebels well-equipped

with modern military hardware used to control the region's diamonds. While the RUF terrorized and looted the countryside, thousands of prisoner-laborers, working to exhaustion, dug up the gems from muddy open-pit mines. Many lived and died in anonymity, resting in shallow graves, executed for suspected theft, for lack of production, or simply for sport.[44]

Whether from the killing fields of Sierra Leone, the Democratic Republic of Congo or Angola, every blood diamond perpetuates a barbaric conflict that, by some counts, has caused 3.7 million deaths and displaced 6 million Africans.[45] In a step to stem the illegal exportation of diamonds, many countries, like the United States, which purchases nearly 60% of the world's diamonds, placed an embargo on diamond purchases from Sierra Leone, Angola and Liberia.[46]

Not all victims of blood diamonds are innocent civilians; workers are often faced with the same brutality. Workers are not allowed to touch the ground, as it is forbidden, for fear that workers will smuggle the stones out. Until recently, workers were kept in relative obscurity and in subhuman conditions – given salaries that cannot sustain, and lodgings that are little more than cells. At all De Beers operations there is a perpetual struggle against temptation, with restricted color coded security zones, remote cameras, and stringent searches. Most mining operations enforce daily x-rays on all those workers who have daily contact with the stones.[47]

Kimberley Process

The recent publicity regarding the destructive nature of diamond trading has led to an international call for standardized industry regulations. Migration of diamonds from unpolished chunks to polished carats in engagement rings is largely unchecked. The Kimberley Process Certification Scheme was initiated in March 2003 by the United Nations and the international community as a response to the need for tracking. The Kimberley Process is a trading system that 49 countries have joined, including all the major diamond producing and consuming nations. Participants in the Kimberley Process are required to use standardized, tamper-proof packaging and an official Kimberley certificate when transferring rough diamonds. No participant in the system may import or export diamonds other than those from other participants.[48]

The certification requirement puts a vital and actual fence around clean diamonds by preventing illicitly mined diamonds from being legally bought, sold, exported, and cut. The weakness of the scheme is the near-complete lack of independent oversight, monitoring, and auditing. There is no formal secretariat, no invasive auditing provision, and no authority to withhold Kimberley credentials from those players who stray from the provisions.

Although the industry is moving toward a system for certifying the source of every diamond, the hundreds of millions of stones moving through the pipeline today are still essentially anonymous, shedding their history as they pass from rough to polished.[49] A better paper trail is not foolproof. Diamonds are sufficiently small and portable to make it unlikely that any regime of certificates or guarantees will ensure that diamonds originate in conflict-free areas. Indeed, it seems that the only sure-fire way to eradicate conflict diamonds is to see an end to the conflicts where the diamonds are found.[50]

DeBeers's Response to Conflict Diamonds

"Perhaps what is happening in Sierra Leone is our problem" announced one horrified industry insider after visiting a camp of amputees. "Perhaps it is our business."[51] The recent media attention that the blood diamonds have sparked has been a concern for De Beers. The company

has become the focus of the media attention and has tried to turn the negative associations with the re-launch of their 1948 campaign, *A Diamond is Forever.*

Many of the company's recent promotions have become the subject of guerilla marketing. In one case outdoor advertisements proclaiming "A diamond is forever" were replaced by "An amputation is forever." De Beers responded by providing the following testimony before the U.S. House Committee on Africa:

> De Beers knows all too well the deleterious effects that conflict and political instability often have on potential large-scale investors. Having spent hundreds of millions of dollars on advertising its product, De Beers is deeply concerned about anything that could damage the image of diamonds as a symbol of love, beauty and purity.[52]

While De Beers has long since boycotted the diamonds of Angola, Sierra Leone, and Liberia, and subsequently ceased all buying operations outside of its own African mines, it has raised concern that the recent negative campaigns could have crippling effects in legitimate markets. The company claims that consumer confidence could irreversibly be eroded and could lead to a consumer boycott which the company believes could ruin the economies of Botswana and Namibia. According to De Beers spokesperson Andrew Lamont, "There is a great danger of throwing the baby out with the bathwater. We have heard the siren calls that diamonds could go the same way as the fur trade. But diamonds don't kill people, people with guns kill people, and these guns are supplied from the West."[53]

Re-branding the Diamond Industry

Considering De Beers's struggles with price-fixing and antitrust allegations, association with the blood diamond trade, and shifting competitive position within the diamond industry as a whole, it is obvious that Nicholas Oppenheimer needs to carefully re-brand the diamond industry for entry in the U.S. retail market. De Beers has already undertaken several steps towards this end. The company was pulled out of Congo and Angola in the 1990's due to concerns about blood diamonds.

De Beers has tried to eliminate blood diamonds from their own stock, and has attempted to position itself as a crusader for the elimination of blood diamonds in the diamond market, and the seller-of-choice for concerned buyers. Still, De Beers will have a hard time combating critics of the Kimberley Process, or the reality that illegal blood diamonds are still finding their way into the diamond pipeline. Although only four percent of the world's diamond production can be considered conflict diamonds, the brutal images of amputee camps and slave-operated mines threaten to tarnish the image of the entire diamond industry.[54]

Discussion Questions

1. In your view, will De Beers be able to shake off the stigma of the blood diamond trade?
2. How can the company market high-end luxury goods without seeming insensitive to war-torn South Africa?
3. How can the American public ever forgive De Beers?
4. How likely is the negative publicity to persist? What effects do you think it will have?

5. How should De Beers handle the human rights' activists and their former ban in the U.S.?
6. As the diamond industry evolves, how could De Beers improve its relationships with its sightholders and competitors?
7. Succeeding in the U.S. court systems is only the first hurdle for De Beers. What other challenges lie ahead for them?

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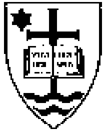
Kmart Corporation: Saving an American Icon.
Brown, J.; Lesser, D.; and O'Rourke, J. S. (editor)

Kmart's new CEO, Jim Adamson, the man responsible for turning around Burger King and Advantica Restaurants, the parent company of Denny's Restaurants, has a new challenge. He has been hired to save Kmart, who in recent years has failed to remain competitive with the likes of Target and Wal-Mart. Despite three CEOs in as many years, the downward trend has continued for the big-box retailer. Investors are counting on Adamson to find a way to convince the market that Kmart can recover. (A) case, 10 pp. (B) case, 4 pp. Case #02-12. (2002)



Eugene D. Fanning Center for Business Communication **02-12**
Mendoza College of Business
University of Notre Dame

Kmart Corporation: Saving an American Icon (A)

On January 22, 2002, James B. Adamson, the newly appointed Chairman of the Board of Directors at Kmart Corporation, filed for protection under Chapter 11 of the United States Bankruptcy Code. Adamson had been named Chairman only five days previous, and was the third person to hold the position in three years. This was indeed a time of great turmoil for the discount retailer, and marked a critical crossroads in its questionable future.

The landscape of retailing has changed over the course of the past decade and Kmart has yet to find its stride. While other big box retailers had positioned themselves to compete on price or higher-quality products, Kmart struggled to find a niche in the hyper-competitive retail sector. With its biggest competitors posting continued earnings growth, Kmart must swiftly make the right decisions to gain back its once large and loyal customer base.

History of Kmart Corporation

It has been more than a hundred years since Sebastian Spering Kresge opened a small five-and-dime store in downtown Detroit.[1] Little did he know that he would forever change the entire landscape of retailing, with the once five-and-dime beginning evolving into an empire of more than 2,100 stores.

The low prices of 5 and 10 cents in Kresge's first store appealed to shoppers, which allowed him to expand. He opened 85 stores by 1912, and garnered annual revenues of more than $10 million. The next few decades were tough for the average family. Financial depression and war left many families with very little. At this crucial moment in American history, Kresge's stores provided not only products at affordable prices, but jobs to support their families as well. This gained Kresge a huge customer base that stuck with them even when times got better. Kmart continued to follow the philosophy and strategy of low prices, which it believed would keep customers coming back.

This case was prepared by Research Assistants Jason Brown and David Lesser under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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To stay competitive, Kresge once again paved the path for many the future of retailing, creating an advertising campaign in newspapers to entice customers to come into the stores. This practice was a precursor to radio promotions, and then television advertisements, which began to air in 1968. It was clear by the end of the 50's that the retail industry had increased significantly in competition, and that the future of the company was dependent on good strategy. In 1959, Harry B. Cunningham was named President of Kresge. This was just the change that the company needed to spearhead a new direction. Cunningham opened the first Kmart store in Garden City, Michigan in 1962. This was something completely new, and a product of Cunningham's studies of other discount stores. Seventeen other stores were opened that year creating $483 million in corporate sales. This set off an explosion of Kmart openings over the course of the next decade. By 1977, Kmart stores generated 95 percent of S.S. Kresge Company's sales. It was then that it officially changed its name to Kmart Corporation.

In the 1980s, Kmart was famous for its continued low prices and the Bluelight Special. Kmart instituted the "Bluelight Special," which was an additional discount on designated items that would only be discounted for a few minutes. At the sight of a flashing blue light, shoppers would rush to see what was for sale, and buy it at an additional discount. This was a big hit with consumers. In 1987, Kmart introduced spokeswoman and consultant, Martha Stewart. This strategy of famous brands continued into the nineties with Kathy Ireland, Jaclyn Smith, Sesame Street, and Route 66.

James B. Adamson

During the 25 years prior to being named chairman of the Board of Directors of Kmart Corporation, Jim Adamson, a Gonzaga University graduate, had developed a reputation on Wall Street as an experienced leader with a knack for leading high-profile corporate turnarounds. After holding leadership positions at The GAP (1975-1984), B. Dalton Booksellers (1984-1986), and Target Stores (1986-1988), Adamson was named Executive Vice President of Marketing at bankrupt drugstore chain Revco Incorporated. Adamson is credited with helping turn around the troubled firm, which was later sold to drugstore giant CVS. In 1991, Adamson joined Burger King Corporation, where he had an immediate impact. After serving as President of the U.S.A Retail Division and Chief Operating Officer for the company's three operating business units, Adamson was promoted to President and Chief Executive Officer in July, 1993. Adamson focused on simplifying the menu and customer service, resulting in increased sales and profits. Restaurant financial analyst Mike Mueller described Adamson's efforts with high praise, "Basically, he turned around Burger King in a remarkably short time and did it with a single-minded focus on why it is that people go there."[2]

While Adamson had engineered two remarkable turnarounds, he was not thrust into the national spotlight until 1995 when he was named CEO of Flagstar Companies (renamed Advantica Restaurant Group in 1998), parent company of the troubled Denny's chain. Adamson took control of the company at a time when Denny's was, in Adamson's words, "a poster child of racism."[3] In fact, Flagstar had recently settled two high-profile class-action race discrimination lawsuits for $54 million, the largest public accommodations settlement ever. In 1997, Flagstar filed for Chapter 11 protection, a result accumulating a significant amount of debt, to fund a leveraged buyout. By 1998, the company reduced its debt burden by more than $1 billion and surfaced from bankruptcy as Advantica.

While the financial recovery engineered by Adamson was a significant accomplishment, it was overshadowed by his transformation of the company's culture and beliefs. Adamson was honored by the National Association for the Advancement of Colored People with its Corporate CEO Achievement Award, CBS news magazine *60 Minutes* aired a comprehensive feature on Advantica's corporate diversity programs, and *Fortune* placed Advantica on top of its list of "America's 50 Best Companies for Minorities" in both 2000 and 2001.[4]

Competitive Landscape

The retailing industry dates back to as long as man has existed, and has always been marked by fierce competition. The current retailing landscape is no different. Over the course of the 20th century, there have been a few names that have emerged as the predominant brands in the discount-retailing market. Kmart has been at the top of that list for the majority of its existence. It was around much before the inception of Wal-Mart and Target, which are Kmart's biggest rivals.

Wal-Mart Stores, Inc.

Wal-Mart, founded by Sam Walton, opened its first store in Rogers, Arkansas, in 1962. Motivated by Walton's commitment to customer satisfaction and "Everyday Low Prices," Wal-Mart has risen to tremendous heights of success.[5] Wal-Mart is the largest retailer in the world, with annual sales of $218 billion. The company has nearly 3500 facilities and employs over 3.5 million people. It has carved out a niche as THE low price retailer with clean stores and friendly service.

Target Corporation

The first Target store opened on May 1, 1962, in Roseville, Minnesota. It was owned by the Dayton Corporation. With annual sales of $30 billion, today there are nearly 1000 Target stores operating in 46 states, employing approximately 214,000 people. After a shift in strategy and identity in the mid 80's, Target successfully transformed its image into the place to find the latest trends at the best prices. This provides Target with a clear point of differentiation.[6] They aspire to be the best place to buy high-quality products at reasonable prices in an environment that is fun. According to USA Today, Target is "in," and in that they could not be happier.[7]

Kmart was the company that everyone chased in terms of stealing market share for many decades. It was not until 1990 that Wal-Mart overtook Kmart to become the nation's number one retailer.[8] Wal-Mart had leveraged its operations and distribution center to maximize its ability to offer "everyday low prices." Its heap prices, buying clout, and efficient inventory and distribution systems have enabled it to put tremendous competitive pressures on all retailers.[9] The Wal-Mart brand is low prices, and they can do it better than anyone.

Wal-Mart's domination of the competition on price has not been tremendously harmful to Target because of Target's strategy to compete on selection. Target has worked hard to carefully craft a brand that is associated with designer products, and attracts a wealthier customer, while still offering discount pricing.[10] This trendy nature of Target's image has allowed consistent growth in revenue and profit over the course of the past five years. Kmart, however, has failed to develop its niche market.

Importance of Brand

Brand awareness, recognition, management, and strategy are vitally important in retailing. It is a promise of experience and a guarantee of consistency. The experience and trust associated with a brand is what generates customer loyalty, which leads to a long-competitive advantage. On the other hand, if a customer has a negative experience with a product or store, he/she may never come back.

Retailing industries rely heavily on the consumers' consistent choice of brand, and thus the development of a relationship with the customer through the brand is essential for future growth. Throughout the 90's, Kmart has struggled with its brand. The essential issue for Kmart to compete in the long run is to carve out a niche that it can dominate. This can only be done through well-defined strategy and a branding campaign that will compliment the vision.

Kmart Corporation: Key Leaders

Joseph E. Antonini: He served as Chairman, President, and Chief Executive officer from 1987 to 1995. Under his leadership, Kmart acquired several companies in a strategy to diversify its business, including: PACE Membership Warehouse (1989), The Sports Authority (1990), and 90% stake in OfficeMax (1991), and Borders Group Incorporated (1992).[11]

In 1995, suffering from falling earnings and a brush with bankruptcy, Kmart announced its decision to make initial public offerings (IPOs) of its interests in The Sports Authority, OfficeMax, and Borders Group Inc. IPO's for 75 percent of Office Max and 70 percent of The Sports Authority are successfully completed.[12]

Floyd Hall: After the IPO's for The Sports Authority and OfficeMax were placed, in 1995 Hall replaced Antonini as Chairman, President, and Chief Executive Officer. Hall has successfully completed the IPO's for Borders Group Inc. and sold Kmart's remaining interests in OfficeMax and The Sports Authority. In addition, he also closed 214 Kmart stores.[13]

During the next several years, Hall launched several innovative product offerings. In 1996, Kmart introduced a private label credit card, followed in 1997 by a new Martha Stewart Everyday line of bed and bath fashions. In 1998, Kmart purchased 45 former Venture stores and converted them to Big Kmart stores, enabling the company to expand into Texas. By year-end, the company opened or converted 1,245 Big Kmart Stores, representing 62 percent of the chain's stores. These decisions are a part of Hall's "transition from a turnaround to a growth company." In 1999, Hall speculated that Kmart will open or expand an estimated 400 stores in the following five years.

The expansion and growth strategy works well initially, but soon begins to suffer significant problems as competition multiplies. Even the newest Kmart locations felt the impact as problems mount for the Troy, MI, based retailer. On a grand opening day in 1998, a warehouse-management system in Chicago crashed, leaving new stores with insufficient merchandise during their first weeks of operation.

Charles C. Conaway: In May 2000, Hall retired as Chairman, President, and CEO. Charles C. Conaway, the President of drugstore chain CVS, was elected Chairman and CEO. Soon after

succeeding Hall, Conaway, an operations expert, announced a restructuring plan designed to increase value chain and information system productivity. 72 stores were closed, including a group of former Venture stores, affecting approximately 5,000 employees. Earnings for the first half of 2000 were down 47%, and Kmart took pre-tax charge of $375 million to close the stores. In July 2000, Conaway announced a $1.7 billion investment in its supply chain and technology infrastructure. Conaway changed the Kmart growth strategy to focus on SuperCenters, which stock both groceries and general merchandise. According to Larry Kellar, Kmart's Vice President of Real Estate, expansion slowed because SuperCenters are more expensive to construct than traditional Kmart stores.[14]

Another significant change Conaway brought to Kmart was a complete overhaul of top management. Conaway brought in 500 outsiders from Wal-Mart, Sears, and Coca-Cola. Among the new executives was Mark Schwartz, an ex Wal-Mart exec, who was hired as Executive Vice President of Store Operations. Six months later, Schwartz was promoted to President and Chief Operating Officer. This move allowed Conaway to focus on long-term strategy and Schwartz to oversee the day-to-day operations of the company.[15]

In 2001, the management team developed a new strategy for Kmart: compete with Wal-Mart on price. Conaway made a series of strategic alliances to increase Kmart's bottom line. Kmart signed an exclusive, $4.5 billion arrangement with Fleming to be the sole food and consumables distributor for Kmart and Kmart SuperCenter stores. Kmart also signed a deal with Disney to design, produce, and sell an exclusive line of children's clothing. In addition to signing a long term agreement with Martha Stewart Omnimedia, Inc., Kmart also expanded the Martha Stewart Everyday brands to include two new collections: Martha Stewart Everyday Keeping (storage products) and Martha Stewart Everyday Decorating (home décor products). The company also established a long-term relationship with JOE BOXER to provide merchandise exclusive to Kmart. These new agreements were complimented by a new marketing strategy that focused on the "Blue Light Special," which was revived after a 10-year absence.[16]

Despite the new growth strategy, infrastructure, and strategic alliances, Kmart continued to experience serious problems. Analysts were not confident that Fleming was a suitable partner, and complained of delivery delays and insufficient warehousing facilities. Also, many outsiders were concerned that Kmart's strategy was unsustainable. Kmart investor, Ronald W. Burkle, a billionaire buyer and seller of supermarket chains (and an 8.7% shareholder in Fleming), was especially alarmed. He "became concerned that they had a Wal-Mart strategy rather than a supercenter strategy" and "became concerned that they were opening supercenters in the hometown of Wal-Mart's chairman."[17] In addition to distribution problems, Kmart is facing a significant challenge within top management: a high turnover rate among executives. Several key officers have left the company within months of arriving, further complicating an already difficult strategy (see Appendix I for detailed information).

A Chronology of Events

The events of the six months prior to Kmart's filing for bankruptcy had a profound effect on the company's financial position. A chronology of these events is summarized in the paragraphs that follow.

August 2001: Schwartz increased the number of items on which Kmart is competing with Wal-Mart on price from 10,000 to 30,000. Anticipating a large increase in the number of shoppers, inventories increased $400 million to $8.3 billion. However, the expected increase in sales did not materialize.[18]

September 2001: Kmart announced plans to close several distribution centers.

October 11, 2001: Kmart September same store sales fell 1.8% from the previous year.

November 8, 2001: Kmart October same stores sales fell 4.4 percent.

November 27, 2001: Kmart reported loss of $224 million on lower sales for the third-quarter, citing reduced advertising, and charges from measures taken to revamp its distribution network.[19] According to Merrill Lynch, Kmart's third-quarter sales per square foot were $243, significantly lower than the $410 per square foot achieved by Wal-Mart. Also, Kmart's selling, general, and administrative expenses as a percentage of sales for the third-quarter were 22.7%, compared to Wal-Mart's 17.3%.[20]

December 6, 2001: Kmart November same stores sales fell 2.6 percent.

December 14, 2001: Moody's cut $4.7 billion in Kmart debt to junk status based on lower than expected November sales.

January 2, 2002: Prudential Securities analyst, Wayne Hood, recommended selling Kmart stock and said he would not be surprised at bankruptcy filing if trends do not improve. Kmart stock closed down 13 percent at $4.74.

January 10, 2002: Kmart reported December same store sales fell one percent, warned that earnings will be below expectations, and disclosed it is in negotiations with lenders to acquire supplemental financing. Kmart stock closed at $4.20.

January 11, 2002: Moody's cut Kmart's debt rating, stock closed at $3.30.

January 14, 2002: Standard & Poor's and Moody's cut debt ratings again. The Kmart Board of Directors met to discuss financial options, but did not reveal what was discussed at the meeting. Kmart stock closed at $2.84.

January 15, 2002: The Board of Directors met again, and continued to maintain silence. Standard & Poor's announced it is removing Kmart from the S&P500. Kmart stock closed at $2.45.

January 16, 2002: Moody's and Standard & Poor's cut debt ratings again, bonds slid to level which could indicate that bankruptcy is inevitable. The Board of Directors remained quiet. Kmart stock closed at $1.60.[21]

January 17, 2002: The Board of Directors named Jim Adamson, a board member since 1996, as its chairman; Conaway retained his position as CEO. Schwartz left the company.

January 21, 2002: Believing the retailer may file for bankruptcy, suppliers postponed shipments until Kmart communicated a recovery plan. An informal survey of 15 to 20 Kmart suppliers conducted by retail consultant Burt Flickinger found that one-third had ceased shipping to Kmart, and another third were postponing shipments until they heard from the company.[22]

January 22, 2002: Kmart petitioned a federal judge for reorganization under Chapter 11 of the United States Bankruptcy Code. In its filing, Kmart disclosed that it owed Fleming $75.8 million.

Questions

1. Who are the key stakeholders, and how might each be affected by the bankruptcy?
2. How should Kmart deal with the financial implications of filing for bankruptcy?
3. How does Kmart prevent the loss of market share to competing chains during the bankruptcy?
4. How should Kmart establish a brand strategy which will allow them to compete effectively with other retailers?

5. What should Jim Adamson's first steps be to reposition the KMart?

Appendix I

Who's Running the Show?

Kmart CEO Chuck Conaway brought in a raft of outsiders but produced little to show for it. Among the miscues:

NAME & TITLE	DESCRIPTION	DEPARTURE
Mark S. Schwartz, 40,President and Chief Operating Officer	A Wal-Mart vet, he became president in March, 2001. Insiders blamed him for the pricing debacle.	He left 10 months later.
Brent Willis, 40, Chief Marketing Officer	The flamboyant and outspoken former Coke executive launched a new BlueLight brand.	He lasted fewer than five months, leaving in May 2001.
Jeffrey Boyer, 43, Chief Financial Officer	The straitlaced former Sears exec clashed with Schwartz, insiders say.	His exit on November 9, 2001, six months after arriving, rattled investors.
Randy Allen, 55, Chief Information Officer	The former mentor to Conaway at Deloitte & Touche, she came in to update Kmart technology.	Retires Spring 2002. She has been reassigned Chief Diversity Officer.

Source: BusinessWeek Online

Kmart Corporation, Income Statements 1997-2001

Year Ended	1/29/97	1/28/98	1/27/99	1/26/00	1/31/01
Sales	31,437	32,183	33,674	35,925	37,028
License Fee/Rental	—	—	—	—	—
Equity in Affiliate	—	—	—	—	—
Total Revenue	**31,437**	**32,183**	**33,674**	**35,925**	**37,028**
Cost of Sales	24,390	25,152	26,319	28,111	29,658
Sell./Gen./Admin.	6,274	6,136	6,245	6,514	7,415
Advertising	—	—	—	—	—
Restructure/Unusual	—	114	19	—	—
Other	(10)	—	—	—	—
Total Expenses	**30,654**	**31,402**	**32,583**	**34,625**	**37,073**
Operating Income	**783**	**781**	**1,091**	**1,300**	**(45)**
Interest Expense	(453)	(363)	(293)	(280)	(287)
Other, Net	—	—	—	—	—
Income Before Taxes	**330**	**418**	**798**	**1,020**	**(332)**
Income Taxes	68	120	230	337	(134)
Income After Taxes	**262**	**298**	**568**	**683**	**(198)**

Preferred Dividends	(31)	(49)	(50)	(50)	(36)
Interest Adjustment	—	—	—	—	—
Net Available to Common, Before Extraordinary Items	**231**	**249**	**518**	**633**	**(234)**
Discontinued Ops.	(451)	—	—	(230)	—
Extraordinary Item	—	—	—	—	—
Accounting Change	—	—	—	—	—
Net Available to Common, Including Extraordinary Items	**(220)**	**249**	**518**	**403**	**(234)**
Average Shares (basic)	483.60	487.10	492.10	491.70	482.80
Earnings Per Share (basic), Before Extraordinary Items	**0.478**	**0.511**	**1.053**	**1.287**	**(0.485)**
Earnings Per Share (basic), Including Extraordinary Items	**(0.455)**	**0.511**	**1.053**	**0.820**	**(0.485)**
Average Shares (diluted)	486.10	491.70	564.90	561.70	482.80
Dilution Adjustment	—	—	50	50	—
Earnings Per Share (diluted), Before Extraordinary Items	**0.475**	**0.506**	**1.006**	**1.216**	**(0.485)**
Earnings Per Share (diluted), Including Extraordinary Items	**(0.453)**	**0.506**	**1.006**	**0.807**	**(0.485)**
Common Dividend Share	—	—	—	—	—

Wal-Mart Stores Incorporated, Income Statements for 1998-2001

Year Ended				
	1/31/98	**1/31/99**	**1/31/00**	**1/31/01**
Net Sales	117,958	137,634	165,013	191,329
Other Income	1,341	1,574	1,796	1,966
Rental Income	—	—	—	—
Total Revenue	**119,299**	**139,208**	**166,809**	**193,295**
Cost of Sales	93,438	108,725	129,664	150,255
General & Admin.	19,358	22,363	27,040	31,550
Debt Interest	555	529	756	1,095
Capital Lease Exp.	229	268	266	279
Total Expenses	**113,580**	**131,885**	**157,726**	**183,179**
Operating Income	**5,719**	**7,323**	**9,083**	**10,116**
Cost of Sales	—	—	—	—
General & Admin.	—	—	—	—
Debt Interest	—	—	—	—
Capital Lease Exp.	—	—	—	—
Income Before Taxes	**5,719**	**7,323**	**9,083**	**10,116**

Income Taxes	2,115	2,740	3,338	3,692
Income After Taxes	**3,604**	**4,583**	**5,745**	**6,424**
Minority Interest	(78)	(153)	(170)	(129)
Net Available to Common, Before Extraordinary Items	**3,526**	**4,430**	**5,575**	**6,295**
Accounting Change	—	—	(198)	—
Net Available to Common, Including Extraordinary Items	**3,526**	**4,430**	**5,377**	**6,295**
Average Shares (basic)	4,516.00	4,464.00	4,451.00	4,465.00
Earnings Per Share (basic), Before Extraordinary Items	**0.781**	**0.992**	**1.253**	**1.410**
Earnings Per Share (basic), Including Extraordinary Items	**0.781**	**0.992**	**1.208**	**1.410**
Average Shares (diluted)	4,533.00	4,485.00	4,474.00	4,484.00
Dilution Adjustment	—	—	—	—
Earnings Per Share (diluted), Before Extraordinary Items	**0.778**	**0.988**	**1.246**	**1.404**
Earnings Per Share (diluted), Including Extraordinary Items	**0.778**	**0.988**	**1.202**	**1.404**
Common Dividend Shares	0.1350	0.1550	0.2000	0.2400

Figures from annual income statement. Figures in millions of U.S. Dollars except shares outstanding. Figures in parentheses are losses. Net available to common refers to net income available to common shareholders, which is net income minus profit used to pay dividends on preferred stock, when applicable.

Target Corporation, Income Statements 1998-2001

Year Ended	1/31/98	1/30/99	1/29/00	2/3/01
Revenues	—	—	—	—
Sales	27,019	30,203	33,212	36,362
Credit Revenues	468	459	490	541
Total Revenue	**27,487**	**30,662**	**33,702**	**36,903**
Cost of Sales	18,944	21,085	23,029	25,295
Selling/Admin.	6,108	6,843	7,490	7,900
Credit Expense	—	—	—	290
Depreciation/Amort.	693	780	854	940
Interest Expense	416	398	393	425
Non-Income Taxes	—	—	—	—
Repositioning Charge	—	—	—	—
Total Expenses	**26,161**	**29,106**	**31,766**	**34,850**
Operating Income	**1,326**	**1,556**	**1,936**	**2,053**
Cost of Sales	—	—	—	—
Selling/Admin.	—	—	—	—
Credit Expense	—	—	—	—
Depreciation/Amort.	—	—	—	—

Interest Expense	—	—	—	—
Non-Income Taxes	—	—	—	—
Repositioning Charge	—	—	—	—
Income Before Taxes	**1,326**	**1,556**	**1,936**	**2,053**
Income Taxes	524	594	751	789
Income After Taxes	**802**	**962**	**1,185**	**1,264**
Preferred Dividend	(20)	(20)	(18)	—
Net Available to Common, Before Extraordinary Items	**782**	**942**	**1,167**	**1,264**
Accounting Change	—	—	—	—
Discontinued Ops.	—	—	—	—
Extraordinary Item	(51)	(27)	(41)	—
Net Available to Common, Including Extraordinary Items	**731**	**915**	**1,126**	**1,264**
Average Shares (basic)	872.20	880.00	882.60	903.50
Earnings Per Share (basic), Before Extraordinary Items	**0.897**	**1.070**	**1.322**	**1.399**
Earnings Per Share (basic), Including Extraordinary Items	**0.838**	**1.040**	**1.276**	**1.399**
Average Shares (diluted)	927.40	934.60	931.40	913.00

Dilution Adjustment	7	12	14	—
Earnings Per Share (diluted), Before Extraordinary Items	**0.851**	**1.021**	**1.268**	**1.384**
Earnings Per Share (diluted), Including Extraordinary Items	**0.796**	**0.992**	**1.224**	**1.384**
Common Dividend Share	0.1650	0.1800	0.2000	0.2100

Figures from annual income statement. Figures in millions of U.S. Dollars except shares outstanding. Figures in parentheses are losses.

Net available to common refers to net income available to common shareholders, which is net income minus profit used to pay dividends on preferred stock, when applicable.

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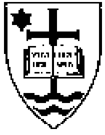
Kraft Foods, Inc.: The Cost of Advertising on Children's Waistlines
Hwa, P.; Housman, T.; and O'Rourke, J. S. (editor)

When Kraft Foods executives met in 2004 with an advisory panel to evaluate their food advertising to children, they were shocked and upset by criticisms of sample advertising and decided to implement some food marketing reforms. In January 2005, the company announced that it would stop advertising to children under the age of 12, but joined a lobbying group to keep the government from regulating food marketing to children a few weeks later. Kraft is known for providing quality in food and beverage products to more than 99% of U.S. households, but today, with health conscious consumers who blame the rise in children's obesity on food marketing, Kraft is under fire for making less healthy foods and targeting promoting them to children. The challenge for Kraft is to communicate a commitment to a healthy lifestyle and to stricter marketing standards for children while maintaining profitability. 6pp. Case #06-13. (2006).



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Mendoza College of Business
University of Notre Dame

Kraft Foods, Inc.:
The cost of advertising on children's waistlines

The room fell silent as Dr. Ellen Wartella, Dean of the College of Communications at the University of Texas at Austin, gave Kraft executives her opinions on a presentation they had just made regarding Kraft and advertising to children. Wartella characterized Kraft's online marketing as *"indefensible"* and concluded that Kraft's claim that it was not advertising to children under the age of six was *"at best disingenuous and at worst a downright lie."* [1] The executives in the room were visibly shaken by her comments.

In late 2003, Kraft formed the Worldwide Health & Wellness Advisory Council, comprising 10 nutritionists and media experts, including Wartella, to investigate allegations that Kraft had been knowingly advertising unhealthy foods and to help address the rise in obesity, among other health issues.[2] The pressure for Kraft to review its advertising policies came amidst increasing criticism from congressional panels, parent groups and other concerned citizens, that food corporations, such as Kraft Foods and McDonald's Corporation, have been knowingly targeting young children (up to age 12) in their advertising campaigns. The concern surrounding childhood obesity stems from statistics showing a 200 percent increase in childhood obesity since the 1980s. Between the 1960s and the 1980s, the percentage of overweight children hovered around 6 percent, but in the last two decades, this rate has leapt to16 percent.[3] Despite this, Kraft decided to keep marketing to children under 12. One Kraft executive admitted, "We didn't want to give up the power of marketing to kids."[4]

This "power" is villainizing the company, however. Currently, Kraft is a trusted brand, but that reputation is already slipping. According to the Reputation Quotient study conducted in 2005 by research firm Harris Interactive, Kraft is ranked in the 50th slot.[5] While this is a small drop from the 48th spot Kraft held the previous year, it is a far distance from the 8th position occupied by competitor General Mills. This survey is based on consumer perception of various factors, including a company's quality of products and services, social responsibility, and vision and leadership. Depending on what Kraft chooses to do about its food marketing issue, the company may rise higher in subsequent the Reputation Quotient studies, or it may fall further down.

This case was prepared by Research Assistants Pauline Hwa and Timothy Housman under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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Kraft Foods is a company that values quality and safety in its products. One of Kraft's key strategies is to "build superior consumer brand value" through "great-tasting products, innovative packaging, consistent high quality, wide availability, helpful services and strong brand image."[6] With products in more than 99 percent of U.S. households, Kraft certainly has earned the trust of its consumers.[7] With the recent feedback from the Health and Wellness Advisory Council and public concerns about childhood obesity due to aggressive food marketing, however, Kraft must take action before it loses consumers' loyalty and trust in its products.

Kraft Foods, Inc.

Kraft Foods, Inc., the largest food and beverage company in North America, has grown considerably from its humble beginnings in 1903. With only $65, a rented wagon, and a horse named Paddy, J. L. Kraft started the company by purchasing cheese from a wholesale market and reselling it to local merchants.[8] These cheeses were packaged with Kraft's name. A decade later, Kraft improved the cheese by processing the product, which prolonged its shelf life. The processed cheese became such a success that a patent for the "Process of Sterilizing Cheese and an Improved Product Produced by Such Process" was issued to Kraft in 1916.[9] Over the years, the company went on to create other new cheese products that are familiar to homes today including *Velveeta* and *Cheez Whiz*, as well as expanding beyond cheese to introduce salad dressings, packaged dinners, barbecue sauce and other products.

Tobacco giant Philip Morris acquired General Foods Corporation in 1985 and then Kraft three years later for $12.9 billion.[10] Through the acquisition of these two major food companies, Philip Morris formed Kraft General Foods, which put products such as *Velveeta*, *Post* cereals, *Oscar Mayer*, and *Jell-O* pudding all under the same food division. Kraft General Foods further expanded its household reach by acquiring Nabisco, home of well-known brands including *Oreo* cookies, *Ritz* crackers, and *Planters* nuts, in 2000. The next big step for Kraft occurred in 2001 when Philip Morris conducted an Initial Public Offering of Kraft's shares (NYSE: KFT). The following year, Philip Morris shareholders accepted a proposal to change the company's name to Altria Group. As of January 27, 2003, Altria Group became the parent company to Kraft Foods.

Kraft's Troubles in Advertising

There are many reasons why Kraft should be concerned about further criticism of its advertising practices. As a leader in the food industry, Kraft is both large and very visible, and the company has experienced repeated controversy and criticism of its advertising campaigns over the years. A few recent issues include:

- Kraft's advertisement of Post cereal in *National Geographic Kids* was not focused on the food but rather on the premium of Postokens instead, which is a violation of The Children's Advertising Review Unit's Self-Regulatory Guidelines for Children's Advertising.[11]

- Kraft had previously announced its intention to reduce portion size and then later backed out of that commitment, saying that consumers wanted to choose their portion sizes for themselves.[12]

- Kraft pulled an *Oreo* commercial directed at teenagers that a promoted "slothlike" lifestyle because the company realized that such an ad would hurt its image and instead opted for promoting "a more active lifestyle."[13]

Obesity in the Courts: The McLawsuit

The food industry became visibly worried about food marketing and childhood obesity in 2002. It was then that McDonald's Corporation faced a lawsuit, *Pelham v. McDonald's Corporation*, in which the company was charged with marketing food products that contribute to the rise of obesity in children and teenagers. Although the judge threw out the class-action lawsuit against McDonald's, he made it very clear that he supports the plaintiffs' position. He encouraged them to redraft and refile the suit with stronger evidence, and went so far as to provide advice on what to look for. One of his recommendations was to show how McDonald's advertising campaigns encouraged over-consumption by promoting its food products for "everyday" eating.[14]

McDonald's Corporation still stands behind their standards in marketing to children. According to David Green, Senior Vice President of Marketing for McDonald's, even though 20 percent of McDonald's commercials are targeted at children, the company follows a strict set of guidelines. The Golden Arches Code, according to company spokesmen, "conforms with the major network Broadcasting Standards and the guidelines of the Children's Unit of the National Advertising Division Council of Better Business Bureaus, Inc., as well as establishing additional standards applicable only to McDonald's advertising."[15] Green says that the Golden Arches Code "states that in our advertising we should never promote the sale of food items to children that might be too large for them to consume realistically at one sitting nor should children be depicted as coming to McDonald's on their own, as they must always be accompanied by an adult."

A month prior to *Pelham v. McDonald's Corporation*, Sam Hirsch, the attorney who filed the suit for the overweight children and teenagers, had filed another class-action suit against McDonald's and other leading fast food establishments.[16] This suit was filed not only against McDonald's Corporation, but also Burger King, Kentucky Fried Chicken, and Wendy's. Observers speculated the driving force behind these two suits was the prospect of a large financial settlement. Hirsch remained adamant about his clients' intentions, saying "we are not looking to get rich from a large money settlement. We are proposing a fund that will educate children about the nutritional facts and contents of McDonald's food."[17] These suits intensified fears in the food industry of a future of "tobacco-like" litigation against restaurants and food manufacturers.[18]

In January 2005, the 2nd U.S. Circuit Court of Appeals reinstated claims that McDonald's falsely advertised the health benefits of its fast food, a violation of the New York's Consumer Protection Act.[19] Unquestionably, the plaintiffs had the full attention of quick service restaurant operators and food manufacturers worldwide.

Studies Show . . .

Fewer Ads. In July 2005, the Federal Trade Commission (FTC) released its findings that children today watch fewer food commercials than they did almost three decades ago. Children today watch 13 food advertisements on television per day, a significant reduction from the 18

television commercials per day in 1977.[20] The FTC also reported that kids today are exposed to fewer ads for cereal, candy and toys but more ads for restaurants and fast-food chains, other television shows, movies, video games and DVDs. Wally Snyder, president of the American Advertising Federation, believed this study was proof that food marketing is not culpable for the rise of obesity in children, which he blamed on a "lack of exercise and moderation in the diet."

More Ads. A year later in 2004, the Kaiser Family Foundation released a study with contrary information, claiming "the number of ads children see on TV has doubled from 20,000 to 40,000 since the 1970s, and the majority of ads targeted to kids are for candy, cereal and fast food."[21] The study suggested that this increase in food advertising was correlated to the rise in obesity in children aged 6 to 11. In 1963-1970, only 4.2 percent of children in this age group were listed as overweight compared to 1999-2000, when the number spiked to 15.3 percent.

The Tie-Breaker. Perhaps because of the conflicting findings or because of rising concerns about food marketing to children and its effects, Congress requested a study of its own from the National Academy of Sciences, which was created by the federal government to advise on scientific issues.[22] In December 2005, The Institute of Medicine (IOM), a private, non-governmental division of the National Academy of Sciences, released the latest study on the subject, *Food Marketing to Children and Youth: Threat or Opportunity?* Based upon individual findings, the IOM committee responsible for the study came to the following five conclusions:[23]

Broad Conclusions

- Along with many other intersecting factors, food and beverage marketing influences the diets and health prospects of children and youth.
- Food and beverage marketing practices geared to children and youth are out of balance with healthful diets, and contribute to an environment that puts their health at risk.
- Food and beverage companies, restaurants, and marketers have underutilized potential to devote creativity and resources to develop and promote food, beverages, and meals that support healthful diets for children and youth.
- Achieving healthful diets for children and youth will require sustained multisectoral, and integrated efforts that include industry leadership and initiative.
- Public policy programs and incentives do not currently have the support or authority to address many of the current and emerging marketing practices that influence the diets of children and youth.

The study also suggested there was "strong evidence" that food marketing influences the preferences, purchase requests, and short-term consumption of children between the ages of 2 and 11. This information combined with the fact that a "preponderance of television food and beverage advertising relevant to children and youth promotes high-calorie and low-nutrient products, it can be concluded that television advertising influences children to prefer and request high-calorie and low-nutrient foods and beverages."[24] Wartella, who served not only on Kraft's advisory council but also as a member of the committee that produced the IOM study, said "We

can't any more argue whether food advertising is related to children's diets. It is."[25]

The Institute of Medicine's recommendations for the food industry included promoting and supporting healthier products and working with government, public health, and consumer goods "to establish and enforce the highest standards for the marketing" of food and beverage products to children.[26] In general, many food companies had already started programs to promote healthier products. The problem was with the latter recommendation in marketing standards. IOM believed this meant licensed characters should be "used only for the promotion of foods and beverages that support healthful diets for children and youth."[27] Most companies, Kraft included, were reluctant to give this up. Licensed characters were typically familiar faces to children. How does a company replace a spokesperson or promoter that already has the trust of the audience, is affordable, and will never get into any real-life trouble?

The Announcement

In January 2005, Kraft announced that it would stop advertising certain products to children under 12. These products include regular *Kool-Aid* beverages, *Oreo* and *Chips Ahoy* cookies, several *Post* children's cereals and some varieties of its *Lunchables* lunch packages.[28] These favorites will still be found in stores, but Kraft said it will no longer be targeting children with television, radio, and print ads for these products. The initial cost of implementing these new guidelines included an estimated $75 million in lost profits, though this figure continued to change several times.[29] While this estimate may seem high, Michael Mudd, a member of Kraft's obesity strategy team said, "If the tobacco industry could go back 20 or 30 years, reform their marketing, disarm their critics, and sacrifice a couple of hundred million in profits, knowing what they know today, don't you think they'd take that deal in a heartbeat?"[30] Kraft, learning the lessons of Philip Morris, was eager for the deal.

Shortly after Kraft made its announcement, however, the company joined competitors General Mills and Kellogg to form a lobbying group to keep the government from regulating food marketing to children. The group's mission statement states its belief that "there is not a correlation between advertising trends and recent childhood obesity."[31] General Mills had always argued for this point. In fact, instead of stopping ads to children, Tom Forsythe, General Mills vice president, announced that the company "launched a vigorous defense of cereal," to support its health benefits.[32] The company also decided to promote "balanced moderation and exercise," believing that such lifestyle choices affect obesity as much as food selection.[33] Thus, General Mills' participation in this group was expected, but for Kraft, joining this group appeared to be a hypocritical move. David S. Johnson, Kraft's Chief of North America, defended the action, "We believe self-regulation of the marketing of food products can and does work, and we are collaborating with the industry to strengthen efforts in this area."[34]

Conclusion

Since the announcement, Kraft has still struggled with child advertising and obesity issues. Margo G. Wootan, Director of Nutrition for the Center for Science in the Public Interest, has called Kraft's new marketing plan only "a really good step forward."[35] The problem is there will always be critics who will demand for more. For instance, although Kraft has taken a huge leap in minimizing television, radio, and print ads, the company has yet to act on Wartella's criticism for its online advertising.

Kraft has spent a great deal of time to respond to critics and potential threats of government regulation. What Kraft really needs at this point is to put the focus back on its customers and communicate with them. The question is how to go about doing this without appearing to go back on its promises of not saturating the market with advertisement.

Questions

1. What are the critical issues of this case? Who are the stakeholders (primary, secondary and indirect)?

2. What should Kraft do to maintain the already declining trust of the consumers?

3. Can the public believe in Kraft's commitment to control food marketing to children?

4. What are Kraft's options concerning its marketing tactics?

5. What media should Kraft use to communicate to its customers?

6. Who should Kraft's key audience be: critics, agencies, parents, children, non-parent adults, or others? Should the company even target a particular audience?

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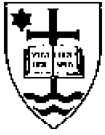
McDonald's Corporation: Who Is Responsible for America's Obesity?
Wysocki, J.; Denhardt, A.; and O'Rourke, J. S. (editor)

McDonald's Corporation, the leader among U.S. franchise quick-service restaurants, found in 2002 that its reputation for steady growth and strong profitability were slipping. At the same time, much of the market for fast food in North America began migrating to lower-calorie, healthier alternatives. Fast food and social trend critics began blaming quick service restaurants for a wide range of health problems, including obesity and weight-related illnesses. New York attorney Samuel Hirsch filed a class action suit on behalf of obese and overweight children against McDonald's, alleging that the fast-food chain "negligently, recklessly and/or intentionally" marketed food products that are "high in fat, salt, sugar, and cholesterol" while failing to warn of those ingredients' links to "obesity, diabetes, coronary heart disease, high blood pressure, strokes, elevated cholesterol intake, related cancers," and other conditions. McDonald's reputation, profitability, and future are at stake as they prepare in 2003 to defend themselves, their products, and their business. 10 pp. Case #03-06. (2003)



Eugene D. Fanning Center for Business Communication
Mendoza College of Business
University of Notre Dame

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McDonald's Corporation:
Who Is Responsible for America's Obesity?

As Walt Ryker walked into his Oak Brook, Illinois office on a warm summer day in 2002, he could almost feel the ketchup moving through his veins. Ryker is a self-described "hamburger guy." He hoped this affinity for the product and business model would help him in his new role as head of Corporate Communication at McDonald's. He would need all that and more as he maneuvered through the turbulent times ahead. McDonald's would soon face a lawsuit in which the plaintiff would allege the fast food company was the cause of his obesity. Ryker, of course, was completely aware of health trends, particularly in the United States, and he knew that obesity rates were spinning out of control. The pending litigation, in this light, was a major cause for concern, and drew a parallel to the lawsuits that the tobacco industry had faced just a few years earlier. While Ryker considered how the Golden Arches could maintain their glimmer, he did not fully anticipate further difficulties the company would face in the months ahead.

McDonald's Corporation, long known for remarkable growth and steady profits, had recently experienced slipping sales and a declining share price. In 2002, full-sized McDonald's restaurants took in about $22,000 less than the previous year, and with approximately 30,000 outlets worldwide, these numbers were not insignificant.[1] By 2003, shares had recently hit a ten-year low at $12.12, reflecting the rather sluggish economy, but also unmistakably showing the company that consumers were not happy about McDonald's meals.

As financials grew bleak for the company, plans were put in place to cut several hundred administrative jobs and to reduce capital spending budgets, delaying renovation plans and postponing much new growth. The company reported its first quarterly loss ever for the last three months of 2002. The $344 million loss forced the company to focus on its troubled core business and to get back to Ray Kroc's vision.

McDonald's made numerous attempts to improve its core business and attract more customers, though several of these efforts served only to heighten problems for the company. The "Made for You" system of customized cooking effectively crippled service time, which, in the fast food industry, left many customers frustrated. In October of 2002, the company

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This case was prepared by Research Assistants Julia Wysocki and Allison Dennhardt under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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attempted to bring customers into the restaurants through significant price discounting with the Dollar Menu. The menu, though, was been blamed for eroding profits.[2] As the company continued to experience declining sales, these initiatives, in effect, caused more problems than they solved, creating disgruntled customers, unhappy franchisees, and eroded profits.

Although the fast food industry had experienced a slowdown in the United States, McDonald's was also struggling to manage customer perception. Competitors were serving McDonald's customers with better food and service, and according to the University of Michigan's American Customer Satisfaction index, "McDonald's has finished dead last among fast-food restaurants every year since the survey began in 1992." [3]

The company responded by attempting to improve its quality, value, and service, though these were still at miserable lows relative to the industry. The McDonald's 800 number confirmed "rude service, slow service, unprofessional employees, and inaccurate service," and that restaurants were meeting the speed-of-service standard only 46% of the time.[4] Both the company and franchisees were worried that those figures would continue to push customers toward competitors and would, in effect, threaten the brand equity that the Golden Arches held. As McDonald's struggled with these perceptions, the company was also fighting to hold its place as a quintessential part of American life. With the many other difficulties that the company was facing, there was a concern that it was also being perceived as "uncultured, unclassy and downmarket in an era of obesity lawsuits." One observer said, "nobody brags about going to McDonald's, that's for sure." [5]

History

Raymond Albert Kroc mortgaged his home and invested his life savings in making himself the exclusive distributor of the Multimixer, a five-spindled milkshake maker. In 1954, Ray Kroc heard about a McDonald's hamburger stand in San Bernardino, California running eight Multimixers at the same time. Kroc wanted to witness this miracle of milkshake technology, and at age 52, he headed west to find a small burger shop, run by two brothers, Dick and Maurice "Mac" McDonald. Kroc envisioned the hamburger stand as a gold mine of Multimixer orders, and he offered to run new restaurants that the McDonald brothers opened. In 1955, the following year, Kroc began the McDonald's Corporation, opening his first restaurant in Des Plaines, Illinois. Only six years later he bought out the McDonald brothers for $2.7 million.[6]

With Kroc at the helm, McDonald's began to experience exponential growth. Employees were trained at McDonald's "Hamburger University" and Kroc ran a tight ship, stressing a company policy of "Quality, Service, Cleanliness and Value." Idle time was not tolerated; Kroc believed, "If you have time to lean, you have time to clean." [7] The company began international expansion in 1967 with restaurants in Canada and Puerto Rico, and new menu items were added with the passage of time. Today, there are more than 29,000 McDonald's restaurants in 121 countries.[8]

McDonald's Franchise Model

Approximately 70% of McDonald's worldwide are owned by franchisees. McDonald's has always been a franchising company, and continues to remain committed to the franchising model, relying upon its franchisees to play a major role in its success. The system is built on the premise that McDonald's Corporation will only be successful if its franchisees are successful.

To McDonald's Corporation, its franchisees are its business partners, so the success of the Corporation is directly attributable to its partners. In order for an individual to become a franchisee, that person must demonstrate good business sense, the ability to effectively lead and develop people, and a history of previous success. These combined factors contribute to the success of McDonald's franchisee business model and have put McDonald's in a position to perennially be named Entrepreneur Magazine's number one franchise.[9]

Obesity in America

Obesity rates in the United States increased 61% during the last decade of the Twentieth Century and per-capita food consumption simultaneously increased 8%.[10] Since 1980, rates of overweight children have doubled and rates for adolescents have tripled in the U.S.[11] Worldwide more than a billion people are overweight or obese, and 22 million of these individuals are children under the age of five.[12]

According to the United States Surgeon General, "For the vast majority of individuals, overweight and obesity result from excess calorie consumption and/or inadequate physical activity. Thus, a healthy diet and regular physical activity should be promoted as the cornerstone of any prevention or treatment effort." With this conclusion, the Surgeon General made equal recommendations relating to diet and to physical activity.[13] Furthermore, in December 2001, the Surgeon General noted that the 300,000 deaths per year are associated with being overweight or obese and cause as much preventable disease and death as smoking.[14]

Studies show that being overweight or obese in America are not the result of what Americans eat, but a combination of <u>how much</u> they consume and <u>how little</u> they exercise. Michael Fumento, an expert on obesity, a senior fellow at the Hudson Institute in Washington, and the author of *The Fat of the Land*, attests to the idea that this combination is the contributing factor to the weight problems in America. Fumento notes that the European culture indulges in considerable amounts of butter and heavy cream, but, as a whole, the population is still slimmer than the American population because there is not the overindulgence that exists in the US.[15]

Evidence supporting the lack of exercise in America revolves around the notion that American society is sedentary. This behavior is observed in children as well as in adults. *The Journal of American Medicine* produced research revealing that by the age of seventeen a child has spent 38 % more time in front of the television than in school, approximately 15,000 to 18,000 hours. American children spend an average of four hours a day watching television or playing video games.[16] The Center for Disease Control has published reports noting that 40% of American adults are completely sedentary during their leisure time, and 70% of American adults do not exercise regularly.[17]

The National Academies Institute of Medicine issued a report in 2002 outlining behavior necessary for a healthy lifestyle. This report recommended at least an hour a day of moderate physical activity and a diet consisting of 45-65% of calories from carbohydrates, 20-35% from fat, and 10-35% from protein.[18]

Obesity Lawsuits

The summer of 2002 saw New York City attorney Samuel Hirsch file a class action suit on behalf of obese and overweight children against McDonald's, alleging that the fast-food chain "negligently, recklessly and/or intentionally" marketed food products that are "high in fat, salt,

sugar, and cholesterol" while failing to warn of those ingredients' links to "obesity, diabetes, coronary heart disease, high blood pressure, strokes, elevated cholesterol intake, related cancers," and other conditions.[19]

The Fatsuit. On January 22, 2003, Manhattan Federal District Judge Robert Sweet threw out the class-action suit brought against McDonald's. Sweet stated that the plaintiffs failed to prove that the fast-food chain's products "involve a danger that is not within the common knowledge of consumers." The judge continued to say no one is forced to eat at McDonald's [20] and "if consumers know (or reasonably should know) the potential ill effects of eating McDonald's, they cannot blame McDonald's if they, nonetheless, choose to satiate their appetite with a surfeit of super-sized McDonald's products."[21] This decision by Sweet indicated that the law is not intended to protect people from their own excesses, but the door on the case is not closed.

Despite the fact that Sweet dismissed the case, his 65-page ruling not only urged the plaintiffs to redraft and refile their complaint, but also provided a road map to support the claim that McDonald's deceives its customers. The challenge will be to find evidence that McDonald's (1) withheld pertinent nutritional information from the public, or (2) tried to encourage over- consumption. The judge noted examples to satisfy both of these issues: first, suggesting that in some cases like the Chicken McNugget (or as he referred to it, a McFrankenstein creation) McDonald's has created an entirely new and more dangerous food than one would expect from chicken cooked at home and, second, citing McDonald's advertising campaigns encouraging consumers to eat McDonald's "everyday."[22]

Unsolicited Fuel Added to the Fat Fire. Beyond the aid administered by Judge Sweet, the obesity lawsuit received help from other, unsolicited sources. In a report issued in December 2001 by former Surgeon General David Satcher, obesity is identified as "an epidemic" creating health care costs of $117 billion a year. Additionally, in April of 2002 the Internal Revenue Service classified obesity as a "disease" eligible for deduction of medical expenses. By identifying obesity as an epidemic or a disease, personal responsibility is removed. Furthermore, the tobacco lawsuits set a precedent for navigating around causation. An individual can sue for damages without proving the magnitude of damages or even that anyone has been injured; damages were proven through the use of statistical analysis and calculated based on market share.[23]

Health Trends

Life in the Fast Food Lane. The United States Department of Agriculture and the Department of Health and Human Services have played a significant role in guiding Americans' eating habits. The Food Guide Pyramid shows that fats, oils, & sweets should be "used sparingly;" milk, yogurt, and cheese as well as meat, poultry, fish, dry beans, eggs, and nuts should not exceed two-to-three servings; the vegetable group should provide three-to-five servings; fruit should account for two-to-four servings; and bread, cereal, rice, and pasta should be limited to between six-and-eleven servings.[24] These recommendations are by no means rigid, but are intended as a general guide to "eating a variety of foods to get the nutrients you need and at the same time the right amount of calories to maintain and improve your weight." [25] The recommended caloric intake also varies with activity, age, sex, and body size, but generally

sedentary women should consume no more than 1,600 calories, while sedentary men may consume up to 2,200 calories.

A 2000 report entitled *Dietary Guidelines for Americans* has provided the "ABC's" for health: Aim for fitness, Build a healthy base, and Choose sensibly.[26] Experts continually study and monitor health and nutrition, but obesity rates continue to rise significantly. Americans have complete information about diet, nutrition, and exercise available to them, but personal choices, in many cases, determine health, body weight, and fitness levels. A recent study from the department of Family and Consumer Sciences at Ohio State University concentrated on helping consumers incorporate fast food into a healthy diet. *Life in the Fast Food Lane* says that a fast food diet can fit into healthy eating if "it is part of one or all of the basic food groups, it allows you to keep [sugars, fat, especially saturated fat, salt, and calories] low in the diet, and it allows you to choose fewer calories and more nutrients." [27] As this study acknowledges, fast food can be a part of a healthy diet, though personal choices affect how successful it can be.

Low Fat, Low Sales. McDonald's first began posting nutritional charts in its restaurants in the early 1970s, around 1973, and there was full nutritional disclosure in restaurants in the early 1990s. The company, in light of its social responsibility and various public health trends, has done even more since then. Bob Langert, head of McDonald's Social Responsibility team, stated that "[health] is an issue we need to manage, because obesity rates are climbing. We can be part of the solution. We can help." The company attempted to add more healthy choices over the years, but choice did not amount to sales. The McLean Deluxe, a 91% fat-free burger was removed from the menu due to lack of sales. Additionally, low-fat shakes, with fat reduced by 55%, have been replaced with Triple Thick Shakes, as a result of low sales.

Americans eat out an average of four times per week, so there are approximately seventeen other meals comprising one diet. On average, customers visit McDonald's only about twice per week. Despite this, the company is making efforts to take a leadership role. Langert said that, "on food, it is about change, offering more choice, variety, and taking a leadership position to help our customers achieve healthy lives." In an attempt to innovate and advocate, a new Vice President of Healthy Lifestyles was been recently appointed, providing the company with a high-powered team to address those issues.

By 2002, the fast food giant began moving quickly to regain the shimmer of the Golden Arches. In light of competitors' success with similar items, premium salads have been unveiled featuring Newman's Own dressings. All-white meat Chicken McNuggets were also tested to gauge the demand for healthier fare. And, while the company was not making a major shift away from its basic menu items, it began taking significant steps to offer customers more choices. Top restaurateurs and chefs outside of the fast food industry were also consulted to help guide McDonald's toward new menu ideas.

Knowledge is Power. In addition to these efforts, the company began working to educate consumers about the role of both nutrition and fitness in maintaining a healthy lifestyle. The food and nutrition portion of the corporate Website were updated and upgraded to help customers meet personal nutritional goals. Some new features include "the ability to choose up to five menu items and calculate the combination's nutritional content, including calories, fat grams, calcium and other nutrients. Customers can also determine the nutritional content of specially ordered items." [28] McDonald's also began working internally to understand how its food could be a part of a balanced diet and, in turn, is communicating this to customers.

Past Troubles

As a good corporate citizen, McDonald's strives to be aware of what is important to society and the company takes an active approach to keeping their customers happy concerning such matters.[29]

Packaging. Originally McDonald's used paperboard packaging for its large sandwich products. During the mid 1970s, environmentalists expressed extreme concern about the destruction of trees, water pollution, and high use of energy involved in the paper-making process and, as such a large user of paper products, McDonald's recognized the need to react. In response to the research conducted by the Stanford Research Institute, McDonald's converted portions of its food packaging from paperboard to polystyrene foam.[30]

By 1985, the environmental focus had shifted as scientific studies were published identifying the potential environmental problems resulting from CFCs, a major component of polystyrene foam.[31] At this point in time, foam packaging was more expensive than paper, but McDonald's had discovered that the foam was superior to paper in delivering a better product as the polystyrene foam package was able to retain heat. With concern for delivering a higher quality product, McDonald's sought research concerning the problem with CFCs. Research revealed that CFCs were only produced during the manufacturing process, [32] so in 1987, acting on its duty to be socially responsible, and out of concern for the Earth's ozone layer, McDonald's led the food service industry to insist its suppliers stop using CFCs in the manufacturing of foam packaging.[33]

In 1991, as part of McDonald's continual assessment of its packaging with concern for changing environmental issues, the company commissioned a report by Franklin Associates Limited on its sandwich packaging. In response, in the United States and in a number of other countries, McDonald's converted from polystyrene foam to paper wraps.[34]

McRecycle. In 1990, McDonald's established the McRecycle program to encourage the industry to follow develop the market for recycled products. The company was eventually able to use more than 200 recycled products in their restaurants, and many of these are identified in the specifications for McDonald's standard buildings; consequently McDonald's has become the largest user of recycled paper products in the quick service restaurant industry.[35]

Ban on Smoking in McDonald's Restaurants. During the late eighties and the early nineties, second-hand smoke was being more largely publicized as its negative effects were being discovered. McDonald's recognized that second-hand smoke was an important issue in restaurants, especially McDonald's because of the number of children served. With this observation, the company decided to be a leader in the non-smoking movement, proclaiming that it was necessary for the health of the children. In March of 1994, McDonald's was a first mover in the restaurant business to ban smoking within their establishments.[36]

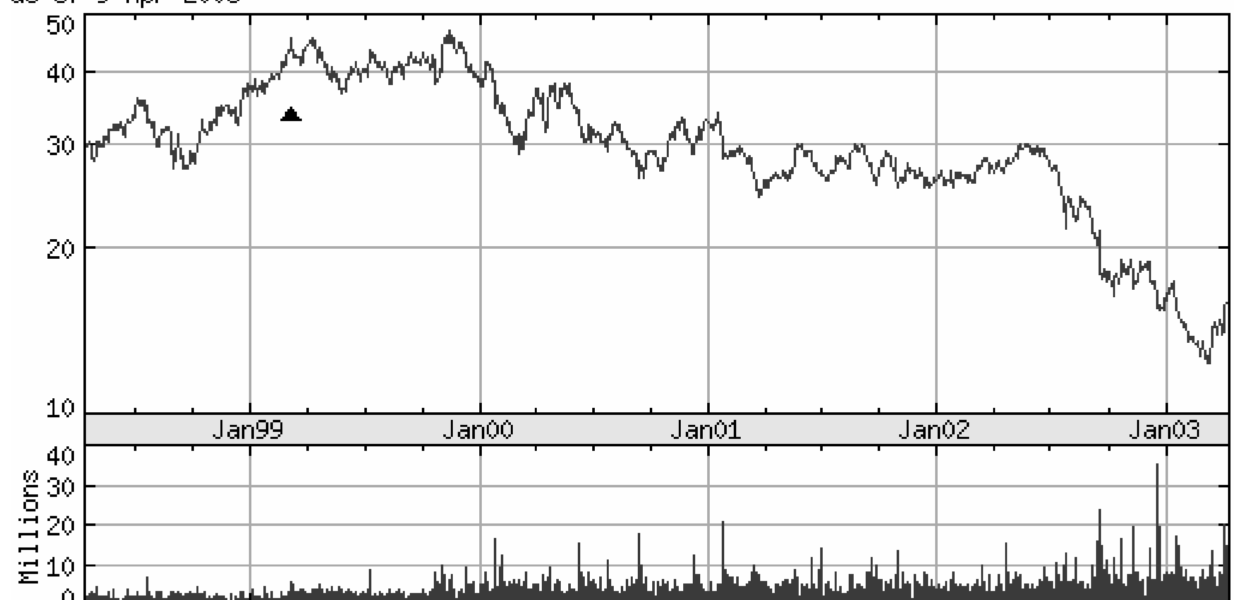
Fries with Beef Flavoring? In 2001, McDonald's was named as the defendant in a class action suit filed by Seattle attorney Harish Bharti on behalf of the Hindu community, alleging the McDonald's Corporation had deliberately misled the vegetarian customers about the content of its fries, causing great emotional damage and endangering the souls of Hindu consumers.[37]

In 2001, social critic Eric Schlosser published *Fast Food Nation* launching an attack on the fast-food industry and culture. In a chapter entitled, "Why the Fries Taste So Good," Schlosser revealed that, despite McDonald's claim to use 100% pure vegetable oil, animal products were also used to make their fries.[38] McDonald's Home Office Customer Satisfaction Department tried to explain that the use of beef flavoring was minuscule and used for flavor enhancement. This explanation was not satisfactory to customers and led to the initiation of a class action suit and violent protests in India.[39]

Fast Food Nation failed to tell the whole truth, though. McDonald's assertion of the use of vegetable oil was true; beef flavoring was added to the potatoes in the processing plant. Also, despite McDonald's tout of its "One Worldwide Taste," the McDonald's restaurants in India did not use even a small amount of meat flavoring.[40]

Conclusion

By the spring of 2003, as Walt Ryker reviewed the company's recent history, he questioned McDonald's potential success in the future. The obesity lawsuits were not completely resolved, and the potential for significant payouts, as seen in the tobacco industry, was not out of the realm of possibility. Additionally, the company was experiencing other difficulties. Although McDonald's was exerting significant effort to regain its market position and its past levels of growth and profit, recent attempts, from the McLean Deluxe to the Dollar Menu, proved less than helpful. As a hamburger guy, Ryker was confident that the company could successfully move through this difficult period, just as it had proactively and responsively worked through other pressing issues. With the help of his communication team, as well as a recently employed Vice President of Healthy Lifestyles, Ryker knew they could succeed. His challenges would include knowing what to do first and how to go about it.



Questions

1. McDonald's has successfully handled issues in the past, such as recycling, although recent months prove efforts such as the Dollar Menu to be unhelpful. How can McDonald's handle the obesity lawsuits? How can the company handle the trend of obesity and its possible association with fast food?

2. Quality, value, and service are critical within the fast food industry, how should McDonald's measure improvement in these areas and how should the company communicate improvement in these areas?

3. How can McDonald's communicate its place as a part of a healthy lifestyle?

4. How can McDonald's ensure that it is providing customers products that they are demanding and how can it communicate these products to such a broad customer base?

5. Will McDonald's recover from the perception problems that it is experiencing, from "unclassy," to slow service, to bad food? What media should the company use to communicate its renewed commitment to its customers?

Writing Assignment

1. Please respond in writing to the issues presented

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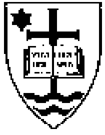
McDonald’s Corporation: Rehabilitating a Troubled Brand
Kays, Chris; Kimmet, Mark; and O’Rourke, J. S. (editor)

Faced with its first quarterly loss in company history, McDonald’s corporation enacted a strategy to improve its declining profitability. Unfortunately, McDonald’s profitability problems were multi-layered and required the company to reevaluate both its current business model and strategy. Links to obesity, negative customer perceptions, and decreased same-store sales were all to blame for the current situation. For a successful turnaround, McDonald’s must recognize its inefficiencies and devise an integrated operational and communication plan to reverse its slide. 11pp. #06-03. (2006).



Eugene D. Fanning Center for Business Communication **06-03**
Mendoza College of Business
University of Notre Dame

McDonald's Corporation:
Regilding the Golden Arches

Sitting behind his desk at the Oak Brook, Illinois headquarters, Jim Skinner, the new CEO of McDonald's Corporation, reflected on the turbulent years during which he had witnessed the precipitous fall of the world's largest fast-food chain. By the spring of 2003, perceptions of the McDonald's brand nosedived with the culmination of several obesity lawsuits and the company's poor financial performance. Most analysts agreed that McDonald's had hit bottom, but a major revitalization strategy started before Skinner's ascension to the top post, brought McDonald's back to prominence. Now charged with the responsibility of developing strategies to capitalize on the company's current momentum, Skinner and McDonald's both face a critical time, one that will greatly influence the company's long-term success.

CEO Turnover

Jim Skinner's rise to power was marked with sadness and turmoil, much the same way his predecessor came to power. McDonald's, long since known for stability in its senior management, was experiencing alarming and rapid turnover. Skinner marked the company's fourth CEO since the end of 2002.

Prior to 2003, Jack Greenberg ran the company with an emphasis on growth.[1] His strategy included expanding McDonald's locations to increase revenue. The focus on expansion came at the expense of other aspects of the business, namely decreased profits and decreased relationships with franchisees.[2] By the end of 2002, the failed expansion strategy led to McDonald's first ever quarterly loss.[3] The loss came as Jack Greenberg retired amid pressure from the Board of Directors at the end of December 2002.[4]

McDonald's board elected Jim Cantalupo to replace Greenberg as the company's CEO in January 2003. Cantalupo retired as vice chairman of McDonald's a year earlier, but agreed to come out of retirement to lead the turnaround. His first steps were to switch from a strategy of expansion to a strategy of quality, service, and new products.[5] This shift in focus coupled with the innovative advertising campaign, "I'm lovin it," spring-boarded McDonald's back into

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This case was prepared by Research Assistants Christopher Kays and Mark Kimmet under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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profitability with double-digit sales increases.[6] Tragically, in April 2004, while at a franchisee convention in Orlando, Florida, Jim Cantalupo died from a massive heart attack.[7]

Cantalupo's death stunned the company. Luckily, there was a clear succession plan in place. Within hours of Cantalupo's death, the board voted to make Charlie Bell the next CEO. As the president and COO of McDonald's since late 2002, Bell had worked closely with Cantalupo in developing the turnaround strategy.[8] Bell was committed to continuing the turnaround strategy. However, only three weeks after being appointed to CEO, Charlie Bell was diagnosed with colorectal cancer. By November 2004, seven months after being named CEO, Bell quit to fight the disease full time. In January 2005 he tragically lost his battle with cancer.[9]

The second consecutive CEO death in ten months further shocked the McDonald's Corporation. Responding to the call of his board, Jim Skinner, the vice chairman, took the helm.[10] The selection of an insider to the CEO position signaled McDonald's commitment to the strategy Cantalupo championed. Under Skinner, McDonald's continued to execute the original turnaround plan. And through his leadership, the company has continued to post consecutive quarterly profits and sales gains.

Even with the changes to the executive staff, the McDonald's recovery has continued, proving the turnaround would be "greater than any one man."[11] The deaths of Cantalupo and Bell however, left the company without the two main architects of its new strategy. In addition to the CEOs, another key executive Larry Light, the Vice President of Global Communications would retire at the end of 2005.[12] The loss of valuable executives over the preceding two years raised questions about McDonald's ability to continue to find talented management to carry on the strategy created by Jim Cantalupo.

McChanging Menu

Ray Kroc, the founder of McDonald's, was fond of saying that he did not know what McDonald's would be selling in the year 2000, but whatever it was, McDonald's would be selling the most of it. Today, Ray Kroc would recognize the traditional hamburgers and fries, but he would probably be surprised to see salads, bottled water, and bunless burgers. These are just some of the improvements that McDonald's has tried since 2002 in an attempt to attract the increasingly health-conscious consumer and address issues raised by critics like Morgan Spurlock, the filmmaker whose 2002 movie "Supersize Me" directed blame at McDonald's for the increasing trend of American obesity.

One of the first changes targeting quality and establishing a shift to a healthier focus was the switch to all white meat Chicken McNuggets in October 2003. The new all-white, six-piece nuggets shed 60 calories and 5 grams of fat.[13] McDonald's did not raise the price of its McNuggets, instead it gambled on increased sales outweighing the increased cost of using white meat. It was a big risk, but the campaign succeeded and led to a 35% increase in the sales of McNuggets.[14]

During the rollout of white-meat McNuggets, McDonald's was also testing a new happy meal. Targeting adults, the new happy meal featured a salad, a bottle of water, an exercise book, and a pedometer. Sponsored by Oprah Winfrey's personal trainer, Bob Greene, McDonald's rolled out the "Go Active" happy meal in May of 2004 as part of an attempt to provide healthier alternatives for adults.[15] Other health conscious items targeting adults include fruit and yogurt parfaits, bagels, and the expansion of salads on the menu.[16] The Fruit 'n' Walnut Salad, the newest addition to the salad line, was introduced in April 2005.[17] Consisting of sliced apples,

grapes, low-fat yogurt and optional walnuts, the salad compliments the three premium salads introduced in early 2003.

All these additions to the menu have given customers healthier options, but the biggest change to the menu was not an addition, but rather the removal of the Supersize option for drinks and fries. According to McDonald's, the removal was an attempt to simplify the menu and provide more options for a balanced lifestyle.[18]

Even with all these changes to the menu, critics still claimed that McDonald's was not doing enough. Many critics were pushing for nutritional facts such as calorie and fat content placed on the menu boards, so customers would have an easier time making informed decisions. Others thought that McDonald's had not added enough health-conscious items to the menu. Noting that top sellers such as burgers and fries still contain large amounts of fat and calories, critics have said that fast food companies like McDonald's are not concerned about growing obesity in America, but are only making changes to carve out niche markets with a few healthy items.[19]

Bolstering critics' claims about McDonald's commitment to healthy eating was the recent removal of 11 new items from the menu in August 2005. Many of the choices the company discontinued targeted vegetarians, but new muffins and fruit toast were also removed.[20] Removal of unsuccessful products, especially healthy products is not new for McDonald's. Perhaps the most publicized failure was its McLean Deluxe sandwich in the mid-1990s.

Franchise Focus

The fast food giant needed to combat the negative perception consumers had of it while trying to correct many of its past marketing and customer service mistakes. Complicating this difficult task was the fractured relationship McDonald's had with many of its franchisees. Cantalupo's vision for the restaurant chain included scaling back its aggressive store expansion and refocusing on its franchisees and its customers by improving customer service efforts and increasing the sales of existing restaurants.

In 2003 one research report stated that McDonald's trailed its other fast-food rivals in the areas of wait times, order accuracy, and the cleanliness of restaurants.[21] In response, the company instituted service initiatives designed to improve the company's "speed, accuracy, and friendliness."[22] These initiatives would be meticulously measured to ensure that McDonald's was showing marked improvements in these core areas of service.

McDonald's strategy of rapid global expansion allowed it to capture significant market share in many locations, but this expansion would eventually hurt the profitability of existing stores. Cantalupo recognized the damage that the expansionary policy had on existing franchises so he announced that in 2004 the company would only open 450 new stores compared to the 1000 stores that it opened two years prior.[23] This strategy also focused on reviving existing locations with modern renovations and even rebuilding certain locations whose future sales projections warranted such a project. The company announced plans to renovate between 1,500 and 1,800 restaurants in 2004, a major increase from the 700 stores that received face lifts in 2003. Also, it would rebuild 30 more stores in 2004 than it did in 2003.[24]

Cantalupo complemented his strategy to redirect attention back to the franchisees with two additional directives. First, under the company's old system for franchise renovations, franchisees were required to meet certain sales goals in order to avoid repaying the $150,000 loans issued by the company. This old system was met with great resistance from franchisees. In

response, McDonald's provided franchisees with an investment of up to $85,000 with no sales goal requirements.[25]

Cantalupo's second directive was to reexamine McDonald's franchise marketing strategies. McDonald's roots had always been a balance of national, co-op, and local marketing. In the 1970s and 1980s, the company contributed significantly to individual stores for local marketing, even using marketing reps to help franchisees with their marketing efforts. McDonald's switched its efforts in the 1990s, concentrating on expansion, discounting, and new product development. The result was franchisees lost focus on their local efforts and began relying on the national and co-op advertising to carry sales. Cantalupo identified this trend as a major factor in the company's negative perception among consumers. As a result, McDonald's now has a re-commitment to build same store sales through grassroots marketing efforts, such as sponsoring local sports teams. Light expressed the success of Cantalupo's focus, saying "I don't think anything had as big an impact on the strategic growth of the brand as when our strategic concept was to grow the visits more than to grow the stores."[26] McDonald's has been successful with this strategy; it has grown store visits by over two million in the past two years.[27]

Cantalupo's platform provided a basis of operations for McDonald's, but the company desperately needed to address its brand image problems with a new advertising campaign.

McLovin' It

On September 29, 2003 McDonald's launched its newest ad campaign entitled "I'm lovin' it."[28] Success of the campaign hinged on the total integration of its "forever young" message throughout the organization from crew members, to the overall dining experience, and to its marketing and promotional efforts. Key elements in "I'm lovin' it" include new commercials centered on customers' families and Ronald McDonald, along with musical celebrities Justin Timberlake and Destiny's Child, a partnership with professional skateboarder Tony Hawk, and grassroots marketing efforts.[29]

For years, the company's target market had consistently focused on two core segments. The first segment was moms and children and the second was young adult males. The problem for McDonald's was that it became too focused on targeting moms, and ignored the young male demographic.[30] The "I'm lovin' it" campaign aims to bring a balance to McDonald's targeting of both groups by showing that the brand is more about young-at-heart than it is young-versus-old. Bill Lamar, the senior vice president and chief marketing officer for McDonald's, believes the campaign will effectively "rekindle the emotional bond our customers have with McDonald's through a campaign that depicts how people live, what they love about life and what they love about McDonald's."[31]

Forging deeper, McDonald's executives recognized three distinct consumer segments that required attention. The first group was "current customers," whom executives wanted to educate about the McDonald's new variety in an attempt to increase total number of visits. The second group, "lapsed customers," consisted of former customers in need of evidence that they could use to convince themselves that it was again permissible to return to McDonald's. The final group identified was "unavailable consumers." This group was comprised of those who had negative opinions about the McDonald's brand. McDonald's had to curb the unfavorable perceptions of this group in order to lessen the group's impact on the other valuable segments.

McDonald's has leveraged its forever young message with its commitment to balanced, active lifestyles. On the McDonald's website, there is a page entitled "It's what I eat and what I

do." Features of the website include nutritional information, a chance to have a workout plan customized for you through an interactive trainer, and the ability to e-mail questions to experts from the American College of Sports Medicine.[32]

Much like its recommitment to individual restaurants, the "I'm lovin' it" campaign has produced much success for McDonald's. At the year end 2004, McDonald's global sales increased 6.9%. The same-store sales for its U.S. restaurants increased 9.6%, the highest increase in 30 years.[33]

Uniformity Through Constraint

McDonald's has historically been one of the most successful global brand building companies. This success is deeply rooted in the company's many unique and memorable advertising campaigns. The Big Mac jingle, "two all-beef patties, special sauce, lettuce, cheese…," was introduced in 1974. The jingle was so widely accepted and identifiable that it became the number one requested song on the radio.[34] Another famous slogan was "You deserve a break today" in 1971, which was changed in 1995 to "Have you had your break today?" Other slogans include "Food, folks, and fun" in 1990 and "We love to see you smile" in 2000.[35]

Much of McDonald's branding problems however, surfaced when the company allowed its advertising efforts in different regions to carry similar messages, but without a consistent look or feel. The "I'm lovin' it" campaign presents a consistent message in all regions in which McDonald's operates. The method McDonald's is using is called *brand journalism*, whereby the ads "tell stories about what customers love and how McDonald's fits into their lives."[36] These stories are complemented by the campaign's new voice – moving from "you" to "I." McDonald's is no longer speaking to customers telling them what they need, rather it is letting customers create their own associations with McDonald's recognizing that it is a personal choice.

The "I'm lovin' it" campaign has received global acclaim for its message. In October 2004, McDonald's received Best in Show at the Advertising Effectiveness Awards in New Zealand.[37] The success of the New Zealand campaign was rooted in its spokeswoman, Sarah Ulmer who won a gold medal in cycling at the Athens Olympics in 2004. One of the most famous athletes in her home country, Ulmer provided instant credibility for the message, plus her healthy active lifestyle helped reinforce McDonald's new brand positioning.[38]

McMerchandise

Total integration of "I'm lovin' it" can even be seen in McDonald's employees. The company's turnover in the U.S. is 5-to-10% less than the national average for quick service restaurants. The company intends to run advertising in 2006 that specifically targets employee pride programs.[39]

McDonald's is currently trying to capitalize on its crew members and reinforce "I'm lovin' it" by beginning the preliminary process of redesigning work uniforms. The impetus for this comes from the Netherlands where work uniforms became so popular that they were for sale in retail outlets.[40] Popular designers like Tommy Hilfiger, plus rappers Sean "P. Diddy" Combs and Jay-Z have all been consulted about possibly designing new clothes for McDonald's workers.[41] McDonald's looks at the merchandising of work uniforms as an opportunity for brand extension through employees. Light believes, "the ultimate measure of our success will be when people wear our logo with pride – both employees and consumers."[42]

Another prominent merchandising effort for McDonald's is its new McKids line of merchandise that includes clothing, videos, toys, and outdoor equipment. McDonald's hopes to reinforce its commitment to an active lifestyle with its product offerings to kids. Original plans were for the line to be introduced in spring of 2004, but the line has been slow moving.[43] On June 14, 2005 McDonald's hired DIC Entertainment as its global licensing partner for the McKids line.[44] A key addition to the product offerings planned by DIC is vintage clothes that feature classic McDonald's logos and advertising themes. The line will launch internationally late in 2005, but no plans have been announced for a U.S. release.

Financial Turnaround

The $343 million fourth quarter loss of 2002[45] was the low point for McDonald's. Driven by the changes in the menu, the increases in quality and service, and the advertising campaign, McDonald's has returned to profitability. The year 2004 marked the first time in 17 years that McDonald's experienced 12 months of positive same-store sales.[46] Annual sales have grown more than 11% a year since 2002, and have increased from $15.406 billion in 2002 to $19.065 billion in 2004.[47]

Net income has increased from $893 million in 2002 to $2.279 billion in 2004.[48] Two years of consecutive net income increases greater than 54% have caused the once slumping stock price that reached a low of around $12.50 in March 2003 to rebound to highs above $35 in 2005.[49] Facing record profits, in September 2004, McDonald's announced the company would increase the annual dividend by 38% from 40 cents to 55 cents per share.[50] A year later, McDonald's announced another 22% dividend increase bringing the dividend to 67 cents per share, to spread the wealth to the shareholders.[51]

The Future of McDonald's

McDonald's now faces the challenge of building on the success of its brand revitalization. It will focus many of its resources on enhancing the restaurant experience for customers. McDonald's will launch premium coffee service in the spring of 2006, featuring new blends of coffee with redesigned cups and lids. Another customer service effort McDonald's wants to implement is increasing the number of restaurants accepting credit and debit cards. Entering 2005, only about 8,000 of its stores offered this service for customers.[52] Another focus is extending the hours of operation at many restaurants. Although franchisees cannot be forced to stay open, McDonalds has been pressuring them to stay open for 24 hours. This is a difficult sell to many franchisees who only receive 1% of their profit between the hours of 11:00 p.m. and 6:00 a.m. To franchisees, this minuscule amount of profit rarely offsets the added headaches that accompany operating late at night, such as theft and staffing issues. McDonald's on the other hand, is not as concerned about the small profit margin because it receives a percentage of the sales, regardless of how small the profit.[53] This effort to increase same-store sales will test McDonald's rebuilt franchisee relationship.

Another attempt at pulling through sales at existing franchises involves installing Redbox (a subsidiary of McDonald's) DVD rental vending machines at the restaurants. Although currently only deployed at McDonald's restaurants in the western United States, the vending machines have had a large impact on sales. Stores with Redbox have seen sales during the usually slow dinner period rise more than 20%. McDonald's has also profited from the rental

fees as well. In Denver 14% of all rentals are made through Redboxes at McDonald's restaurants.[54]

The biggest advancements in the guest experience exist in both its McCafe and Bistro Gourmet concepts. The McCafe is a modern-day McDonalds recently completed next to the corporate headquarters in Oakbrook, Illinois. The McCafe is reminiscent of a modern coffee house with Internet hookups and a more premium menu selection. It also boasts giant plasma televisions and cd burning stations. The company plans to continue introducing the McCafe concept throughout the U.S. in supporting locations.[55] The Bistro Gourmet was launched in 2001 in Florida. Growth of the concept has been slow with only 13 Bistro Gourmets open through early 2004. Bistro Gourmets feature granite counters, classical music, and a made-to-order menu featuring panini sandwiches, and hand-dipped ice cream.[56] McDonald's plans to use both of its upscale restaurants to compete with the increasing number of "fast-casual" chains similar to that of Panera Bread. "Fast-Casual" chains have been growing at 25% since 1999 compared to fast-food's growth of 2-3%.[57]

In the last couple of years, McDonald's has taken steps to return to its core business and improve service. In late 2003, McDonald's Corporation sold Donato's Pizza back to the restaurant's founder at a loss of more than $300 million.[58] More recently, in September of 2005, McDonald's announced that it would spin off the Mexican eatery, Chipotle Grill in an IPO.[59] McDonald's made these divestitures in an attempt to refocus on the main McDonald's franchise.

Conclusion

Jim Skinner rose from his desk and put on his suit jacket. He began to walk and get his lunch at McDonald's headquarters. On his way, he wondered to himself if the company had successfully turned the corner. Sales and stock price were rebounding, franchisees were once again involved in corporate strategies, and a successful ad campaign helped repair a tarnished brand image. Was it enough though? Did McDonald's need to make more substantive changes to its menu to fully change consumer perception, or had consumer perception already been restored to once high levels? Important decisions lie ahead for Skinner, the depth of which he would ponder over his #1 with Diet Coke.

Discussion Questions

1. What are the critical issues in this case?

2. Who are the key stakeholders here? What's at stake for each of them?

3. Do healthy menu options have long-term appeal for consumers? Can they be profitable?

4. Has McDonald's done enough to address growing American obesity?

5. Can McDonald's continue sales growth in an already saturated U.S. market? How?

6. Is the improved franchisee relationship sustainable given McDonald's past problems?

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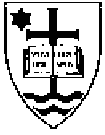
Mothers Work, Inc.: Brand Image and Accusations of Employment Discrimination
Billick, C.; Wong, L.; and O'Rourke, J. S. (editor)

The nation's largest retailer of maternity wear finds itself accused of employment discrimination over the dismissal of a manager attempting to return from maternity leave. President and COO, Rebecca Matthias, and Communications Chief, Mona Liss, find themselves confronted with charges of discriminating against a young mother and press reaction ranging from shock to disbelief. A thorough review of the Family Medical Leave Act (FMLA) and Pregnancy Discrimination Act (PDA) of 1978 are included. 7 pp. Case #04-04. (2004)



Eugene D. Fanning Center for Business Communication **04-04**
Mendoza College of Business
University of Notre Dame

Mothers Work Inc.:
Brand Image and Accusations of Employment Discrimination

Introduction

On June 27, 2003, Rebecca Matthias, the COO of the world's largest maternity clothing company, Mothers Work, Inc., called an urgent meeting with her top executives: Dan Matthias, Mother Work's chairman, Sheryl Roth Rogers, vice president of marketing, Mona Astra Liss, Mothers Work's publicity director and Frank Mullay, vice president of stores. The five administrative personnel were gathered to discuss how the company would address a recent lawsuit filed against Mothers Work, Inc. by a former district manager, Cynthia Papageorge. Papageorge has accused Mr. Mullay of firing her three years earlier because of her gender and pregnancy.

Mothers Work, Inc. has already settled two similar discriminatory complaints (one of which was filed by Papageorge's boss, Jane Dowe). Papageorge's case, however, has been embraced by the media and damage to Mothers Work's reputation could ensue. Women's rights groups issued statements of disapproval within days of the lawsuit's filing. For example, Serrin Foster, the president of Feminists for Life, declared, " 'It is mind blowing to think that a company named Mothers Work that profits from selling apparel to pregnant women would terminate [women's employment] simply because of their maternity.' "[1]

Rebecca Matthias is renowned for her support of women in the workplace, as her company was founded on the premise that women can be both professionals and mothers. The Mothers Work corporate officers must now determine how their five-hundred-million-dollar maternity clothing company should react to allegations that it discriminates against pregnant women.

This teaching note was prepared by Research Assistants Carolyn E. Billick and Lusiena H. C. Wong under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Company History

Mothers Work, Inc. is the leading designer, producer and vendor of maternity clothing in the United States and abroad. The organization was founded in 1982 by Rebecca Matthias, a civil engineer who could not find professional maternity clothing once she became pregnant. The company operated out of Matthias' front closet in her Philadelphia home with an investment of $10,000. Ms. Matthias' commitment to "giving the customer what she wants, when she wants it" has allowed Mothers Work to increase its store base 1300% since its initial public offering in 1993. This offering was facilitated by Meridan Venture Partners, a venture capital firm.

The company now owns the Motherhood Maternity, Mimi Maternity, A Pea in a Pod and iMaternity brands. The firm also conducts sales from its website, Maternitymall.com and through its catalog. Mothers Work, Inc.'s stores and its distribution channels provide career, casual, exercise, formal and nursing fashions for pregnant women. The organization enjoys the cost savings associated with vertical integration and prides itself on being an efficient, "Real Time Retailer" for its customers. Matthias cites new stores, acquisitions, increased sales volume and employees as the company's main sources of growth.

Mothers Work, Inc. had record sales, net income and earnings per share (EPS) in fiscal 2002. Sales increased 16.7% to $453.2 million, an increase attributed to the acquisition of iMaternity stores and the opening of 60 new Mothers Work, Inc. locations. The company opened 138 new shops during 2002, bringing the total location count to 909 stores. Mothers Work, Inc. believes that although the retail and global political environment remains difficult and uncertain, the corporation's leadership, cost saving measures and strong balance sheet will position Mothers Work for future success.

Rebecca Matthias

Rebecca Matthias began her professional career as an architect working in the construction industry until her husband began his own computer company. Rebecca quit her job and began working with her husband, Dan. Rebecca's new job required her to go on business trips, but when she became pregnant, Rebecca could not find professional maternity clothes at existing retailers. Ms. Matthias recognized business maternity wear as an untapped market, and began Mothers Work Inc. to help working women with families find professional attire.[2] Ms. Matthias currently works as Mothers Work, Inc.'s President and COO while Dan Matthias serves as the Chairman and CEO. Rebecca also functions as the organization's public spokesperson. She and Dan have run the company since its inception while raising their three children.

Ms. Matthias has been very supportive of other women entrepreneurs and has encouraged women to start their own businesses. She has stated, " 'I'm a huge advocate for women starting businesses because it fits into [their] lifestyle in a lot of ways. Women need flexibility, especially women with children . . . .' "[3]

Matthias has earned degrees from MIT, Columbia University and the University of Pennsylvania. She is the author of *Mothers Work: How a Young Mother Started a Business on a Shoestring and Built it into a Multi-Million Dollar Company*. Matthias serves on the Board of Trustees at Drexel University and Hahnemann MCP Medical University and is a member of the Board of Overseers of the School of Arts and Science at the University of Pennsylvania.[4] On

September 16, 2003, Rebecca Matthias was recognized by the United States Small Business Administration at the National Entrepreneurial Conference in Washington, D.C. for her success with Mothers Work.[5]

Corporate Communication at Mothers Work

No Corporate Communication division exists at Mothers Work, so many of the communications tasks are undertaken by Rebecca Matthias and Publicity Director Mona Astra Liss. Ms. Liss is responsible for all of Mothers Work's fashion publicity in print and in broadcast. She organizes Mothers Work's fashion shows and other activities promoting the Mothers Work maternity lines. One of Ms. Liss's initiatives was the creation of A Pea in a Pod's celebrity program. Famous women such as Cindy Crawford, Sarah Jessica Parker, Toni Braxton and Claudia Schiffer showcased Mothers Work maternity wear while pregnant.

Ms. Liss has written for *The New York Times*, *The Washington Post*, *People* and *US Weekly* and has been featured on the Today Show, Oprah and E! Entertainment. She is currently working with cable television channel, TBS Superstation, to provide maternity clothing advice to pregnant women. Ms. Liss has been a very prominent individual known for promoting Mothers Work clothing and products.[6]

Women in the Workforce

Since 1950, the increase in the percentage of working women has been overwhelming. In 1999 about 60% of females 16 years of age and older were in the work force, an increase of 20% since the turn of the 20th century. Women also accounted for 85% of the total increase in the number of workers with more than one job for periods between 1989 and 1999. Labor force participation for women continues to be highest in the 35-44 age groups.[7]

Women are working harder as with all Americans. The average full time worker works about 43 hours per week. For married working women, the amount of hours increased from 41 hours in 1989 to 46 hours in 1998.[8] In addition, women also have to take care of their families and so in a way, they are working "double shift." Balancing between a career and a family can be difficult. As the number of women entering the workforce continues to rise, more businesses are offering services and information to help women find jobs or to better their understanding maternity rights. A good example of such an information source would be "*The 100 Best Companies for Working Mothers List 2003*"[9], a magazine published by Working Mothers.

Pregnancy Discrimination

The Pregnancy Discrimination Act of 1978 was passed as an amendment to Title VII of the Civil Rights of 1964. The act states that "women affected by pregnancy, childbirth, or related medical condition shall be treated the same for all employment-related purposes, including receipt of benefits under fringe benefit programs, as other persons not affected but similar in their ability or inability to work."[10]

Despite the protection offered by the legal system against pregnancy discrimination in the work place, the number of pregnancy-related discrimination cases is on the rise. Pregnancy discrimination complaints nationwide jumped 10 percent last year to just over 4,700 cases,

according to the Equal Employment Opportunity Commission (EEOC). Such complaints have increased by approximately 40 percent since 1992.[11]

Lawyers, enforcement officials and workers' advocates believe that the increase is partly a symptom of widespread layoffs. According to Will Hannum, an Andover, Mass., attorney who represents employers in labor matters, the shaky economy has exacerbated the situation as companies try to cope with pressures that sometimes force them to choose which employees to keep on the payroll.[12]

The Family Medical Leave Act

The Family Medical Leave Act (FMLA) was passed by the Congress of the United States and signed into law in 1993. That legislation guarantees employees of companies up to 12 weeks of unpaid leave annually for certain medical reasons or for the birth or adoption of a child.

To be eligible, the employer must have 50 or more employees who have worked for the employer at least 12 months and 1,250 hours in the last year. The FMLA requires that employers reinstate employees to their former job or an equivalent job at the end of the leave, and must maintain any group health insurance coverage under the same conditions of coverage and cost-sharing arrangement as if the employee were working during the leave.[13]

Massachusetts Medical Leave Act

Besides the Family Medical Leave Act, residents of Massachusetts (the state in which Papageorge filed her lawsuit) receive additional protection from the Massachusetts Maternity Leave Act (MMLA). The MMLA requires that an employee on leave be restored to her previous or a similar position upon her return to employment following leave. That position must have the same status, pay, length of service credit and seniority as the position the employee held prior to the leave.[14]

The MMLA also requires that a maternity leave not affect an employee's right to receive vacation time, sick leave, bonuses, advancement, seniority, length of service credit, benefits, plans or programs for which she was eligible at the date of her leave, and any other advantages or rights of her employment incident to her position. Such maternity leave, however, need not be included in the computation of such benefits, rights and advantages.[15]

An employee returning from the leave does not have greater rights in terms of benefits or work conditions over other employees who have been working while the prior employee was on leave. The employer is also not required to reinstate a returning employee to her previous position if other employees of the same caliber and length of service have been laid off during her leave period due to economic conditions or operation changes.

Nothing in the MMLA shall be construed to affect any bargaining agreement, employment agreement or company policy providing benefits that are greater than, or in addition to, those required under the statute. An employer may grant a longer maternity leave than required under the MMLA. However, if the employer does not intend for full MMLA rights to apply to the period beyond eight weeks, the employer must communicate it clearly to the employee in writing prior to the commencement of the leave.[16]

Papageorge's "Condition"

Cynthia Papageorge began working for Mothers Work, Inc. in 1997 as a district manager for stores in Massachusetts, Connecticut and Rhode Island.[17] In October of 1999, Papageorge was thirty-seven weeks pregnant with her first child when Mothers Work vice president, Frank Mullay, inspected four of Papageorge's stores unannounced. Mullay found deficiencies in the stores' housekeeping, made several references to Papageorge's pregnancy and even suggested that Cynthia could not meet her job requirements as a result of her "condition."

The lawsuit claims that within several days of the random store inspection, Mullay ordered Papageorge's supervisor, Jan Dowe, to fire Papageorge on the grounds that Papageorge was pregnant. In an affidavit, Dowe stated she refused to fire Papageorge after company officials told Dowe it would be illegal to let Papageorge go. Dowe met with Mullay and informed him of the illegality of his proposal. He responded with, " 'There are ways of getting around the law.' "[18] Six months later, Papageorge was released after requesting medical leave for a shoulder injury, which was unrelated to her pregnancy. Dowe was also fired for inadequate job performance after taking maternity leave.

Mark Itzkowitz, Papageorge's lawyer has claimed, " 'It seems that pregnant women are subject to termination by virtue of their pregnancy. That position was made known in meetings with managers at Mothers Work. The other women [from the other three law suits] were terminated for the same reason.' "[19]

Questions

1. What facts in this case appear to be the most important to you?

2. Who are the key stakeholders in this case? How will a verdict for or against Papageorge affect the parties?

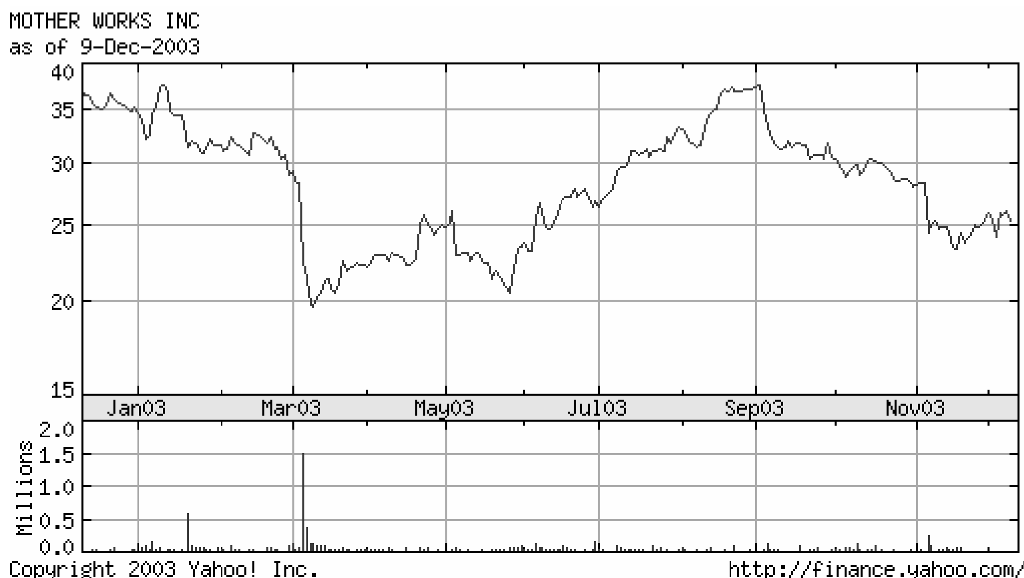
3. What actions (if any) should Mothers Work, Inc. take? What message should the company send to the public? Who is Mothers Work's target audience?

4. What are the critical issues of this case? Which issues should Mothers Work confront first?

5. Since there is no Corporate Communications department, who should deliver Mothers Work's message? What media should Mothers Work use to convey its position?

6. This lawsuit has not received much media attention (since the original filing of the suit). Why do you think this is the case?

Appendix A



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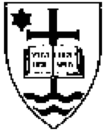
The New York Times and Jayson Blair: All the News That's Fit to Print?
Smeraglinolo, M.; Wehmer, J.; and O'Rourke, J. S. (editor)

A promising young reporter is given unprecedented opportunity to move up quickly through the ranks of *The New York Times.* Questions about the accuracy of his reporting and the source of his material, however, soon turn his case into a referendum on the leadership of Executive Editor Howell Raines and Managing Editor Gerald Boyd. Reporters soon begin taking sides as a credibility crisis and loyalty rift develop among the Times staff. (A) Case, 9 pp. (B) Case, 2 pp.Case #04-05. (2004)



Eugene D. Fanning Center for Business Communication **04-05(A)**
Mendoza College of Business
University of Notre Dame

The New York Times and Jayson Blair (A)
"All the News That's Fit To Print"?

On June 6, 2003, *The New York Times* Executive Editor Howell Raines and Managing Editor Gerald Boyd resigned amidst a scandal that had already resulted in the resignation of one reporter, Jayson Blair, and a subsequent hard look at *The Times'* internal management and procedures. After speaking to the newsroom about what the paper had meant to them, and hugging many of their colleagues, Raines and Boyd left the building.

As Catherine Mathis, Vice President of Corporate Communications at the New York Times Company, sat in her office later that day, she felt saddened by the events of the past few months that had taken a toll on the reputation of the newspaper. She also realized that a daunting task lay before her, namely restoring the status of one of the world's most widely read and respected papers.[1]

The New York Times Company

The New York Times Company was founded in 1851 by Henry Jarvis Raymond and George Jones. Raymond, a sometimes politician, reporter, and editor who learned his trade working for the *New York Tribune*, and Jones, a business manager who also worked at the *Tribune*, joined forces to produce a paper that presented the news in a conservative and objective fashion, which was in stark contrast to the journalism of the day which emphasized crime, scandal and radical politics. The first issue of *The New York Daily Times* (the word "Daily" was dropped from the title in 1857) was published on September 18, 1851, and promised an editorial policy that emphasized accurate reporting and moderation of opinion and expression. *The New York Times* established itself early on as a "newspaper of record," being the only paper to carry the full text of Lincoln's "Gettysburg Address" on November 20, 1863 and providing coverage of the U.S. Civil War, with Raymond himself reporting on the Battle of Bull Run.[2]

The New York Times Company has come a long way from the small brownstone on Nassau Street where its first issue was published. Today, the New York Times Company

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This case was prepared by Research Assistants Jennifer I. Wehmer and Mark C. Smeraglinolo under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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(NYTC) is a diversified media company including newspapers, magazines, television and radio stations, electronic information services, and electronic publishing. The company publishes two daily newspapers, *The New York Times* and the *Boston Globe*, as well as twenty-one regional papers, nine magazines, and has a fifty-percent stake in the *International Herald Tribune*. The company also operates eight network-affiliated television stations, two New York City radio stations, and The Times Syndicate which sells columns, magazine and book excerpts, and feature packages to media throughout the world.[3] *The New York Times* newspaper reaches more than 1.1 million readers on weekdays[4] and almost 1.7 million on Sundays[5] making it the third largest newspaper behind *USA Today* and *The Wall Street Journal*.

New York Times Executives

Howell Raines: Replaced Joe Lelyveld as Executive Editor of *The New York Times* in 2001. He worked as a chief in London and Washington, also serving as the editor of the editorial page before his promotion. He guided the newspaper to some amazing accomplishments, including eight Pulitzer Prizes in 2001 and 2002.

Author of the important civil rights novel *My Soul is Rested*, Raines was known to be a successful editor in the newsroom.[6] He managed the team with heavy control on much of the newspaper. Other editors did not always appreciate Raines' need to be involved in every decision. Some reporters and editors had trouble approaching Raines because of his intimidating demeanor and inaccessibility.

Gerald Boyd: Was promoted from Deputy Managing Editor to Managing Editor in 2001 when Howell Raines became the Executive Editor. He also served as the Metropolitan Editor and as a White House correspondent throughout his career. Boyd helped lead *The New York Times* reporting on the Columbia spaceship explosion, 9/11 terrorist attacks, and subsequent war on terrorism.[7] Boyd, known for his dedication to his profession, created many meaningful relationships with the newspaper's staff.

Arthur O. Sulzberger, Jr.: Became the chairman of The New York Times Company on October 16, 1997. He was named publisher of *The New York Times* in 1992. He remains in charge of both the company's long-term strategy and the everyday operations of the newspaper. Since Sulzberger became publisher, *The Times* has won 26 Pulitzer Prizes. It is considered one of the premier newspapers in the United States, consistently receiving critical acclaim for its efforts. The New York Times Company placed first in its industry in *Fortune*'s 2002 list of America's Most Admired Companies.[8]

Sulzberger began as a reporter for *The Raleigh Times* in 1974. He joined *The Times*' Washington D.C. department in 1978. He became assistant publisher in 1987 and deputy publisher one year later, monitoring the news and business departments. His father, Arthur Sulzberger, Sr., ran *The Times* before his son. The family retains a significant portion of the company's publicly traded stock.

Jayson Blair

Jayson Blair, an African-American, began working for *The Times* as a summer intern in 1998 in a largely minority program. In his application seeking the internship, Blair wrote, "I've seen some who like to abuse the power they have been entrusted with . . . my kindred spirits are the ones who became journalists because they wanted to help people."[9]

During his ten-week internship, he wrote 19 news articles, helped other reporters, and never seemed to leave the newsroom. According to the senior editor who oversaw Blair's internship program, "He did very well." Some however, including Metropolitan Editor Joyce Purnick, recalled thinking that he was better at socializing than reporting. At summer's end, Blair was offered an extended internship, but he had more college course work to complete before his scheduled graduation in December 1998. When he returned to the newsroom in June of 1999, everyone assumed he had graduated. However, he had not. In fact, Blair had more than a year of coursework to complete according to college officials at the University of Maryland.[10]

Blair was assigned in 1999 to working the *Times*' police bureau, where he impressed many of his co-workers with his quick ability and willingness to work long hours. However, he was repeatedly warned by one of his mentors, Editor Jerry Gray, that he was too sloppy, both in his reporting and in his appearance. But even so, Blair was promoted in 1999 to intermediate reporter, the next step toward a full-time staff position.[11]

Even in his new position, Blair continued to make mistakes, requiring more corrections, explanations, and lectures about the importance of accuracy. Many of his colleagues also reported that he did bold things, including showing copies of confidential *Times* documents, running up company expenses from a bar down the street, and taking the company car for extended periods, racking up parking tickets.[12]

Despite all of this, in January of 2001, Blair was promoted to full-time staff reporter with the consensus of a recruiting committee headed by Gerald Boyd, then Deputy Managing Editor, and the approval of Mr. Lelyveld, the former Executive Editor before Raines. Blair had just moved to the sports department when he was called up to the national desk to help coverage of the sniper case. [13]

A low point in the 152-year history of the Times

On April 26, 2003, Blair published an article entitled, "Family Waits, Now Alone, for a Missing Soldier" about a missing Army mechanic and the anguish of his family as they waited for news. Unfortunately for him, he did not count on anyone from *The San Antonio Express-News* reading his article, which bore a striking resemblance to its own front page story written by Macarena Hernandez, a former Times intern with Blair[14]. Upon further investigation, it was discovered that Mr. Blair had never been to Los Fresnos, Texas, although the article carried the dateline Los Fresnos and included references to the house and to the missing soldier's mother.[15]

After this revelation, a team of *Times* reporters and researchers was put together to review Blair's work, specifically the 73 articles he had written since late October of 2002, when he was given roving national assignments. This investigation revealed problems in at least 39 of the articles Blair had written during the period[16], while spot checks of the more than 600 articles he wrote before October have found other apparent fabrications. [17] Blair had in fact made up stories, plagiarized other publications, and filed fake expense reports to make it appear he was traveling on assignment when he was actually at home.[18]

Two of Blair's most poignant articles dealt with subjects very close to the nation's heart at the time: the sniper shootings in Washington and Virginia and the rescue of Army Private Jessica Lynch. In his front-page exclusive story about the arrest of John Muhammad, one of two sniper suspects, Blair reported that the United States attorney from Maryland, under pressure from the White House, had forced interrogators to stop questioning Muhammad just as he was about to confess. In response, Howell Raines sent Blair a note of praise for his "great shoe-leather reporting." According to senior law enforcement officials, this was not the case. Instead the discussion had touched on much lighter issues like arranging for a shower and a meal.[19]

In his story dated March 27th, Blair wrote a moving account datelined West Virginia that described Lynch's father choked up as he stood on his porch, overlooking the tobacco fields and the cattle pasture. The porch, according to the *Times*, overlooks no such thing. In fact, Blair never visited West Virginia, nor did he ever interview Lynch's father.

The Times Reacts

On Sunday May 11, *The Times* confronted the scandal by publishing a 7,165-word front-page piece, the result of a team of reporters, along with an accompanying editorial. In it, publisher Arthur Sulzberger Jr. acknowledged the extent of the damage, calling it a "huge black eye" and "an abrogation of trust between the newspaper and its readers."[20]

The next day, the newspaper outlined a series of steps that it planned to take to prevent any future recurrence of journalistic fraud. In an email to their staff, Sulzberger along with Raines and Boyd said, "In the case of Jayson Blair, our organizational safeguards and our individual responses were insufficient. Howell, Gerald and I accept responsibility for that. We are resolved to do all that we can to learn from this tragedy and prevent any similar instances of journalistic fraud in the future." In a later email on the same day, Raines announced the formation of a committee to examine what went wrong. In addition, he revealed that two top editors would begin to inspect what repairs needed to be made to the paper's system for managing expense accounts and keeping track of where reporters are.[21]

On May 14th, the Times rented a movie theater and hosted a meeting for staff members to apologize for mistakes they had made regarding the handling of Blair. Howell Raines told the staff he would not, however, resign as a result of the scandal and would "serve as head of the paper until Arthur (Sulzberger) said he wasn't." Staff members used this time as an opportunity to vent their anger and frustration at the *Times'* top editors.[22]

The Atmosphere at *The New York Times*

Blair's resignation sent shockwaves through *The Times* newsroom. Every employee felt violated by Blair's actions and appalled that the editors did nothing to stop Blair. "We've got a case where apparently one person decided to purposely violate that atmosphere of trust and integrity. And there is a big sense of betrayal," said Howell Raines.[23] To discuss the problems within the newspaper, Howell Raines rented an entire movie theater for a town-hall style staff meeting.

Staff Meeting: Arthur Sulzberger, Howell Raines, and Gerald Boyd initiated a town-hall style meeting with employees on May 14th. Raines began the meeting by accepting responsibility for the oversights and apologizing to his employees. He asked the employees to voice their opinions concerning Jayson Blair. "I'm here to listen to your anger, wherever it's directed," Raines told

his staff.[24] When asked if he had considered resigning because of the scandal, Raines said he did not. Publisher Arthur Sulzberger, Jr. called the incident "a huge black eye," adding that Raines' resignation would not be accepted even if offered.

Staff Response: Employees took full advantage of Raines' invitation, openly questioning his management style, leadership ability, and corporate culture. No one understood how the editors of a prestigious newspaper like *The Times* could allow deception so blatant. They demanded that checks and balances be created to stop behavior like Blair's.

Although the newspaper was successful under Raines, employees were concerned with Raines' hierarchical management style. Employees viewed Raines as arrogant and inaccessible. People did not feel led, but bullied into agreeing with management's vision of the newspaper. They also questioned the lack of communication among the paper's editors. Editors were even scared to bring Raines negative news.[25] At one point, even Raines acknowledged that, "Fear is a problem to such extent …that editors are scared to bring me bad news."[26]

Staff members made it clear that leadership changes were necessary for the paper to function properly. They also made it clear that Raines needed to communicate better with individual employees. "I'm not sure he realized that the staff was going to be assigning meaning to every flick of his eyebrow," said David Carr, media reporter for *The Times*.

Star System: People within *The Times* believed Raines created a "star system," which gave favorite employees unwarranted promotions and undeserved assignments. Jayson Blair was seen by many employees as one of Raines' "stars." Because of his system, employees blamed Raines for giving Blair unwarranted opportunities at the newspaper. Raines has never admitted to having a star system, only saying, "I heard that [employees] were convinced there's a star system that singles out my favorites for elevation."

Staff Meeting Aftermath: Employees continued to voice their frustrations with management. Employees felt that Raines and Boyd did not publicly defend the newspaper properly. They rarely gave interviews after the initial *Times* apology piece on May 11th. Employees wanted to see the most important executives at the newspaper vigorously defending the newspaper's name and reputation. They also rarely gave interviews concerning Rick Bragg, a reporter who resigned for receiving credit for a story written by a freelancer.[27]

Although Raines attempted to recapture newsroom morale, it was too little, too late. "I do not feel a sense of trust and reassurance that judgments are properly made," said Joe Sexton, a deputy editor.[28] Afterward, reporters commented that it could take years before Raines could lift the employee morale.

Did Race Play A Role?

Critics of affirmative action have raised the question about whether Blair, despite his track record of mistakes and problems, was able to stay at *The Times* because he was African American. It is true that *The Times* was trying to diversify its staff. Blair began as an intern in a largely minority program, his three other colleagues being Macarena Hernandez, Edward Wong, and Winnie Hu.[29]

Raines added fuel to the fire during the staff meeting on May 14th when a staff member asked if race had anything to do with Blair's quick progression. "Not consciously," said Raines.

"But [employees] have a right to ask if I, as a white man from Alabama, with those convictions, gave him one chance too many by not stopping his appointment to the sniper team. When I look into my heart for the truth of that, the answer is yes."[30]

However, Gerald Boyd, who himself is African American, had the opposite response stating, "To say that his promotion was about diversity in my view doesn't begin to capture what was going on. He was a young, promising reporter who had done a job that warranted a promotion."[31]

Rick Bragg

Rick Bragg did visit Apalachicola briefly, but he relied on reporting and interviewing done by a freelance journalist named J. Wes Yoder.[32] Bragg, a Pulitzer Prize winner, contended, however, that he did not do anything improper. His defense was that it is "common for *Times* correspondents to slip in and out of cities 'to get the dateline' while relying on the work of stringers, researchers, interns and clerks."[33] *The New York Times* policy states that Bragg should have included Yoder's name on the story's byline. Some reporters, like Peter Kilborn, disagreed with Bragg's vision, "I want to control the story. I know what the essential elements are for a feature story. I want to see the images. I want to hear the voices. It's a matter of pride. I'm not going to paint a picture and have somebody else come in with his brush."[34]

Although the article ran in the June 15, 2002 *New York Times*, the correction did not appear until May 23, 2003. Bragg subsequently resigned on May 28th, causing further damage to the reputation of *The New York Times*.

News Media Studies and Statistics

Advertising Revenue: Like any newspaper, The New York Times relies heavily on advertising to generate revenues. Advertisers look closely at circulations figures because advertisement trends tend to follow subscriber trends. Some media buyers believe the overall subscriptions will not be affected, but others are worried that customers will no longer respect the newspaper as they once did. To quell fears, the newspaper will meet with key media buyers and reassure them their reputation will survive.

***The New York Times* Circulation:** Despite the tumultuous fallout from the Jayson Blair incident, the New York Times circulation seems to be consistent with its history. From March 2003 to September 2003, circulation of the New York Times decreased by only 1.1%. During the same span in 2002, circulation decreased by 6.8%. The decrease in 2003 circulation seems to be consistent with the pattern of *The New York Times*. The chaos recently surrounding the paper has not significantly changed readership of the newspaper.

Public Opinion: Recent studies have revealed that public opinion toward the press has not changed since Jayson Blair's deception at *The New York Times*. However, while the opinions show no damaging effects to *The Times* because of Blair, this in itself represents a problem for the entire news media. The majority of people surveyed believed that the media misreports stories and 58% believe that the media creates false news stories.[35] The numbers for 2003 are consistent with public sentiment in the recent past.

What Next?

After it was announced that Howell Raines and Gerald Boyd had resigned, Catherine Mathis sat in her office faced with a challenging situation. What steps should she take to restore employee confidence and morale? How would they confront this story in the media? How could *The New York Times* go about trying to restore their reputation?

Discussion Questions

1. Who are the key stakeholders in this case? What is at stake for each of them?
2. What are the most important issues facing the newspaper and how would you deal with them?
3. Which channels should the paper use to communicate its message?
4. What can *The New York Times* do to regain its reputation?
5. How should the paper go about fixing the loopholes that Blair was able to fall through?
6. What ethical issues confront *The New York Times* at this point?

Writing Assignment

Please respond in writing to the issues presented in this case by preparing two documents: a communication strategy memo and a professional business letter.

In preparing these documents, you may assume one of two roles: you may identify yourself as an Excel Industries manager who has been asked to provide advice to Ms. Mathis regarding the issues she and The New York Times Company are facing. Or, you may identify yourself as an external management consultant who has been asked by the company to provide advice to Ms. Mathis.

Either way, you must prepare a strategy memo addressed to Catherine Mathis that summarizes the details of the case, rank orders critical issues, discusses their implications (what they mean and why they matter), offers specific recommendations for action (assigning ownership and suspense dates for each), and shows how to communicate the solution to all who are affected by the recommendations.

You must also prepare a professional business letter for Mr. Arthur O. Sulzberger, Jr.'s signature. That document should be addressed to all employees of The New York Times Company, explaining what happened, what the publisher's position is on these issues, and what his plan is for the future of the paper. If you have questions about either of these documents, please consult your instructor.

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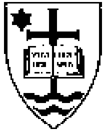
Sony BMG Corporation: Digital Rights Management
Butcher, K.; Curry, J.; and O'Rourke, J. S. (editor)

On October 31, 2005, computer programmer Mark Russinovich wrote in his online blog about how listening to his new Sony BMG CD on his computer had turned into more of a trick than treat. Russinovich discovered that the anti-piracy software on his Sony CD had installed a hidden program that made his computer vulnerable to potential viruses. Within hours, Russinovich's article became a hot topic across the Web. Hundreds of other sites linked to his blog and the security hole created by Sony's software became a headline in major U.S. and British newspapers. Sony BMG initially rejected the uproar against the software as technobabble, and the digital rights management issue quickly turned into a public relations and legal nightmare. Since CD copy protection is still an experiment in progress, Sony must balance its desire to protect its intellectual property with consumer rights concerns. 10 pp. Case #06-12. (2006).



Sony BMG Corporation:
Digital Rights Management

After buying the latest Van Zant CD, computer programmer Mark Russinovich popped the new disc into his computer and forgot about it. Several days later while doing a routine security check on his computer, Russinovich discovered a hidden program installed on his computer known as a rootkit. Rootkits are cloaking technologies that hide computer system files from diagnostic and security software, and they can be used by malicious software attempting to keep their implementation hidden.

With further investigation, Russinovich learned the rootkit's code was developed by a company called First 4 Internet, a U.K.-based company that develops Digital Rights Management (DRM) software designed to prevent music from being illegally copied. First 4 Internet's Extended Copy Protection (XCP) software had automatically installed onto his computer from his new CD on the Sony BMG music label. By exploiting a hole in the copy protection code, virus writers could modify an old Trojan horse to take advantage of the powerful, though inadvertent, shielding provided by the Sony BMG software.[1] Trojan viruses are typically used to steal personal information, launch attacks on other computers and send spam. To make matters worse, the software had no uninstall tool, and Russinovich's attempts to remove the software resulted in disabling his CD player.

On October 31, 2005, Russinovich wrote in his blog about how listening to his new Sony BMG CD on his computer had turned into more of a trick than treat.[2] He concluded the article by saying, "While I believe in the media industry's right to use copy protection mechanisms to prevent illegal copying, I don't think that we've found the right balance of fair use and copy protection yet. This is a clear case of Sony taking DRM too far." Within hours, his article became a hot topic across the Web, with hundreds of other sites linking to his blog.[3] The post sparked an online conversation about DRM in general and particularly Sony's use of it. Sony BMG initially rejected the uproar against XCP as technobabble. The head of Sony BMG's global digital business, Thomas Hesse, told National Public Radio, "Most people, I think, don't even know what a rootkit is, so why should they care about it?"[4] However, Sony BMG soon found out

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This case was prepared by Research Assistants Joseph J. Curry and Kathleen A. Butcher under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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that consumers did care, and one blogger's discovery quickly escalated into a public relations and legal nightmare.

Sony Corporation & Sony BMG

Sony Music can trace its roots back to two major record companies, Columbia and Epic Records. The Columbia Graphophone Company in Bridgeport, Connecticut was created in the 1880s by Charles Sumner Tainter and Chichester A. Bell. The firm manufactured office dictating machines and then began recording the works of John Phillip Sousa onto cylinders which moved the graphophone, an improved version of the phonograph, into popular culture. By the end of the 1800s, Columbia sold a catalogue of over 5,000 cylinder recordings. The firm offered its first disk for sale in 1901.

Throughout the early 1900s, Columbia was an innovator in both content and technology, recording disks by Louis Armstrong, the New York Orchestra and the Original Dixieland Jazz Band. The American Recording Company purchased Columbia in 1934. In 1938, ARC and Columbia became the Columbia Broadcasting System and CBS Records was born.

In 1953, CBS launched Epic Records, a firm that would specialize in jazz and classical releases. Within its first ten years, Epic moved into mainstream, R&B, rock and country music achieving multi-platinum success through the 1990s. CBS Records continued to grow throughout this time adding a direct mail-order club and divisions to market and distribute pre-recorded music and video content. In 1968, CBS formed a joint-venture with the Sony Corporation which would allow records to be marketed alongside Sony players and, eventually, Sony Walkmans. The combination of a strong musical catalog and new technological advancements allowed the partnership to pioneer the compact disk (CD) format in 1982 with the release of Billy Joel's *52nd Street* album.

In 1988, Sony Corporation purchased CBS Records Group and formed the company known today as Sony Music Entertainment, Inc.[5] The firm proposed a 50-50 joint venture with Bertelsmann Music Group (BMG) in November 2003 which was completed in the summer of 2004. Sony Music Entertainment chairman Andrew Lack labeled the agreement, "appropriate and necessary [in] response to current market conditions." The two companies felt they would be better positioned to fight music piracy and the illegal online market by combining resources. Following the merger, Sony BMG Music Entertainment controlled 25.2% of the world's music.[6]

Sony BMG currently operates offices in 43 countries, and the firm controls 21 different labels including Columbia, Jive, Epic and RCA Records.[7] In 2005, music sales comprised only 3.3% of Sony Corporation's total revenue and had a positive operating income for the first time since the completion of the joint venture (See Exhibit 1). However, the company experienced a dramatic drop in sales from ¥400.3 billion in 2004 to ¥249.1 billion in 2005 (a total decline of 43.4%).[8]

U.S. Copyright Law and the Piracy Problem

United States copyright law grants six exclusive rights to copyright holders. These include the right to reproduce a work, distribute a work, create derivative works, display the work to the general public, transmit the work (a form of distribution most often associated with sound recordings), and to perform the work.[9]

The exclusive right of distribution includes all distribution regardless of whether or not money has changed hands in the transaction. The notion that music distributed free of charge, via a peer-to-peer service like Kazaa or content emailed to a friend, does not violate copyright laws is a prevalent myth in American culture. Many consumers believe that no law has been broken if music is not sold. While copyright law gives the public the right to fair use and the limited use of a work for specific purposes including criticism and parody, the right to distribution remains solely in the hands of the copyright owner.[10] Therefore, while the severity of fines and legal ramifications can increase if pirated music is sold or purchased, anyone who distributes copyrighted music without receiving prior permission from the owner violates copyright law.[11]

The Recording Industry Association of America (RIAA) estimates the recording industry loses $4.6 billion each year due to all varieties of piracy. This is comparable to the size of the entire legal music market in the UK, Netherlands and Spain.[12] The industry attributes a substantial portion of this sum to Internet piracy, which is defined as the "unauthorized uploading of a copyrighted sound recording and making it available to the public, or downloading a sound recording from an Internet site, even if the recording isn't resold." The RIAA claims that the price of piracy goes beyond the direct cost to record companies, producers and musicians. The organization blames Internet piracy for the reduction in legitimate music retail outlets as well as the decrease in the quantity and quality of music offered. The RIAA contends that record companies and musicians will have little or no motivation to provide products if there is no profit to be made in supplying them.

Given the proliferation of Internet piracy and peer-to-peer file sharing programs, record companies, publishers, artists and other providers of music content have begun taking steps to curb copyright violations. In addition to enforcing current U.S. copyright laws (Title 17 U.S.C. Section 101), other international agreements include the Digital Millennium Copyright Act and the No Electronic Theft Act which specifically address Internet piracy and MP3 file sharing.[13] The RIAA has launched a program to help authorities find and eliminate copyright violations through lawsuits and criminal prosecution.[14] The International Federation of Phonographic Industries (IFPI), the world's leading fighter of piracy, works in conjunction with the RIAA to catch and prosecute offenders in an effort to enforce copyright agreements around the world.

The negative effects of music piracy are not confined to those directly employed in entertainment. Nearly five percent of both the U.S. and European economies consist of industries dependent on intellectual property and copyright law. The industry represents approximately one billion dollars worldwide. Any illegal activity cuts into both industry profitability and the national gross domestic product (GDP). As piracy grows, net exports of U.S. entertainment products decline. The IFPI estimates there are over 1.5 billion instances of piracy annually. Although the IFPI and the RIAA have had success pursuing music pirates, record labels have started taking action to protect their product lines.[15]

Digital Rights Management: Record Companies Respond

Digital rights management (DRM) is an evolving term. Generally, it is defined as "several technologies used to enforce pre-defined policies controlling access to software, music, movies or other digital data." The first and most commonly recognized form is the Content Scrambling System, which was used to prevent the copying of DVDs and other movie files. Other systems with similar anti-piracy algorithms soon followed but were quickly defeated by computer

hackers, resulting in the Digital Millennium Copyright Act which made it illegal to violate such protections through software code modifications.[16]

However, as hackers refined and refocused their programs, companies reexamined their DRM technology and began introducing new copy protection systems. Sony BMG utilized two types of copy protection on its CDs – XCP which was on select titles beginning in January 2005 and MediaMax which started appearing on certain titles in August 2003. XCP software, developed by U.K.-firm First 4 Internet, limits the number of personal copies a consumer can make of any given CD. In theory, this prevents individuals from creating copies for mass distribution while still protecting the right to make copies for personal use. MediaMax, developed by the Phoenix, Ariz.-based software firm Sunncomm, also allows for a predetermined number of identical backup copies. MediaMax also offers a feature that permits users to legally share songs with family and friends for a limited time period, which deters users from illegal file-sharing sites. See Exhibit 2 for the labels supplied on Sony's XCP and MediaMax protected CDs.

Proponents of DRM technology claim that digital music distribution creates new threats to copyright holders and diminishes the effectiveness of copyright laws. Artists will have no motivation to create new work unless their rights are secured and they can be assured of opportunities to profit from their work. If copyrights are not upheld, DRM advocates claim the public will suffer in terms of a reduction in variety and quantity of CDs and other music products. Supporters also maintain that it is possible to offer copyright protected recordings without causing a noticeable disruption in music listeners' daily lives. However, several activist groups have already spoken out about the emergence of this technology. The Electronic Frontier Foundation has the most vocal opposition to DRM technologies.

The Electronic Frontier Foundation

The Electronic Frontier Foundation is a non-profit organization founded in 1990 by a group of concerned lawyers, public analysts, activists and technologists to "defend freedom in the digital world." The group lobbies lawmakers, protests legislation it believes will limit technology and uses the U.S. judicial system in an effort to influence public policy. The group recently won major cases against the Federal Communications Commission (FCC), Grokster (a peer-to-peer file-sharing service that has been accused of facilitating the distribution of illegal music and movies) and the United States Department of Justice. Fred von Lohmann, a senior staff attorney with the EFF, claims DRM technology "seriously compromises fair use." Furthermore, he says that given new digital delivery methods, DRM is ultimately worthless in terms of preventing Internet piracy."[17]

The Story Unfolds

November 2: A Consumer Outcry Is Not Music to Sony's Ears. Sony BMG faced an onslaught of consumer outcry after Russinovich's blog posting and story proliferated on other Internet blogs as well as major U.S. and British newspapers. In response to the negative media attention, Sony BMG and First 4 Internet announced Wednesday, November 2 that they were distributing a free software patch to reveal hidden files that automatically installed to hard drives when playing some of its music CDs on personal computers. The patch would prevent virus writers from cloaking their work using the XCP copy-restriction tools. Sony BMG spokesman

John McKay said the XCP technology had been deployed on just 20 titles so far, but that the company may include it on additional titles in the months ahead.[18] Sony BMG released the following statement:

> "This Service Pack removes the cloaking technology component that has been recently discussed in a number of articles published regarding the XCP Technology used on Sony BMG content protected CDs. This component is not malicious and does not compromise security. However, to alleviate any concerns that users may have about the program posing potential security vulnerabilities, this update has been released to enable users to remove this component from their computers."
>
> "We want to make sure we allay any unnecessary concerns," said Mathew Gilliat-Smith, chief executive of First 4 Internet. "We think this is a proactive step and common sense."[19]

Gilliat-Smith added that the patch will be automatically distributed to people who use tools such as Norton Antivirus and other similar antivirus software programs. However, Sony BMG didn't make it easy for consumers to find the patch or remove the software entirely. Buried on Sony BMG's FAQ page, the answer directed the consumer to another page that required completing a form to receive uninstall directions via e-mail.[20] Contact information was required to access the uninstaller, and a Sony BMG privacy policy link notified consumers that email addresses would be added to various Sony BMG marketing lists. A second e-mail assigned a case ID and provided a link to another Sony BMG webpage, requiring the user to submit an uninstall request a second time.[21]

The patch only uncloaked the files and did not remove the anti-piracy software itself. Consumers who wanted to remove the DRM software altogether from their computer could contact the company's customer support service, a Sony BMG representative said.[22]

November 4: Concern Arises about Whether Sony BMG CDs Phone Home. Russinovich published further research on November 4, explaining that the XCP software seemed to communicate with Sony's Web site. The software appeared to connect with Sony's servers looking for updates to lyrics or album art, but the way the software operates raises some privacy concerns, he wrote in his blog.[23] According to Sony BMG company spokesman John McKay, the company is not using the software to gather information on its users. "No information ever gets gathered, that's for sure," he said.[24]

November 8: Software Could Be Used to Track Consumer Behavior. However, Computer Associates International, one of the world's largest software and IT companies, announced on November 8 that Sony's anti-pirating software secretly communicates with Sony BMG via the Internet when listeners play the discs on computers with an Internet connection.[25] The software uses this connection to transmit the name of the CD being played to an office of Sony's music division in Cary, N.C. The software also transmits the IP address of the listener's computer, but not the name of the listener, Computer Associates said.

"This is in effect 'phone home' technology, whether its intent is to capture such data or not," said a vice president of Computer Associates' eTrust Security Management unit. "If you

choose to let people know what you're listening to, that's your business. If they do it without your permission, it's an invasion of privacy."

November 10: Situation becomes "Stinx-E." Although Sony BMG and First 4 Internet both claimed that the rootkit DRM posed no security dangers, the first virus exploiting the cloaked files appears. Anti-virus firm Sophos found a virus, named the "Stinx-E" trojan, that opened a backdoor into infected computers and tried to download more malicious code from the Internet to further compromise an infected machine. The virus is also known as "Breplibot" and "Ryknos." While the virus had design flaws that prevented it from causing damage, the DRM software on Sony BMG's CDs had opened the door for hackers to harm consumers' computers.

November 11: Sony BMG Suspends Production of CDs Using XCP. Twelve days after the initial blog posting, Sony BMG announced it was suspending production of audio CDs that contain XCP technology. However, Sony BMG declined to follow EMI's example, when in September 2005 that recording label issued a recall of its first anti-piracy CD because there were errors in the content protection technology. After Sophos' website drew attention to the implications of XCP, Sony BMG was deluged with more complaints, prompting a class-action lawsuit in California. Sony BMG said in a statement:

> "We are aware that a computer virus is circulating that may affect computers with XCP content protection software. Nonetheless, as a precautionary measure, Sony BMG is temporarily suspending the manufacture of CDs containing XCP technology. We also intend to re-examine all aspects of our content protection initiative to be sure that it continues to meet our goals of security and ease of consumer use."[26]

The California lawsuit asked the court to prevent Sony BMG from selling additional CDs protected by the anti-piracy software and sought monetary damages for California consumers who purchased them.[27] The suit alleged that Sony's software violated at least three California statutes, including the "Consumer Legal Remedies Act," which governs unfair and/or deceptive trade acts; and the "Consumer Protection against Computer Spyware Act," which prohibits software that takes control over the user's computer or misrepresents the user's ability to uninstall the program.

November 12: Microsoft Declares Software as Spyware. In a posting on its corporate Web log, Microsoft announced that the rootkit component of the XCP software on some Sony BMG CDs can pose a security risk to Windows PCs. Microsoft planned to update its Windows AntiSpyware software and the Malicious Software Removal Tool as well as the online scanner on Windows Live Safety Center to detect and remove the Sony BMG software, the software manufacturer said in its blog.[28] Two popular antivirus software programs, McAfee Antivirus and Norton Antivirus, added detection codes to their software on November 9 and November 11, respectively, that would remove the DRM cloaking device installed from Sony BMG CDs. These security fix options were in addition to the patch provided by Sony BMG and Net 4 Internet.

November 14: More Lawsuits Filed. The U.S. District Court for the Southern District of New York filed a class-action lawsuit against Sony BMG on behalf of all Americans affected. In

addition, lawsuits soon followed in the District of Columbia, Massachusetts, Mississippi and several other states.

November 15: DRM Patch Found to Open Serious Security Hole. According to Ed Felten and Alex Halderman, security researchers from Princeton University, the patch for Sony's controversial digital rights management (DRM) software opened a critical security hole more serious than the original DRM software itself.[29] The software installed a web-based component which allows any Web site to run software on the user's computer without restriction. This component was used by First 4 Internet's Web site to download and run the uninstaller, but it remained active, allowing any Web site the user visits to take over the computer. In response, Sony BMG discontinued distribution of the web-based patch.

November 18: Sony BMG announces recall. In a press release on November 18, Sony BMG announced that it was instituting a mail-in program that allowed consumers to exchange any CD with XCP software for the same CD without copy protection and receive MP3 files of the same title. Sony BMG also asked its retail partners to remove all unsold CDs with XCP software from their store shelves and inventory. (See Exhibit 3.) Nearly five million copies of the CDs had been shipped with the XCP software and more than 2 million were sold, according to a Sony BMG spokesman. Sony BMG also raised the issue from obscurity on its Web site, featuring a link on the bottom of the homepage in large capital letters that read "Information on XCP Copy Protection."

The CDs that used XCP were only sold in the U.S. and Canada but were available as import in Europe. Sony BMG previously said that only 20 titles were affected but now published a full list of the 52 titles that use XCP. Sony BMG said it was also working on an improved uninstaller that did not leave PCs open to more attacks.

"Ultimately, the experience of consumers is our primary concern, and our goal is to help bring our artists' music to as broad an audience as possible," Sony BMG added in its statement.[30] See Exhibit 4 for the company's press release announcing the recall.

November 21: "Don't Mess with Texas Computers." The crisis at Sony BMG worsened when the Texas attorney general sued the record label, saying it violated the state's new anti-spyware law. Attorney General Greg Abbott said that despite the recall, his staff found CDs with XCP copy protection created by First 4 Internet on store shelves Monday. He estimated that as many as tens of thousands of Texas consumers have bought the CDs, and noted that Texas's spyware law calls for fines of $100,000 per violation. "Our message to Sony," he says: "Don't mess with Texas computers."[31]

Twelve states have enacted anti-spyware software legislation: Alaska, Arizona, Arkansas, California, Georgia, Indiana, Iowa, New Hampshire, Texas, Utah, Virginia and Washington. New suits could still spring up from users claiming actual damages to their computers.

November 29: Researchers Uncover Another Bug. Sony BMG received more criticism after researchers found a security issue in its other DRM technology, SunComm's MediaMax Version 5 anti-piracy software. The vulnerability was discovered by the security firm iSEC Partners after Electronic Frontier Foundation requested an examination of the SunnComm software.[32] The MediaMax software installs a file folder on users' computers that could allow malicious third

parties who have localized, lower-privilege access to gain control over a consumer's computer running the Windows operating system.[33] The MediaMax software was used on 32 CDs released in the U.S. and Canada, and the security vulnerability was different from the XCP software.

December 1: Lawsuits consolidated in New York District Court. On December 1, the U.S. District Court for the Southern District of New York consolidated about 10 pending class-action cases and appointed law firms in New York and California to handle the combined suit. However, even if the settlement is approved by the court, it won't end Sony BMG's legal woes. Texas Attorney General Greg Abbott's lawsuit would continue because he cited Texas's anti-spyware statutes.

December 5: Sony BMG Finds Itself in a Hole, Stops Digging. Sony BMG issued a joint news release with the digital rights group Electronic Frontier Foundation (EFF) on December 5. In that statement, Sony urged users to install a patch that closed the security loophole of MediaMax software. Sony BMG planned to notify consumers about the MediaMax vulnerability and the update through the banner functionality included on the MediaMax music software player, in addition to an Internet-based advertising campaign. Sony BMG also provided an update to major software and Internet security companies. See Exhibit 5 for a list of CDs using MediaMax technology.

"We're grateful to EFF and iSEC for bringing this to our attention," said Thomas Hesse, president, Global Digital Business, Sony BMG. "We believe that the availability of the update coupled with our campaign to notify customers will appropriately address the CDs with MediaMax Version 5 in the market. [34]

However, independent security researchers soon discovered that the MediaMax patch suffered the same security problems as the original program, and the EFF subsequently withdrew its support. On December 8, Sony BMG issued an updated patch that closed the loophole in the original MediaMax patch.

Security experts said it was unlikely that any attacker would have been able to exploit the bugs in MediaMax and its patch. "Even if the issue is only a slight one, at Sony BMG we are very clear that any software security issues are taken with the utmost seriousness," Hesse said.

December 12. The consumer furor over the XCP software had lead Sony BMG to diligently re-evaluate how it protects music on CDs. Thomas Hesse, president of Sony BMG's global digital business, said to the BBC News website, that all the bad publicity had made it think hard about its approach to stopping people from making illegal copies.

"The key point to remember is that copyright infringement is a huge issue for the recording industry as a whole and that's where we came from originally," he said. "But this whole story has led us to look at the approach we have to take going forward."[35]

Discussion Questions

1. Who are the affected stakeholders? How should Sony address them?

2. How could Sony have communicated differently?

3. Is artist brand equity more important than the Sony name? In other words, will consumers stop buying their favorite artist's CDs if they contain DRM technology?

4. Should Sony settle the lawsuit claims or fight for its right to use DRM technology?

5. Should Sony continue looking for new and improved DRM technologies?

6. For companies that deal in intellectual property, how should they address digital rights issues?

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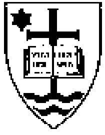
Target Corporation: Pharmacists' Acts of Conscience and the "Plan B" Pill
Cox, J. L.; Berry, K. M.; and O'Rourke, J. S. (Editor)

In September 2005, Rachel Pourchot entered a Target store in Fenton, Missouri intending to fill prescriptions for Ortho TriCyclen, a common hormonal contraceptive, and for Levonorgestrel, an emergency contraceptive known as the "Plan B" pill. Target's pharmacist, however, told her that he would not fill the prescription for Levonorgestrel on moral and religious grounds. As competitors Walgreen's and Wal-Mart made their positions clear on the issue of pharmacists' acts of conscience, Target Corporation struggled with an appropriate response that would satisfy the needs of their customers and their employees, while protecting the reputation of the firm at the same time. 6 pp. Case #06-11. (2006)



Eugene D. Fanning Center for Business Communication **06-11**
Mendoza College of Business
University of Notre Dame

Target Corporation:
Pharmacists' Acts of Conscience and the "Plan B" Pill

On a humid and cloudy day in late September '05, Rachel Pourchot entered a bright, clean, air-conditioned Target store in Fenton, Missouri. She intended to fill prescriptions for Ortho Tri-Cyclen, a common hormonal contraceptive, and for Levonorgestrel, an emergency contraceptive otherwise known as the Plan B pill. Despite Target's reputation for efficiency, diversity, and friendly service, Pourchot told the Planned Parenthood Federation of America (PPF) that she left the store without the emergency contraceptive. The Target pharmacist, she claims, had rudely refused to fill her prescription on moral and religious grounds. PPF immediately contacted Target Corporation for comment.[1] A spokesperson initially denied Pourchot's account of events, and, according to PPF, declined to clearly state the company's policy concerning pharmacists' right to refuse. PPF launched a letter writing campaign that led over 60,000 supporters to contact Target. For many, the incident cast doubt on the company's reputation as a non-discriminatory, impartial, and friendly company.[2]

Target Corporation

The Dayton Corporation opened the first Target store in Roseville, Minnesota in 1963. The corporation had long been notable for its policy of giving five percent of its pretax profits back to the community.[3] In 1969, the Dayton Corporation merged with the J. L. Hudson Company. Over the next four decades, Target stores would become the Dayton Hudson Corporation's largest source of revenue, allowing it to purchase Mervyn's and Marshall Fields. By 1978, Target was the nation's 7th largest retailer.

In 2000, the Dayton Hudson Corporation was renamed the Target Corporation. It is currently headquartered in Minnesota and has 1,300 stores in 47 states, including 140 SuperTarget stores, which introduced upscale grocery shopping to Target customers. In addition to the expansion into grocery goods, the company has matched growing consumer demand for convenience by launching its bridal registry and gift card divisions. Besides one-stop-shop

This case was prepared by Research Assistants Joshua L. Cox and Katherine M. Berry under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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convenience, aisles are well-organized, products are attractive and stores are always clean. Thus, as Target has evolved, it has earned the reputation of being a no-hassle, friendly, and easy place to do everyday shopping. It boasts the most rapid revenue growth in the industry and, with a market capitalization of over $48 billion, provides Wal-Mart, the world's largest retailer, with a significant source of competition.

Plan B Pharmaceuticals

The Plan B pill is a large dose of the hormone Levonorgestrel (synthetic progestin).[4] Progestin is a naturally occurring hormone in the human body that plays an important role in regulating a woman's menstrual cycle and uterine environment. The hormone has been available for decades in traditional birth control pills, though in smaller, more regular doses. The drug is manufactured and distributed in the United States by Duramed, a division of Barr Pharmaceuticals, Inc.

When taken within 72 hours of sexual intercourse, Levonorgestrel will reduce the risk of pregnancy by 89 percent by stopping ovulation, or, if ovulation has already occurred, by preventing the implantation of a fertilized egg. Patients are normally instructed to take one .75 mg tablet as soon as possible, followed by a second tablet 12 hours later. It is important to note that the drug is most effective when taken immediately, and becomes much less effective after the first 72 hours.[5]

The Plan B pill is often confused with RU-486, or mifepristone, sometimes called the "abortion pill." Mifepristone was first made available to European women in 1988, though political and scientific controversy delayed its approval for sale in the United States until 2000.[6] Also a synthetic hormone, mifepristone is classified as an abortifacient rather than a contraceptive. When taken during the first seven weeks of pregnancy, the drug is intended to terminate pregnancy. In contrast to mifepristone, the Plan B pill will not terminate an established pregnancy or cause any harm to a developing fetus.[7]

Not everyone involved in the nation's abortion debate recognizes a distinction between emergency contraceptives and abortifacients. The controversy came into focus on May 6, 2004, when the FDA rejected Duramed's application to make the drug available over-the-counter. Dr. David Hager, a gynecologist from Lexington, Kentucky, testified before the FDA committee considering the proposal. Dr. Hager refuses to prescribe the pill to his patients because he believes that the drug's effects constitute chemical abortion. Though he concurs with FDA studies that no deaths, heart attacks, or strokes, associated with the drug occurred, Dr. Hager expressed concern that young girls would misuse the drug.[8]

For only the second time in 50 years, FDA administrators overruled its advisory panel's recommendation that the drug be approved for over-the-counter sale.[9] An FDA spokesperson stated that the application was rejected for scientific, not moral or religious reasons. Critics, however, pointed to a letter writing campaign by a group of conservative members of Congress that encouraged the FDA to oppose the application. On the other side of the aisle, senators who support making Plan B more easily available have delayed the confirmation of the FDA Commissioner Lester Crawford.[10] To contribute to the fury, the director of the FDA's Office of Women's Health resigned in protest over the decision.[11]

Target Policy and Response

Provoked by outside players like Planned Parenthood, Target was forced to define and publicly express a clear policy. Target announced that pharmacists have the right to refuse to fill a prescription if doing so would be counter to their moral or religious convictions. Nonetheless, the company stated, pharmacists must also sign a "conscience policy" that requires them to help customers get their medications in a timely manner by referring them to another pharmacist on duty or to another pharmacy.

Reaction to this policy was mixed. Planned Parenthood applauded Target's commitment to ensuring that prescriptions be filled, but expressed concern that refusals could cause delays that would interfere with qualified medical treatment and possibly make the medication less effective. This, critics argue, would be of particular concern in areas where there is no other pharmacy nearby. "Timeliness," in other words, was left open to interpretation. In a panel interview on National Public Radio, a Target spokeswoman responded to a Planned Parenthood spokeswoman: "Most Targets are in metropolitan, suburban or urban areas, so, you know, there's very likely to be another pharmacy very close by."[12]

Target has also been pressed for clarification about how broadly applicable pharmacists' right of refusal should be. While the corporation states that it is required by the 1964 Civil Rights Act to make "reasonable accommodations for their employees' religious beliefs," the corporate policy applies only to the Plan B drug. Pharmacists are not allowed to refuse prescriptions for any other medications.[13]

If strongly held moral beliefs made this issue complicated for Target to navigate, differences in state laws have made the problem almost intractable. In fact, state law typically determines the balance between pharmacists' and consumers' rights and some states take very different approaches from others. Legislative directives about pharmacists' rights in Missouri, for example, were in many ways opposite those in neighboring Illinois. State laws complicate Target's response and its competitors' responses.

Walgreen's in Illinois

The American Center for Law and Justice (ACLJ) is currently representing 4 pharmacists who were terminated at an Illinois Walgreen's after failing to fill prescriptions for Plan B. Defending the "Healthcare Right of Conscience Act," the ACLJ claims that the pharmacists have a right to refuse based on moral grounds. While this law does support the pharmacists' actions, it also stipulates that the *pharmacy* must ensure that prescriptions be filled in a timely manner through a referral.[14] At first glance the Missouri and Illinois laws appear identical, but they differ in their definitions of "timely manner" and of "referral."

In Missouri, the law allows a pharmacist to refer a customer to a different nearby pharmacy.[15] In Illinois, the pharmacist must refer the customer to another professional within that pharmacy, unless the customer *specifically* requests a referral to a different pharmacy. Furthermore, Illinois defines "timely" as about 45 minutes, the average time it takes to fill a typical (not necessarily emergency contraception) prescription. Missouri law, on the other hand, doesn't specify a maximum delay. A pharmacist may refuse to fill a prescription without regard to the delay it will cause the customer, and the pharmacy is not compelled to ensure that the prescription is filled. In Illinois, the pharmacists' rights are protected only insofar as they do not exacerbate the time constraint for the customer.[16]

Wal-Mart in Massachusetts

Historically, Wal-Mart has managed to skirt the emergency contraception controversy by refusing to stock the drug. Increased public attention to corporations' policies on the matter, however, has left few companies unprovoked. On February 1st, 3 women filed a lawsuit against Wal-Mart for not stocking Plan B in its pharmacies. Technically, all Massachusetts pharmacies are required by law to carry all "commonly prescribed medicine" that the community needs. Wal-Mart's policy was legally viable only if Plan B could be considered unnecessary or uncommonly prescribed. However, on February 14th, the state addressed the legal technicality and required Wal-Mart to stock Plan B in all pharmacies. Wal-Mart complied immediately and company officials say the retailer is considering stocking the drug nationwide, though there is no indication that the policy has changed yet.[17]

Current Situation

In a lawsuit unrelated to Rachel Pourchot's case, Target is currently being sued by a Missouri pharmacist, Heather Williams, under the Federal Equal Opportunity Employment Commision. Williams refused to sign the company's "conscience policy" and argues that her rights were violated when she was fired. A Chicago-based anti-abortion group, Americans United for Life, claims that the termination occurred because Planned Parenthood threatened a boycott of Target stores. Planned Parenthood has vehemently denied any involvement in the matter and denies having planned or threatened a boycott. As of January 26, 2006 Target had not returned calls to the Associated Press.[18]

Target will continue to face public scrutiny as the public expects the corporation to take a side in the debate over pharmacists' right to refuse and the consumers' right to have a prescription filled without delay. Complicating matters further, the corporate strategy will have to differ across state lines, which will likely create issues over how accurately Target's corporate values are portrayed in the media.

Questions

1. Can Target craft and maintain an image of neutrality in this national debate? If not, how should they decide their position?

2. How likely is Target to suffer significant loss of revenue because of Plan B? What consumer group will be the most likely cause for revenue leakage?

3. How important is it to articulate a consistent, clear policy on accommodating pharmacists' beliefs?

4. Is a consistent policy even possible in the context of many contradictory state laws? How can Target communicate this complexity without appearing indecisive?

5. What is the likely effect of the controversy on employees' image of the company?

6. How should Target respond to Heather Williams's Federal complaint?

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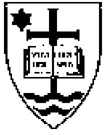
Wal-Mart Stores, Inc: Image Issues for the World's Largest Retailer
Katcherian, A. L.; Blazek, M. F.; and O'Rourke, J. S. (editor)

Federal immigration agents' raids on Wal-Mart stores, referred to simply as "Operation Rollback," raises some concerns for the world's largest retailer, especially in light of the negative media exposure the company receives largely due to its massive size and expansionist efforts throughout the globe. Criticisms of Wal-Mart's non-union stance and its controlling relationship with suppliers continue to surround the publicity of Operation Rollback, transforming the raids into a symbol of the effects of the company's low cost business model and unbeatable low prices. 12 pp. Case #04-08. (2004)



Eugene D. Fanning Center for Business Communication **04-08**
Mendoza College of Business
University of Notre Dame

Wal-Mart Stores, Inc.:
Image Issues for the World's Largest Retailer

In the predawn hours of October 23, 2003, agents of the Bureau of Immigration and Customs Enforcement, working on "Operation Rollback," raided 61 Wal-Mart stores in 21 states. As Wal-Mart executives arrived at work, they were greeted with a deluge of phone calls from more than 60 Wal-Mart store managers who were calling to report the raids. When federal agents finished their raids, 241 workers from 18 nations had been arrested and a search warrant had been executed on Wal-Mart's Bentonville, Arkansas headquarters. Investigators alleged that Wal-Mart officials knew about the immigration violations.[1] Mona Williams, Wal-Mart vice president for corporate communication, would later refute accusations that Wal-Mart knew about the contractors' use of illegal immigrants.[2]

Later that day, at an award ceremony in Springdale, Arkansas, H. Lee Scott, Jr., CEO and President of Wal-Mart, joked about Wal-Mart's tumultuous morning, stating, "I was born March 14, 1949, in Joplin, Missouri. I am a U.S. citizen. I have documentation to that fact." As the crowd responded with laughter, Scott remarked, "Boy, isn't it a great day?"[3]

Sam Walton's Vision

The events of October 23, 2003 were not something Sam Walton would have likely envisioned in 1962 when he started the first Wal-Mart discount store in Rogers, Arkansas. Since Sam Walton's prior store ownership had been as a franchisee of Five-and-Dimes, the discount market was something he knew well. Walton became a crusader for driving costs, and therefore prices, down. In decreasing his business expenses, Walton passed his cost savings on to his customers. Walton's basic business strategy demonstrated that income lost in price would be compensated for in volume. By 1967, Wal-Mart had 24 stores and a total of $12.6 million in sales.[4] Two years later, the company incorporated as Wal-Mart Stores, Inc.

This case was prepared by Research Assistants Amy Katcherian and Mary Blazek under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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In addition to his pricing philosophy, Sam Walton dedicated his practice to customer service. His three basic beliefs included respect for his workers and associates, quality service to Wal-Mart customers, and striving for excellence and improvement of products and costs.[5] These basic tenets have survived throughout the existence of the company and are propagated as part of the Wal-Mart culture today.

Decades of Growth

In 1970, Wal-Mart opened its first distribution center and home office in Bentonville, Arkansas. For the first time, Wal-Mart stock was traded over the counter as a publicly held company, and by 1972 Wal-Mart was listed on the New York Stock Exchange under the ticker symbol of WMT. By the end of the 1970s, Wal-Mart had reached $1.248 billion in sales, employing 21,000 people in 276 stores across eleven states.[6] Wal-Mart now refers to its employees as "associates."[7]

Wal-Mart's growth was unstoppable as its expansion continued rapidly throughout the 1980s. In 1983, the company started the now well-known position of "people greeter" at all of its stores and was well-respected, evidenced by the company being ranked number one among general retailers by *Forbes* magazine for the eighth straight year.[8] In 1988, David Glass was named chief executive officer of Wal-Mart Stores, Inc. The company opened its first Sam's Club and its first supercenter in 1983 and 1988, respectively.[9]

By 1990, Wal-Mart had gained the title of the nation's number one retailer, which was one of the last milestones Sam Walton would see his company reach before his death on April 5, 1992.[10] By then, Wal-Mart had entered 45 states and was experiencing increasing international growth. In that same year, S. Robson Walton was named chairman of the board, continuing the role of the Walton name in the retailer's management. Expansion continued at a rapid rate, and by 1995, Wal-Mart was in all 50 states, operating 1,995 Wal-Mart discount stores, 239 Supercenters, 433 Sam's Clubs and 276 international stores, with total sales of $93.6 billion.[11] By the end of the millennium, the company was ranked the number one corporate citizen in America by the 1999 *Cone/Roper Report*, an annual national survey on philanthropy and corporate citizenship.[12]

The new century has shown no growth slowdown for Wal-Mart. In 2000, H. Lee Scott was named president and CEO. At the end of that same year, Wal-Mart had the biggest single day in sales history with $1.43 billon in sales on the day after Thanksgiving.[13]

21st Century Wal-Mart: The World's Largest Retailer

From its first discount store in Rogers, Arkansas, Wal-Mart has consistently grown its retail presence throughout the world. By 2004, the Wal-Mart empire included Discount Stores, Supercenters, Sam's Club wholesale membership warehouses, and Neighborhood Markets. Located in South America, Asia, Europe, and Canada – as well as its original home in the U.S. – Wal-Mart has become a growing and dominant force within the global economy. Wal-Mart currently operates nearly 5,000 stores around the globe, 3,500 of which are located in the United States.[14] Each week, 138 million shoppers visit a Wal-Mart retail store somewhere, and 82% of American households made at least one purchase at Wal-Mart in the year 2003.[15]

Larger Than Life

Wal-Mart is currently the largest private employer in world, employing a global workforce of 1.5 million people.[16] The company employs 56 times as many employees as the average *Fortune 500* company.[17] In the United States, Wal-Mart represents the third largest public employer, after the federal and California state governments.[18] It is also the world's largest retailer, generating sales of $256 billion dollars during the fiscal year ended January 31, 2004 ($9 billion net earnings).[19] The company's revenues are 50% greater than sales from Target, Costco Wholesale, Sears Roebuck & Co., and Kmart combined.[20]

Moreover, Wal-Mart is the largest company in the world, bigger than ExxonMobil, General Motors, and General Electric.[21] Wal-Mart single-handedly accounted for 2% of the U.S. GDP in 2003.[22] Generating revenues larger than that of the 2002 GDP of Switzerland,[23] Wal-Mart's size defies comparison. According to Ira Kalish of Deloitte Research, "There is nothing like Wal-Mart. They are so much bigger than any retailer has ever been it's not possible to compare."[24]

Its massive size has fostered its control over an increasingly large market share of the sale of U.S. consumer products, such as soap and beauty products.[25] For example, Wal-Mart sales represent 28% of Dial's total sales, 24% of Del Monte Foods', 23% of Clorox', and 23% of Revlon's total sales.[26] Moreover, the company holds around 30% of the U.S. market in household staples such as toothpaste, shampoo, and paper towels.[27] Some analysts predict this share could reach 50% before the end of the decade.[28] Additionally, Wal-Mart enjoys 79% of the supercenter market.[29] According to *Business Week*, "The supercenter is a combination supermarket and general merchandise discounter built to colossal scale."[30]

The Customer Is Always Right

The company's consumer-centric business model takes a hard line on costs, from its toughness on suppliers to its non-union stance with respect to its employees. Jeffrey E. Garten, the dean of the Yale School of Management, wrote that "The essence of Wal-Mart is that it is propelled by one thing: offering products at the lowest possible prices."[31] By lowering its cost of labor and supplies, Wal-Mart can afford to pass on cost savings to its customers. In delivering low prices, Wal-Mart has saved its customers $20 billion in one year, according to one study by New England Consulting.[32]

In addition to providing low costs, the company tracks consumer purchases by its sophisticated and cutting-edge technology.[33] By assessing popular items among consumers, Wal-Mart is able to order and to provide these products at low prices for its customers, thereby perpetuating consumer demand in its stores.[34] Rated number one in *Fortune* magazine's *America's Most Admired Companies* list for the years of 2003 and 2004, other corporations admire Wal-Mart "because it is the most dominant force in commerce, renowned for its superb efficiencies, unprecedented clout with suppliers, and pervasive influence on everything from pop culture to the consumer price index."[35]

For consumers, Wal-Mart's drive for efficiency means low costs and more money in their pockets. For the nation, Wal-Mart's efficient business model has been partly responsible for the nation's low inflation rate in recent years and for an eighth of the nation's productivity gains in the late 1990s.[36] Thus, in benefiting its customers, the company benefits the total economy under which it operates.

"Every Day Low Prices" for a Premium

Wal-Mart's central promise to its customers is always to have low prices for the goods they want. With all the benefits, however, low prices may carry a heavy price tag.

Suppliers

In December of 2003, *Fast Company* magazine published an investigative article entitled "The Wal-Mart You Don't Know. Why Low Prices Have a High Cost." In examining Wal-Mart's business practices, Charles Fishman writes "for many suppliers . . . the only thing worse than doing business with Wal-Mart may be *not* doing business with Wal-Mart."[37] In selecting the lowest possible price among suppliers, Wal-Mart forces its suppliers to become more efficient, leaner and faster in production and in management of costs. Consequently, suppliers often have to outsource their production offshore in order to maintain their profit margins. In 2003, Wal-Mart and its suppliers imported $15 billion in goods from China, accounting for over 10% of the U.S. total imports from China.[38] Moreover, in setting the price it will pay for goods, Wal-Mart dictates the design and the packaging of products.[39] In the end, a contract with Wal-Mart may prove to be more of a burden than a benefit.

Vlasic's gallon jar of whole pickles: *Fast Company*'s Fishman described how Wal-Mart priced a gallon jar of Vlasic pickles – a year's supply for a family of four – at $2.97, a price lower than most grocers get for a quart.[40] Wal-Mart used the gallon jar as a "statement" item, to represent what Wal-Mart is about, even though Vlasic and Wal-Mart were only making a penny or two on each jar.[41] Usually, pickle companies make their profits on "the cut, slicing cucumbers into spears and hamburger chips" and not from whole cucumbers in a jar.[42] Vlasic's gallon jar became a "devastating success," propelling its market share in pickles but shrinking its profit margins by 25%, millions of dollars.[43] Wal-Mart sales accounted for 30% of Vlasic's business,[44] but this portion of sales became unprofitable with the advent of the $2.97 gallon jar. In Vlasic's attempt to raise the price of the gallon to $3.49, Wal-Mart threatened to stop buying Vlasic's other products.[45] Eventually, Wal-Mart loosened its tight reins over Vlasic. That didn't prevent Vlasic from filing for bankruptcy in January 2001, although most observers agree the gallon jar was not the critical factor in the company's failure.[46]

Levi Strauss and Company: Levi's decline in sales from $7.1 billion in 1996 to $4.1 billion in 2002 led to its business relationship with Wal-Mart in 2003.[47] Levi began selling its jeans at every Wal-Mart store in America. In 2002, however, Levi did not offer jeans for less than $30 a pair. This price point was too high for Wal-Mart, so Levi developed a new line specifically for Wal-Mart, the Levi Strauss Signature brand, featuring adult pants for about $23 a pair.[48] Levi immediately experienced an increase in profits because of its Signature brand. By increasing its sales at Wal-Mart, though, some suggest Levi Strauss has diminished its brand value. Paul Farris, a professor at the University of Virginia's Darden School of Business, said "It's hard to see how this relationship will boost Levi's higher-end business."[49] Moreover, Levi Strauss, a company with more than 60 clothing plants in the United States 22 years ago, closed its last two U.S. factories and, in 2004, began importing all of its clothing products.[50]

Labor Practices and Working Conditions

Wal-Mart has been the recipient of continued bad press because of its labor practices and the working conditions of its associates. By 2004, supporters and detractors of the company had drawn a line of contention that focused mainly, though not exclusively on Wal-Mart's anti-union and labor law practices.

Unions: For more than 42 years, Wal-Mart's workforce remained non-unionized. By the summer of 2004, however, workers at a Wal-Mart outlet in the Canadian province of Quebec were granted permission to form a collective bargaining unit – the first in the company's history. On August 2nd of that year, the Quebec labor relations board accredited Local 503 of the United Food and Commercial Workers (UFCW) Union to represent roughly 170 workers at the Wal-Mart store in Jonquiere, a city about 137 miles north of Quebec City. The UFCW subsequently filed with provincial authorities in Saskatchewan, Manitoba, and British Columbia for similar recognition.[51] In the United States and elsewhere, though, unions have yet to make headway in organizing the Wal-Mart workforce.

The average hourly wage for a full-time Wal-Mart employee is $9.76 an hour.[52] Although that's well above the U.S. federally mandated minimum wage, some critics complain that many associates earn income below the national poverty level and are forced to seek public assistance, such as welfare payments or state-administered food stamps. Some critics also complain about the lack of workers' health insurance benefits. Wal-Mart supporters counter that 90% of Wal-Mart associates do in fact have health insurance coverage.[53] Just less than half of those employees receive insurance through the company, though, while the other half receives coverage through spouses or other family members.[54]

In-House Audit: A 2001 internal audit, conducted by Bret Shipley, a Wal-Mart auditor, revealed violations of child labor laws and various state employment regulations.[55] The audit confirmed Wal-Mart's pattern of making its employees work through their breaks and lunches.[56] It also noted instances where children worked too late at night or too many hours a day and worked during school hours.[57] Wal-Mart responded to the allegations by noting that employees probably took their lunches and breaks but had failed to record them.[58] Regarding the alleged child labor violations, Mona Williams, Wal-Mart's vice president for communication, claimed that schools might have been closed on a given weekday so that the audit does not necessarily reflect actual behavior in stores.[59]

Lock-Ins: In January, 2004, *The New York Times* published an article describing overnight lock-ins of Wal-Mart employees.[60] Wal-Mart's policy is to lock-in its associates during the overnight shift while maintaining access to the outside through a fire exit and through a night manager who holds a key. Wal-Mart claims its policy prevents "shrinkage" – theft by employees and outsiders.[61] Some workers, however, reported the ill-effects of such a policy. One worker, Michael Rodriguez, had to wait for several hours for someone to unlock the doors after some heavy machinery crushed his ankle.[62] Another worker was throwing up violently with no one to let him out.[63] The workers complained that on some nights there was no manager with a key, and workers protested that they were repeatedly told they would be fired for using the fire exits without an actual fire.[64] The company defended its policy by saying it protects stores and

employees in high-crime areas, as well as increases efficiency, since workers are unable to take cigarette breaks or make a quick trip home.[65]

Can Anyone Compete with Wal-Mart?

Wal-Mart's presence in the grocery business has caused rippling effects through the world of unionized supermarkets. Wal-Mart is the number one market leader in retail grocery, generating $138 billion in grocery sales.[66] The second-highest grossing grocery retailer, Kroger, generated only $53.6 billion in comparison.[67] Retail Forward released a study in 2003, concluding that for every Wal-Mart Supercenter that opens within the next five years, two supermarkets will close, amounting to 2,000 closed supermarkets stores in the next five years, or 400 per year.[68]

Southern California Supermarket Strike

In October 2003, more than 70,000 United Food and Commercial Workers (UFCW) went on strike in Southern California. In an effort to compete with Wal-Mart's low cost business model, Kroger, Albertsons, and Safeway attempted to cut union wages and health benefits. Corporate supermarket executives cited Wal-Mart as the reason for the proposed cuts, arguing that the retail giant's presence would force them into bankruptcy if they could not reduce their costs of labor. Facing studies that show a 13% to 16% drop in grocery prices after Wal-Mart enters a market, the supermarkets sought concessions from the unions on these grounds.[69] After five months on strike, California union supermarket workers returned to work after saving health care benefits and pension funds and securing a new three-year employment contract.[70]

Stopping Wal-Mart at the Polls

On April 6, 2004, the city of Inglewood, California, a predominantly minority community located in near Los Angeles, voted to stop Wal-Mart from building in the community. Wal-Mart aimed to construct a supercenter the size of 17 football fields in Inglewood.[71] If enabling legislation had passed, the company would have been exempted from any zoning ordinances or environmental regulations, creating what *The New York Times* called a "city-within-a-city."[72]

Some localities, such as Contra Costa County in Northern California, have not been as successful as Inglewood. Contra Costa's attempt to prevent so-called "big box" retailers from entering the community failed, as Wal-Mart rallied supporters in the area, sending newsletters and mobilizing voters. Opponents claimed that Wal-Mart and similar stores destroy local businesses, drive down wages, and create sprawl, thereby gutting communities.[73] In 2003, Wal-Mart announced plans to open 40 new supercenters in California, but by the autumn of 2004, had managed to open only one.[74]

On Top of All This . . . A Sex-Discrimination Suit

On Tuesday, June 22, 2004, a federal judge granted class-action status to a lawsuit filed on behalf of 1.6 million women who claim that Wal-Mart stores, Inc. discriminated against them in pay and promotions. This is potentially the largest civil rights suit in the nation's history.

In approving class action status for the three-year-old case, U.S. District Judge Martin Jenkins of San Francisco carefully expressed no opinion on whether the company had

systematically favored men over women, leaving that issue to a jury. At issue was whether Wal-Mart would have to defend itself against lawsuits by six individual women who brought the original lawsuits or against a single suit on behalf of nearly every woman who has worked all 3,566 of the company's stores in the United States since December of 1998.[75]

In his 84-page ruling, Judge Jenkins said the case, despite its unique scope, meets the traditional criteria for class actions – in particular, the need to show a single issue, common to all plaintiffs, that outweighs individual differences among the plaintiffs. That issue, he said, is sex bias, allegedly carried out by individual managers who determined pay and promotions with little outside review under the influence of "a strong corporate culture that includes gender stereotyping."[76]

Of Wal-Mart's 1.5 million employees, women make up 65 percent of the non-management staff, 33 percent of the managers, and 14 percent of the store managers, figures that the plaintiffs say show much less diversity than other large retailers. Judge Jenkins said in his ruling that some of the plaintiffs' evident was largely undisputed: that women were paid less than men in every region and in most job categories; that the salary gap widens over time, even for employees hired into the same jobs; that women take longer to reach management positions; and that "the higher one looks in the organization, the lower the percentage of women."[77]

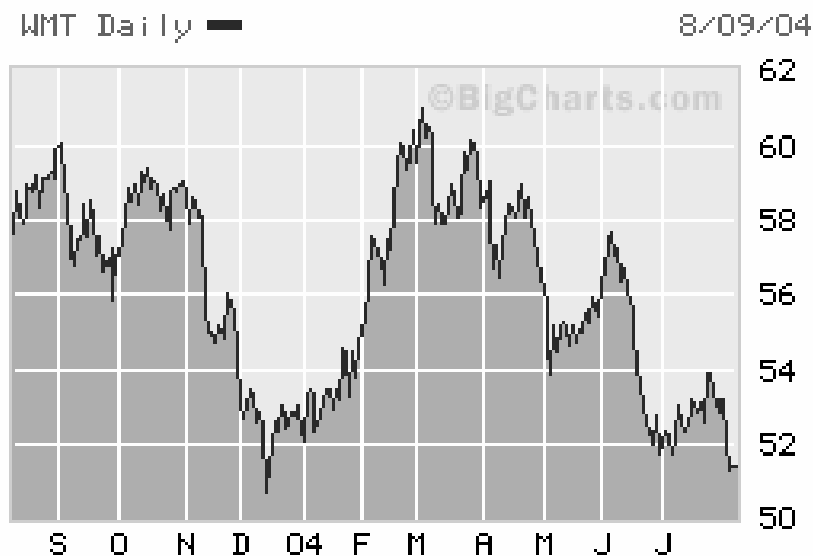

Figure 1: Wal-Mart Stock Performance
(NYSE: WMT): August 2003 - August 2004. Source: BigCharts.com. Used by permission.

Thank You for Shopping at Wal-Mart

Beginning with the evening news of October 23, 2003, and concluding with the Federal District Court announcement of June 22, 2004, it became clear the image issues facing Wal-Mart would not simply fade away like most unpleasant news: on the front page one day and forgotten the next. The company's problems were now eliciting national and international attention. Two months after the "Operation Rollback" raids, corporate VP Mona Williams was still refuting accusations that Wal-Mart knew contractors were hiring illegal workers, but eventually disclosed

that Wal-Mart had been cooperating with the federal government for more than three years to investigate ongoing potential immigration violations by such contractors.[78] The federal immigration raids and the class-action suit had become two more links in a chain of bad press for the world's largest retailer.

During the autumn of 2003 and throughout 2004, a number of Anti-Wal-Mart Websites began to appear, including *Wal-Mart Watch*, http://www.walmartwatch.com, a site aimed at blocking the company's expansion and highlighting bad press accounts; *Wal-Mart vs. Women*, a site featuring Carolyn Sapp, Miss America 1992, http://www.walmartvswomen.com; and *Wal-Mart Class.com*, http://www.walmartclass.com, a site operated by plaintiffs' bar lawyers looking for litigants to join the class action suit against Wal-Mart.

Although the company maintains a healthy balance sheet and continues to expand its retail locations, from August of 2003 to August of 2004, operating margins shrank while same-store sales remained steady. The value of Wal-Mart common stock hovered near a 52-week low, just above $51 a share, more than $10 a share below its high-water mark in March of that year.

Lee Scott Responds

Anticipating a continued spate of bad news in the press, CEO Lee Scott chose the company's annual shareholders meeting to announce a new pay system for hourly employees. On Friday, June 4, 2004, Scott told employees and shareholders that executive bonuses, including his own, would be cut by 7.5 percent that year and 15 percent the next year if the company could not meet its goals for promoting women. The aim, he said, would be to promote women and minorities in proportion to the number that apply for management positions. "If 50 percent of the people applying for the job of store manager are women, we will work to make sure than 50 percent of the people receiving those jobs are women," he said.[79]

Scott promised other changes in job classifications and pay structure for hourly workers, which he said would lead to fairer wages, though he declined to provide any specific details. Critics, not surprisingly, were skeptical of the company's planned changes in work conditions and pay scales. "None of it sounds like a huge improvement in the lives of Wal-Mart workers," said Ross Eisenbrey, vice president of the liberal Economic Policy Institute in Washington, D.C.

Tom Coughlin, Wal-Mart executive vice president in charge of the Wal-Mart and Sam's Club divisions, complained about criticism that has been heaped on the company, then thanked employees for their loyalty. "The fact of the matter is, we do need to tell our story better," Coughlin told his audience.[80]

The real question facing Wal-Mart by the summer of 2004, though, was whether its consumer-centric business model still conformed to the public's interest. Lee Scott and Mona Williams were confronted with the challenge of improving Wal-Mart's image as a socially responsible company, as well as finding ways to temper claims that Wal-Mart had become an evil empire. With the help of community groups and the media, the company's campaign had already begun.[81] How to capitalize on a small amount of earned media and community goodwill would be the larger challenge. And for the world's largest company, this challenge would be neither easy nor inexpensive.

Discussion Questions

1. What should the company do to counter and/or respond to the media's and the public's charges against Wal-Mart? What is the appropriate manner in which to communicate this response?

2. What actions, if any, should the company take to maintain or to develop an image as a socially responsible corporation?

3. Should the company seek outside assistance to help combat the recent negative media exposure?

4. Who are the key stakeholders in this case and what are the critical issues they face?

5. How should Wal-Mart respond to allegations of unfair labor practices and criticisms of its non-union stance? What, if anything, should Wal-Mart do to better its relationships with its suppliers?

6. Should Wal-Mart continue to expand into communities where there is local opposition?

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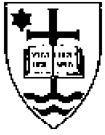
ChoicePoint: Personal Data and a Loss of Privacy
Bailey, Q.; Gilfillan, B.; and O'Rourke, J. S. (editor)

On September 27, 2004, ChoicePoint, a company that stores and sells critical personal information, discovered possible fraudulent activity within their network of databases. On further investigation, ChoicePoint security officials realized that they may have allowed identity thieves in Los Angeles, who acted as legitimate business clients, to access more than 110,000 people's personal information. CEO Derek Smith and communications chief James Lee are faced with explaining the loss to clients, the press, the public, and those who may have been compromised. They also face the daunting task of restoring confidence in the company. (A) Case: 7 pp. (B) Case: 6 pp. #06-07. (2006).



Eugene D. Fanning Center for Business Communication
Mendoza College of Business
University of Notre Dame

06-07

ChoicePoint:
Personal Data and a Loss of Privacy (A)

On September 27, 2004, ChoicePoint, a company that stores and sells critical personal information, discovered possible fraudulent activity within their network of databases.[1] Upon further inquiry, ChoicePoint security officials realized that they may have allowed identity thieves in the Los Angeles area, who acted as legitimate business clients, to access people's personal information. In mid-October the company began working with the Los Angeles Sheriff's Department (LASD) and soon discovered that an identity theft ring had set up over 50 fake companies that posed as legitimate business clients. The illegitimate companies inquired and received everything from social security numbers to credit reports, more than enough information to steal someone's identity. The security breach effectively put 35,000 Californians and 110,000 people across the country at an increased risk of identity theft.[2]

An Arrest is Made

The LASD, working with ChoicePoint, were able to set up a successful sting operation which resulted in the arrest of one of the data thieves. On October 26, 2004, Olutunji Oluwatosin was arrested after receiving a fax from ChoicePoint requesting an additional signature for one of the illegitimate companies the thieves had previously set up. The contact information for the fake company was that of a local Kinkos and when Mr. Oluwatosin arrived to pick up the fax he was apprehended by the LASD.

Instructions from LASD to Delay Announcement of Breach. The LASD originally instructed ChoicePoint to delay any public announcement of the security breach because it would have hindered an ongoing investigation. However, there are some inconsistencies with regard to how long ChoicePoint was told to wait. Company officials maintain that they were told to hold off any announcement until January while a representative of the LASD has said that they instructed

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This case was prepared by Research Assistants Quinn Bailey and Benjamin Gilfillan under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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ChoicePoint to start disclosing problems in November.[3] At any rate, ChoicePoint will have to disclose the security breach at some time in the near future. California state law mandates that its citizens be informed when their personal information is compromised.

A Questionably Timed Executive Stock Sale. On November 3rd, whether or not the security breach was known at the time to ChoicePoint executives, Derek Smith, CEO, and Douglas Curling, President and COO, adopted plans for prearranged stock sales over a six month period.[4] The plans, which had previously been approved by the board of directors, call for the sale of 24% of the executives combined stock in the company. The executives started to sell their ChoicePoint shares on November 9th, before any public announcement of the security breach.

ChoicePoint

ChoicePoint was founded in 1997 by Equifax, an information management company, when it spinned-off its insurance services group. Former Equifax Vice President and Senior Vice President of Finance and Administration Derek Smith and Doug Curling, respectively, joined ChoicePoint at its inception and have helped evolve the company into being the premier provider of decision-making intelligence to businesses and government.[5] ChoicePoint now stores private information such as social security numbers, credit ratings, and criminal history reports on its databases and makes this information available to qualified clients.

After the events of September 11, 2001, the United States government's need for background information increased exponentially as did ChoicePoint's services to various government agencies. The acquisitions of Templar Corp. which employs an information sharing system originally envisioned by the departments of Defense and Justice and IMapData Inc., an information gathering company whose clients include intelligence and homeland security agencies, further enabled ChoicePoint to increase business with the federal government.[6] Through their strategic acquisitions, over 60 in all, and the increased use of data brokers by the federal government and businesses, ChoicePoint has experienced rapid growth. ChoicePoint now employs 5,500 people and is listed on the New York Stock Exchange under the symbol CPS. The company registered record annual revenue in 2004 of over 884 million dollars.[7]

Corporate Communications at ChoicePoint. The communications team at ChoicePoint is relatively small and has had no experience with situations such as this. The team is made up of James Lee, Chief Marketing Officer, who is in charge of all internal and external messaging, and three other persons, two of which are dedicated to employee communications.[8] The fraudulent activity coupled with a questionably timed stock sale by company executives agreeably puts the communications team at ChoicePoint in a crisis situation.

Derek Smith and Douglas Curling. Derek Smith joined ChoicePoint as CEO after its spin off from Equifax in 1997 and became Chairman in 1999. Mr. Smith is seen by many in the industry as being on the leading edge of information technology.[9] He has written several books including: *A Survival Guide in the Information Age*, a book that contains ways to safeguard you and your family from identity theft, and *Risk Revolution; The Threats Facing America & Technology's Promise for a Safer Tomorrow*.[10] Derek Smith is an advocate for using technology to combat terrorists and criminals and he believes it is possible to make our nation more secure while protecting civil liberties.[11] Smith serves on the board of the Society of International

Business Fellows and The Educational Foundation of Georgia State University and is an honor graduate of Pennsylvania State University.[12]

Douglas Curling, like Derek Smith, joined ChoicePoint at its inception. He has held the positions of Chief Financial Officer, Chief Operating Officer, and is now President Chief Operating Officer and Director. Mr. Curling has been responsible for ChoicePoint's acquisitions which successfully diversified revenue sources. Douglas Curling emphasizes efficient internal organization in the ever changing technology industry.[13]

The Data Brokerage Industry

The data brokerage industry is a relatively new industry. The technological advances of the past decade have paved the way for new kinds of companies such as ChoicePoint and Lexis Nexis, a rival firm, to exist. Through the increased power of computers, lowered costs of data storage, and the ever increasing speed of the Internet, these companies are able to aggregate, store, and retrieve large amounts of information in a quick manner. The information collected by these firms range from as detailed as someone's social security number, driving, criminal, and credit records to as general as one's college alma mater.[14] However, for a business opportunity to exist for these firms there must be customers who would like to purchase this information.

Fortunately for data-brokers, there are more than enough potential businesses and governmental agencies that would like to get their hands on such data. Businesses use information such as criminal records and social security numbers to help in wise hiring decisions and credit reports are used when contemplating whether or not to grant credit. Governmental and law enforcement agencies rely on data brokers to compile and use information to solve crimes and protect the nation from terrorists. Data brokers are able to provide the agencies with information that would otherwise be non accessible due to several privacy laws that restrict the government's ability to obtain personal information.[15] Technology breakthroughs and large customer bases have allowed data brokers to experience large profits and growth, a trend that is likely to continue in the future. Today the data brokerage stands as a 5 billion dollar industry.[16]

Current Regulation

The data brokerage industry is, more or less, unregulated. There are certain laws such as the Fair Credit Reporting Act (FCRA) which regulates companies that issue consumer credit reports but their main objective is to make sure credit reports are not distributed for marketing purposes.[17] In 1997, the Federal Trade Commission issued a set of principles for data brokerage firms in an effort to set up acceptable best practices for the industry. Nevertheless, these principles mostly deal with certain types of information not to be used for marketing purposes. California disclosure law, Senate Bill 1386, is the only law of its kind that requires data brokers like ChoicePoint to report any potential release of their personally identifiable information.[18] Any other federal or state disclosure laws regarding breaches of data security are limited to certain types of businesses such as financial institutions.[19]

Privacy and Identity Theft in Today's High Tech World

Individual privacy today is at an all time low. The technological advances of the computer and Internet have allowed for virtually anyone to collect data on people. Internet companies have

devised ways to track Internet users as they travel through the Internet (devices known as cookies), grocery stores issue discount cards that track what people buy and when they buy it, and federal and state governments have put an increasing amount of public information on the Internet.[20]

Arguments can be made on both sides of the issue. The quick accessibility of information on the Internet in many cases has allowed for an easier and more efficient lifestyle. Businesses that track our buying behavior are more capable of pointing us in the direction of other items we may want and often offer us discounts on frequently purchased products. And as more records are put online by government the faster we can get a hold of duplicate records such as birth certificates and voter registration cards when we need them. Companies like ChoicePoint have provided many benefits to society as they have actively participated in finding many abducted children, have helped track down numerous deadbeat dads, and have provided information to law enforcement agencies that has led to the arrest of criminals.[21]

On the other hand, privacy advocacy groups such as Privacy Rights Clearinghouse point out that this enhanced accessibility to personal information makes us vulnerable to not only identity theft but also incorrect data profiles. One of the biggest problems with aggregating information from a variety of sources is errors and omissions in the data. These mistakes and holes in someone's profile create opportunity for misunderstandings between the party using the information and the individual that is portrayed. This can especially be a problem when the incorrect profiles are used in the hiring and credit granting decisions, as the individual does not get a chance to review their information. Privacy Rights Clearinghouse quotes *The Unwanted Gaze: The Destruction of Privacy in America* by Jeffrey Rosen.

> "Privacy protects us from being misdefined and judged out of context in a world of short attention spans, a world in which information can easily be confused with knowledge."[22]

One thing known for sure is that personal information that gets into the hands of the wrong people can prove harmful to both our pocket books and our reputations. Identity theft is one of the fastest growing crimes in the United States. According to a Federal Bureau of Investigation report, in upwards of 900,000 people are victims of credit theft in this nation each year.[23] At an average cost of $1,000 for victims to repair the destruction done by identity theft, this delinquency is costly to the individual and at an average cost to financial institutions of $6,767 per crime it puts a toll on the economy.[24] To make matters worse, a survey done by The Privacy Rights Clearinghouse showed that 12% of identity theft victims suffered damage done to their good names and were left with unjust criminal records due to the thieves' activity.[25]

ChoicePoint's Actions

A public announcement by ChoicePoint is inevitable. With the arrest of one of the identity thieves, the LASD's investigations will begin to wrap up soon. Whether instructions were to start disclosing the security breach in November or January, it remains clear that at some point ChoicePoint will have to go public with the problem. How should ChoicePoint come out with the information? Should ChoicePoint inform only those Californians that may be affected by the breach? Which individuals or groups should ChoicePoint be concerned with as they make the announcement? What changes, if any, should ChoicePoint make in the future? As they get

closer and closer to the public announcement, these questions and more will have to be answered by James Lee and the communications team at ChoicePoint.

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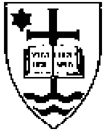
Guidant Corporation: Heart Implants and Patient Trust
Anderson, J.; Eggleton, L.; and O'Rourke, J. S. (editor)

On June 17, 2005 medical device maker Guidant Corporation announced a recall of 50,000 implantable cardioverter defibrillators (ICDs) due to flaws in the devices. These devices are designed to correct a chaotic and deadly type of heart rhythm. This recall was expanded to include 109,000 ICDs and another recall affected Guidant's pacemaker products. These problems brought an impending acquisition by Johnson & Johnson into question, and created patient concerns about the integrity and honesty of the company. 8 pp. #06-08. (2006).



Eugene D. Fanning Center for Business Communication **06-08 (A)**
Mendoza College of Business
University of Notre Dame

Guidant Corporation (A):
Heart Implants and Patient Trust

In March of 2005, 21-year-old Joshua Oukrop was mountain biking with his girlfriend in Moab, Utah when he complained of feeling fatigued. Moments later he was on the ground, dead of cardiac arrest. Joshua's implanted heart defibrillator, produced by medical device maker Guidant, had short-circuited when it was charging up. A Guidant executive, Dr. Joseph M. Smith, said, "There was evidence of a device malfunction." Mr. Oukrop, Joshua's father, had the same defibrillator but soon underwent a replacement procedure. He commented that "Whoever made this decision at Guidant, I pray he doesn't have a son who this happens to."[1]

Joshua Oukrop had inherited a genetic heart disease from his father, hypertrophic cardiomyopathy, which causes erratic heartbeats and an enlargement and thickening of the heart wall.[2] To lessen the risk of serious health consequences, his father and doctor convinced Joshua to have an implantable cardioverter defibrillator ("ICD") implanted in his chest.[3] Joshua agreed to have such a device implanted in his chest and after the operation returned to an active lifestyle. However, in this case the device did not effectively protect his health.

Company History

Guidant Corporation was founded in 1994 as a spin-off of pharmaceutical giant Eli Lilly & Co. The company and its subsidiaries provide medical solutions for customers, patients, and healthcare systems around the world. The company concentrates on developing and manufacturing products to treat cardiac arrhythmias (irregular heart contractions), heart failure, and coronary and peripheral disease.[4] The main products they produce to treat these health problems are ICD systems, implantable pacemaker systems, coronary stent systems, angioplasty systems, and cardiac surgery systems.[5] Headquartered in Indianapolis, this spin-off was created as a result of Eli Lilly's strategy to concentrate on pharmaceuticals and consequent divestiture of its medical device divisions, which became Guidant Corp. Today, Guidant has a presence in nearly 100 countries, but the bulk of its sales are in the United States, Europe, and Japan.[6] The

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This case was prepared by Research Assistants John P. Anderson and Loren J. Eggleton under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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company's slogan, "It's a great time to be alive" emphasizes its commitment to creating medical solutions that save and improve the lives of people around the world. [7]

Sales & Products

In 2004, Guidant had $3.77 billion dollars in sales. These sales came primarily from four main categories of products, with the ICD category accounting for the largest portion at 47% ($1.77B). Following ICDs were pacemaker systems with 19% ($.71B) of the company's profits. Angioplasty systems and coronary stent systems accounted for 12% ($.45B) and 14% ($.53B) respectively. The remaining 8% ($.3B) in total sales included a variety of other Guidant-manufactured products.[8] The four major product categories:

Implantable Cardioverter Defibrillator (ICD): a device surgically implanted under the skin that emits an electrical shock to the heart to interrupt a chaotic and deadly type of heart rhythm.

Pacemaker: a device surgically implanted under the skin that regulates a heart that is beating too fast or too slowly.[9]

Angioplasty Systems: products used in procedures to open blocked arteries in the heart.

Coronary Stent: a slender coil inserted into the blood vessel to prevent it from narrowing. A stent is often inserted following angioplasty.[10]

Guidant Corporation currently has 12,000 employees and total assets of $5.4 billion.[11] The company has seen substantial growth since its creation in 1994. At that time, Guidant had 4,500 employees and total assets of just $1.1 billion. A very attractive element of Guidant is the quickly growing ICD market; in 2005 more than 200,000 patients are expected to receive an ICD implant.[12] This growth is also reflected in Guidant's sales figures. The portion of the company's sales attributed to this product line increased from 27% in 1994 to 47% in 2004.[13] Sales of ICDs are expected to continue growing as the populations of Guidant's largest markets grow older.

Defibrillator Industry

The ICD market has three principal competitors: Guidant, Medtronic and St. Jude Medical. These three companies share the majority of the estimated $5.6 billion market for the devices in 2005. This figure represents a 20% increase from 2004.[14] Medtronic is the largest producer of ICDs, with Guidant the second-largest producer and St. Jude Medical the smallest of these three.[15]

ICDs are a costly investment for patients: the device itself can cost up to $25,000 and other costs related to the surgery, including doctor and insurance fees, can add another $15,000 to the overall cost.[16] There are also risks of infection related to the surgery, which cannot always be measured in financial terms but which patients must evaluate in consultation with their physicians. Upon successful implantation, patients have regular check-ups (typically every 3 months) to test the device for problems.[17] Additionally, due to the device's limited battery life,

the ICDs must be replaced every five to six years, requiring further financial and emotional commitment on the part of the patient.

Recall of ICDs and Prior Knowledge of Problems

On June 17, 2005, Guidant announced the recall of nearly 50,000 of its ICDs. This recall affected approximately 28,000 patients who would require a medical operation to correct the flaw (the remaining 22,000 devices could be fixed through external programming). This recall was the result of three confirmed deaths, by Guidant, due to ICD device failure.[18] By mid-September, 109,000 ICD devices had been recalled by Guidant.[19] In an attempt to soften the blow of the recall, the company announced that if a problem were found with a patient's ICD, and both the patient and physician decided it best to replace the device, Guidant would replace it at no cost. The large number of patients who had received the implant, coupled with the enormous replacement costs meant that Guidant's decision could cost the company in the tens of millions of dollars.[20]

Guidant allegedly knew for three years that the ICD devices had defects, but remained silent. It wasn't until February of 2005, that Guidant notified the Food and Drug Administration (FDA) of these flaws. Despite possessing the knowledge that the devices were defective, Guidant continued to manufacture and sell these devices to doctors and patients all over the world.

Mounting Concerns and Lawsuits

On September 20, 2005, a class action lawsuit was filed against Guidant by Viles & Beckman, LLC of Fort Myers, FL. This suit claims that Guidant learned well in advance of their product recall that the ICD devices were defective, and that the company delayed notification to physicians and the general public, hoping that they would be able to correct the problems in future models. Viles & Beckman has received worldwide recognition for their work in defending the rights of consumers against large corporations. They led the effort to recall defective tires in the Ford/Firestone class action lawsuit and were the first U.S. firm to file suit against the manufacturers of the diet drug Fen-Phen.[21]

This is not the first time that Guidant has faced significant court cases. In 2003 Endovascular Technologies, Inc., a California subsidiary of Guidant, pleaded guilty to 10 felony counts, including making false statements to government regulators. Guidant was fined and agreed to pay a $92.4 million penalty. More lawsuits regarding Endovascular are still pending, and there may be future suits filed as well.

Johnson & Johnson Merger in Question?

On April 27, 2005, Guidant shareholders held a special meeting to decide whether or not to approve an acquisition by Johnson & Johnson. Several months prior, in December of 2004, Johnson & Johnson had announced their intention to acquire Guidant. The Guidant shareholders approved the acquisition for $76 per share, a deal worth $25.4 billion. This acquisition would be the largest transaction in Johnson & Johnson's history. In an address to shareholders, Johnson & Johnson's Chairman and CEO, Ralph Larsen, announced that this deal would create an "unparalleled cardiovascular device business, boosting and balancing J&J's product portfolio to

roughly 42% pharmaceuticals; 41% medical devices and diagnostics; and 17% consumer products."[22]

The consistent growth of Guidant was a major reason that Johnson & Johnson saw the company as a good target for acquisition. Another major reason was the attractiveness of Guidant's stent business, which would complement Johnson & Johnson's Cordis stent systems. Guidant's stent systems are seen in the industry as superior to Cordis and Johnson & Johnson hopes to improve this image by implementing Guidant technology in their products.[23] However, J&J soon found themselves on the defensive when on June 17, 2005, Guidant disclosed that 50,000 of their ICDs had possible defects.[24] Guidant's disclosure resulted in a sharp decline in their share price from $74 to $63.[25]

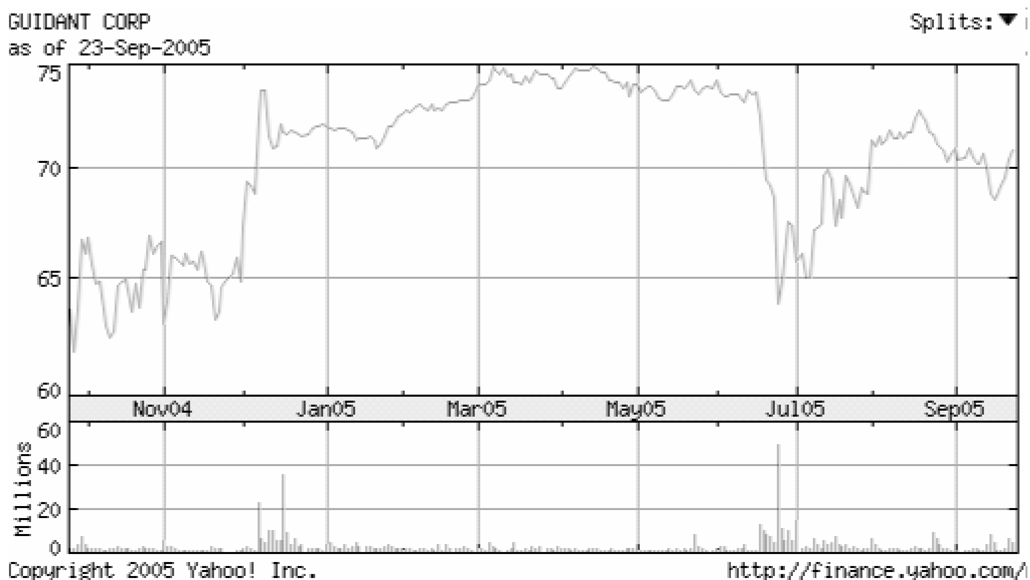

Figure 1: One Year History of Guidant's Share Price

Analysts have speculated that Guidant's problems could pose a materially adverse change to Guidant's business, thus causing Johnson & Johnson to consider renegotiating the deal and paying less, or even walking away from the deal completely. Even though Johnson & Johnson has made very few comments concerning the deal since Guidant's disclosure of possible defects, the company has remained positive about the deal, stating that it will proceed with the planned purchase.[26]

Financial Incentives or Honest Survey Feedback?

Guidant ran an evaluation program that consisted of giving doctors $1,000 for completing five surveys and implanting one of Guidant's leads (a device that connects an implanted cardiac device to the heart) in at least three patients. The purpose of these surveys was to provide Guidant with data on how doctors use Guidant's products, so that Guidant could improve the future models. However, internal Guidant documents and emails provided to the *New York Times* suggest another motive behind this paid survey program. One company executive sent a

congratulatory email to employees concerning the survey program, "It generated 300+ implants . . . Let's say that just 25% were incremental . . . that yields >$2 million in new sales with physicians who are not necessarily Guidant friendly. We paid each physician who completed all five surveys $1,000 so our total cost was $80,000."[27] The questionable motivations for this evaluation program are likely to further hurt Guidant's reputation.

Pacemaker Failures Cause More Problems

As if Guidant didn't already have enough problems with their ICD failures, another problem with one of their most lucrative products was about to confront them: the failure of their pacemakers. On September 22, 2005 Guidant announced that it had identified problems with two of its implantable pacemaker models. These problems, much like with their ICD, could potentially lead to deadly device failure.[28] In the same announcement, Guidant stated that they had "confirmed one type of failure in 36 out of 49,500 pacemakers, which treat slow heart beats," with an estimated "potential future failure rate of between 0.017 percent and 0.037 percent for the 41,000 patients who still have the device."[29] Director of the U. S. Food and Drug Administration's Center for Devices and Radiological Health, Dr. Daniel Schultz, said that the FDA does not currently have information that would suggest a need to replace devices in those patients who are not experiencing problems. Further, Schultz also said that the FDA believes that the final decision should be left up to the physician and the patient.[30]

Just two days after Guidant's pacemaker announcement, U. S. Senator Charles Grassley (R-IA), chairman of the Senate Finance Committee, notified Guidant that his committee would be investigating their company. The purpose of the investigation would be to determine if Guidant violated a prior agreement of alerting the government of product failures. This prior agreement was made in 2003 after Guidant entered into a Corporate Integrity Agreement with the Department of Health and Human Services after settling criminal and civil charges pertaining to their stents manufactured by the Endovascular subsidiary (used to treat aortic aneurysms). Guidant quickly replied that they believed they were in compliance with the laws and their prior agreement.[31]

Rumor of FDA's Criminal Investigators Getting Involved

On September 29, 2005, the *New York Times* published an article suggesting that the FDA's Office of Criminal Investigations was investigating Guidant. The FDA neither confirmed nor denied the possible criminal probe.[32] To this charge, Guidant's management stated that they were not aware of a criminal investigation into *current* employees, but did acknowledge that two *former* Guidant employees had been contacted by criminal investigators.[33] In either case, Guidant's management has a lot of problems to confront. A decline in the public's perception of the company is the least of Guidant's pressing concerns. A possible federal criminal investigation, volatile stock prices, and worries about the merger with J&J all beg the question: Can Guidant survive the onslaught? Perhaps a more vital question: Does the company deserve to endure?

Discussion Questions

1. How should Guidant proceed, going forward?

2. Do you think Guidant's problems will hurt the anticipated merger with Johnson & Johnson?

3. What can Guidant do to win back the public's (patients & doctors) trust?

4. Should the company seek outside help in addressing the many issues it's facing?

5. Will most of Guidant's problems go away if they are acquired by Johnson & Johnson?

6. How should Guidant handle the lawsuits and possible criminal investigation?

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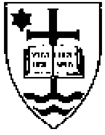
Martha Stewart Living Omnimedia, Inc.: An Accusation of Insider Trading.
Westby, A.; Moulton, M. P.; and O'Rourke, J. S. (editor)

Domestic advice and home products maven Martha Stewart is accused of selling nearly 4,000 shares of ImClone Systems, Inc. stock shares, just ahead of a public announcement that the company's promising new drug, Erbitux, has failed FDA clinical testing. Accusations of insider trading, based on her special relationship with ImClone CEO Samuel Waksal, and Merrill Lynch broker Peter Bacanovic, threaten her own company's reputation, share price, and market position.

Can Martha Stewart Living Omnimedia survive accusations of misconduct or the downfall of its namesake? (A) case, 16 pp. (B) case, 5 pp. Case #02-15. (2002 & 2004)



Eugene D. Fanning Center for Business Communication **02-15 (A)**
Mendoza College of Business
University of Notre Dame

Martha Stewart Living Omnimedia, Inc. (A)
An Accusation of Insider Trading

The sun shone brightly as the private jet touched down in San Antonio to refuel before heading on to San Jose del Cabo, Mexico. Martha Stewart flipped open a cell phone to check her messages. After discovering that someone from brokerage firm Merrill Lynch was trying to contact her, she returned the call. Within minutes, she placed a sell order on her entire holding of ImClone shares. Her call was made at 1:41 p.m., Eastern Standard Time. Just two minutes later, at 1:43 p.m., Merrill Lynch trading assistant Douglas Faneuil executed the order, selling 3,928 shares of ImClone Systems Inc. common stock for $58 per share.[1]

Martha Stewart: The Person

Martha Kostyra was born in Jersey City, New Jersey in August of 1941. She was the granddaughter of Polish immigrants and the second of six children.[2] Early in life, Martha developed a passion for helping around the house. Her mother, a schoolteacher and homemaker, taught her the basics of cooking, baking, canning, and sewing. Her father, a pharmaceutical salesman and avid gardener, introduced her to gardening at the age of three in the family's small, but orderly, backyard.[3]

During her days at Nutley High School she modeled ready-to-wear at the Bonwit Teller department store on Fifth Avenue in New York. She was also a member of the Honor Society and active in the school's Art Committee. After graduating from high school in 1959, she entered Barnard College in New York. During her freshman year, she met her future husband, Andy Stewart, on a blind date. At the time, Andy was in his second year at Yale Law School. His family background seemed to Martha to be far more glamorous than her own. His father, George, held a seat on the New York Stock Exchange but was forced to give it up in 1957. Midway through her sophomore year, Martha and Andy were engaged, and a year later in July of 1961,

This case was prepared by Research Assistants Arianne R. Westby and Mary P. Moulton under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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they were married. As Andy graduated from law school in June of 1962, Martha continued her education to finish her Art History degree at Barnard. In September of 1965, Martha gave birth to daughter Alexis, their only child.[4]

Martha Stewart: The Professional

In 1968 Martha attended a brokerage course at the New York Institute of Finance, and on August 14th of that year, she was licensed to conduct securities transactions with the public as a member of the New York Stock Exchange. She joined the firm of Perlberg, Monness, Williams and Sidel, where she worked for five years before moving to Connecticut with her husband, Andy. From the start, Martha was on the fast track and threw herself into her work with enthusiasm. Within two years, she was among the firm's top sales representatives.[5]

Once the Stewarts moved to Westport, Connecticut, Martha stepped off the fast track and adjusted to suburban living. In January of 1977, though, she was eager to get back into business and partnered with a friend to form a company called *An Uncatered Affair*. Their business was a huge success, which led Martha to launch another venture named the *Market Basket*, a store in Westport that sold a variety of prepared dishes and desserts. As her success gained momentum, she opened Martha Stewart Inc., based out of her home in Westport. As the business grew, Andy helped Martha orchestrate a book contract with Crown Publishing. The publisher later launched her best-selling book, *Entertaining*. Martha published several more book titles between 1983 and 1987, when her marriage of 25 years ended in divorce.[6]

That same year, discount retailer Kmart was searching for a brand affiliation to ignite its lagging sales. Joseph Antonini, the soon-to-be corporate president of Kmart, approached a friend and savvy business woman named Barbara Lonen-Snyder for advice. Lonen-Snyder devised a plan to convince Martha Stewart, by then a nationally recognized figure in decorating and lifestyle issues, to liven up the aisles at Kmart. On July 6, 1987, Stewart signed a contract with Kmart in which she agreed to create and oversee the manufacture of a line of bedding and bath products. In return, Kmart paid royalties on all Martha Stewart branded products. By 1990, Martha Stewart's line accounted for 3% of the company's revenue and $1 billion in sales. Just over a decade later, in January of 2002, Kmart filed for bankruptcy.[7]

The Making of Martha Stewart Living Omnimedia

In July 1991, Martha Stewart and Time Publishing Venture, Inc. printed the first issue of *Martha Stewart Living*, a monthly lifestyle magazine. Martha later teamed up with Sharon Patrick, a graduate of Stanford University and the Harvard Business School. A business plan for Martha's company emerged during an adventurous trip in which the two climbed Africa's Mount Kilimanjaro. The plan included a strategy to buy back her magazine with a combination of cash and stock (unregistered stock at the time of the arrangement). Within two years, on October 19, 1999, Martha Stewart Living Omnimedia was born. As she stood on the balcony overlooking the main trading floor of the New York Stock Exchange, Martha watched her net worth soar instantly from $614.7 million to $1.27 billion.[8]

Martha Stewart Living Omnimedia is a leading creator of "how to" content and related products for homemakers and other consumers. It was valued at $295 million in 2001 and produced $21.9 million in profit. Leveraging the well-known "Martha Stewart" brand name across a broad range of media and retail outlets, the company provided consumers with ideas,

products and other resources to raise their quality of living. Martha Stewart Living Omnimedia (commonly known by its ticker symbol as MSO) owns and manages multiple media, including four core magazines, an Emmy award-winning domestic arts television program, a weekly segment on *CBS This Morning*, and 34 book titles, which together have sold more than 10 million copies. Additionally, MSO manages a weekly askMartha® newspaper column, syndicated in more than 230 newspapers; a radio program, airing on more than 330 stations throughout the United States, and a website, *marthastewart.com*, with more than 1.7 million registered users.[9] From 1994 to 2002, Martha earned countless accolades ranging from winning six Daytime Emmy Awards to being counted among “America’s 25 Most Influential People” in *Time Magazine’s* June 1996 issue. The most relevant accomplishment in light of the issue at hand, however, was when Martha Stewart was elected to the NYSE Board of Directors on June 6, 2001.[10]

Known widely as the “Diva of Domesticity” or “Domestic Doyennes,” Martha combined the attributes of a skilled businesswoman with the culinary instincts of Julia Childs by the 1990s. With such notoriety, however, come both admirers and abhorrers. She appeals to some as the girl next door, while others think she will do literally anything to get ahead. Proxy statements filed in April 2001 show that Martha Stewart Living Omnimedia paid about $2.7 million to Martha in salary and bonuses. In addition, she received another $2 million in royalties for allowing her name to appear in various company publications and television programming. And then there are the $30.6 million in Class B shares of which Ms. Stewart is the sole owner, giving her ultimate control of the company.[11]

Merrill Lynch

Peter Bacanovic joined Merrill Lynch Pierce Fenner and Smith as a broker in 1993. He had previously worked for two years as a Marketing Director at ImClone Systems, Inc. His personal and professional contacts quickly grew, as Peter used his good looks and social savvy to gain entry into the fast-paced, heady world of New York’s *Social Register*. By the mid-1990s, his client list featured a number of New York’s social elite, including members of the Waksal family (Samuel, Aliza and Jack) as well as Martha Stewart, whom he had met shortly after coming to New York.[12] In 2001, Bacanovic hired a young man named Douglas Faneuil as his assistant at Merrill Lynch. Faneuil, who graduated from Vassar in 1997, was also visible in another of New York’s social scenes. He fit Bacanovic’s requirement for an assistant who understood both the financial and social needs of his clients. According to *New York Times* reporter Alex Kuczynski, “People who know Mr. Faneuil and Mr. Bacanovic . . . all said that Mr. Faneuil was considered an easy-going person who looked to Mr. Bacanovic as a role model.”[13]

On December 27, 2001, Douglas Faneuil executed a trade for Martha Stewart, selling 3,928 shares of ImClone Systems, Inc. The sale was based on what Stewart claimed was a standing stop-loss order of $60.[14] Mr. Faneuil later changed his official statement to federal investigators on June 19, 2002, contradicting the prior claim of a stop-loss order. Just two days later, Merrill Lynch suspended both Faneuil and his boss, Bacanovic, with pay and declined to comment on the details of the internal investigation. Bacanovic’s tight network of clients, which at times was his strength, would soon prove to be a liability.[15]

ImClone Systems, Inc.

ImClone Systems, Incorporated was founded by Dr. Samuel Waksal in 1984 as a biopharmaceutical company dedicated to developing breakthrough biologic medicines in the field of oncology.[16] In addition to his role as Chief Executive Officer of ImClone Systems, Dr. Waksal founded Scientia Health Group in late 2000, an incubator for biotechnology firms.[17] During 2001, two issues were emerging concurrently at ImClone and Scientia. At ImClone Systems, a promising new colon cancer drug, Erbitux, was under review by the United States Food and Drug Administration (FDA). And at Sciencia Health Group, leadership issues were tearing at the structure of the firm.

Dr. Waksal's brother, Harlan, assumed the role of ImClone CEO in the autumn of 2001, just weeks before indications surfaced in early December that the FDA might reject Erbitux.[18] Just one month earlier, Samuel Waksal fired Scientia President James Neal after just eight months with the firm. For his part, Neal claims the reason for his termination was that Dr. Waksal "felt hampered in his ability to engage in illegal, unethical and fraudulent conduct." The reason for the termination offered earlier by Dr. Waksal involved Neal's compensation plan and its interference with potential investments in the company.[19] By the time ImClone learned that the FDA rejection was "99% likely," Sam Waksal was $80 million in debt, with his ImClone shares staked as collateral.[20]

The Case Unfolds

In late October of 2001, Bristol-Myers Squibb made a tender offer of $70 per share for ImClone stock. At that time, Martha Stewart was interested in unloading her nearly 5,000 shares of the stock. Because the offer was oversubscribed, however, she was able to sell just 1000 shares.[21] Apparently, just one month later in November, Martha told her broker to afix a $60 stop-loss order to her remaining ImClone shares. Her broker, Peter Bacanovic, remembers the request to have taken place sometime in December.[22]

On December 4, 2001, Lily Lee, an ImClone employee, met with the FDA to discuss issues facing the company's new oncology drug, Erbitux. After her meeting, Lee wrote an internal memo detailing her discussions with FDA officials, suggesting that the drug might not receive approval. At this point, news of the decision was neither official nor public, and some within the company still held out hope for Erbitux.[23] ImClone CEO Harlan Waksal was apparently not among them. He sold his shares for $50 million just two days later. He later claimed that the Board of Directors knew of his intention to sell those shares weeks before he executed the trade.[24]

How the Grinch Stole Christmas

The holiday season turned ugly for the Waksal family as Harlan learned on Christmas Day from Brian Markison of Bristol-Myers Squibb that the rejection of Erbitux was "99% likely." He waited until the next day, Wednesday, December 26th, to share the news with his brother, Samuel. Harlan has said that he did not share the news sooner with others because he "did not feel it was appropriate to wreck Christmas for the people of the company."[25]

Sam Waksal flew home immediately from his vacation in the Caribbean. Knowing that he could not sell the shares himself without approval from the ImClone General Counsel, Sam

instructed his accountant to transfer 79,797 shares to his daughter, Aliza. That night, he also called his father. He also knew that the company did not plan to announce the FDA rejection until after the markets closed on Friday, December 28th. According to a Federal complaint filed later against Dr. Waksal, he also knew there would be a "blackout" that day, a period during which no insiders could sell their shares before the news became public.[26]

It is not clear how quickly the accountant reached anyone at Merrill Lynch or to whom he spoke. Public documents show that Dr. Waksal, his daughter Aliza and his father, Jack, raced to unload more than $15 million of the company's shares in trading on December 27th. Merrill Lynch was unable to execute Dr. Waksal's trade order without specific authorization from the ImClone General Counsel, however. Desperate to save his investment, Sam then shifted his 79,797 shares of stock to Bank of America, only to find that they, too, would not execute the trade. One bad decision led to another, and Sam forged the signature of the ImClone General Counsel in a last ditch effort to sell his shares, which later led to charges of bank fraud.[27]

That same day, in the midst of all this turmoil in the Waksal family, Martha Stewart and some friends cruised through the clear, blue skies over Texas in her private plane, en route to San Jose del Cabo, Mexico. About midday, the corporate jet landed in San Antonio to refuel before continuing on to its destination. The exact sequence of events that took place next is still unclear. What is known is that Martha Stewart responded to a message from either her broker or his office. Who spoke with whom, and what mechanisms for communication were used (i.e.: laptop, cell phone, etc.) is still subject to investigation. At the time of her trip, Peter Bacanovic was in Miami, and his assistant Douglas Faneuil was in the office at Merrill Lynch in New York City. What is also known is that Martha placed a call at 1:41 p.m. (EST), and her trade of ImClone stock was executed by Douglas Faneuil at 1:43 p.m. for $58 per share.[28]

What actually led to the sale of ImClone stock by Martha Stewart on December 27, 2001 is among the questions that have come under scrutiny. Who did she talk to and what exactly did they say? Did she know that the Waksal family was simultaneously dumping their shares? Did she know why? Martha contends that the sale was in response to the alleged $60 stop-loss order that she claims to have placed in November of 2001 with her broker, Bacanovic. If this is true, why was her stock not sold immediately when the share price dipped below $60 for the first time since placing the order, to $59.98 at 11:07 a.m. that same morning? At the same time that her shares were being sold, Martha placed a call to Sam Waksal and left a message, which was recorded on his phone log as "something is going on at ImClone and she [Martha] wants to know what." Her call was never returned.[29]

Also on the plane with Martha that fateful day was Mariana Pasternak. Early the next morning, Mariana's ex-husband, Bart, sold 10,000 shares of ImClone stock. Later that same day, at 2:55 p.m., ImClone received official notification from the FDA that it was, indeed, rejecting Erbitux. The company waited to release this information to the public until 4:30 p.m., when the markets closed.[30]

On Monday, December 31st, 18.5 million shares of ImClone were traded, leaving the closing price at $46.46 per share.[31] About a week later, the SEC requested documents from the company regarding its investigation into possible insider trading by the Waksal family. In the midst of this investigation, Waksal was also sued by a former executive at Scientia concerning issues of "illegal and unethical conduct."[32]

Hands in the Cookie Jar

In early June 2002, news broke of the investigation into Martha Stewart's ImClone trade.[33] On June 12th, Martha released a statement asserting that she had no insider information and sold the stock simply because a pre-existing agreement with Merrill Lynch and broker, Peter Bacanovic. She claimed that the sale was "entirely proper and lawful."[34]

At about the same time, information also began to leak out regarding sales of MSO stock by both Martha and her associates totaling approximately $79 million.[35] Some shareholders became disgruntled because these trades were made prior to information about Martha's investigation being made public. MSO stock began a steady fall and closed on June 25, 2002 at $13.60 per share, an all-time low since her company went public in 1999. Her paper losses were approximated at nearly $200 million.[36]

"I Just Want to Focus on My Salad"

Soon after news of the investigation was made public, Martha made her regularly scheduled appearance on the CBS Television Network's *The Early Show*, in a segment on how to prepare appetizing summer salads. Jane Clayson, the show's anchor, asked Martha a pointed question about ImClone. Stewart continued to chop cabbage in between gestures made with a knife in hand. She replied that she hoped "the scandal would be resolved soon" and that she would be "exonerated of any ridiculousness." After this appearance, she canceled future segments on the show.[37]

By mid-July 2002, Martha Stewart was the subject of three separate investigations. The United States Department of Justice was looking into the possibility of obstruction of justice, which carries a maximum prison term of five years. The Securities and Exchange Commission was investigating the possibility of insider trading, with securities fraud carrying a prison term of as many as ten years. A separate investigation began in the U.S. House of Representatives Committee on Energy and Commerce. Prosecutors wanted to know precisely what Stewart knew when she sold the shares. The Committee had already combed through phone logs, cell phone records and a flight log for Stewart, as well as transaction documents.[38]

Cooperating Key Witnesses

On June 19, 2002, Douglas Faneuil retracted an earlier statement he made to Merrill Lynch investigators regarding how Peter Bacanovic came to sell ImClone stock for Martha Stewart. Mr. Faneuil initially supported her version of the events, telling federal investigators that she had previously arranged a "stop loss agreement" to sell the stock when it fell in value. Mr. Faneuil then changed his story, casting doubt on Ms. Stewart's account.[39] Two days later, Merrill Lynch put both brokers on paid leave because of what it called "factual issues regarding a client transaction."[40] Douglas Faneuil's testimony could be central to any decision to charge Ms. Stewart with obstruction of justice.

Marianne Pasternak was another witness who cooperated with investigators. Mariana, a friend of Ms. Stewart and a real-estate agent in Westport, Connecticut, was en route with her to Mexico when Martha ordered her broker to sell those ImClone shares.[41] Additionally, Mariana's ex-husband, Bart, sold 10,000 of his own shares of ImClone stock before the FDA rejection of Erbitux was made public. He later claimed to have made an independent investment decision. He has also stated his willingness to cooperate with investigators.[42]

Dr. Waksal Indicted

On August 7, 2002, Samuel Waksal, ImClone's former CEO, was indicted on charges of securities fraud for trying to sell shares and for tipping off others to sell stock before the FDA released information on the rejection of Erbitux. Dr. Waksal was also charged with bank fraud, perjury, and obstruction of justice for allegedly ordering the destruction of documents which were subpoenaed by the SEC as part of the ImClone probe. According to the indictment, Dr. Waksal also conspired with two people he allegedly tipped off about the FDA announcement to testify falsely before the SEC.[43] Then a week later, on August 14, 2002, ImClone Systems Inc. sued Samuel Waksal in an attempt to recover the $7 million severance which was paid in the fall of 2001 when he resigned as CEO.[44]

Stewart Under Investigation

That same month, Martha's lawyers delivered various records totaling approximately 1,050 pages to the House Energy and Commerce Committee. The documents were received on the day of the deadline, August 20th at 4:00 p.m., with only an hour to spare. Later that month, on August 21, 2002, Martha Stewart Living Omnimedia share price reached $8.91, down some 54% from June 6, 2002. The 52-week low was reached on August 8th, when the share price hit $6.29 before closing up slightly at $6.78.[45]

To add insult to injury on August 22, Howard Rosen, an MSO shareholder, sued Martha and several of her associates for selling stock in MSO before the investigation of her ImClone sale became public. John Doerr, a well-known venture capitalist, his firm (Kleiner Perkins Caufield & Byers), and six other top MSO executives were also named in a suit for selling shares prior to the June announcement of the Stewart investigation. In addition, a class action lawsuit was filed by MSO shareholder, Conrad Hahn. Mr. Hahn claimed that his loss from stock depreciation was a result of brand equity damage due to Martha Stewart's personal conduct.[46] By the end of August, both ImClone and MSO stock had endured a beating and closed the month at $8.30 and $7.45 respectively.[47]

What's Next for Martha and MSLO?

The House Energy and Commerce Committee ended their investigation by referring the matter to the United States Department of Justice on September 10, 2002.[48] As news of House Committee Chairman Billy Tauzin's (R-Louisiana) decision reached Martha Stewart's office in New York, a moment of relief was followed by continued uncertainty. The stock price of her company rebounded over the next few days in response to the news. Yet, she and her advisors knew that this was just the end of one phase and the beginning of another. Would a Justice Department investigation end with indictments for either insider trading or obstruction of justice? Could her

domestic publishing and retail empire be saved? Would the Martha Stewart brand name be forever tarnished as a result? Would she be looking at holiday decorating in a U.S. Federal Prison Camp?

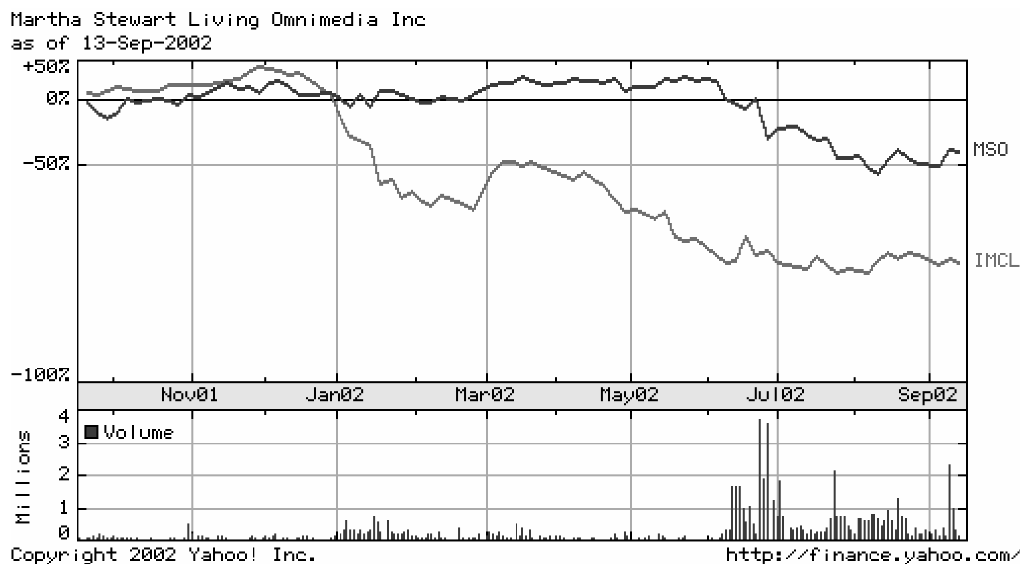

Figure 1: Comparative Stock Price Movement. Martha Stewart Living Omnimedia (MSO) share price (top line) and ImClone Systems, Inc. share price (bottom line) from December 2001 to September 2002.

Discussion Questions

1. What are the legal risks to Martha if she speaks out now? What are the reputational risks if she remains silent?

2. Should Ms. Stewart consider stepping down from her role as Chief Executive of Martha Stewart Living Omnimedia as she concentrates on her personal problems? Would some distance from the company's day-to-day operations improve or jeopardize the firm's position in the marketplace?

3. What are the risks inherent in building a brand around the name of a living person?

4. What are the critical issues at this juncture in the case and how would you rank order them?

5. What sort of help does MSLO need in order to address these issues going forward?

6. How should Ms. Stewart and her senior team address their relationships with CBS Television? With Kmart Corporation? With Crown Publishing?

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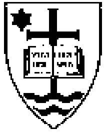
Morgan Stanley and the Events of September 11, 2001
Ulto, S.; Strmiska, D.; and O'Rourke, J. S. (editor)

When two airplanes struck the World Trade Center on September 11, 2001, more than 3,000 Morgan Stanley employees sprang into action. Following an earlier terrorist attack on the Center in 1993, the company developed an emergency evacuation plan to ensure employees could safely and quickly exit the building. With all the chaos following the attacks, CEO Phil Purcell had difficulty in determining if all of the company's employees had made it out. News was also traveling around the world that Morgan Stanley was completely destroyed from the bombing. Purcell must quickly determine how many employees survived and how to inform the world that Morgan Stanley was still in business. (A) case, 4 pp. (B) case, 5 pp. Case #02-04. (2002)



Eugene D. Fanning Center for Business Communication **02-02 (A)**
Mendoza College of Business
University of Notre Dame

Morgan Stanley:

The Events of September 11, 2001 (A)

September 11, 2001 began as a routine Tuesday for Morgan Stanley's managing director of corporate affairs, Raymond O'Rourke, who works out of their corporate headquarters at 1585 Broadway in New York. Shortly after O'Rourke began conducting the weekly global corporate affairs conference call at 8:30 a.m., though, his secretary burst into the office telling him that he had an urgent call from a *Bloomberg* reporter.

The reporter told O'Rourke that a jetliner had crashed into the North Tower of the World Trade Center. O'Rourke relayed the message to the Morgan Stanley global affairs team, and then broke off the call. Stunned by the news, O'Rourke rushed to an office window. He watched in horror as a second plane hit the South Tower of the World Trade Center where Morgan Stanley occupied 22 floors, housing 2,500 employees. The firm also had an additional 1,000 employees at Number 5 World Trade Center.

As the morning of September 11th progressed, it became obvious that these two events were not accidents, but terrorism. Four planes were hijacked that morning: American Airlines Flight 11 hit the North Tower; United Airlines Flight 175 hit the South Tower; American Airlines Flight 77 hit the Pentagon; and United Airlines Flight 93 crashed in Somerset County, Pennsylvania. A total of 266 passengers, pilots, and flight attendants aboard these planes perished. The precise death toll on the ground in New York and Washington, D.C. remained uncertain at day's end with thousands listed as "missing."

This case was prepared by Research Assistants Stephanie Ulto and Dorinda Strmiska under the direction of James S. O'Rourke, Concurrent Associate Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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Company Background

Morgan Stanley was established in 1933 in response to banking legislation known as the Glass-Steagall Act. The firm joined the New York Stock Exchange in 1941 when it reorganized itself as a partnership. Throughout the 1940s and 1950s, Morgan Stanley engaged such clients as Mobil Corporation, H. J. Heinz, and Standard Oil of Indiana, among others. In 1964, Morgan Stanley created the first financial analysis computer model. In the 1970s the company incorporated and began expanding globally in size and profitability. During the 1990s, Morgan Stanley opened field offices worldwide, while acquiring such companies as Miller Anderson & Sherrerd and Van Kempen American Capital.

In 1977, The Morgan Stanley Group merged with Dean Witter Discover and Company to position Morgan Stanley as a prominent global financial services company, as well as preeminent investment banking firm. With a leading market position in securities, asset management, and credit services, the company also developed a wide range of professional skills in institutional and retail markets. The company continued to offer the Discover line of financial services as a business unit of Morgan Stanley. By 2001, that division accounted for more than 50 million credit card members. With more than four million participating merchants and cash access locations, Discover has become one of the largest credit card networks in the United States.

Phillip J. Purcell, III was named chief executive officer when the Morgan Stanley Group, Discover, and Dean Witter merged in 1997 to become Morgan Stanley Dean Witter Discover and Company. By the spring of 2001, the firm re-branded, using the name Morgan Stanley. When Purcell was named CEO, analysts and employees alike expressed reservations. Purcell brought a new management style to the company, changing employee expectations. Initially, he maintained a low profile with employees, clients, and the media. During and after the 9/11 events, however, he became a visible public figure, gaining the respect and support of employees, clients, and the news media.

Morgan Stanley now maintains more than 700 offices in 28 countries. The New York corporate headquarters houses the firm's trading and backup facilities, with administrative offices at 5 World Trade Center. The company had occupied 22 floors at 2 World Trade Center, and was the largest tenant in the building with the greatest number of employees.

Prior Terrorist Attacks – The 1993 Bombing

Before 9/11/01, Morgan Stanley was no stranger to terrorism. On February 26, 1993, at approximately 12:15 p.m., an explosion occurred on the underground level B2 of the World Trade Center. The blast, initially identified as a transformer vault explosion, later was determined to be a terrorist attack on the World Trade Center complex. The resulting damage was substantial. Six people were killed and more than 1,000 were injured. Structurally, the steel-reinforced floors were blasted away on three underground levels, a 150-foot diameter crater was left on the concourse level, walls were destroyed, elevators were out of service, and broken water pipes flooded the lower levels. The explosion also damaged or destroyed more than 200 trucks and automobiles.

As the 1993 crisis scenario unfolded, Morgan Stanley's head of security, Rick Rescorla, rushed into action, quickly ushering people out of the Tower. Rescorla had served in Vietnam as an infantry lieutenant and platoon leader, and one of his former Army buddies remembered that day. "To get our attention," Sam Fantino said, "he dropped his pants." Rescorla was the last person to leave the Morgan Stanley offices on February 26th, having ensured that everyone was safely escorted out.

The aftermath of this attack was severe. The cost of restoration was estimated at $250,000,000. It took 2,700 workers, along with 160,000 gallons of cleaning fluid and 200,000 gallons of detergent to remove the 2,500 tons of rubble and restore the Tower to working order.

Morgan Stanley's Answer to the 1993 Bombing

After the bombing of 1993 awakened the company to terrorism, the company reevaluated and refined its emergency evacuation policies. One of the first steps involved developing a crisis plan for the organization and its employees. The crisis plan included actions necessary to quickly and completely evacuate the building. Employees on each of the 22 floors occupied by Morgan Stanley were appointed as wardens and searchers responsible for ensuring that all other employees got out safely and promptly. The firm held periodic fire drills, in addition to those held by the New York Port Authority.

This foresighted emergency crisis planning enabled Morgan Stanley to evacuate the South Tower after the North Tower had been hit. Although there was an announcement shortly after employees began to evacuate the building that "Everything is under control and employees should report back to work," Morgan Stanley employees continued to evacuate according to plan.

Morgan Stanley Reaction to September 11, 2001

Mere minutes after the second plane crashed into the North Tower, O'Rourke and Morgan Stanley's management team sprang into action. Security director Rescorla was one of management's first phone contacts with employees in the World Trade Center complex. Rescorla said the evacuation was going well, and that he pledged to get "every Morgan Stanley employee out of the building safely."

Almost immediately, Morgan Stanley evacuated the headquarters building at 1585 Broadway and reconvened with all essential personnel at a predetermined training facility in Midtown as a command center. The rest of the day was spent attempting to account for more than 3,500 employees working at the World Trade Center. Nearly all of the 1,000 employees at 5 World Trade Center were evacuated safely. News about the 2,000 in the South Tower started arriving at 10:30 a.m. and originated from a few of the firm's employees who had made the four-mile journey to the command center from ground zero, as the Trade Center complex began to be called. Although not all employees were accounted for at the end of the day, the initial numbers were much higher than expected, given the extreme circumstances.

News of the horrific acts traveled the world instantly. Unfortunately, a casualty of this blizzard of instant information was accuracy. Asian investors received false information that Morgan Stanley was completely “gone.” Rumors that Morgan Stanley was “out of business” began traveling quickly throughout the world, primarily via the Internet. As realities of the attacks began to sink in, O’Rourke knew he would have to construct an operations plan while simultaneously focusing corporate efforts on the human crisis. For one thing, he would somehow have to find out how many Morgan Stanley employees were still alive and where they were.

Questions

1. What is the first step Morgan Stanley would take in responding to the crisis? Should Mr. O’Rourke pursue outside crisis management assistance? How would he find an agency to help and what, in particular, should he ask them to do?

2. Which issues are most urgent for Mr. Purcell and his senior team at Morgan Stanley?

3. Which stakeholders seem most important at this moment? What’s at stake for them?

4. How should Mr. O’Rourke address false reports of Morgan Stanley’s demise?

5. What should the management team do to locate and account for its 3,500 employees?

6. Does Morgan Stanley have a responsibility to the families of missing employees to provide help in the location efforts?

7. What sort of communication tools or capabilities would the company have at its disposal at a time like this? Who could they depend on for help?

Writing Assignment

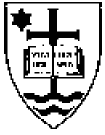
Please respond in writing to the issues presented in this case by preparing two documents: a communication strategy memo and a professional business letter.

In preparing these documents, you may assume one of two roles: you may identify yourself as a Morgan Stanley corporate communication manager who has been asked to provide advice to Mr. Raymond O’Rourke regarding the issues he and the company are facing. Or, you may identify yourself as an external management consultant who has been asked by the company to provide advice to Mr. O’Rourke. Either way, you must prepare a strategy memo addressed to Raymond O’Rourke, Managing Director, Global Corporate Affairs, Morgan Stanley. That memo should summarize the details of the case, rank order critical issues, discuss their implications (what they mean and why they matter), offer recommendations for action (assigning ownership and suspense dates for each), and show how to communicate the solutions to all who are affected by the recommendations.

You must also prepare a professional business letter for Mr. Philip Purcell's signature. That document should be addressed to Morgan Stanley clients and customers. If you have questions about either of these documents, please consult your instructor.

Procter & Gamble: Confrontation with People for the Ethical Treatment of Animals
Dillon, P.; Paxton, J.; and O'Rourke, J. S. (editor)

On March 25, 2003 People for the Ethical Treatment of Animals (PETA) revealed an undercover investigation of alleged abuses in Procter & Gamble subsidiary The Iams Company's independent research facilities. Iams, a company of self-described animal lovers, responded quickly to evolve testing procedures to better conditions for study animals. Intense media coverage of PETA's aggressive protests, however, has generated many questions about whether Iams is concerned about profits to the detriment of their customers' pets. 8 pp. #05-04. (2005).



Eugene D. Fanning Center for Business Communication **05-14**
Mendoza College of Business
University of Notre Dame

Procter & Gamble Company:
Confrontation with People for the Ethical Treatment of Animals

On March 25, 2003, People for the Ethical Treatment of Animals held a press conference to announce findings of animal cruelty in an independent laboratory used by the Iams Company. PETA announced these claims as the result of a nine month secret investigation of an independent research laboratory. The press conference was held in Dayton, Ohio, the home of the Iams Company and just down the road from Iams' parent company, Cincinnati-based Procter & Gamble.[1]

The chain of events leading up to this press conference started in September of 2001 when Iams executives met with PETA to discuss what PETA called "consumer concern" over testing conducted in Iams' independent laboratories.[2] While Iams has garnered praise from such organizations as the Humane Society of the United States and the American Veterinary Medical Association, PETA was concerned that Iams conducted tests that were unnecessary and under conditions that were cruel to the animal "research associates" that were the subjects of the testing. In 2002 and 2003, a representative of PETA was hired by Iams to work in its independent laboratory, the Sinclair Research Center, in Columbia, Missouri. While her exact role as an employee has been debated, she made observations of alleged animal abuse. PETA claims that 27 "research associates" were destroyed during the course of testing and that other inhumane practices such as debarking procedures and muscle removal surgeries were performed.[3] Iams claims that the inhumane procedures were directly tied to the investigator while PETA claims that this is not true.[4]

While both sides dispute the actual role of the investigator and the degree of the abuse, if any, it was clear that Iams' reputation as a high-quality producer of pet products that had genuine concern for the well being of animals was being called into doubt. Iams needed to act immediately to determine the validity of PETA's claims and to take any appropriate action to protect the well being of their "research associates" in independent labs. Proper communication

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This case was prepared by Research Assistants Patrick Dillon and James Paxton under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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of their record on preventing animal abuse, the validity of PETA's claims and any actions taken as a result of these claims was imperative to protecting Iams' reputation.

A Company for Animal Lovers

The Iams Company was founded in 1946 by an animal nutritionist. Mr. Iams started operations in a modest feed mill outside Dayton, Ohio. Mr. Iams took on Clay Mathile in 1970 as a business partner. Eventually, Mr. Mathile purchased the company in 1982.[5]

The Iams Company sells under two brand names, Eukanuba and Iams dog and cat food. The company's mission is "to enhance the well-being of dogs and cats by providing world-class quality foods and pet care products." The company prides itself on being a collection of dog, cat and animal lovers. The Iams Company markets itself as the maker of high quality brands that are sold in specialty pet stores, veterinary offices and clinics, feed and grain stores, gourmet food stores and pet boarding and grooming locations, as well as commercial grocery stores.[6]

Iams conducts its research and development through the Paul F. Iams Technical Center. A significant part of this research revolves around dog and cat "research associates" which help test nutritional content and taste of new or modified products. Iams holds the research conducted with the help of dogs and cats to standards set forth by the Animal Welfare Act of the U.S., the U.S. Department of Agriculture and Directive 86/609/EEC of the European Union.[7]

A Partnership is Born

Procter & Gamble can trace its roots back to two European immigrants who intended to settle out West. However, due to unforeseen circumstances, the two men settled instead in the busy city of Cincinnati, Ohio. William Procter was an established candlemaker while James Gamble worked as a soap maker. The two men met years later when they married sisters Olivia and Elizabeth Norris. Their father-in-law convinced the two men to become business partners and in 1837 the partnership Procter & Gamble was formed.[8]

Procter & Gamble initially sold only candles and soap. During the Civil War, the partnership was awarded several contracts to supply Union soldiers with their products. Their reputation grew as Union soldiers returned home with their P & G products. In 1890, Procter & Gamble incorporated to raise additional funds for the company. William Alexander Procter, the son of the founder, was named president. He set up an analytical lab to study and improve the soap-making process. This was one of the first research labs in American industry, and helped build Procter & Gamble's reputation for being an innovator and industry leader.[9]

International Expansion

Procter & Gamble continued to grow for the next 120 years through research, innovation and international expansion. They developed new product lines such as Tide detergent and Crest toothpaste and purchased similar companies throughout the world. P&G grew into a truly global company and, by 1993, their sales exceeded $30 billion with over half of their sales coming from outside the United States. In September of 1999, P&G purchased the pet food manufacturer Iams Company. Since then, Iams has grown to become the number one pet food manufacturer in the U.S. And, because of brands like Iams, P&G has grown into a major, multinational corporation with nearly 98,000 employees working in almost 80 countries worldwide. P&G's portfolio of

brands is the envy of many corporations. They are recognized throughout the world, with 16 of the brands exceeding $1 billion in annual revenues. P&G's total revenues for 2003 exceeded $51 billion and their net earnings were nearly $6.5 billion.[10]

PETA: People for the Ethical Treatment of Animals"

"People for the Ethical Treatment of Animals," better known as PETA, is a non-profit organization founded in 1980 and based in Norfolk, Virginia. PETA's mission statement is "animals are not ours to eat, wear, experiment on, or use for entertainment." They have spent the last 24 years working to protect the rights of all animals. PETA works through public education, cruelty investigations, research, animal rescue, legislation, special events, celebrity involvement, and direct action.[11]

PETA first gained national recognition in 1981 when they uncovered the abuse of animals in experiments. The organization's undercover investigation led to the precedent-setting Silver Springs Monkeys case. This case resulted in the first arrest and conviction of an animal experimenter in the United States on charges of cruelty to animals, the first confiscation of abused laboratory animals, and the first U.S. Supreme Court victory for animals in laboratories. As a result, PETA has had a major effect on the way U.S. corporations conduct their business. During the 1990s, PETA launched an international campaign against cosmetic companies that used animals for cosmetic testing. They convinced Benetton to halt their animal testing, and the major cosmetic corporations soon followed. PETA now lists 550 cosmetic companies that do not test on animals. Corporation after corporation has learned of PETA's power and influence the hard way. McDonald's, General Motors, Calvin Klein, and, most recently, Burger King have all acquiesced to the demands of a PETA-led campaign in one way or another.[12]

PETA has recently gained large support among many entertainers and celebrities in Hollywood. PETA compiled two animal rights albums, *Animal Liberation* and *Tame Yourself*, featuring artists such as Chrissie Hynde, Indigo Girls, Michael Stipe, and Belinda Carlisle. PETA also has held several "Rock against Fur" and "Fur Is a Drag" benefit concerts featuring The B-52s, K.D. Lang, and others. Long-time supporter Paul McCartney invited PETA to set up literature tables on his world tour.[13]

This Hollywood influence has led to a major problem in the fur industry. PETA has launched a major "I'd rather go naked than where fur" campaign with models such as Christy Turlington, Tyra Banks, and Marcus Schenkenberg, actor Kim Basinger, among others posing for the campaign. They have also received pledges from filmmakers including Oliver Stone, Martin Scorsese, and Rob Reiner to keep fur off movie sets. According to the *San Francisco Chronicle*, "Protests by groups such as PETA have hobbled the fur business." PETA's influence is continuing to grow as a result of the large amount of Hollywood backers. In fact, Britain's *Time Out* magazine named animal rights the number one "hip cause," thanks largely, it said, to the high-profile campaigns of "super-trendy PETA."[14]

Regulation of Animal Testing

In 1966, Congress enacted Public Law (PL) 89-544, known as the Laboratory Animal Welfare Act. This law regulates dealers who handle dogs and cats, as well as laboratories that use dogs, cats, hamsters, guinea pigs, rabbits, or nonhuman primates in research.

The first amendment to the Laboratory Animal Welfare Act was passed in 1970 (PL 91-579) and changed the name of the law to the Animal Welfare Act (AWA). This amendment authorized the Secretary of Agriculture to regulate other warm-blooded animals when used in research, exhibition, or the wholesale pet trade.

An amendment was added to the AWA in 1985 as the Improved Standards for Laboratory Animals Act, which was part of the Food Security Act. These amendments required the Secretary to issue additional standards for the use of animals in research. This standard governs facilities such as the Sinclair Research Center.

The Regulations

The United States Department of Agriculture (USDA) is charged with developing and implementing regulations to support the AWA. These regulations (which appear in Title 9, Code of Federal Regulations (CFR), Chapter 1, Subchapter A, Parts 13) require the licensing of animal dealers, exhibitors, and operators of animal auction sales where animals regulated under the AWA are sold. The regulations also require all non-Federal research facilities to register with the Secretary of Agriculture.[15]

All licensees and registrants must provide their animals with care that meets or exceeds the USDA's standards for veterinary care and animal husbandry. These standards include requirements for handling, housing, feeding, sanitation, ventilation, shelter from extreme weather, veterinary care, and separation of species when necessary.[16]

Over the years, the USDA has made substantive changes to the AWA regulations. In the late 1980s, the USDA amended the requirements pertaining to the use of animals in research. These amendments, in response to the Improved Standards for Laboratory Animals Act, established standards for the exercise of dogs and psychological well-being of nonhuman primates. The amendments also set standards to minimize the pain and distress of animals; ensure the proper use of anesthetics, analgesics, and tranquilizers; and require researchers to consider alternatives to painful procedures.[17]

To ensure that these standards are met, the amendments require each research facility to establish an Institutional Animal Care and Use Committee to approve and monitor all research conducted at the institution. The regulations for this amendment were published February 15, 1991.[18]

The Investigation Unveiled

While March 25, 2003 was the official unveiling of PETA's claims against Procter & Gamble subsidiary Iams, the course of action was set several years earlier. A United Kingdom animal rights group closely affiliated with PETA called "Uncaged Campaign" protested Iams in Europe in the late 1990s. They based their protests on 13 years of published Iams research which disclosed the euthanasia of some dogs and cats. This gained some publicity in European newspapers. After meeting with Uncaged Campaign, Iams announced that it would suspend any new research that resulted in the euthanasia of dogs and cats in March of 1999.[19]

As a reaction to the publicity generated in Europe by Uncaged Campaign, PETA began investigating Iams research policies. They had a meeting with Brian Brown, the Associate Director of Global External Relations for the Iams Company at the time, and Dan Carey, Iams

Director of Research and Technical Development. PETA walked away from this unsatisfied with the progress of Iams' efforts to improve conditions for research on laboratory dogs and cats.[20]

This led to the now well-known undercover operation. According to Mary Beth Sweetland, PETA's director of research and undercover investigations, the non-profit organization had a budget of approximately $3 million for undercover operations in 2002. Thus, the investigation into the Columbia, Missouri facility was well funded and supported by PETA. Sweetland said in a 2003 interview, "We see our undercover actions as helping the government do its job. The USDA visits for a day, while we stay for months."[21]

The exact nature of the position that the undercover PETA representative held is debated by both sides. Iams claims that the representative was hired by Iams as an "animal welfare specialist."[22] The representative's duties were focused on the testing environment and improving the lives of the testing subjects. However, Iams claims that the representative had a "clear conflict of interest," as PETA had spent time and money to place her inside the Sinclair Research Center. She was, thus, responsible for much of the abuse in order to produce video of suffering animals to advance PETA's cause. In fact, Dan Carey, Iams director of technical research and development, in a 2003 interview, said, "the PETA spy was the one that told the facility in question that debarking was an acceptable course of action." [23]

PETA vehemently denies these claims. They claim that the representative was a "study monitor" employed directly by Sinclair Research Center and any form of care for the animals was not included in her job description. PETA claims that the agent is an animal lover and tried to contact Liz Fuess, the supervisor of that particular Iams study, to alert her of the debarking procedure. PETA claims that the debarking was ordered by the facility director, Guy Bouchard.[24]

PETA also claimed that in addition to the debarking procedures and the termination of 27 dogs, Iams dogs were dumped on cold concrete flooring after having huge chunks of muscle cut out of their thighs. They also claim dogs and cats were stir-crazy from confinement in "windowless, dungeon-like buildings." Allegedly, a co-worker instructed the PETA representative to hit the test dogs on the chest if they quit breathing and another co-worker talked about an Iams dog found dead in his cage, bleeding from the mouth. PETA claims cruel studies were done by Iams involving sticking tubes down dogs' throats to force them to ingest vegetable oil. These claims are just a few of the alleged findings from their investigation.[25]

Iams and Procter & Gamble dispute these claims. They assert that posing as an animal lover, the PETA representative captured sensational video that did not include any scenes of the socialization and enrichment activities she was being paid to develop and deliver. They claim her video also falsely attributed footage and stories of dogs and cats that were not a part of Iams studies. Company literature clearly states, "Iams doesn't kill dogs or cats! It's against the research policy that has been in place for years."[26]

The Procter & Gamble Response

Procter & Gamble is an international conglomerate that is no newcomer to external relations. However, Iams is an extremely valuable brand and the global leader in pet food supplies. The reputation of this valuable brand is at stake as it is built upon the ideal that "Iams is a company full of pet lovers who dedicate their lives to helping dogs and cats live longer, healthier lives."[27]

Discussion Questions

1. Who are the affected stakeholders? Who are the most important? Which stakeholder(s) should Procter & Gamble communicate with first? How should communication goals be accomplished?

2. Is this only an external communication problem? How strong of a response should Procter & Gamble have for internal communication?

3. What are the risks and potential rewards of working with PETA? Can PETA ever be fully satisfied by Iams and Procter & Gamble without sacrificing product quality and/or business goals?

4. Should any external agencies be consulted for external and internal communication? How much will Iams current and potential consumers be aware of and affected by the PETA campaign?

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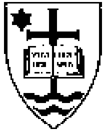
Wendy's International: Pointing a Finger at Fraud
Christine Gaumond; Howard Kim; and J. S. O'Rourke (editor)

On March 22, 2005, a woman discovers a human finger in her chili while dining at a Wendy's restaurant in San Jose, California. As widespread and strongly negative media coverage surrounds the event, sales figures begin to plummet. Wendy's executives are under intense pressure to discover what really happened in their restaurant while they try to repair the damage done to their once well-respected brand. 6 pp. #06-01. (2006).



Eugene D. Fanning Center for Business Communication **06-01**
Mendoza College of Business
University of Notre Dame

Wendy's International, Inc.:
Pointing a Finger at Fraud

Introduction

In the late hours of March 22, 2005, Denny Lynch, the Senior Vice President of Communications at Wendy's International, Inc., was awakened by a telephone call. The voice on the other end was that of Bob Bertini, the restaurant chain's media relations manager. Mr. Bertini immediately informed Mr. Lynch that a woman visiting a San Jose, California restaurant had discovered a human finger in her Wendy's chili just hours earlier. With virtually no warning, Mr. Lynch was handed a public relations crisis that would linger for the next several months.

Wendy's Old Fashioned Hamburgers

The first Wendy's restaurant, "Wendy's Old Fashioned Hamburgers," was founded in 1969 in Columbus, Ohio. Its founder, Dave Thomas, was inspired to name the restaurant after his youngest daughter, Melinda, who went by the nickname Wendy. Mr. Thomas developed an innovative method to prepare fresh, made-to-order hamburgers with the customer's choice of toppings. Focusing on quality and featuring innovative services, Wendy's expanded throughout the mid-1970s and had its first public stock offering in 1976. Since then, Wendy's Old Fashioned Hamburgers has become the third largest quick-service hamburger restaurant in the world, with more than 6,600 restaurants in North America and international markets.[1]

Wendy's International Inc.

Wendy's did not intend to expand its international business, but chose to instead focus on acquisitions and mergers to achieve growth.[2] In 1995, Wendy's acquired the Canadian Tim

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This case was prepared by Research Assistants Christine Gaumond and Howard Kim under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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Hortons chain for about $400 million. The deal added diversity to Wendy's core hamburger business, as Tim Hortons offered breakfast items, such as coffee and doughnuts.

In 2002, Wendy's acquired Baja Fresh Mexican Grill, a fast-casual Mexican food chain with approximately 295 operating units in the U.S. During 2002, the company invested in two additional brands: Café Express and Pasta Pomodoro. By 2005, Wendy's International Inc. became one the world's largest restaurant operating and franchising companies with $11.6 billion in sales and more than 9,700 total restaurants.[1, 3]

Dave Thomas

Dave Thomas was born in 1932 in Atlantic City, New Jersey. As a young boy, he spent a great deal of time moving around with his adoptive father who was looking for employment. During that time, one of Dave's biggest joys was eating at family restaurants where he saw families interacting with one another and having a good time. Since then, opening a family restaurant became his lifetime goal. Wendy's successful business was based on Dave's passion in providing fresh, quality hamburgers to customers. Dave was also one of the nation's most recognizable TV spokesmen. The founder and senior chairman of Wendy's became a household name when he began appearing in Wendy's commercials in 1989.[4] North Americans loved him for his down-to-earth, homey style. As a successful businessman, Dave founded numerous charities including the Dave Thomas Foundation for Adoption. The organization formulized Dave and Wendy's commitment to finding permanent homes for foster care children and provided a national voice for the 150,000 children in North America's child welfare system.[5]

Dave's Way

Dave Thomas lived his life according to five key values, which he believed could apply just as easily to the business world. Dave insisted on quality in everything, from the food served in his restaurants to the way his customers were treated. The quality aspect was so important to him and his business that "Quality is Our Recipe" became part of the Wendy's logo. Dave also felt strongly about the importance of personal integrity and believed that individuals earn their reputation through their actions. He believed it was simple to treat people with respect by living according to the Golden Rule. Dave also knew that one of his business goals was to make a profit, and he believed there was nothing wrong with that. Profit is what allows business to expand, take advantage of opportunities, and share with others. Finally, Dave realized the importance of sharing in his success and giving back. This meant not only giving money but also sharing time and skills with those in need.[6]

Media Attention

The news of the Wendy's finger discovery quickly saturated multiple news media channels. In fact, the media had become aware of the crisis situation and had asked for a statement from Wendy's representatives before Denny Lynch had even been informed.[7] Despite the simultaneous news that Pope John Paul II had died the same day, the media continued their constant coverage and placed heavy time demands on Mr. Lynch. As time continued to pass and the mystery remained unsolved, other media outlets took advantage of the opportunity to provide non-stop exposure to the gruesome story.

It didn't take long for the news to get around. The local California news organizations were already reporting on the incident on their nightly news programs on the same day of the discovery. By the next morning, the talk-radio shows had also created a stir from the discussion of the subject. Just when it seemed that Wendy's would have the opportunity to repair some of its tarnished reputation as a result of a successful inspection from the Santa Clara County Department of Health, Mr. Lynch discovered that the officials had also released a photo of the finger to the media.[8] The photo quickly moved across the country and effectively eliminated any sense of ease the public had felt from learning that Wendy's restaurants created no risks for public health.

It was only a matter of time before many of the late-night television programs were using the Wendy's finger incident as prime material for the show's jokes. *Tonight Show host, Jay Leno, even went so far as to involve founder Dave Thomas in his series of jokes* on the matter.[9] During what was quickly becoming the most serious crisis in the company's history, the public seemed to make light of the occurrence, discussing it along with other nationwide gossip. When that information is considered along with the history of Anna Ayala, the 39-year-old Las Vegas, Nevada woman who claimed to have found the finger, it "made the case seem more like a circus slideshow than the deadly food threats of the past."[10] By the week following the incident, Ms. Ayala had agreed to appear on ABC television's *Good Morning America*, and once again, Mr. Lynch, with minimal warning, was forced to prepare the Wendy's statement on the situation within a matter of hours.[11] The American public was able to personally witness the emotional distress Ms. Ayala had supposedly suffered, and with the origin of the finger still a mystery, Wendy's began to lose the confidence of its customers.

Wendy's Performance

With the amount of negative publicity given to Wendy's by the media, a nationwide drop in the company's sales figures seemed inevitable. The dollar loss in the Bay area as a result of the incident amounted to $2.5 million.[12] During the five-week period following the discovery, sales declined nationally by as much as 2.5% according to Wendy's estimates. Despite the decreasing sales numbers, Wendy's appeared to experience a strong earnings performance. The per-share earnings for the first quarter of 2005 were 45 cents a share, exceeding Wall Street's estimates of 40 cents a share. In addition, Wendy's share price rose by $1.03 to $42.30 and revenue in the first quarter grew by 7.1%, even with a 2.2% drop in same-store sales. The company also increased the 2005 earnings per share estimate from $2.29 to $2.35.[13]

The True Story Unfolds

Upon the conclusion of an extensive internal investigation, Wendy's was able to announce to the public that no accidents had occurred at either the San Jose Wendy's restaurant or at any of the company's suppliers. Another piece of heartening news came when the coroner's office reported that forensic evidence indicated that the finger had not been cooked. Ayala's claims of vomiting could also not be proven.[14] Ayala eventually dropped her case, citing the emotional stress it caused her, but soon afterwards was arrested and charged with attempted grand theft.[15] Ms. Ayala had been known to police and prosecutors for her suspicious history of lawsuits, including spurious claims against an El Pollo Loco restaurant, a former employer, and General Motors.[16] On September 9, 2005 Ayala and her husband, Jaime Placencia, both pleaded guilty to the charges and learned that they would face up to ten and thirteen years in prison, respectively.[17]

What's Next for Wendy's?

Despite his 25 years of experience with Wendy's International, Inc., nothing could prepare Denny Lynch for the finger mystery that would propel his communications team into overdrive to repair Wendy's damaged reputation. Mr. Lynch had experienced another crisis management situation just five years earlier when an attempted robbery left five Wendy's employees dead. But this situation was different. Mr. Lynch had to struggle not only with the quick and widespread media coverage but also with several lesser accusations coming from other restaurant patrons all over the country. He knew that immediate action was necessary in order to rebuild the company's reputation and "get customers thinking about Wendy's again."[18]

Questions

1. What are the critical issues in this case?

2. Who are the key stakeholders Mr. Lynch should try to reach? How should Mr. Lynch communicate with the stakeholders?

3. What actions should Wendy's take? Are there any actions the company needs to take immediately?

4. With all the negative publicity, how can Wendy's repair its image and ensure stakeholders that the company is concerned for their safety?

5. Dave Thomas' values are an important part of the Wendy's culture. How should Wendy's communicate those values to stakeholders?

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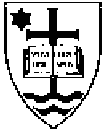
Citigroup: Restoring Ethics and Image Before Growth
Lee, D; Ratliff, J: and O'Rourke, J.S. (editor)

The new CEO of Citigroup, Charles Prince, proposes a Five Point Ethics Plan in an attempt to change the ethics, culture and operations of the company. The plan is a response to significant regulatory scrutiny, paying out massive legal settlements and a Federal Reserve announcement requiring the company to refrain from mergers and acquisitions until they have cleaned up the internal controls. His plan includes expanded training, enhanced focus on talent, balanced performance appraisals, improved communications, and strengthened compliance controls. As current key executives leave the company and experts in ethics are skeptical, many wonder if Citigroup will be able to successfully communicate this program while they hold back on growth to implement this new culture.



Eugene D. Fanning Center for Business Communication **06-04**
Mendoza College of Business
University of Notre Dame

Citigroup:
Restoring Ethics and Image Before Growth

Charles Prince, CEO of Citigroup, is facing a daunting challenge as the head of the largest financial services organization in world. He has joined a company that has experienced significant regulatory scrutiny and that has been linked to the biggest scandals in corporate history. Unfortunately for Prince, the problems are pervasive throughout most of Citigroup's diverse service offerings.

In March 2005, Prince announced his strategy to transform the financial giant and to provide a new direction for the future. He called it the "Five Point Ethics Plan" to: improve training, enhance focus on talent and development, balance performance appraisals and compensation, improve communications, and strengthen controls. Due to the size and complexity of the organization, there were significant unresolved questions. How could the plan be effectively revealed? Would the plan be strong enough to change the culture of the entire organization? How should the corporate communications department handle both the initial and long-term communication of this plan to major stakeholders?

About Citigroup

Incorporated in 1998, Citigroup Inc. is a diversified global financial services holding company providing services to consumer and corporate customers. The company has approximately 141,000 full-time and 7,000 part-time employees in the United States and 146,000 full-time employees in more than 100 countries outside the United States. All of Citigroup's services can be grouped in 3 main areas: Global Consumer, Corporate and Investment Banking, and Global Wealth Management. Citigroup also has two stand-alone businesses, Citigroup Asset Management and Citigroup Alternative Investments. Global Consumer Group was 72% of income in 2004, with Investment Banking coming in second at 13%.[1]

The Citigroup umbrella covers several brands including Citibank, Citifinancial, Citistreet, Citi, Primerica, Banamex, and Solomon Smith Barney (SSB). Citigroup has a 200-year-old

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This case was prepared by Research Assistants Julie Ratliff and David Lee under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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legacy of innovation and achievement. The City Bank of New York is Citigroup's earliest ancestor, establishing a credit union for merchant-owners in 1812. Many of the rest of Citigroup's ancestors originated in the late 19th century, including Travelers, Smith Barney, Bank Hadlowly, and Banamex. In the 20th century, acquisitions included IBC, Salomon Brothers, and The Associates. Sandy Weill, former CEO, was recognized as bringing it all together under the one red umbrella of Citigroup in 1998.[2]

Sandy Weill: The Man Who Shattered the Glass-Steagall

"Everything about Weill is big, including his ambition"
Charles Gasparino, *Blood on the Street*

Congress passed the Glass-Steagall Act in 1933, which established what was known as the Chinese Wall between commercial banking and investment banking. That same year, the man who would influence the repeal of that act in 1999 was born. Sandy Weill later became one of Wall Street's most influential men as the Citigroup CEO in 1998. He ran the one-stop financial supermarket until 2003.[3]

In the 1960s, Weill grew Shearson Loeb Rhodes brokerage from a mid-sized business into an empire that he sold to American Express Corporation in 1981. After being bounced from Amex, he had one of the most notable comebacks on Wall Street. He merged his insurance company, The Traveler's Group, with the Salomon Smith Barney brokerage and the Citicorp banking empire. This merger made Weill a very rich and powerful man, but the fame also brought a lot of negative publicity. During Weill's era as CEO, Citigroup was associated with numerous corporate scandals, regulatory investigations and legal settlements.

In an interview with the *New York Times* on September 11, 2005, Weill still defended what he built, saying "I don't think it's too big to manage or govern at all. I'm sure there would have been things that would have been tweaked this way or that way, but when you look at the results of what happened, you have to say it was a great success."

Charles Prince became the next Citigroup CEO after Weill. His advice for Prince, "Don't screw (the legacy) up." [4]

Charles Prince – Maintaining the Legacy

Charles Prince became the chief executive officer with Citigroup in 2003 and has been an employee with the company for 24 years. He began his career in 1975 as an attorney with U.S. Steel Corporation. In 1979 he joined Commercial Credit Company, which Sandy Weill took over in 1986. At that point, Prince became what *Fortune*'s Carol Loomis called, "an absolute Weill loyalist, who has promptly accepted whatever assignments Sandy has wanted him to take on."[5] He served as main counsel until 2003, when Weill chose him as CEO. Since 2003, Prince has been a fireman, cleaning up the scandals and improprieties that have been building since the late 1990s. Much of that cleaning has meant removing companies and executives that helped build Weill's legacy, including the sale of Traveler's Insurance.

Prince has been described as "a smart, logical thinker who's big in frame, in laugh, and in capacity for work." One long-time analyst notes, "I believe that non-charismatic Prince is going to be a more positive force at Citigroup than the other three charismatic CEOs going back to the 1960s."[6]

Distributing Biased Research

In 2001, the Office of New York State Attorney General Eliot Spitzer began an investigation into possible conflict of interest problems with Citigroup's investment banking practice. This joint investigation between state and federal regulators was resolved and settled in April 2003. In addition to payment of $400 million, Solomon Smith Barney (SSB) was required to adopt a series of reforms and measures. This payment was larger than any other financial institution included in the investigation. The financial impact is even larger due to additional private litigation arising from the settlement. Citigroup took a $1.5 billion charge primarily for litigation reserves in the quarter of the findings. [7]

There were multiple findings from the investigation concerning Citigroup's internal operating practices and communications with clients. The investigation found that the research analysis and correlating ratings were not performed with independence and integrity. SSB business practices encouraged research analysts to provide favorable coverage of companies that were also investment banking clients. A portion of each analyst's compensation was based on revenues from the investment banking unit and investment banking evaluations. The investigation found incidents of fraudulent and misleading research reports. SSB also practiced spinning activities that allocated lucrative shares of IPO stocks to executives at investment banking clients.[8]

One of the most notable reforms required as part of the settlement was to separate the investment banking operations from the research operations of the company. Senior investment banking executives working for a client were forbidden from directly communicating with the research analysts covering the same client. The reforms also required the CEO of SSB's research unit to periodically report to the Citigroup board of directors concerning the quality and independence of the research products.

The Star Telecom Analyst

Jack Grubman was a notorious telecommunications analyst for Solomon Smith Barney. He touted his relationships throughout the industry and earned an estimated $20 million per year. In 10 different deals, he helped SSB earn $24 million in fees from investment banking with WinStar Communications. [9]

In January 2001, Grubman assigned a $50 price target and classified WinStar with a "Buy" rating. With the stock subsequently trading at $13, Grubman's assistant e-mailed a large investor stating, "Buy here and sell in the low $20s." However, Grubman did not change his price target or rating in public. In fact, he maintained the status quo even when WinStar shares were trading at less than one dollar and the company was on the eve of bankruptcy. He later noted in e-mail, "we support our banking clients too well and for too long."[10]

The National Association of Securities Dealers alleged that SSB's research was materially misleading after investigating the WinStar incident. SSB agreed to pay $5 million to settle the charges.

Deceptive Lending Practices

Citigroup acquired Associates First Capital Corporation and Associates Corporation of North America in November 2000. They subsequently merged the acquired entity into the Citifinancial

Credit Company division. The Associates were one of the nation's largest subprime lenders. Subprime lending serves borrowers who cannot obtain credit in the prime market. The loans carry higher costs due to the additional risk taken by the lender and are frequently held by low-income families.

In March 2001, the Federal Trade Commission filed suit against Associates for deceptively inducing consumers to refinance existing debts into home loans with high interest rates and fees. They also alleged that Associates tricked borrowers into purchasing high cost credit insurance without their knowledge. In some cases, the fees were included in monthly payments and added thousands of dollars in additional cost. When consumers noticed the fees, the employees of Associates employed various tactics to discourage them from removing the insurance. The FTC described the activities as, "systematic and widespread deceptive and abusing lending practices." The result was the largest consumer protection settlement in FTC history and required Citigroup to pay $215 million.[11]

Helping Enron Corporation Commit Fraud

On December 2, 2001, Enron filed for bankruptcy protection from its creditors. Investors later found that the company used highly complex special purpose entities and partnerships to keep $500 million off of the consolidated balance sheet and to mask significant deficiencies in cash flow. Citigroup was one of the financial institutions that helped Enron design these transactions.

The Securities and Exchange Commission initiated enforcement proceedings with Citigroup for assisting Enron in producing misleading financial statements. The Commission alleged that loans to Enron were disguised as commodity trades. The transactions were essentially loans because they eliminated the commodity price risk. Under these transactions, commodity price risk was passed from Enron to Citigroup and back to Enron. Without regard for the change in price of the underlying commodity, Enron was required to make repayments of principal and interest. The commission also alleged that Citigroup helped Enron design transactions that transferred cash flow from financing into cash flow from operations. There was further evidence of similar deceptive transactions with Dynegy. Citigroup agreed to pay $120 million to settle the allegations that it helped Enron and Dynegy commit fraud.[12]

Spinning WorldCom Executives

In May 2004, Citigroup agreed to pay $2.65 billion to settle class action suits related its role in the collapse of WorldCom. Plaintiffs in the suit alleged that SSB wrongfully provided favorable ratings on the company. Telecom analyst, Jack Grubman, provided the coverage. WorldCom was not downgraded to "neutral" until WorldCom lost 90% of its value. The U.S. House of Representatives Financial Services Committee additionally found that Grubman warned WorldCom executives, in advance of public disclosure, that Citigroup was dropping the stock from the recommended list.[13]

A former U.S. Attorney General appointed examiner alleged that Bernard Ebbers, WorldCom's chief executive officer, violated his fiduciary duties by passing over $100 million of investment banking business to SSB in exchange for allotments of IPO stock shares. Ebbers was the chief executive during the time when massive accounting fraud and questionable personal loans were discovered. WorldCom subsequently restated earnings by $17.1 billion in 2001 and $53.1 billion in 2000.[14]

The End of Japanese Private Banking

Citigroup is the largest and oldest foreign-owned bank in Japan. The history of their operations dates back to 1902. The operations in Japan are some of the largest outside of the U.S. for Citigroup. Bank officials at Japan's Financial Services Agency began investigating Citigroup transactions linked to money laundering, as well as loans that were used to manipulate publicly traded stocks. The FSA warned Citigroup in 2001, but little corrective action was performed.

In December 2004, Citigroup was handed the damaging news that the FSA would terminate all private banking operations in Japan. This included a requirement to close over five thousand bank accounts. The FSA cited the corporate culture and governance for the infractions. Citigroup executives blamed the problem on the unclear reporting structure for key executives in Japan. Heads of divisions reported to different bosses in New York. In addition to the lost earnings, the closing of the bank accounts represents a challenging blow to Citigroup's image in Japan and threatens the consumer and corporate banking units still operating in the country.[15]

Financial Effects of the Corporate Scandals

By the end of 2002, the effects of the various allegations were weighing heavily on Citigroup. The SEC, FTC, NASD, the New York State Attorney General and other agencies had performed investigations. The reserves set aside for still outstanding legal liability grew by billions because of the costs of regulatory and private litigation.

During 2002, the year that many of these issues were discovered, the company lost over 30% of its market value. In May 2003, Citigroup dropped coverage of 117 firms and fired seven of its top analysts. There was an increasing number of analyst layoffs up and down Wall Street. J.P. Morgan, Goldman Sachs and Morgan Stanley cut up to 25% of their research staffs.[16]

In 2005, the Federal Reserve publicly announced that it would not approve any major Citigroup Mergers and Acquisitions until the company resolved these various issues. This unusual warning from the Federal Reserve was especially restrictive to Citigroup because some analysts believed that big acquisitions were the only way to continue the aggressive growth.[17]

Changing Citigroup's Reputation

One of the initial steps Prince took to clean up Citigroup was hiring Sally Krawcheck as chief financial officer and head of strategy. Krawcheck was known at Smith Barney as "The Queen of Clean," and Prince hoped that she would continue this trend as Citigroup pushed to clean up its image.[18]

On February 16, 2005, Prince announced his Five Point Ethics Plan in a group memo to his employees as part of his goal to make Citigroup the world's most respected financial institution. While this is the most important goal Prince gave in his public plan, there are other benefits that will, hopefully, come with this ethical improvement. Prince hopes to grow the consumer and international business, and to make the corporate and investment bank the best in its class.

The four-page ethical document listed a series of initiatives that employees would start to see implemented in 12 to 18 months, beginning March 1, 2005.

Details of the Five Point Plan

- **Expanded Training.** This point is designed to instill an appreciation for Citigroup legacy. The ethics program was kicked off with a company-wide broadcast of *The Company We Want To Be* to relate the main three responsibilities within the company: the responsibility to clients, to each other, and to the franchise. Annual training about the history and the culture of the Citigroup franchise will be required for all levels of management. Additionally, all employees will receive Annual Ethics/Code of Conduct training.
- **Enhanced Focus on Talent and Development.** A new initiative will be launched, focusing on flexibility, 360 degree reviews, manager surveys, and business leadership seminars for senior managers. New jobs will be communicated and posted internally to encourage those with outstanding talent to stay within the company.
- **Balanced Performance Appraisals & Compensation.** Standardized performance appraisals and evaluations of all managers will be conducted annually. All compensation for business heads will be based on how Citigroup performs, not just how individual managers perform. Employees will be paid bonuses on the basis of how well they participate in training and ethics programs.
- **Improved Communications.** Charles Prince demonstrated that he takes this initiative very seriously, as he has traveled around, meeting with and visiting managers and employers. Citigroup wants to improve the consistent communication of values and goals. Results of any issues reported to Ethics Hotline will be discussed, and more conferences will be planned for Senior Managers.
- **Strengthened Controls.** Such control includes compliance training, risk control self-assessments, and the creation of the Independent Global Compliance function that will be responsible for ensuring Citigroup's compliance with rules and regulations.[19]

Prince Hires Administrative Ethics Officer

Additionally, on September 26, 2005, Lewis B. Kaden joined Citigroup as Vice Chairman and Chief Administrative Officer. Kaden served as a moderator for the PBS's Media and Society seminar, including the *Ethics in America* series which won a Peabody Award. Kaden was a lawyer from Davis Polk & Wadwell, where he handled issues of corporate governance, mergers and acquisitions, and advised major corporations such as Citigroup on significant issues. Prince said of Kaden, "Lew's deep experience, insight, and integrity will be of great value as we pursue our ambitious agenda to build the most respected global financial services company. We look forward to his contributions."[20]

Reaction to the Plan

"Ethics is something you learn as a child; teaching it doesn't make you an ethical person," said Prof. Charles Elson, director of the Weinburg Center for Corporate Governance at the University of Delaware. He did say, however, that "if (Prince's plan) can clarify blurry issues and help instill a culture of compliance to a code, I applaud it. But to teach ethics to make people ethical, that's a bit strained."[21] Elson went on to suggest, "The acid test is going to be sort of a no-tolerance policy for ethical violations, not just legal violations . . . . If the company demonstrates

to its employees that it will not tolerate violations of its code of ethics . . . then you begin to effect a change in culture." Elson further stated that Prince's efforts were a "good start" but that he would need to distance himself from former administration that did not put compliance first. "Rethinking his board, bringing in new blood would be quite helpful," said Elson. He added that Sandy Weill must go, "I think that Mr. Weill's complete retirement from the company would go a long way to distance Mr. Prince from the earlier regime." [22]

The Departure of Weill's Army

A few months after Prince's plan was announced, Robert B. Willumstad, Citigroup's President, COO and Director announced that he was going to leave to become a chief executive of a public company. Willumstad had a key role in creating Citigroup in 1998 with the combination of Travelers Group and Citicorp. During his tenure as Chairman and CEO of the Global Consumer Group at Citigroup, the company witnessed strong profit growth and several successful acquisitions. Willumstad worked closely with Charles Prince and Sandy Weill for years, and was very disappointed when he was not chosen as CEO. [23]

In the same month, Weill stated that he wanted to end his contract early, and launch a private-equity fund. There are reports that he was frustrated by Prince's Five Point Plan and the Traveler's Group transaction. One bank analyst stated, "Sandy always told me he preferred to fix things as opposed to sell them…I'm sure he hated (the Traveler's Group) sale."[24] Weill decided to stay on until April of 2006 due to conflicts of interest and information access.

A month after the announcements about Willumstad and Weill, Marjorie Magner announced her plans to leave, as well. Marjorie was the chairman and chief executive of the Global Consumer Group segment of Citigroup. Magner planned to pursue a career change outside the financial services industry.[25] She was among the highest-ranking women at Citigroup, and her group contributed more than half of the bank's income over the last several years. Executives at Citigroup knew that Magner disagreed with Prince's plan and major changes. Prince responded to Magner's announcement by saying that she was one of the "legends who built Citigroup," and that he is "most proud" of the people she is developing, including her successors. [26]

On a more positive note, Saudi Prince Alwaleed bin Talal, Citigroup Inc's biggest investor, said chief executive Charles Prince would need more time to prove himself as head of world's largest financial-services firm. "This company is a giant," Alwaleed said, "You have to give him time to institute his culture and way of thinking. I'm backing them all the way." [27]

Prince's Response

Charles Prince said of all these initiatives, "The real question is, can we execute it in a way that becomes more embedded? The systems are designed to provide sticks. This will all tie to how you pay people. People who don't complete the required training, for example, won't receive bonuses. If we don't pay people the right way, the initiatives risk becoming no more than cynical happy-talk."[28] Prince acknowledged that he had to *own* this program. He said, "If we delegate this to the (human-resources) department, it's not going to work."[29]

Discussion Questions

1. Has Citigroup grown too large to enforce corporate governance or internal controls? What effect has the organization's size and complexity had on the continued problems?
2. What effect will the new plans have on Citigroup's investors? What can Citigroup do to mitigate negative responses?
3. How can Citigroup continually communicate the reformed organizational culture to the public?
4. How would you react if you were the corporate communications officer of a Citigroup competitor?
5. Do you believe it is possible to enforce an ethics program with this or any other organization?
6. As a corporation communications officer, what would be your method to communicate the plan to Citigroup employees and inspire change?
7. Is Prince's plan sufficient given the magnitude of the problems facing Citigroup?
8. Who are the critical stakeholders? How should Prince handle the stakeholders' responses and concerns?

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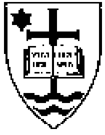
Google, Inc.: Responding to Scrutiny Surrounding its Initial Public Offering
Ellescas, S. D.; Gonzales, J. C.; and O'Rourke, J. S. (editor)

Google's IPO opened at $85 per share, substantially below the expected share price of $135, representing a $10 billion loss in market capitalization. Since deciding to go public, Google's once lauded unique and innovative culture has become problematic for the former Internet start-up. Unorthodox management practices, lack of corporate governance, increased competition, and regulatory issues hobbled Google's IPO and continue to plague the company. Additionally, Google's policy of secrecy leaves its stakeholders with no guidance as to future plans to confront their concerns. Despite its rising stock price since going public, these problems cast doubt on Google's future business viability. CEO Dr. Eric E. Schmidt and Corporate Marketing VP Cindy McCaffrey must decide how to proceed in the face of mounting criticism and lurking competition. 10 pp. #05-03. (2005).



Eugene D. Fanning Center for Business Communication **05-03**
Mendoza College of Business
University of Notre Dame

Google, Inc.:
The Risks and Rewards of a Dutch-Auction IPO

Introduction

On the morning of October 22, 2004, Eric Schmidt, CEO of Google, Inc., finished reading the *New York Times* article under the headline, "A Strong Quarter . . . but Skeptics Remain."[1] Now, only two months after taking Google public in the largest Internet Initial Public Offering (IPO) in history,[2] Schmidt wondered how he should address the continued scrutiny from Wall Street and the media. Despite Google's loyal customer base of 65 million users a day[3] and its stock trading at $172.54 that morning, Schmidt knew the skepticism would continue as competition heightened and the SEC continued its investigations surrounding the IPO.[4]

The Largest Technology IPO in History

On August 19, 2004, Schmidt and co-founders Larry Page and Sergey Brin took Google, Inc. public, selling part of the company in the form of ownership shares. This allowed shareholders to invest in the enterprise while generating capital for the company. This day marked the end of a long journey for Google's IPO. Months prior, the offering was the toast of Wall Street. Google was the first major technology IPO since the dot-com boom-and-bust of the 1990s, but sputtered to the finish line with a host of problems.[5]

Google's handling of its IPO process upset many people on Wall Street and beyond due to several missteps. Instead of garnering the company's anticipated share price of $135, trading opened at only $85, almost 40 percent below the projected figure.[6] This reduction lowered Google's potential market capitalization of $36 billion down to $25 billion. Many called this price reduction a failure since the novel "Dutch Auction" that Google used to distribute its shares elevated uncertainties to the point that investors backed away.[7]

Since deciding to go public, Google has faced challenges on many fronts and has had trouble handling the growing pains start-up companies face surrounding an IPO. Google has left

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This case was prepared by Research Assistants Saun D. Ellescas and Jonathan C. Gonzales under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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investors, analysts, and the media with more questions than answers. Many condemn Google's practice of intense secrecy, accusing the company of "playing its cards close to its vest," at the expense of shareholder interests.[8] Accordingly, skeptics have criticized Google's method of addressing Wall Street, as many have had trouble analyzing and forecasting the profitability of this fast-growing company.

Further, Google's unorthodox management style and business structure, coupled with increased competition in the search engine sector have left investors concerned about the company's continued viability. Thus, on the eve of the largest Internet IPO ever, many on Wall Street knew as the offering came to a close it was "the beginning of another saga, which is how will the company . . . do competitively?"[9] Eric Schmidt now has to answer questions like these, as Google begins its life as a public company.

Google, Inc.

In 1995, Larry Page and Sergey Brin met at Stanford University as computer science Ph.D. students. By early 1996, the two began a research project to prove a theory that using mathematical algorithms would offer a better way to search for information on the World Wide Web.[10] After years of analyzing computer science, depicting the psychological intricacies of the Internet, and writing mathematical algorithms Page and Brin developed a search engine called *BackRub*. After taking *BackRub* to several potential buyers, including Yahoo! founder David Filo, they failed to sell their system. On September 7, 1998, at ages 25 and 24, Page and Brin decided to start their own business with only $1 million in investments.[11] Subletting workspace out of a friend's garage, Google, Inc., whose unique name comes from the mathematical term "googol," which means the number one followed by 100 zeros, was born.[12]

Today, Google is the largest search engine in the world and ranks among the five most popular internet sites visited.[13] As mentioned previously, Google has more than 65 million users per day[14] and offers its services in 35 languages. In early 2004, Google handled approximately 80 percent of all search requests on the web.[15] Analysts believe Google's revenue topped $900 million in 2003, with $150 million in net profits.[16] The company is located in Mountain View, California, and has more than 1900 employees worldwide. Google's mission is "to organize the world's information and make it universally accessible and useful [by being] a trustworthy company interested in the public good."[17]

Google's success has come almost entirely through word of mouth from satisfied users and the company is one of the fastest growing in history. This success has led to several awards including the Top Ten Best Cybertech from *TIME* magazine, *PC Magazin*e's Best Internet Innovation and Technical Excellence Award, and Best Search Engine on the Internet from *Yahoo! Internet Life*.

Googling

Now a part of Webster's English dictionary, the definition of "google" means, "to search for information on the Internet, esp. using the Google search engine."[18] Google remains profitable by offering companies its search technology and by selling targeted advertising solutions via its free search engine. Googling is made possible via "server farms" of linux computers that process more than 3,000 search requests per second. Searches are pulled using mathematical alogrithms which conduct simultaneous calculations in a fraction of a second, allowing Google to surpass

traditional search engines that pull search requests based on word frequency alone.[19] The company has grown from searching 25 million sites in 1998, to searching more than 8 billion sites in 2004.[20] Google continues to pride itself on offering a free democratic service accessible to and used by the rich and poor, from children on the streets to traders on Wall Street.[21]

Dr. Eric E. Schmidt

From 1998 through 2001, Larry Page served as CEO of Google, Inc. In 2001, he relinquished his position as CEO to Dr. Eric Schmidt, former CEO and Chairman of Novell, Inc., to become President of Products. Schmidt had also served on Google's Board of Directors since March of 2001. He earned a B.S. in electrical engineering from Princeton University, an M.S. and a Ph.D. in computer science from the University of California-Berkeley. As Corporate Executive Officer and Chief Technology Officer at Sun Microsystems, Inc., Schmidt brought to Google 20 years of experience in software development, management, and marketing expertise. Today, he leads Google, bringing credibility to the former start-up company.

Not Your Typical Culture

Despite Google's new status as a public company, its corporate culture remains unorthodox and has been criticized in the media, leaving shareholders to wonder whether the company will be able to maintain its unique environment. The Google office décor includes lava lamps, scooters, rubber exercise balls in the hallways, and a piano in the lobby. The recreation facility has a pool table, foosball table, video game arcade, and onsite masseuse with roller hockey games in the parking lot. There are bins of free food in the kitchens and free meals are cooked by the former chef for the Grateful Dead. Employees, including co-founders Page and Brin, share offices in an effort to increase the flow of information and to keep costs down.[22]

Innovation is a key focus for Google; engineers spend 20 percent of their time thinking up new ideas. Day-to-day duties are managed by Schmidt, and decisions are "three way negotiations" with Schmidt, Page and Brin. Investors find Google's controlled chaos unsettling and comment that they "do not sound even remotely like a fiercely competitive world-class company, [but] rather kids playing in a sandbox."[23] One week after going public, Institutional Shareholder Services (ISS), criticized Google for "leaving shareholders to place their trust in an unproven senior management team."[24] Page, when asked about what management theories the company applies, summed up the loose corporate hierarchy at Google by stating that they try "to use some theory from different companies, but a lot is seat-of-your-pants stuff."[25]

Search Engine Competitors

Google's phenomenal success has caught the attention of major players Yahoo! and Microsoft (MSN) who have entered the arena to battle for the heart of the search engine market. All three competitors have unique advantages over the others. Google continues to defend its position as the largest search engine, while these intimidating giants copy its services and integrate increasingly better search capabilities into their hallmark features.[26]

Google's most valuable assets are its brand, loyal users, technology, and advertising policy. Google maintains its loyal users by ensuring its searches are editorial products with a clear separation between advertising and information. Unlike competitors such as Yahoo,

Google prides itself on disallowing paid inclusion, a practice where advertisers pay to have their website included, and somewhat disguised, as search results.

Yahoo's competitive advantages are its technology, execution ability, and large user reach. Since Yahoo is a portal website, providing a range of services such as e-mail, shopping, yellow pages, and finance data, it has acquired valuable information on 141 million registered users that allows personalized results. Yahoo currently has the best execution ability because of Google's management and leadership challenges, while Microsoft may find it difficult to build a search engine from scratch. Nevertheless, Microsoft may be in the best position with its large user reach and enormous research and development (R&D) budget. The company is planning to integrate web search capabilities by 2006 and has an overall R&D budget almost twice the combined revenues of Google and Yahoo.

The Traditional IPO Process

The typical process for a company seeking to go public is to hire an underwriting team of investment banks for their expertise in obtaining the best price for the shares the company wants to sell. The underwriters do this by holding a road show, in which the investment banks present the company's offering to large institutional investors and wealthy individuals, who then tell the underwriters the number of shares they would like to buy and the price they are willing to pay. The underwriters use this information to best approximate demand and determine the appropriate share price.

A negative result from the underwriting process is the investment banks' tendency to price the shares lower than their true value, reducing the money generated from the offering. Underwriters will underprice IPOs for a number of reasons. First, they must minimize their risk. Many times, the investment banks agree to buy all the shares from the company, bearing the risk of being unable to resell these shares to the public. If the banks price the offering too high, they will be left holding more shares of the company than they would like or selling many shares at a loss. Thus, to ensure the complete resale of the shares, they underprice the offering.[1]

Another reason banks underprice is to serve their investors. The institutional investors and wealthy individuals to whom banks cater are the clients that generate trading fees. Worse than selling the securities at a loss is giving these important investors shares that lose money. Thus, banks have a tendency to underprice so that their best clients will benefit from the shares and will continue to do business with the banks.[2] Since the pricing system investment banks use almost certainly generates a "pop," or large increase in value, on the first day of trading, the customers who can participate in hot IPOs make a tidy profit. Accordingly, investment banks generally dole out shares to their most valued customers, typically institutional investors and wealthy individuals.

Google's *Atypical* Dutch Auction IPO

When Google decided to go public, CEO Eric Schmidt reminded potential investors that "Google is a very unusual company in many ways."[3] The company lived up to this promise when it spurned Wall Street's traditional IPO practice in favor of a "Dutch auction" platform to distribute its shares. Google's Dutch auction is a novel approach to a corporate IPO that is meant to attract and get shares to individual and long-term investors who would hold Google stock instead of the traditional goal of profiting from an IPO "pop." This method also lowers

investment banking fees and, in theory, prevents the IPO pop, ensuring that the IPO generates more capital for the company and less profit for outsiders. In Google's Dutch auction, investors register and bid for shares online.[4] The underwriters tally the bids so that the lowest bid price necessary to sell all shares becomes the IPO clearing price. Any bids at or over the clearing price purchase the stock for the clearing price, while those potential investors who bid too little get nothing.

Wall Street's Reaction

Investment banks became very frustrated with Google's Dutch auction IPO. Instead of garnering the typical 4-7 percent in IPO fees, the Dutch auction limited the underwriters' fees to 3 percent, a reduction of over $100 million. This reduction is justified in a Dutch auction by the fact that there is less of a need for distributing shares since Google's IPO website would accept many of the bids, supplementing the traditional investment banking marketing through road shows.[5]

Another requirement Google placed on the lead underwriters, Morgan Stanley and Credit Suisse First Boston (CSFB), and the other underwriters was an unprecedented level of secrecy surrounding the IPO. Google restricted the lead underwriters from disseminating information to the other investment banks on the team. Morgan Stanley and CSFB bankers were upset with the restrictions, and the other banks were even more upset being left in the dark.[6]

Eventually, these frustrations caused many on Wall Street to openly proclaim that Google's opening share price would not be as high as the company predicted.[7] They were proven correct when Google opened trading at $85 a share. Investment banks blamed the low price on an inability to predict Google's earnings potential and strength due to company secrecy and its unconventional approach.[8] Nevertheless, when Google stock popped, it looked as if Google's own estimates of its stock value were correct.[9] Critics speculate that Wall Street may have wanted Google to fail in order to deliver value to its clients in the form of a "pop" and to keep its capital raising IPO franchise alive and well.[10] If the Dutch auction system becomes a viable alternative to the traditional IPO process, this may lead to industry-wide cuts in underwriting fees.[11] In addition, this system would eliminate the IPO pop that investment banks like to give to their favored customers. In response to these pressures, critics contend that Wall Street "talked down" the Google offering.[12]

The auction method was not the only unusual practice for Google's IPO. Google also chose an odd time to go public. Not only was the summer of 2004 a bad market for technology stocks in general,[13] but the IPO date was set in August, usually a down month for Wall Street. Another unusual feature to the IPO was Google's dual class share system that left certain shares with little effective voting power. Those shares offered to the public have one vote to the 10 votes per share for Google founders Page and Brin. While this structure meets with exchange requirements as long as Google doesn't reduce voting power or issue new stock with wider voting privileges, exchanges generally disapprove of structures in which shareholders are not treated equally.[14]

In addition, Google continues to have a strained relationship with Wall Street. Google has stood by its policy that the company would not offer analysts short-term guidance on its business, a common practice for public companies. This lack of information makes it difficult for investors and analysts to gauge the true value of the company. One financial analyst summed up the sentiment of many, saying "we can't adequately answer the question of whether the company's stock is overvalued until we can tell what the company is."[15]

All of these problems have contributed to Google's reputation as a company lacking proper corporate governance. Institutional Shareholder Services (ISS) conducted a corporate governance practices survey of companies in the S&P 500 stock index and included Google despite the fact that the company is not in the index. Because of market capitalization, a measure of the value of the company, ISS decided to include Google and ranked them nearly last in the survey, citing many of the factors listed above.[16]

The NYSE vs. The NASDAQ

Google's offering was the hottest IPO that Wall Street had seen in years. In its initial prospectus, Google did not specify the exchange on which it would list its stock symbol, noting only that it would list on either the New York Stock Exchange (NYSE) or the Nasdaq.[17]

A Google listing would generate a tremendous amount of money for the exchange it chooses. The listing fee for the NYSE is $250,000 while the NASDAQ listing fee is about half that amount. More importantly, the listing fee pales in comparison to the amount of trading revenue a Google listing would generate. Brokerage houses pay exchanges based on trading volume, and by virtue of its strong brand, Google is almost guaranteed to make money.[18]

In addition to the large amounts of money at stake, the exchanges are also fighting for bragging rights. During the dot-com boom of the 1990s, the NASDAQ supplanted the NYSE in the minds of many as the major stock exchange when it took the business of hot technology issues.[19] Long the world's leading exchange, the NYSE was understandably excited with Google considering listing on the Big Board. After months of speculation and lobbying from both exchanges, Google decided to list on the NASDAQ, the premier destination for technology listings.[20]

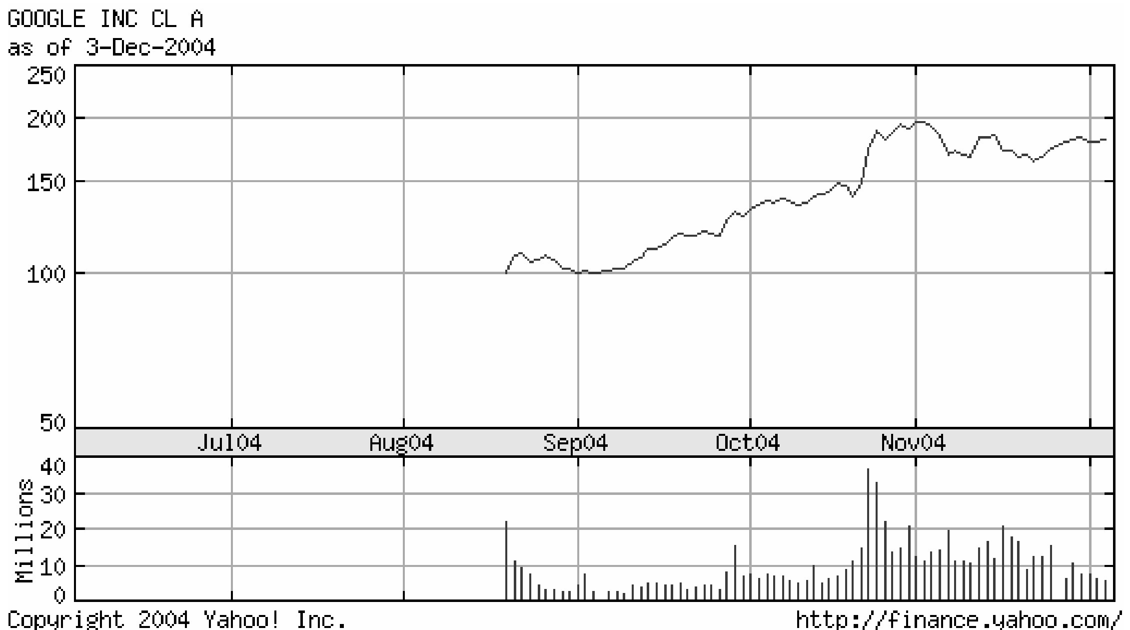

Figure 1: Google equity volume and share value, Aug - Dec 2004.
United States Securities and Exchange Commission

Congress established the Securities and Exchange Commission (SEC) in 1934 to protect investors by ensuring the fairness and integrity of securities markets through mandated disclosure. This disclosure ensures adequate and accurate information which helps the investing public decide whether to invest. Accordingly, Congress has given the SEC authority to promulgate rules and regulations to accomplish this goal.[21]

One of these rules to protect investors is the SEC's prohibition against conditioning the market before an IPO. This rule, known as the "quiet period," applies before the public offering, preventing the initiation of a public sales campaign and restricting the ability of companies to comment with the effect of stimulating interest.[22] Google may have violated this rule when its founders, Page and Brin granted an interview to *Playboy* magazine which was printed in the September 2004 issue of *Playboy*, during the quiet period. While the IPO proceeded as planned, the SEC continued to investigate Google after the IPO.[23] In addition to the "quiet period" violation investigation, the SEC also found that Google failed to register options to current and former employees, possibly in violation of federal securities laws.[24] The pair of SEC investigations was just another blemish on the face of Google's once lauded IPO.

What's Next for Google?

Analysts report they expect the search engine market "to grow an average of 38 percent a year over five years, rising from $2.6 billion in 2003 to $13.4 billion in 2008."[25] The search engine business has become increasingly complex, with user requests becoming more challenging and unusual. In an effort to remain competitive and innovative, Google released new additions to its website this year, such as *Google Print*, *Google Scholar*, and *Google Catalogs*, which continue to focus on the company's core search business. The company has recently grown internationally, with more than 50 percent of its users outside the United States, and there has been speculation that international growth will continue.

By early December of 2004, Google's stock price continued to rise and was trading around $180 per share, despite its initial opening price of $85 per share in August (see Figure 1).[26] Google continues to struggle handling the scrutiny from Wall Street and the media, often having "no comment" or giving vague answers as to its business strategy. When Google has made comments in the media, they often come from co-founders Page and Brin, with very few made by CEO Eric Schmidt or Cindy McCaffrey, the Vice President of Corporate Marketing, who is also in charge of corporate communications. When asked what's next, Google responds, "Hard to say. We don't talk much about what lies ahead, because we believe one of our chief competitive advantages is surprise."[27]

Questions

1. How should Eric Schmidt respond to the scrutiny surrounding Google's IPO in order to retain investor and user loyalty, as well as strong financial stability? Which issues should be addressed first?

2. Who are the stakeholders? How should Google address them?

3. How should Google handle future scrutiny from Wall Street (the United States Securities and Exchange Commission, institutional investors, analysts, and others)?

4. How should Google compete with giants Yahoo! and Microsoft, while remaining true to the company's core search engine business?

5. What role should Larry Page and Sergey Brin play? What role should Cindy McCaffrey, the Vice President of Corporate Marketing (also in charge of Google's corporate communication) play?

6. Can Google maintain its unique corporate culture and management structure as a public company? If so, how? If not, how should they change?

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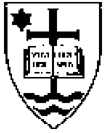
KPMG: Running for Shelter
Ragsdale, M.; Bucholz, E.; and O'Rourke, J. S. (editor)

Beginning in the late 1990's, public accounting firm KPMG marketed and sold tax shelters specifically designed to help clients evade taxes. When the IRS challenged these tax shelters, KPMG resisted its investigation. In the face of mounting evidence against the firm, KPMG eventually realized it had no choice but to cooperate with the Justice Department and try to save itself from criminal indictment. Late in the summer of 2005, KPMG reached a settlement with the Department of Justice. The settlement terms required KPMG to make a public admission of wrongdoing. This admission paved the way for the Justice Department to file suit against former KPMG employees involved with the tax shelters. Some argue that KPMG betrayed its former employees. With the risk of criminal indictment abated, now KPMG must turn its attention to rebuilding the trust of its partners and its clients. 12 pp. #06-06. (2006).



Eugene D. Fanning Center for Business Communication **06-06**
Mendoza College of Business
University of Notre Dame

KPMG:
Running for Shelter

Introduction

It was September 30th and Timothy Flynn was all too ready for the month to end. Only a few months earlier, Flynn had taken over as Chairman and Chief Executive Officer of KPMG, LLP when his predecessor, Eugene D. O'Kelly, stepped down after being diagnosed with a terminal form of cancer.[1] Flynn took office during a difficult time in the company's history. Flynn's first few months as CEO marked a time when KPMG almost met its end.

An ongoing Internal Revenue Service investigation revealed that KPMG had committed illegal acts by marketing and implementing tax shelters with the sole purpose of creating tax losses. Since the transactions in question had no legitimate business purpose other than to create tax losses, they were not tax deductible. The U.S. Justice Department could have filed criminal charges against KPMG; an indictment would have ruined the company. Instead, the Justice Department decided to spare KPMG by negotiating a settlement with the company.

On August 28, 2005, the settlement was finalized. KPMG then moved quickly to settle the flood of civil suits filed by former tax-shelter clients. These clients claimed that they were unaware of the risk that the IRS might not accept these deductions. On September 29, KPMG agreed to settle a class action suit with a number of these former clients.

Flynn was relieved that KPMG had escaped federal prosecution and was beginning to address former clients' grievances; he knew, however, that more challenges lay ahead for the company. The terms of the settlement imposed significant restrictions on KPMG's tax department. Flynn could only hope that the company had not lost the trust of its audit clients and that the core of its clients would stay with the company. Flynn also worried about the backlash surrounding the indictment of eight former KPMG executives. The indictments were announced on August 29, 2005, the day after KPMG reached its settlement with the Justice Department. Some of the lawyers representing those indicted argue that KPMG sacrificed some of the

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partners involved in its tax sheltering business in order to save the company. Flynn worried that this perception might injury partner loyalty and talent recruitment.

Additionally, Flynn realized that as the media continued to follow these indictments, they would continually remind the public of the fraudulent nature of the tax shelters and of KPMG's admission of wrongdoing. Although it looked as if KPMG would survive, Flynn braced himself for the imposing challenge of saving the company's tarnished reputation and leading KPMG into the future.

Industry Profile

The public accounting profession is highly concentrated and that concentration has only increased over the last few years. The Big Six of the early 1990s are now the Big Four since Price Waterhouse merged with Coopers & Lybrand and since Arthur Andersen collapsed.[2] When Andersen failed, the remaining Big Four absorbed their former competitor's clients. The Big Four include Deloitte & Touche, PricewaterhouseCoopers, Ernst & Young and KPMG. These four firms audit more than 78% of all U.S. public companies, representing 99% of public company sales.[3] These firms provide accounting, audit and tax services that are virtually indistinguishable, even for those trained in accounting. They generate the largest portion of their revenue from audit services and the second largest portion from their tax services. The most important differentiating factor between the Big Four and other accounting firms is their size.

The advantages these firms derive from their size goes far beyond economies of scale. With relatively few exceptions, public companies turn to one of the Big Four for audit services. Other accounting firms cannot offer a large enough collateral bond to its clients. A collateral bond is the restitution an accounting firm can afford to make to its client if the firm issued an unqualified opinion on the financial statements despite a material misstatement and a lawsuit results.

Business Profile

As the fourth largest accounting firm in the United States, KPMG is one of the accounting profession's Big Four. KPMG, LLP represents the United States operations of KPMG International. Built over time through mergers of several international accounting firms, KPMG boasts the widest international operations of all firms in the industry.[4] Although the smallest of the Big Four, KPMG's ninety-five domestic offices evidence the company's strong presence in the United States.[5] In 2004, KPMG, LLP generated over $4 billion in compensation for services.[6] KPMG International numbers for the same year totaled almost $13.5 billion.[7] The company's audit and tax functions have been trusted by clients for over 100 years.

In 1997, KPMG and fellow Big Four competitor, Ernst & Young discussed merging their firms.[8] The merger negotiations eventually died, largely because of concerns about antitrust regulations.[9] Despite its failure, the proposed merger indirectly made a significant impact on KPMG's business. During a routine pre-merger examination of Ernst & Young's books, KPMG discovered the impressive profits its competitor was gleaning from selling tax shelters.[10] KPMG's then chief executive, Stephen G. Butler, decided the company could not afford to miss out on this market opportunity.[11] Butler placed Jeffrey Stein, then head of KPMG's tax department, in charge of creating a brand of tax shelters for the company.[12] Stein's tax shelters likely made a significant contribution to the tremendous growth experienced by the tax

department between 1998 and 2001. During this time, the department's annual gross revenue increased from $829 million to $1.2 billion.[13]

Introduction to Tax Shelters

The *Oxford English Dictionary* defines a tax shelter as "an opportunity for incurring expenses so that they can be used to reduce tax liability." In the 1990s, it was common practice for accounting firms to market tax shelters to taxable entities, most often wealthy individuals or corporations. A tax shelter works as follows: the accounting firm finds a way to structure a transaction or series of transactions for the taxable entity which intentionally creates a loss. The entity then uses this loss to offset income and reduce its tax liability. The accounting firm then takes a fee for the service of helping the entity make this transaction happen. The American Institute of Certified Public Accountants (AICPA) rules stipulate that Certified Public Accountants (CPA) may not receive contingent fees based on the services they provide, so the firm receives compensation for structuring the tax shelter even if the transaction is challenged by the Internal Revenue Service (IRS).

In order for a transaction that creates a loss to be tax-deductible, it must have a legitimate business purpose other than tax avoidance, economic substance, and profit motive. The taxable entity must prove to the IRS that the tax shelter meets this requirement. If the taxpayer fails to establish that the transaction had a legitimate business purpose, then the taxpayer will be guilty of filing a false return. The fulfillment of this requirement is anything but bright line. The definitions of business purpose and economic substance used by the IRS and articulated through the courts are vague, confusing, and inconsistent. Since the rules involved are difficult to interpret, an accounting firm decides whether to market a tax shelter based on an assessment of the risk that the IRS may challenge the transaction. Firms usually adopt a decision structure that allows a tax shelter to be marketed as long as it is "more likely than not" that the tax shelter will not be challenged.

KPMG's BLIPS

The federal investigation into KPMG's practices was in response to four tax shelters known as BLIPS, FLIP, OPIS, and SC2. The tax shelter known as BLIPS, which stands for "Bond Linked Issue Premium Structure," was sold to 186 individuals and was the most profitable of the four shelters, generating over $53 million in revenue for KPMG.[14]

BLIPS were marketed to individuals who had at least $20 million in ordinary or capital gains income. KPMG and Presidio, an investment bank, approached such wealthy individuals and proposed a transaction to create a loss that would offset their capital gains. Presidio arranged the necessary investments and financing for the individual, while KPMG and a separate law firm provided opinion letters indicating that is was "more likely than not" that the tax loss would survive an IRS challenge.

BLIPS worked as follows: The taxpayer formed a limited liability corporation (LLC) to which they contributed cash equal to 7% ($1.4 million) of the gain to be offset. The LLC then obtained a loan from a bank, usually for about $50 million, at an above-market interest rate. Since the interest rate was greater than the market rate, the LLC received a loan premium equal to the amount of the gain to be offset. The LLC then agreed to severe restrictions on the loan in

order to reduce credit risk. The restrictions included the provision that the LLC maintain 101% of the loan amount in cash or liquid securities.

Next, the LLC formed a partnership with two affiliates of Presidio known as a Strategic Investment Fund. The LLC received a 90% partnership interest, one of the affiliates received a 9% interest, and the other affiliate received a 1% interest and assumed the role of managing partner.

The LLC then contributed all of its assets, including the loan, the loan premium, and the cash contribution, to the partnership. The two affiliates also contributed cash in the amount of 10% of the LLC's total assets or about $155,000. The Fund then had total capital of $71.6 million. The partnership assumed the obligation to repay the loan. At this point, the Fund entered into an interest rate swap with the bank, which effectively reduced the interest rate of the loan to a market-based rate.

The Fund converted most of the U.S. dollars into euros with a contract to convert them back to U.S. dollars in 30-60 days. The Fund used the euros to engage in short-selling low-risk foreign currencies, which were monitored by the bank to ensure the restrictions on the loan were not violated (see Exhibit 1).

After 60-180 days, the LLC withdrew from the partnership and the partnership was liquidated. All of the euros were converted back to U.S. dollars, which were then used to pay off the loan. Any remaining assets in the partnership were divided among the three owners and the LLC sold any securities obtained at fair market value.

For tax purposes, the LLC passed its gains or losses to the individual owner. The opinion letters issued by KPMG and the law firm stated that the LLC should be able to claim both the cash contribution of $1.4 million and the $20 million of loan premiums as losses for tax purposes. This is how the original gain of $20 million was claimed to be offset. KPMG profited through the receipt of up to 7 percent of imaginary loss figures[15] (see Figure 2, p. 10).

The Investigation

The IRS started investigating KPMG in 1999 after receiving anonymous tips about the company's tax shelters.[16] The IRS asked KPMG to turn over details about how the tax shelters worked and who invested in them. The company refused.

While KPMG was not the only auditing firm promoting questionable tax shelters, the firm did put up the most resistance to government regulatory efforts. When the IRS began raising concerns about tax shelter abuses, other firms decided to quickly and quietly settle.[17] Ernst & Young, KPMG's inspiration in the tax shelter business, settled with the IRS in 2003 for a mere $15 million dollars.[18] KPMG took the opposite approach, insisting the company did nothing wrong. Unnamed insiders suggest that KPMG either arrogantly thought that it could outsmart the IRS and the Department of Justice or thought that with its industry position the IRS would not or could not challenge them.[19]

KPMG defended itself as late as the November 2003 Senate subcommittee hearing over the company's tax shelters. KPMG was railed at the hearing. The Senate produced internal documents which revealed that the firm's tax department gave little concern to the legality of the tax shelters. Instead, the documents showed how KPMG engaged in a cost benefit analysis and decided that the gains to be made from selling tax shelters outweighed the costs associated with the risk of IRS disapproval.[20]

After seeing the disparaging subcommittee report, Flynn's predecessor, Eugene D. O'Kelly, announced to KPMG's board that the company would begin cooperating with the investigation.[21] In January 2004, KPMG began making personnel changes. The company forced Stein to retire. The company reassigned Richard Smith, the vice chairman of tax services and placed another high level partner, Jeffrey Eischeid, on leave. Despite some signs of remorse, KPMG was not yet ready to turn over all relevant documents. In February 2004, out of frustration with KPMG's lack of cooperation, the Department of Justice convened a grand jury to begin a criminal inquiry. By May 2004, a federal judge hinted that KPMG might be guilty of obstruction of justice. In March 2005, KPMG finally got serious about resolving the dispute. The company hired Sven Erik Holmes, a federal judge from Tulsa, as vice chairman of legal affairs. Holmes quickly fired several partners involved in the questionable shelters.

Prior Trouble at KPMG

This is not the first time that KPMG, LLP has been in trouble with the law. In 2003, the SEC filed fraud charges against the company and some of its partners. The allegation related to former KPMG client Xerox, who fraudulently inflated its profits in the late 1990s.[22] In October 2004, KPMG settled charges that its audit of Gemstar-TV Guide International's financial statements was improper.[23] KPMG was also implicated recently when audit client Fannie Mae had to restate its earnings.[24]

Reluctance to Indict KPMG

Had the Justice Department indicted KPMG it would have meant the end of company in the same way that Arthur Andersen's indictment led to its departure from the industry. Andersen's case proved how quick industry clients and partners are to leave a firm following its indictment. Convicted firms are banned from practice, according to SEC regulations.[25] Neither clients nor partners are willing to stick around, chancing their luck that an indictment will not result in conviction.

The Justice Department likely considered that indicting KPMG would mean the end of the firm, leaving only three large firms in the industry. A reluctance to see the industry become even more concentrated likely factored into the Justice Department's decision to settle with the company.

Settlement with the Justice Department

After a few months of pleading, KPMG's outside counsel Skadden, Arps convinced the Justice Department not to indict the company. On August 28th, a settlement was announced. The settlement is structured as a deferred prosecution agreement. As long as KPMG complies with the terms of the agreement, the Department of Justice will dismiss charges against the firm on December 31, 2006. The terms of KPMG's settlement require the company to pay $456 million in fines to the government in a series of three installments over a period of 16 months. The conditions of the settlement stipulate that the fine cannot be paid with insurance money. The settlement figure represents $100 million in civil fines for failure to register the tax shelters with the IRS, $128 million in criminal fines over fees earned by KPMG, and $228 million in

restitution over lost IRS revenue. The fines constitute 11% of the firm's fiscal 2004 revenue and average to $300,000 per U.S. partner.

As part of the settlement terms, KPMG also agreed to supervision by an independent monitor for a period of 3 years. Former SEC chairman Richard Breeden will monitor KPMG's compliance with the agreement. Breeden has a great deal of experience with criminal investigations. He previously acted as Corporate Monitor of WorldCom, Inc. on behalf of the U.S. District Court. Breeden will monitor KPMG's compliance with the specific restrictions the settlement imposes on the firm's tax practice. The settlement bans KPMG from offering pre-packaged tax products. The settlement also restricts KPMG from charging fees not based on hourly rates.

As part of the settlement, KPMG also made a public admission of wrongdoing. KPMG's statement included the comment that "a number of KPMG tax partners engaged in conduct that was unlawful and fraudulent."[26] KPMG's admission paved the way for charges against individual partners.

Indictment of Employees

On August 29th, the day after the Department of Justice proclaimed its settlement with KPMG, a federal grand jury announced the indictments of nine individuals charged with conspiracy to commit fraud in connection with the KPMG tax shelters. Eight of the nine defendants are former KPMG employees. The ninth individual, Raymond Ruble, is a former partner at the law firm of Sidley Austin Brown & Wood, LLP. Ruble contributed to the sale of the tax shelters by composing opinions supporting the shelters' legality. Each individual faces large fines and potential prison time.

Stanley Arkin, the defense attorney for former KPMG executive Jeffrey Eischeid, argues that KPMG's cooperation with prosecutors represents "a profound betrayal by KPMG of its partners."[27] Arkin is not alone in this argument. Jonathan Hamilton, editor of the newsletter *Public Accounting Report*, warns that KPMG's action "sends a very solid message to any partner: Even if what you're doing has the firm's blessing, if the firm gets in big trouble, you're going to be on your own."[28]

Settlement with Former Tax Shelter Clients

As part of KPMG's cooperation with the Justice Department, the firm had to turn over the names of those who invested in its tax shelters. The IRS then required these tax shelter clients to restate their tax liabilities for the relevant years. Considering interest and penalties, many of KPMG's former clients owed the IRS millions of dollars.[29] Some of these clients are trying to recover a portion of these expenses by suing KPMG. These taxpayers argue that they trusted that KPMG would not advise them to do something illegal and that they were unaware of the risks that the IRS might challenge these transactions.

Thus far, former tax shelter clients have filed three class-action lawsuits against KPMG. On September 29, 2005, KPMG settled a class-action suit filed by investors who bought shelters through KPMG *and* the law firm of Sidley Austin Brown & Wood. Brown & Wood was one of the outside firms participating in the tax shelters by drafting supporting legal opinions. The class party to this suit, which may include as many as 280 investors, will receive a $195 million dollar payment. Brown & Wood will pay 20% of this figure and KPMG will pay the remainder. KPMG

and Brown & Wood will also pay the plaintiffs' lawyers' fees. Inclusion in the class is voluntary. Investors can opt out of the class and pursue their own lawsuits against KPMG and Brown & Wood. If the class is as large as projected, each participating investor will realize an average settlement of $686,000, a figure significantly smaller than the average taxpayers' real losses.

This settlement represents a significant step in KPMG's handling of the civil suits filed by former tax shelter clients. It is important to note, however, that this settlement only encompasses the grievances of clients who bought their tax shelters based on legal opinions offered by Brown & Wood. Brown & Wood is one of several law firms who supported KPMG's tax shelters. KPMG is not yet finished addressing suits by angered tax shelter clients. KPMG still faces two other class-action lawsuits and the possibility that more suits will be filed in the near future.

Moving Forward

Flynn grabbed his jacket and headed out of the office. With the immediate threats brought on by the investigation averted, he planned on spending the weekend relaxing and rejuvenating his energies. Flynn knew that Monday would represent another day in the company's marathon to rebuild its tarnished reputation. Now that the firm's efforts to settle civil suits filed by former tax-shelter clients were finally meeting with success, Flynn wondered where he should focus his attention next.

Discussion Questions

1. What is the biggest risk facing KPMG post-settlement?

2. In the aftermath of the criminal indictments against former employees, what message should KPMG communicate to its current partners?

3. How should KPMG respond to IRS or Department of Justice inquiries in the future?

4. What should KPMG do to regain its clients' trust?

5. What type of relationship should KPMG strive to create with independent monitor Richard Breeden?

Exhibits

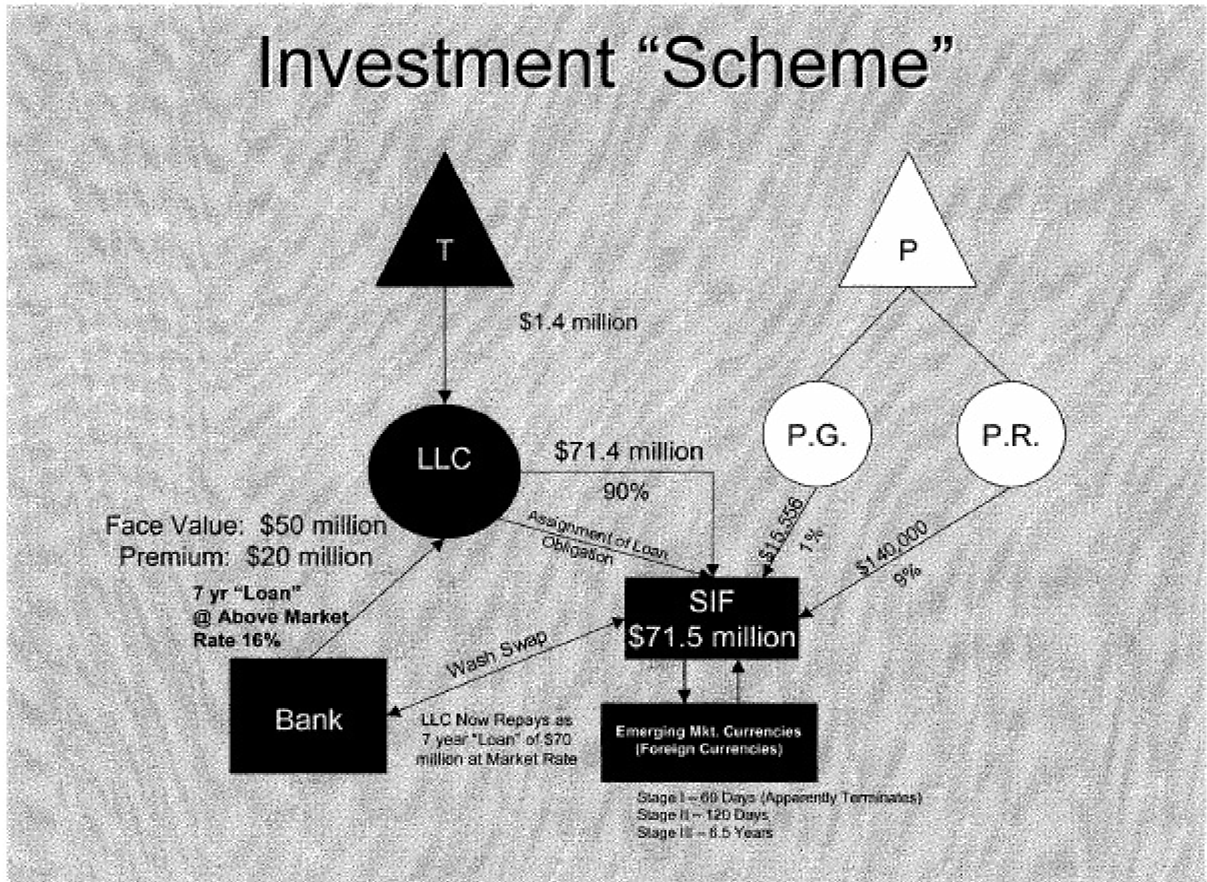

Figure 1. Investment Scheme. Source: Report of the Minority Staff of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate. "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals; Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2." Appendix A.

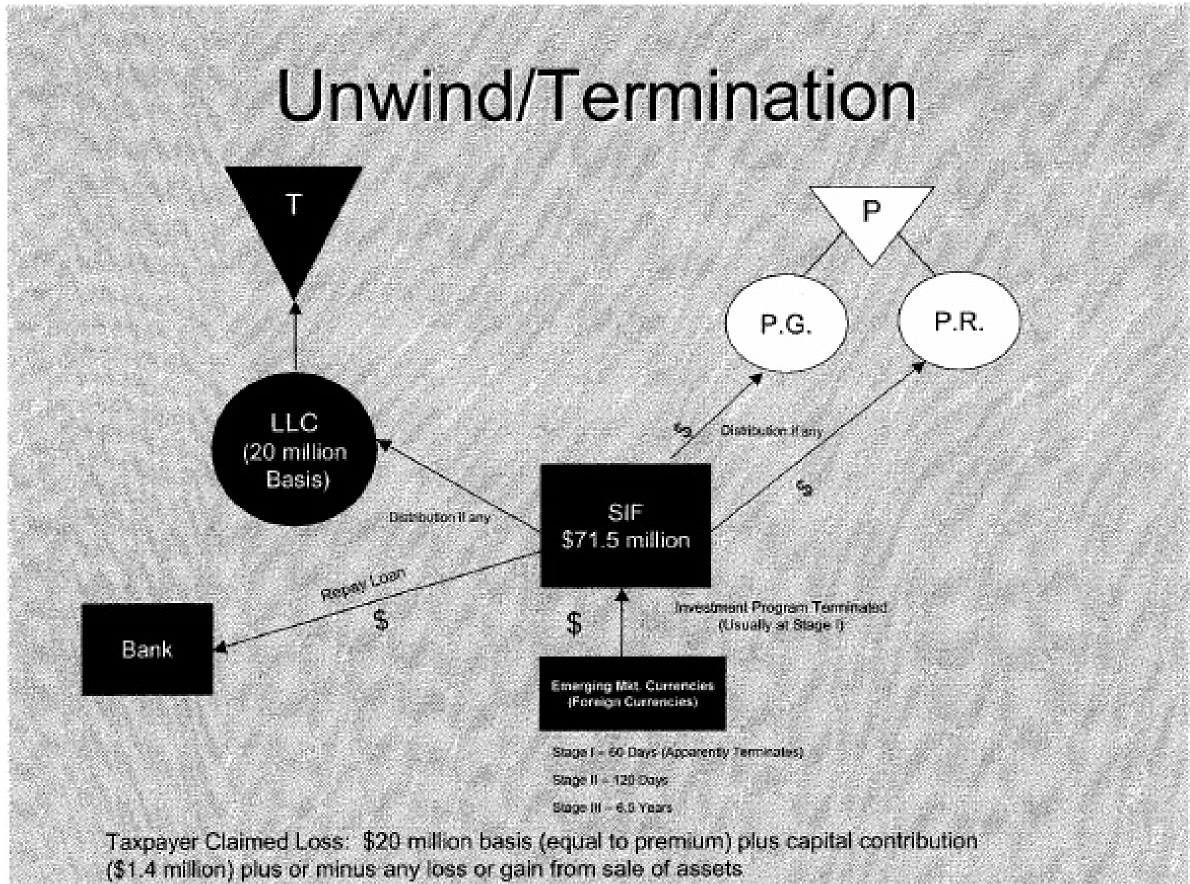

Figure 2. Unwind/Termination. Source: Report of the Minority Staff of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate. “U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals; Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2.” Appendix A.

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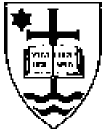
The New York Stock Exchange: An Identity in Jeopardy
Abdalla, S. A.; Sanderson, S. J.; and O'Rourke, J. S. (editor)

A crisis of leadership and brand image is precipitated by the revelation of a compensation package for NYSE Chairman Richard Grasso. Critics and insiders alike regard the level of compensation as exorbitant and call for Grasso's resignation. Far more serious than the loss of a capable chief executive, however, is the growing sentiment that the exchange chairman may be unfit to regulate the board members who vote on his compensation. Aggressive competition from electronic trading systems such as the NASDAQ threaten the very existence of the NYSE market-maker model and the system which governs it. 33 pp. Case #04-03. (2004)



Eugene D. Fanning Center for Business Communication **04-03**
Mendoza College of Business
University of Notre Dame

The New York Stock Exchange
An Identity in Jeopardy

September 17, 2003

Robert Zito, executive vice president of communications for the New York Stock Exchange (NYSE), could predict the outcome of the late-day board meeting currently in progress. Recent events had proven particularly damaging for the NYSE and its executive team. Now, several influential stakeholders were upset and calling for NYSE Chairman and CEO Richard Grasso to step down. The chief executive and his Board of Directors were meeting to discuss this issue.

Zito thought back over the media relations nightmare that began with the August 27 announcement of a $139.5 million payout of the CEO's deferred compensation package. Initially, the head of corporate communications felt this story played fairly well in the press. There was plenty of criticism about the size of the package, but he thought his team had been effective in delivering the message of why Grasso deserved the money.[1] But, instead of fading away, new developments kept making the story worse.

The phone rang at Zito's desk. The communications director picked it up to see if his prediction was true.

New York Stock Exchange

The New York Stock Exchange has had a long and illustrious history rooted in the very foundation of America's financial markets. In the mid 1700s, stockbrokers, merchants and auctioneers bought and sold equities in offices and coffee houses both on and around Wall Street. In the absence of both a set location to trade and a time to meet, potential buyers and sellers had to search for one another, making trading difficult. On May 17, 1792, two dozen Wall Street brokers met and signed an agreement to trade strictly with one another. Signed at an informal location underneath a Buttonwood tree at 68 Wall Street, this two-sentence document became known as the "Buttonwood Agreement" and would evolve the group into today's New York Stock Exchange.[2]

This case was prepared by Research Assistants Stephen A. Abdalla and Stephanie J. Sanderson under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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In 1934, the Exchange registered as a national securities exchange with the Securities and Exchange Commission (SEC), hired its first paid president in 1938 and established a 33-member Board of Governors. This Board, consisting of Exchange members, non-member partners and public representatives, was converted into a Board of Directors in 1972, a year after the Big Board incorporated as a not-for-profit corporation. The Board consists of 12 directors from the securities industry and 12 public directors, and includes the Chairman and CEO, two Presidents, co-COOs and executive vice chairmen.[3]

In 1817, thirty stocks traded on the "New York Stock and Exchange Board." By 1863, the name was changed to New York Stock Exchange, still listing 30 stocks. In an open auction, brokers would call out their bids to buy or sell stock from their assigned chairs. This is why members are said to have a "seat" on the Exchange. This membership gives the right to trade stocks and can be bought directly from owners of the 1,366 seats. Large financial firms and specialist firms own the majority of seats in the modern NYSE. Seats first were sold for $25; today the price exceeds $2.0 million.

Chairman and CEO Richard Grasso

Richard Grasso grew up in the Jackson Heights section of Queens in New York City and aspired to be a policeman. After two years at Pace University, he dropped out and joined the army, earning a good conduct medal and a badge as a sharpshooter. His first job after the army was in 1968 as a clerk in the NYSE's stock-listing department, paying $80 a week. Rising swiftly through the ranks, Grasso became a vice president in nine years, an NYSE president 10 years later, and then chairman and chief executive in his 26th year with the Big Board.[4]

The last seven years were strong for the NYSE. Under Dick Grasso's leadership, the Exchange remained competitive and relevant despite the growth of the NASDAQ, a slew of corporate scandals and a major terrorism attack. In fact, the events of Sept. 11, 2001 could have been devastating to the NYSE and the American economy. Instead, under his leadership, the NYSE was up and running within one week of the falling of the Twin Towers. The opening bell rang on Monday, Sept. 17, 2001, delivering to the world a message that the U.S. economy had not been beaten, firmly establishing Chairman and CEO Grasso as an exceptional and renowned leader.

NYSE Trading Model and Electronic Exchanges

Trading on the NYSE continues to use the original model. Buy and sell orders arrive at the exchange via brokers and are handled at the trading post by a specialist (details of how a trade is executed can be found in Appendix 1). Each specialist handles a very small number of stocks (or just one). It is the specialist who handles the "book" listing all *limit orders* (see glossary) awaiting execution. Specialists are required to trade from their own portfolios in the situation where there is an imbalance in the number of buyers and sellers, thereby improving liquidity.

The American Stock Exchange (AMEX) founded its roots in the early days of the NYSE, when individuals traded stocks that did not meet NYSE listing requirements on the street at the steps of the NYSE. (Currently, these requirements include $40.0mm market capitalization, $40.0mm in assets and $2.0mm in earnings each of the past two years, among other requirements.) Despite developing into a major exchange, the AMEX now handles mostly small stocks as a result of a recent merger with the NASDAQ.

In 1961, the SEC commissioned a study to examine the fragmentation of the *over-the-counter market* (OTC: see glossary). As a result, the National Association of Securities Dealers (NASD) was commissioned in 1971 by the SEC to implement a solution. The NASD created the NASDAQ (National Association of Securities Dealers Automated Quotation), an electronic "exchange;" or a place where buyers and sellers could electronically meet and agree on prices for securities not listed on the NYSE or any other formal exchange. Over the next 30 years, the NASDAQ has surpassed the NYSE in trading volume (both number of shares traded and the value of those shares).[5]

The NASDAQ differs from the NYSE in that there is no trading floor; all trades occur electronically, providing faster trades, potentially superior *spreads* (see glossary) and lower transaction costs. In this electronic marketplace, millions of participants compete for orders, improving prices. The addition of *market makers* (see glossary) improves liquidity, as they trade from their own portfolios (as do NYSE Specialists).

The advent of Electronic Communication Networks (ECNs) has further improved the competitive advantages of the non-NYSE markets. ECNs are networks that allow investors to trade *directly* with one another, routing and matching orders through bypassing an "exchange" altogether. Advocates of ECNs claim fair, neutral and efficient trading, better anonymity, lower cost trading and the ability to trade after-hours.

The NYSE remains the premier exchange despite the strong competition from the NASDAQ and ECNs. Some industry pundits claim the NASDAQ model offers lower trading costs under the guise of faster trades and therefore better prices; many others see the NYSE delivering the better deal for investors by actually delivering a more competitive price as well as lower volatility.[6] However, the prestige, selectivity and brand recognition associated with the Big Board drives the biggest firms to continue to list with the NYSE.[7]

Corporate Governance on the Hot Seat

Throughout the late 1990s and into early 2002, several major issues arose that questioned corporate governance measures in corporate America. Among these are Enron's off-balance sheet financing leading to the demise of auditor Arthur Andersen, accounting scandals at WorldCom and Global Crossing, and arrests of senior executives at Tyco International accused of looting hundreds of millions of dollars from corporate coffers. In February 2002, then-SEC Chairman Harvey Pitt appealed to the NYSE to review corporate governance policies of firms listed on the NYSE. As a result, the NYSE Board approved a list of changes in August 2002 and submitted them as a request for rules changes to the SEC. By April of the following year, the SEC issued a document soliciting comments from "interested persons."[8] Comments received were supportive of the primary changes, focusing on board composition (sufficient outside directors) and audit procedures. Throughout the summer of 2003, the general tone in the business press was extremely supportive of the proposed governance improvements.

A Time of Turmoil

At the end of 2002, the NYSE wielded perhaps the strongest brand equity to date. But a series of events in 2003 would become a dangerous weight on the Big Board's name. It all began in February 2003, when Dick Grasso was appointed to the board of Home Depot Inc. Along with

his board membership of Computer Associates Inc., the move was criticized as a potential conflict of interest as both companies were listed on the NYSE.[9]

On March 23, 2003, the NYSE announced its intention of naming Citigroup Chairman and Chief Executive Sanford Weill to the Board as a public director.[10] The Exchange was publicly criticized for naming a CEO whose brokerage firm (Salomon Smith Barney) was part of a Wall Street research analyst scandal.[11] Two days later, the nomination was withdrawn.

On March 26, 2003, SEC Chairman William Donaldson sent a letter to all Self-Regulating Organizations (SROs) regarding corporate governance issues. In the letter (Appendix 2), the Chairman requested a review of the corporate governance of the NYSE, in a reply due May 15, 2003.

On April 17, 2003, the *Wall Street Journal* broke a story stating the NYSE was investigating front-running on its trading floor, which is a federal offense. In response, the NYSE released a statement indicating that the investigation was regarding treading "ahead" of investors, not front-running.[12] Although the front-running part of the story was inaccurate, *The Wall Street Journal's* attention to the issue forced the NYSE to reveal information regarding its investigation of possible specialist violations.[13] This announcement triggered criticism of the NYSE trading model.

On May 7, 2003, *The Wall Street Journal* broke a story announcing Grasso's $10.0mm 2002 pay package. This article put the NYSE on the defensive and angered its floor traders, who were not aware of the large executive pay. The news also began a very public debate about the NYSE and its role as a regulator. The Exchange itself establishes stiff regulations and rules regarding corporate governance, yet the Exchange was paying its chairman a salary on par with some of the highest paid CEOs in the country.

To meet the SEC requirement mandated in the March 26th letter, the NYSE Board of Directors formed a special Governance Committee. Chairman Grasso forwarded a copy of the draft report (an ongoing process) in his May 15, 2003 response (Appendix 3).

U.S. Securities and Exchange Commission

Founded in 1934 by Congress, the U.S. Securities and Exchange Commission was created to monitor the securities industry. The SEC exists to protect investors and maintain the integrity of the securities markets. To achieve this goal, the SEC regulates the information public companies must disclose, including key financial data and other information necessary to make an informed investing decision. Additionally, the SEC oversees other members of the securities world including stock exchanges like the NYSE, broker-dealers, investment advisors, mutual funds and public utility holding companies. The SEC also has enforcement authority and every year brings civil enforcement actions against individuals and institutions that break securities laws.[14]

The current chairman, William H. Donaldson, was appointed February 18, 2003 by the President of the United States. Donaldson served as chairman of the NYSE from 1990 to 1995 and brings an extensive business background to the chairman seat.

An Unusual Pay Package

On August 27, the NYSE promulgated a press release announcing a contract extension for Chairman and CEO Dick Grasso from 2005 to 2007. His pay would be maintained at

$1.7 million with a bonus of $1.0 million, and would include a payout from his deferred compensation, retirement and savings plan. According to the press release (Appendix 4), this includes his "savings account balance of $40.0 million, his previously accrued retirement benefit of $51.6 million and his previously earned account balance of $47.9 million relating to prior incentive awards."[15]

The business press, fund managers, government and regulators immediately released a flurry of press releases, articles and letters criticizing the $139.5 million package as far too large for an executive whose primary role is to be a regulator. Members of the compensation committee defended the contract provisions, saying Grasso deserved to be paid commensurate with the level of other financial services industry executives because he both runs a competitive business and serves as a regulator.

Dissent arose from within the ranks; traders on the NYSE floor were particularly upset because the NYSE had been raising fees required of them to support technological advances to thwart the rising competition from the NASDAQ, totalling nearly $80.0 million over only a few years. As well, decimalization[16] further squeezed profits from the specialists and brokers by narrowing the quoted prices from 12.5 cents to one penny.

Corporate governance questions were now the key issue and the criticisms were directed at the core of the Big Board itself. The key governance issues at the NYSE were the perceived conflicts of interest of the owners, management and customers of the Big Board. Brokers and specialists handle the orders of individual investors, and at the same time own the NYSE itself. These same seat owners choose the Board of Directors of the Exchange who sit on the audit and compensation committees, and set the pay of the CEO. This same CEO and Board oversee the regulatory arm of the NYSE, responsible for policing the very brokers and specialists who own the exchange.

The SEC Steps In

On September 2, 2003, Donaldson sent a letter to H. Carl McCall, NYSE compensation committee chairman (Appendix 5). In the letter, Donaldson expressed great concern about Grasso's pay package, stating, "In my view, the approval of Mr. Grasso's pay package raises serious questions regarding the effectiveness of the NYSE's current governance structure."[17] Also included in the letter was a list of nine requests regarding the terms of the pay package and related information due to the SEC by September 9, 2003. As Zito read the letter, it was clear the amount and type of information Donaldson was requesting was going to be an enormous task given the short time allotted for a response. In addition, Donaldson's letter was public information, which meant Zito had to address the deluge of media calls, coming in by the dozens.

Complications, Complications

A complex communication challenge became significantly more difficult when on September 9, the NYSE responded to SEC Chairman Donaldson's letter of a week earlier (Appendix 6). In this communiqué, the NYSE revealed that Grasso was owed an *additional* $48.0 million previously undisclosed payout. While the NYSE's position was that this information was not significant (because it was *future* compensation) the public outcry was enormous. Appearing on CNBC and in newspaper interviews, the CEO publicly announced that he would forgo the additional monies

to end the time when the exchange was, "preoccupied talking about the compensation of its leader."[18]

The Rest of the Story

By September 16, 2003, Grasso was clearly under fire and the fervor was only increasing. Several strong stakeholders including major fund managers were calling for his resignation and floor traders were visibly upset with the giant pay package. One NYSE seat-holder stated, "People have problems down here on the floor with how much [Mr. Grasso] has made, especially considering the slowdown in business, [and] the increase in technology costs."[19]

Late in the day on September 17, Grasso called an emergency board meeting to discuss the situation. In the meeting, he offered to resign as chairman and CEO only if the board requested it. The board voted for his resignation, 13 to 7. High profile directors, including the Goldman Sachs CEO, former Secretary of State Madeline Albright and the CEO of J.P. Morgan all voted for Grasso to leave.[20]

What Now?

Zito has several problems on his hands. The NYSE has no senior leadership and reaction from the SEC and other stakeholders demonstrates the NYSE has a larger problem than an overpaid executive. How should he proceed from here? Who are his key audiences at this point and how does he go about re-establishing the NYSE brand in the face of harsh criticism by the SEC?

Discussion Questions

1. Which stakeholders are most important to Zito and the NYSE?

2. What are the critical issues in this case? Can you rank order them?

3. What are the NYSE's business problems? Which ones need to be addressed first?

4. How can Zito begin to rebuild the NYSE brand?

5. Do you think the NYSE has a place in the future of securities markets?

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Appendix 3: NYSE Response to Securities and Exchange Commission Chairman William H. Donaldson on Review of NYSE Governance.

Appendix 4: NYSE Announces New Contract for Dick Grasso Through May 2007.

Appendix 5: Letter to NYSE Regarding NYSE Executive Compensation.

Appendix 6: NYSE Response to SEC Regarding NYSE Executive Compensation.

Appendix 7: Glossary.

Appendix 7: Glossary

American Stock Exchange (AMEX). Originally called the "Curb Exchange" (for trading unlisted stocks on the steps of the NYSE), now owned by the NASDAQ and trading mostly small stocks.

Ask Price. The price that a person wishing to sell a stock is requesting.

Bid Price. The price that a person wishing to buy a stock is willing to pay.

Book. The listing of all buy/sell limit orders awaiting transaction. For example, an investor submits a limit order to buy 1,000 shares of General Electronic (NYSE: GE) at $27.00 (GE is currently trading at $28.91 for example). This order will not be executed until a seller is found willing to sell for $27.00 per share. The book will list this unfilled limit order until it is executed; it therefore contains important data regarding the potential of where market prices will go (recall that price movements are based on supply and demand).

Electronic Communications Network (ECN). Computer system that routes and matches orders directly (bypassing exchanges). ECNs also route orders to the NASDAQ. Examples of ECNs include Island, B-Trade, Instinet, Archipelago, Nextrade.

Market Orders. A request by an investor to buy or sell a stock at the current price (required by the SEC to be the best price possible)

Market Makers (NASDAQ). Independent dealers competing for orders by displaying buy/sell interest on the system.

NASDAQ. The first over-the-counter "exchange," the NASDAQ is now the largest equities exchange, listing such major stocks as Microsoft, Cisco and Intel.

Order Entry Firm (NASDAQ). Broker/dealers who trade on the NASDAQ. Broker/dealers do not commit capital, unlike market makers.

Over-the-Counter. Stocks not listed and traded on a formal exchange such as the NYSE, as they do not meet the minimum listing requirements.

Limit Orders. A request by an investor to buy or sell a stock at a specified price. If this price is not available, the order will remain in the "book" maintained by the specialist until it can be executed (when another order arrives to match the price plus the spread).

Spreads. also known as "bid-ask spread" – the difference between the bid and the ask price of a stock, or the difference between what one person is willing to buy a stock for and what the holder of the stock is willing to sell for. Normally, these prices range from a few cents to a few dollars.

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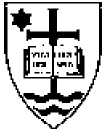
Dewey Ballantine, LLP: Cultural Stereotypes and an Interoffice E-Mail
O'Rourke, J. S.

A partner in the London offices of Dewey Ballantine, LLP set off a furor when he responded to an interoffice e-mail seeking someone to adopt a puppy. In his reply to all subscribers, he wrote, "Please don't let these puppies go to a Chinese restaurant!" Some of the firm's associates found the message offensive and said so; dozens of Asian-American law student associations and bar associations stepped forward to criticize it, as well. Despite several prompt apologies, the controversy would not die, in part because of the culturally insensitive history of the firm. Senior partners are faced with growing dissent and a public image that may hurt business as well as recruiting. 9 pp. Case #04-06. (2004).



Eugene D. Fanning Center for Business Communication **04-10**
University of Notre Dame

Dewey Ballantine, LLP:
Cultural Stereotypes and an Interoffice E-Mail

It began, like so many office controversies, with an e-mail message. Responding to a note seeking someone to adopt a puppy, a partner in the London office of the law firm of Dewey Ballantine wrote, "Please don't let these puppies go to a Chinese restaurant!"

Some of the firm's associates found the message offensive and said so; dozens of Asian-American law student associations and bar associations stepped forward to criticize it, as well. Senior partners in the firm apologized almost immediately, sending out a firm-wide apology. So did the author of the message. [1]

The firm had already put its lawyers through sensitivity training in the wake of a skit performed at a dinner the year before when lawyers infuriated members of the Asian-American community. Their after-dinner parody mocked stereotypical Asian accents to the tune of "Hello, Dolly," singing that they were "so solly" that the firm was closing its Hong Kong office. The firm now no longer even holds that annual dinner. "Somebody made a mistake, and they've apologized," said Morton A. Pierce, a co-chairman at the firm, adding that the partner would be disciplined. "And we keep apologizing," he added. [2]

It is rare but not unheard-of for dog to appear on the menu in a restaurant in rural China, though dog meat is much less likely to be offered by Chinese restaurants in other parts of the world. The message was offensive, associates at the firm say, because it seemed to mock Chinese people. "People say, 'Oh, you're just being over-sensitive,' but I think it's a symptom of something underlying," said Karen Y. Tu, a second-year law student at Columbia who is co-chairwoman of the Asian Pacific American Law Students Association. She later said, "What is going to change this environment? What is going to make it easier? What is going to make Asian-Americans comfortable about going back to Dewey?" [3]

Dewey Ballantine, LLP

Founded in 1909, Dewey Ballantine LLP is an international law firm with offices in key financial centers around the world. For nearly a century, they have provided guidance, experience, and insight to clients on a wide range of complex legal matters. The firm employs

This case was prepared by James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered entirely from public sources.

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582 attorneys worldwide and specializes in more than 40 separate practice areas, including litigation, taxation, mergers and acquisitions, intellectual property, and banking.[4]

Dewey Ballantine established its London office in 1991. The London office consists of more than 40 attorneys, including 14 partners, qualified in the U.K. and the U.S., as well as in France, Germany, Ireland, Israel, Italy, Kazakhstan, Russia and the Ukraine. They provide clients in Europe, the Middle East and Africa with advice under the laws of those jurisdictions with a focus on capital markets, mergers and acquisitions, private equity, project finance, securitization, structured finance and international tax. The firm's clients include FTSE 100 and *Fortune* 100 companies with commercial interests in consumer goods, financial services, infrastructure, oil and gas, power, technology, telecommunication, and transportation. [5]

The company's website describes the firm as one that "serves a sophisticated and diverse client base." [6] Of 582 lawyers at Dewey Ballantine, 41 are Asian-Americans, according to the firm. [7]

The Infamous Dinner Skit

The firm issued an apology nearly six weeks after the *New York Law Journal* reported that at a January 31, 2003 annual dinner, the firm had parodied the closing of its Hong Kong office with a version of "Hello Dolly" re-titled "The Dirge of Long Duck Dong," an apparent reference to the stereotyped Chinese exchange student in the movie *Sixteen Candles*.

The song said the seven-lawyer office, which closed at the end of March 2003, was "chow mein" and would get "the gong." "You were the firm's folly," the song intoned, "and now we so solly to be cutting off your source of livelihood." The annual black-tie dinner and its anonymously penned parodies were a longstanding tradition at the firm. Sanford Morhouse and Morton Pierce, discontinued the dinner shortly after becoming the firm's co-chairs in October of 2003. [8]

"It was a party culture that had outlived its usefulness," Mr. Morhouse told reporters. But he stressed that neither the dinner nor the e-mail incident in January of 2004 should be taken as representative of the firm's character. He said Asian and Asian-American lawyers were "tremendously well-regarded" and "highly valued at the firm." [9]

An E-Mail to Regret

On the afternoon of Monday, January 26, 2004, Douglas L. Getter, the head of Dewey Ballantine's European Merger and Acquisition practice, returned from lunch to the firm's offices at 1 Undershaft in London's east end, near Lincoln's Inn and the famed Old Bailey courthouse. As he opened his e-mail, Mr. Getter discovered a firm-wide memo in his inbox advertising the availability of some puppies for adoption. He quickly composed a firm-wide reply with the concluding line: "Please don't let these puppies go to a Chinese restaurant!"[10]

By clicking the "reply all" button on the e-mail server, Getter set off a firestorm of criticism, much of which began inside the firm. Within minutes, senior partners began hearing from irate associates and others. Following a brief conversation with Getter, co-chairs Sanford Morhouse and Morton Pierce issued a response. "This afternoon an offensive e-mail was circulated by a partner," they wrote. "Comments of this nature are inconsistent with the values of this firm and will not be tolerated. We extend our immediate apologies to the entire Dewey Ballantine community." [11]

In a press interview the next day, Mr. Morhouse said the firm's executive committee would be meeting shortly to determine what further action to take.

Opposition Begins to Emerge

Shortly after news of the e-mail message began making its way around the Internet to law firms, law students, public interest groups, and various Internet message boards, a group of Asian-American law student organizations sent a letter to Dewey Ballantine, asking what proactive steps the firm intended to take to prevent the recurrence of such an incident.

Mr. Pierce responded to critics by saying that it was not clear what the firm should do other than to keep apologizing. "I wish that there were some way we could convince them very easily and quickly that this was truly aberrational with respect to our culture," he said. "But clearly that's not going to happen." Several associates at the firm said they were thinking of leaving to work elsewhere but added that they had already decided to move on before this particular e-mail message was sent. One executive recruiter said that his firm had noted an increase in resumes from Dewey Ballantine associates over the preceding several months, but noted that the trend predated the e-mail message. [12]

News of the incident, however, along with a careful recounting of the dinner skit a year earlier, moved quickly across the Internet and onto a number of weblogs devoted to legal issues and Asian-American concerns. One blog poster at *Angry Asian Man* wrote:

> "It's got to be the world's worst luck for one firm to make national news twice in a twelve month period for the same kind of incident, and against the same racial group. Various national Asian groups are lining up to excoriate the law firm. I, however, have some mixed feelings. Obviously, Getter's e-mail is more than tasteless and obnoxious; it's culturally insensitive and borderline bigoted. But it's hard to find any criticism of the law firm's response." [13]

Another poster on the same website disagreed:

> "As another American of Asian descent who continues to hear the same questions/remarks 'Where are you from . . . . No, I mean your nationality. . . . No, I mean . . . .' And, 'You speak English so well!' . . . The Dewey Ballantine story does not surprise me. Though for the chairman to say this 'may' have been in bad taste? There is NO 'may be' about it. If the parody was made of African Americans – use your imagination – there is no way the chairman would have simply said this 'may' have been in bad taste." [14]

And yet another shared his personal frustration:

> "The funny thing is that one of my good friends from law school – also of Asian descent – worked for Dewey as an associate out of law school. (He left long ago). I don't mean to blow this out of proportion, however. Maybe the associates who planned that skit simply lacked decent taste (or sobriety). And to be fair, the firm's chairman did agree that song was 'maybe' in bad taste. Still, this incident reminds me of the many times I've been told, 'Oh, you speak English so well.' I do not have an Americanized given name. But why should it be so surprising?" [15]

An Offer to Talk

Senior partners at the law firm met with Asian-American associates on the afternoon of Thursday, February 5th to talk about the incident. The message, according to Mr. Pierce, was simple: "This isn't Dewey Ballantine; this isn't who we are. This isn't the firm that they joined. It's not emblematic or symptomatic of who we are." The firm said it would hold a special round of sensitivity training in its London office, in addition to its twice-yearly firm-wide training. [16]

"There is no defense in these situations," said Roger Cramton, a law professor at Cornell University. He added that law professors have had to re-think the examples they use to illustrate legal issues in classes. "This is such a politically correct world."[17]

Several Asian-American lawyers and law students said that the problem was not the e-mail message itself but the fact that the partner who sent it did not stop to think first. "What scares the rest of us," said Andrew Thomas Hahn, a partner at Seyfarth Shaw in New York, "is [whether] it is pervasive at law firms generally or corporations generally that Asians can be mocked with impunity?" Mr. Hahn is president of the Asian American Bar Association of New York. At law firms generally, he thinks Asians worry that they may be stereotyped as passive and are steered out of certain areas of practice.

Ms. Tu, the law student at Columbia, said that Asian-American law students there were meeting to discuss how to respond. One possible step, she said, would be to boycott Dewey Ballantine during the fall recruiting season – something that might happen informally anyway. "Not as a statement," she said, "but because they don't want to work in that environment." Ms. Tu said that working at big firms can already be difficult for non-white lawyers, given their small numbers.

John C. Liu, a member of the New York City Council who has received numerous complaints about the e-mail message, had one suggestion in particular about what Dewey Ballantine could do to assuage concerned Asian-Americans, both within and outside of the firm. "I would like to see them take up a case involving bias against Asian-Americans pro bono. And I have one or two specific cases that I would like to see them take up."

Questions

1. From Dewey Ballantine's point-of-view, what are the critical issues in this case. Which among them are most important?

2. Who are the principal stakeholders here? What's at stake for each of them?

3. Is this just a temporary matter for the firm, or are complaints and animosity like to persist? Can Dewey Ballantine take a low profile on this issue and simply wait for the controversy to pass?

4. From a reputation management point-of-view, what sort of problems does the firm face?

5. What actions are available to the managing partners? Which actions would you advise they take first?

6. Does Dewey Ballantine need outside communications management counsel for this matter, or can they reliably handle this with existing staff?

7. Is this, as some observers have said, simply a case of overreaction or political correctness taken to an extreme? Would be it helpful if the firm were to position these events on the context of "good-natured humor?"

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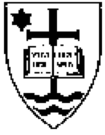
Google: Entrance into the Chinese Market and Government Censorship
Harris, B.; Ogilvy, A.

On January 25, 2006 the leading U.S. Internet search engine Google, Inc. announced that it would be locating a new server inside China in order to provide Chinese citizens with their own portal, Google.cn. Locating the server inside China would allow for faster service than the Chinese version of their U.S. site was able to provide, and would give Google a greater chance at capturing China's estimated 111 million regular Internet users. Locating the server in China also meant that the company, whose corporate philosophy is "Don't be e vil," had agreed to censor its search results in compliance with the laws of the Chinese government. The U.S. media and several human rights groups brought the issue to the public's attention, and Google's reputation and share price were severely damaged. Today, a little more than a month after the announcement, Google's share price has partially recovered but it is still too early to measure the long-term damage the controversy will have on their reputation. The company faces the challenge of rebuilding its reputation, and balancing their idyllic corporate philosophy with the need to grow and capture market share.



Eugene D. Fanning Center for Business Communication **06-16**
Mendoza College of Business
University of Notre Dame

Google:
Entrance into the Chinese Market and Government Censorship

On January 25, 2006, Google, Inc. announced that it would provide access to the Internet in China through a new portal, Google.cn. At the same time, Google executives agreed to censor all search results which included content considered objectionable by the Chinese government. This decision was announced in the wake of Google's very recent refusal to provide user information to the United States Government case against child pornography.

Wall Street's response confirmed the profit potential of the venture, as the company's share price rose 3.6% in just one day.[1] However, the company's announcement brought strong reaction from the press and human rights organizations, as well. Within days, headlines were screaming across the United States and around the world, accusing Google of abandoning its principles all in pursuit of profit.

Two Kids in a Sand Box

As a graduate student at Stanford University, Sergey Brin led a tour for a prospective classmate, Larry Page. Both were strong willed and very opinionated, the two disliked each other immediately. Soon, however, they were practically inseparable because of a shared interest in technology. For years, the two Ph.D. students in computer science worked to develop a search engine they believed would revolutionize the use of the Internet. One of Page's Stanford professors literally laughed at his assertion that he could change the way early search engines were working.

By 1998, the duo founded a company known as BackRub, a name meant to reflect the technology's use of backward links to find useful websites. BackRub operated out of a dorm room until the duo received their first investment, a check for $100,000 from an angel investor. Within two weeks, they rented out a space in a friend's garage and officially founded Google,

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This case was prepared by Research Assistants Marie Halvorsen-Ganepola and Katie Murphy under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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Inc. By definition, Google refers to the number one followed by 100 zeros and was meant to represent the vast amount of data available on the Internet. The company was founded with a mission to "organize the world's information and make it universally accessible and useable."[2]

By 1999, less than one year later, Page and Brin had secured more than $25 million in venture capital funds. Google had grown to just over sixty employees, and began to develop its own very unique culture. During that same year, the company relocated to the "Googleplex," an imposing office complex in Mountain View, California.

Page and Brin remained in executive roles, imparting their unique visions on the development of the company. They had successfully developed a business model which brought in large advertising revenues while maintaining a reputation as a free, user friendly search engine. Programs such as AdWords and AdSense allowed Google advertisers to target users according to keywords used in searches. Although the company seemed incredibly successful, their unique management styles led to the reputation that these two executives were still just kids playing in a sand box. The long-term success of the company was widely doubted, though, both in the press and on Wall Street.

Don't Be Evil

Over the next few years, Google continued to grow at a rapid pace. Although competitors such as Microsoft's MSN relied on traditional advertising, Google grew solely by word of mouth. The search engine's speed and ability to deliver highly accurate results drove its increasing popularity. The company developed multiple products meant to complement its search engine, including the Google Toolbar, Google Image Search, and Froogle—an Internet shopping tool.

By 2001, Brin and Page sought outside industry experience to fill the role of CEO, and found this expertise in Eric Schmidt. While Schmidt has taken official leadership of the company, the two founders remain in active roles as Presidents. Decisions are made by committee, with all three participating.

In 2004, Brin and Page took the company public. The Initial Public Offering was controversial, due to its unorthodox style. Despite SEC investigations and negative attention on Wall Street, the offering was highly successful and valued the company in excess of $100 billion.

At the time of the IPO, the company released a letter from the founders. The public document reasserted the mission of the company: "We believe strongly that in the long term, we will be better served . . .by a company that does good things for the world even if we forgo some short-term gains. We aspire to make Google an institution that makes the world a better place." Google's popularity and rapid growth are often attributed, in part, to the company motto which embodies these ideals: "Don't Be Evil."[3]

Google has since grown to become the 5th most popular website in the world, with more than 380 million visitors per month. More than 50 percent of all users are international. Since the IPO, Google's stock price has rocketed to an astounding price.[4]

The company is continuing its tradition of branching out into multiple product lines. By 2006, they had projects in development that included programs which would allow individuals the ability to track DNA history for themselves online. Google believes this will provide individuals the ability to take ownership of their own healthcare through identification of potential hereditary health risks.

Department of Justice Request

In December of 2005, the Department of Justice requested all major search providers submit user information in an effort to investigate the prevalence of child pornography on the Internet. The ongoing investigation is an attempt to support the Child Online Protection Act, which imposes on all web sites the legal responsibility of shielding minors from harmful materials.

The subpoena requested a sampling of 1 million searches initiated through Google within a one-week time frame. Competitors MSN and Yahoo! were also subpoenaed for similar information, and have complied with Department of Justice requests. Google refused to provide any information, citing the importance of user privacy, and has chosen to fight the subpoena in federal court.[5, 6]

The Chinese Market

With a population of 1.3 billion and a growing economy, China represents an enormously important market for the future of U.S. companies. The number of Internet users in the country has grown substantially over the past few years, and is currently estimated to have reached 111 million regular users. China, in fact, is now ranked as the second largest Internet market in the world. The Chinese government gives all Internet search providers a difficult choice: either censor results or do not do business in China.

The primary Internet search provider in China is Baidu.com, a Chinese company which owns approximately 48% of the search engine market. Baidu has been ranked with the fastest responsiveness rate by users in China. The site is accepted as a clear leader in the market for both brand recognition and usage rates.

A study by Keynote Customer Experience Rankings acknowledges that the competitive advantages maintained by Google in the United States would be easily transferable to the Chinese market. Chinese customers ranked Google first, beating Baidu, Yahoo!, and MSN in categories such as search quality, image search, and reliability. According to director of research and public services for Keynote, "we see that Chinese consumers really like the overall Google experience better. Eventually, this promises to translate into increased market share, particularly given Google's strong resources and focus on the market." [7]

Google did have a presence in the Chinese market prior to the announcement on January 20, 2006. However, the company had been unwilling to censor information on behalf of the Chinese government. A typical user search request initiated through the Google.com website would then would be filtered by the Chinese government to remove objectionable material. This process slowed Google's search results significantly, making it difficult for the company to compete in the market.

Google.cn

With the introduction of Google.cn, Chinese Internet users could access the same search engine with a speed similar to that of Google.com in the United States. Instead of the Chinese government filtering search results, Google now routes the inquiry through their own servers and removes any officially banned content. Search results are typically returned within only a fraction of a second. Although Chinese users would have previously received the same limited results, Google had no role in the actual censorship of information until the debut of Google.cn.

The filtered search results remove any reference to a number of subjects deemed by the Chinese government to be objectionable. Any content including mention of topics such as Tibet, Taiwan, Falun Gong, or the Dalai Lama is banned. A search on Google.cn for the phrase Tiananmen Square returns results showing a smiling couple in the square at spring, or the large photo of Chairman Mao, which is permanently displayed. Absent are any links to the massacre of 1989. The same search on Google.com would include pages showing the all-too-familiar image of a student standing in front of line of tanks in protest. [8] See Appendix A for images.

Press Coverage

The decision to censor their Chinese service turned Google, which had been heralded by an adoring press just months earlier for their exceptional stock performance, into the newest poster child for the more controversial elements of competing in the Chinese market. The fact that Google's actions appeared to be completely at odds with their motto of "Don't be evil" was an irony not lost on their critics, who quickly drew attention to the inconsistency. While a December 2005 issue of *Business Week* magazine had "Googling for Gold" as their cover story, February 2006 saw them headlining *Time* magazine with the less flattering, "Can We Trust Google with Our Secrets?" [9,10] The situation escalated when Tom Lantos, member of the United States House of Representatives and a Holocaust survivor and human rights advocate began to publicly speak out against the Internet providers, comparing their actions to those of the U.S. companies that collaborated with Nazis prior to World War II.[11]

Non-Government Organizations

Reporters Without Borders (RWB). RWB is a Paris-based public interest group that acts as a media watchdog on an international level, condemning any attacks on what it considers to be the rights and freedoms of the press.[12] They quickly established themselves as the leading critic of those U.S. search engines that agreed to censor their material in order to gain access to international markets, beginning back in 2004 by writing top U.S. officials and pleading for a code of conduct regarding oversees Internet filtering. They said in their letters that "(the U.S.) places no restrictions on private-sector activity even when firms work with some of the world's most repressive regimes."[13] When Google decided to enter into the Chinese market two years later, the interest group was able to bring the issue more squarely into public attention, and Google became their top target.

"Google's statements about respecting online privacy are the height of hypocrisy in view of its strategy in China," said RWB in a January 25, 2006 press release issued in response to Google's announcement regarding its upcoming Chinese operations.[14] They argued that the censorship would result in China, which was already ranked 159th out of 167 counties in a 2005 RWB survey of press freedom, becoming even more isolated from the outside world.[15,16] "When a search engine collaborates with the government like this, it makes it much easier for the Chinese government to control what is being said on the Internet," said Julien Pain, head of RWB's Internet desk.

Human Rights Watch (HRW). HRW is the largest human rights organization based in the United States, with offices in regions around the world. The group investigates key human rights abuses both within the United States and internationally, and then publishes their findings in an

effort to draw exposure to the issue.[17] Their testimony before the Congressional Human Rights Caucus on February 1 made a compelling argument that the Chinese government would be unable to carry out its censorship effectively without the cooperation of U.S. search engines:

> One lesson of China's experience with the Internet is that repressive governments cannot exercise full control over this medium without the willing cooperation of the private sector companies that are leaders in the industry . . . . China sought and received the cooperation of global Internet companies in limiting access to information.[18]

HRW argued that the U.S.'s dominance in the search engine market gave them considerable leverage against any country that hopes to benefit from the information age. The group proposed that if all the search engines acted together in refusing to comply with Chinese censorship rules, they would be in a very strong position to push for free access.[19] Despite their strong stance, the group has so far made no threat of a boycott. "How much choice do you have if all of these companies are doing this?" asked Mickey Spiegel, Senior Researcher at HRW. "We're not going to stop using the Internet."[20]

Competitor Response

Top competitors Yahoo! and Microsoft's MSN pose tough competition for market share in China. Yahoo is placing very different bets on the future of search engines, and Microsoft has the resources to really challenge Google in search capability and advertising.[21] Both companies were complying with Chinese censorship regulations before Google began to, and have had their own negative publicity to manage.

Yahoo!. Yahoo! came under fire for giving the Chinese government information that was used to convict Chinese Internet journalists Shi Tao in 2004 and Li Zhi in 2003.[22] The company defended its actions by saying that it didn't know how the information would be used. "I do not like the outcome of what happens with these things," said Yahoo! co-founder Jerry Yang. "But we have to follow the law."[23] They also publicly encouraged the U.S. government to handle the issue, although they stated that it was too early for them to recommend how.[24]

MSN. In December 2004, Microsoft complied with an order from the Chinese government to close a site belonging to Michael Anti, a Beijing-based employee of *The New York Times* and one of China's most popular bloggers, which had been addressing sensitive political issues.[25] Microsoft Chairman Bill Gates responded by stating that "The ability to really withhold information no longer exists," and by outlining a policy in which sites blocked by government restrictions will still be available in all other parts of the world.[26]

Cisco Systems. While not a direct competitor for Chinese market share, the physical networking provider is one of the two U.S. companies the Chinese government relied on for the 2004 network upgrade that substantially improved their ability to track Internet searches.[27]

Microsoft and Yahoo! issued a joint-statement on February 1 showing their support for collaboration with Google, Cisco, and the U.S. government in order to create industry guidelines for handling governmental restrictions.[28]

Google's Response

Page, Brin, and CEO Eric Schmidt have been open in admitting that suppressing free speech for a totalitarian government is more than a little controversial. However, in this case they argue the benefits outweighed the costs. Senior Policy Council Andrew McLaughlin issued a statement defending Google's decision on the day of the announcement. "While removing search results is inconsistent with Google's mission, providing no information – or a heavily degraded user experience that amounts to no information – is more inconsistent with our mission."[29]

Vint Cerf, who serves as "Chief Internet Evangelist" at Google further justified the move in an interview with *Time* magazine. "There's a subtext to 'Don't be evil,'" he explained, "and that is 'Don't be illegal.'"[30] McLaughlin outlined the dilemma behind the decision in a Google Blog posted on January 27. See Appendix B for the full statement.

> We ultimately reached our decision by asking ourselves which course would most effectively further Google's mission to organize the world's information and make it universally useful and accessible. Or, put simply: how can we provide the greatest access to information to the greatest number of people?[31]

Essentially, the Chinese market is simply too important for any major search engine to miss out on, regardless of the cost, and U.S. companies point out that if they withhold their expertise then firms from other countries will just step in.[32] Yahoo!, MSN, and Google have also defended their actions by pointing out that the simple availability of the Internet, even if limited in scope, is considered a powerful engine spurring democratization. Then-President Bill Clinton observed in 2000 that "By letting our high-tech companies in to bring the Internet and the information revolution to China, we will be unleashing forces that no totalitarian operation rooted in the last century's industrial society can control."[33]

Congressional Human Rights Caucus Briefing

The U.S. Congressional Human Rights Caucus held a briefing on February 1, addressing "Human Rights and the Internet: The People's Republic of China" in an effort to encourage policy discussion among Internet companies. Attendance at the briefing was optional, and Yahoo!, Google, MSN, and Cisco all chose not to attend.[34,35] Google released a statement on the day of the briefing, thanking the Caucus for the invitation, and citing a previously scheduled commitment as their reason for not attending.[36] See Appendix C for the official Google Blog.

The statement also outlined Google's strategy for its operation in China, emphasizing the protection features put in place in order to minimize the harmful effects their filtering system has on information seekers: First, Chinese users are notified when their search has been altered by the filtering system. Second, services such as GMail, chat rooms and blogging that involve users' personal information will not yet be offered out of concern that the Chinese government could demand such information, as they did from Yahoo! in prior years. Third, large investments are to be made that encourage research and development within China.[37,38] These features, when

combined with Google's decision to continue to provide users with the Chinese version of their unfiltered U.S. site, were intended to minimize the backlash for the agreement to censor in the first place. For Representative Tom Lantos, head of the House International Relations Committee, this statement was not enough.

"These massively successful high-tech companies, which couldn't bring themselves to send representatives to this meeting today, should be ashamed," he said. "They caved in to Beijing for the sake of profits."[39] While attendance at this meeting was optional, a February 15 hearing was called by Representative Chris Smith for which subpoenas were threatened. All four major companies indicated their plans to attend.

Legislative Action

Global Internet Freedom Act. On the day before the congressional hearing, February 14, Secretary of State Condoleezza Rice proposed the Global Internet Freedom Act. A resolution under this name has been proposed by Congress every year since 2002; this version would commit $50 million to the creation of a global Internet freedom policy and a task force to fight Internet-jamming by governments around the world.[40]

Congressional Hearing. A hearing called by Representative Smith, chairman of the House International Relations subcommittee on Africa, Global Human Rights and International Operations, was held on February 15 to officially examine the operating procedures of U.S. Internet companies in China. Smith questioned representatives from Yahoo, Google, Microsoft, and Cisco, as well as state department officials, and representatives of several human rights NGOs. The search engines faced harsh questioning and criticism in regards to their actions in China, and were even accused by Smith and Lantos of collaborating with persecutors who torture and imprison Chinese citizens, comparing the roles of US companies in China to the collaboration of American companies with the Nazis prior to WWII.[41]

When Google was asked by Representative James Leach if they tried to negotiate at all with the Chinese government, Elliot Schrage, Google's Vice President for Corporate Communications and Public Affairs had to admit that they did not. "We did not have much of a negotiating position," he began. "It was a condition of doing business. Lots of businesses in China perform filtering and censorship."[42]

Representative Lantos, who is also a Holocaust survivor and human rights advocate, was not impressed with the performance of the search engine representatives. "I believe their performance at the hearing was worse than dismal," he said. "They were unprepared to admit to any mistake, to any shame, to any responsibilities for what their behavior had brought."[43]

Representative Smith had already begun drafting legislation that would regulate the relationship between U.S. companies and nations that place restrictions on the Internet, though Representative Lantos admitted that the proposal's chances of passing would be hurt by the controversial nature of the legislation.[44]

Global Online Freedom Act. Representative's Smith's legislation, titled the Global Online Freedom Act of 2006 was introduced on February 16. The act would forbid U.S. Internet companies from locating content servers inside China or any country that abuses human rights, and from cooperating with officials of such countries in effecting political censorship of online content.[45] Yahoo!, Microsoft, and Google have all expressed support for the pending legislation.

Shareholder Reaction

In the weeks leading up to the release of its fourth-quarter earnings report, Google's stock fell nearly 7.5% from its high of $471.63 on January 11 as a result of the controversy concerning their refusal to supply the Department of Justice with the user information it requested.[46] The January 25 announcement to enter the Chinese market was met favorably by investors, with share price increasing 3.6% overnight. (See Appendix D for a chart of stock price.) The stock price was at $432.66 when the market closed on Tuesday, January 31 prior to disappointing fourth quarter results: the 23% increase over the company's third quarter revenue fell short of the 30% investors were expecting.[47] The result was an Earning Per Share (EPS) figure of $1.54 instead of the estimated $1.76. It was the first time Google had missed its earnings expectations since going public in August 2004.

The stock dropped by over 16% at one point in after-hours trading, and opened at $389.03 with a loss in value of nearly $15 billion on Wednesday morning, February 1. The stock rebounded modestly that day, closing at $401.78.[48] Google blamed their disappointing figures on a higher effective tax rate than they had expected, but the market was not forgiving. The share price continued to fall as investors awaited the results of the Congressional Hearing on February 15. After hitting a low on the day of the hearing of $342.40, the stock began to improve, ending the week after the Congressional Hearing at $368.75.[49]

Under Investigation in China

In addition to all the problems at home, Google found themselves facing trouble in China as well. A state-run newspaper called the Beijing News reported on Tuesday, February 21 that Google was under investigation by Chinese authorities for operating in China without a proper license.[50] The ad ran alongside an editorial that harshly criticized the service provider for entering into the Chinese market only to complain about being required to follow Chinese law. Additionally, Chinese authorities had recently begun pressuring Google to remove the notification that appears on the bottom of every page filtered due to government regulation, to cut off access in China to its regular, unfiltered search engine, and to offer GMail and blogging services.[51] So far, Google has refused, but the fact that the license they use in China is standard for foreign Internet firms has raised speculation that the Chinese Ministry of Information Industries only brought up the license issue in order to put pressure on Google to comply with the demands of the Chinese government.[52] If this is the case, Google's legal issues in China will not be easily solved.

Current Dilemma

The image of Google in the media and among investors has been severely damaged. Their refusal to provide the U.S. Justice Department with the user information it requested contrasts sharply with the perceived desertion of their principles that seemed to accompany their entry into the Chinese market. The combination of this inconsistency and the disappointing fourth quarter earnings results had many investors wondering if Google had finally lost its momentum, and if a company that prided itself on "not being evil" would be able to uphold their ideals while growing internationally. Brin, Page, and Schmidt knew they would have to develop a strategy

that would convince the market that Google could handle the balancing act, and reestablish themselves as the innovative leader with a conscience they had been in the past.

Discussion Questions

1. Did Google's decision to censor information for Chinese users compromise their business principles, or is providing some information better for the Chinese people than providing none at all?

2. Was Google's refusal to comply with the Department of Justice investigation inconsistent with the company's cooperation with Chinese censorship policies?

3. How, if at all, did the company's philosophy of "Don't be evil" influence their decision?

4. Why was Google subjected to so much more scrutiny than their competitors were in this case? Should they embrace this higher standard, or find a way to separate themselves from it?

5. What effects did Google's decision to not attend the Congressional Human Rights Caucus briefing have?

6. As Google continues to grow, is it possible to maintain the same corporate structure and philosophy the company was founded upon?

7. How should Google respond to organizations protesting their entry in the Chinese market? What about press coverage?

8. Do businesses have a responsibility to uphold human rights when entering international markets?

9. Can Google remain competitive in the Chinese market without offering blogging and GMail services? If not, how can they protect themselves and their users' privacy?

10. What long-term implications will this decision have on Google's reputation?

Appendix A

Sign in

Web **Images** Groups News Froogle Local Scholar **more »**

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www.rollins.edu

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multigraphic.dk

... on protesters in **Tiananmen Square** .
220 x 168 pixels - 13k - jpg
www.cnn.com

... Demonstrations in **Tiananmen Square**
400 x 282 pixels - 71k - gif
www.historywiz.com

Remember **Tiananmen Square**
640 x 403 pixels - 58k - jpg
www.loc.gov

Tiananmen Square, 15 Years After
450 x 383 pixels - 24k - jpg
www.lilithgallery.com

Tiananmen Square, 15 Years After
705 x 742 pixels - 133k - jpg
www.lilithgallery.com
[More results from www.lilithgallery.com]

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crisispictures.org

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网页 **图片** 资讯 更多 »

tiananmen square [搜索] 高级图片搜索 使用偏好

使用了 SafeSearch 功能。(了解更多)

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... Mrs. Gutierrez at **Tiananmen Square**
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www.usembassy-china.org.cn

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Appendix B

Googler insights into product and technology news and our culture.
Google in China
1/27/2006 11:58:00 AM
Posted by Andrew McLaughlin, senior policy counsel

Google users in China today struggle with a service that, to be blunt, isn't very good. Google.com appears to be down around 10% of the time. Even when users can reach it, the website is slow, and sometimes produces results that when clicked on, stall out the user's browser. Our Google News service is never available; Google Images is accessible only half the time. At Google we work hard to create a great experience for our users, and the level of service we've been able to provide in China is not something we're proud of.

This problem could only be resolved by creating a local presence, and this week we did so, by launching Google.cn, our website for the People's Republic of China. In order to do so, we have agreed to remove certain sensitive information from our search results. We know that many people are upset about this decision, and frankly, we understand their point of view. This wasn't an easy choice, but in the end, we believe the course of action we've chosen will prove to be the right one.

Launching a Google domain that restricts information in any way isn't a step we took lightly. For several years, we've debated whether entering the Chinese market at this point in history could be consistent with our mission and values. Our executives have spent a lot of time in recent months talking with many people, ranging from those who applaud the Chinese government for its embrace of a market economy and its lifting of 400 million people out of poverty to those who disagree with many of the Chinese government's policies, but who wish the best for China and its people. We ultimately reached our decision by asking ourselves which course would most effectively further Google's mission to organize the world's information and make it universally useful and accessible. Or, put simply: how can we provide the greatest access to information to the greatest number of people?

Filtering our search results clearly compromises our mission. Failing to offer Google search at all to a fifth of the world's population, however, does so far more severely. Whether our critics agree with our decision or not, due to the severe quality problems faced by users trying to access Google.com from within China, this is precisely the choice we believe we faced. By launching Google.cn and making a major ongoing investment in people and infrastructure within China, we intend to change that.

No, we're not going to offer some Google products, such as Gmail or Blogger, on Google.cn until we're comfortable that we can do so in a manner that respects our users' interests in the privacy of their personal communications. And yes, Chinese regulations will require us to remove some sensitive information from our search results. When we do so, we'll disclose this to users, just as we already do in those rare instances where we alter results in order to comply with local laws in France, Germany and the U.S.

Obviously, the situation in China is far different than it is in those other countries; while China has made great strides in the past decades, it remains in many ways closed. We aren't happy about what we had to do this week, and we hope that over time everyone in the world will come to enjoy full access to information. But how is that full access most likely to be achieved? We are convinced that the Internet, and its continued development through the efforts of companies like Google, will effectively contribute to openness and prosperity in the world. Our continued engagement with China is the best (perhaps only) way for Google to help bring the tremendous benefits of universal information access to all our users there.

We're in this for the long haul. In the years to come, we'll be making significant and growing investments in China. Our launch of google.cn, though filtered, is a necessary first step toward achieving a productive presence in a rapidly changing country that will be one of the world's most important and dynamic for decades to come. To some people, a hard compromise may not feel as satisfying as a withdrawal on principle, but we believe it's the best way to work toward the results we all desire.

Appendix C

Googler insights into product and technology news and our culture.
Human Rights Caucus briefing
2/01/2006 08:26:00 AM
Posted by Andrew McLaughlin, Senior Policy Counsel
For today's Member Briefing of the U.S. Congressional Human Rights Caucus on "Human Rights and the Internet – The People's Republic of China," we've submitted the following statement:

Congressional Human Rights Caucus Members' Briefing"Human Rights and the Internet – The People's Republic of China"Submission of Andrew McLaughlin, Google Inc.February 1, 2006

On behalf of Google, I would like to thank the Members of the Human Rights Caucus for inviting Google to participate in today's Member Briefing on Human Rights and the Internet in China.

Though previously scheduled commitments prevent me from appearing in person today, I reiterate Google's offer to participate in a Member Briefing on another date, to brief Members individually, and to continue briefing staff on our activities in China.

I. Google.cn in China

The rationale for launching a domestic version of Google in China – a website subject to China's local content restrictions – is that our service in China has not been very good, due in large measure to the extensive filtering performed by Chinese Internet service providers (ISPs). Google's users in China struggle with a service that is often unavailable, or painfully slow. According to our measurements, Google.com appears to be unavailable around 10% of the time. Even when users can reach Google.com, the website is slow, and sometimes produces results that, when clicked on, stall out the user's browser. The Google News service is almost never available; Google Images is available only half the time.

These problems can only be solved by creating a local presence inside China. By launching Google.cn and making a major ongoing investment in people, infrastructure, and innovation within China, we intend to provide the greatest access to the greatest amount of information to the greatest number of Chinese Internet users. At the same

time, the launch of Google.cn did not in any way alter the availability of the uncensored Chinese-language version of Google.com, which Google provides globally to all Internet users without restriction.

In deciding how best to approach the Chinese – or any – market, we must balance our commitments to satisfy the interests of users, expand access to information, and respond to local conditions. Our strategy for doing business in China seeks to achieve that balance through improved disclosure, targeting of services, and local investment.

A. Improved Disclosure to Users of Google.cn. In order to operate Google.cn as a website in China, Google is required to remove some sensitive information from our search results. These restrictions are imposed by Chinese laws, regulations, and policies. However, when we remove content from Google.cn, we disclose that fact to our users. This approach is similar in principle to the disclosures we provide when we have altered our search results to comply with local laws in France, Germany, and the United States. When a Chinese user gets search results from which one or more results has been filtered, the Google webpage includes an explicit notification – an indication that the search results are missing something that might otherwise be relevant. This is not, to be sure, a tremendous advance in transparency to users, but it is at least a meaningful step in the right direction.

B. Targeting of Services on Google.cn. Google.cn today includes three basic Google services (web search, image search, and Google News), together with a local business information and map service. Other products – such as Gmail and Blogger – that involve personal and confidential information will be introduced only when we are comfortable that we can provide them in a way that protects users' expectations about that information. We are conscious of the reality that data is subject to the laws and regulations of the country in which it is stored, and we make decisions about where to locate our services with that reality squarely in mind.

C. Local Investment and Innovation. Looking beyond the Google.cn launch, we will continue to make significant investments in research and development in China. We believe these investments – and the innovations that will result – will help us to better tailor our products to user demands and better demonstrate how the Internet

can help advance key objectives supported by the Chinese government, such as building stronger, more efficient, and more equitable markets, promoting the rule of law, and bolstering the fight against corruption.

While China has made great strides in the past decades, it remains in many ways closed. We are not happy about governmental restrictions on access to information, and we hope that over time everyone in the world will come to enjoy full access to information. Information and communication technology – including the Internet, email, instant messaging, weblogs, peer-to-peer applications, streaming audio and video, mobile telephony, SMS text messages, and so forth – has brought Chinese citizens a greater ability to read, discuss, publish and communicate about a wider range of topics, events, and issues than ever before. We believe that our continued engagement with China is the best (and perhaps only) way for Google to help bring the tremendous benefits of universal information access to all our users there.

II. Next Steps

1. Expanded Dialogue and Outreach. For more than a year, Google has been actively engaged in discussion and debate about China with a wide range of individuals and organizations both inside and outside of China, including technologists, businesspeople, government officials, academic experts, writers, analysts, journalists, activists, and bloggers. We aim to expand these dialogues as our activities in China evolve, in order to improve our understanding, refine our approach, and operate with openness.

2. Voluntary Industry Action. Google supports the idea of Internet industry action to define common principles to guide technology firms' practices in countries that restrict access to information. Together with colleagues at other leading Internet companies, we are actively exploring the potential for Internet industry guidelines, not only for China but for all countries in which Internet content is subjected to governmental restrictions. Such guidelines might encompass, for example, disclosure to users, and reporting about governmental restrictions and the measures taken in response to them.

3. Government-to-Government Dialogue. In addition to common action by Internet companies, there is an important role for the United States government to address, in the context of its bilateral government-to-government relationships, the larger issues of free expression and open communication. For example, as a U.S.-based company that deals primarily in information, we have urged the United States government to treat censorship as a barrier to trade.

On behalf of Google, I would like to thank the members of the Human Rights Caucus for their attention to these important and pressing issues.

Appendix D

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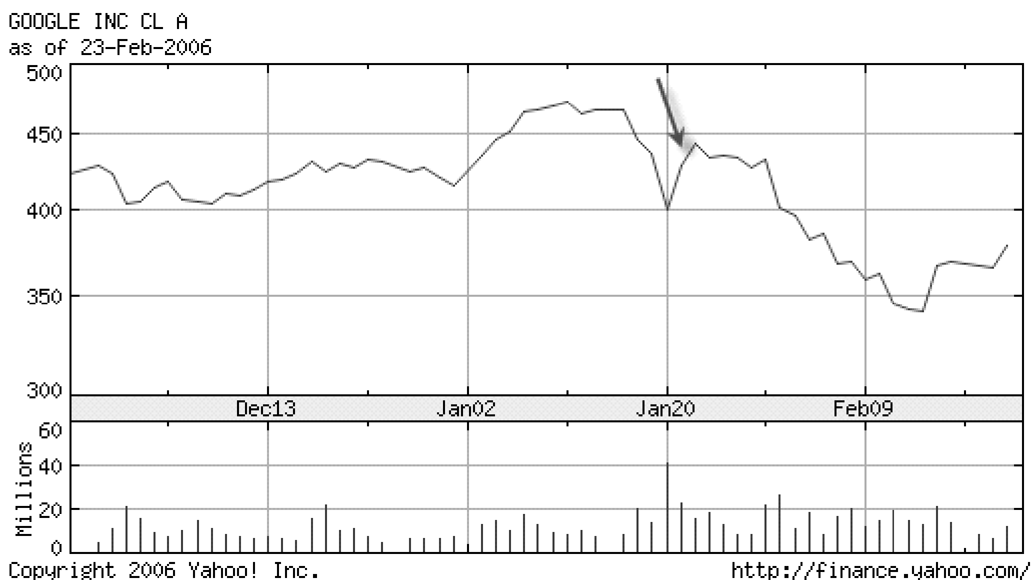

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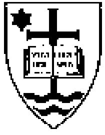
The Walt Disney Company: Launch of a Hong Kong Theme Park
Baldwin, J. L.; Liu, A.; Suzuki, H.; and O'Rourke, J. S. (editor)

In September 2005, the Walt Disney Company announced the opening of its third theme park outside of the United States, and the second in Asia. Hong Kong Disneyland would become one of the most ambitious, expensive, and difficult ventures in the company's history, and – if the company's experience in Europe were any guide – they would have just one chance to get it right. Unlike the Disney experience in Tokyo, a theme park in Hong Kong would prove culturally challenging for a number of reasons, including language, food, souvenirs, entertainment, environmental concerns, contract relationships, local employees, cultural sensitivities, and the Chinese central government. Public Affairs VP Irene Chan is faced with enormous challenges as the company prepares for the park's opening day. 17 pp. #05-06. (2005).



Eugene D. Fanning Center for Business Communication **05-06**
Mendoza College of Business
University of Notre Dame

The Walt Disney Company:
Launch of a Hong Kong Theme Park

Introduction

On November 3, 1999, an official announcement by Judson Green, the Chairman of Walt Disney Attractions and the executive in charge of development, made Hong Kong Disneyland no longer a much-debated possibility but an inevitable reality, with no less than the Hong Kong government as a business partner. After much negotiation, the parties agreed to a US$3.55 billion collaboration deal to build Hong Kong Disneyland at Penny's Bay, on Lantau Island. This massive project would be Disney's fifth theme park resort, and the third outside the U.S.[1]

At the opening ceremony, the Walt Disney Company's CEO, Michael Eisner and the Hong Kong Chief Executive, Tung Chee-hwa broke ground together with a golden shovel into the reclaimed land of Lantau Island, celebrating the start of construction of the Hong Kong Disney project. Eisner called the joint venture, "the most culturally sensitive theme park ever."[2]

Irene Chan was appointed the Vice President of Public Affairs for the Hong Kong Disneyland Resort. Previously, she was the Regional Director of Corporate Communications for the Asia Pacific region of the Walt Disney Company and was selected for her extensive range and depth of knowledge and experience on the issues and public affairs related to the Hong Kong Special Administrative Region (SAR) and the Greater China mainland. In her position as Regional Director, she was a key driver in significantly increasing foreign investment and business development in Hong Kong, Taiwan, Singapore, Australia, and other parts of the Asia Pacific region.

Chan is the official spokesperson for the Hong Kong Disneyland Resort and responsible for governmental affairs, environmental affairs, community relations, media relations, and publicity.[3] She is instrumental in communicating the vision and story of Disney, its unique, high level of guest service and the creative content and quality of its family entertainment to the Hong Kong public and the greater Asia Pacific region. She is responsible for the task of assuring the public of Disney theme park's success, which will feature a traditional American concept and

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This case was prepared by Research Assistants Julianne Lee Baldwin, Alex Liu, and Hidehito Suzuki under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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theme, while also reassuring them of Disney's respect and appreciation of the culture and traditions of Hong Kong and China.

A Brief History of Disney Theme Parks

Founded in 1927 by Walt Disney and his brother Roy, The Walt Disney Company began as a small, unassuming cartoon and animation production company and has since grown to a global entertainment empire that consists of theme parks and resort complexes, motion picture and television production and distribution, publishing and retail, consumer products licensing and various limited entertainment ventures.

Walt Disney Attractions consists of theme parks, retail complexes, hotel and conference facilities and a range of various recreational properties. It is its theme parks, however, that provide Walt Disney Attractions with its most significant and consistent revenues, which are also used to financially support other Disney divisions as needed.

Walt Disney Attractions opened its first theme park, Disneyland, in 1955 in Anaheim, a city near Los Angeles, California. In 1971, Disney opened its largest property, the Walt Disney Resort, which spans 29,000 acres near Orlando, Florida, and is comprised of three separate theme parks, the Magic Kingdom, Disney-MGM, and the EPCOT Center.[4]

In 1983, the company launched its first international theme park, Tokyo Disneyland, located in the metropolitan city of Tokyo, Japan. The theme park was designed by Disney but owned and operated by the Oriental Land Company, a well-established Japanese management company. The park spans over 114 acres, more than twice the size of the Disneyland in Anaheim, but is substantially similar in concept, design and delivery.[5]

When Michael Eisner became CEO of the Walt Disney Company, he was struck by the enormous success of Tokyo Disneyland, which seemed to prove the appeal and success of the Disney theme park experience in international markets. In 1992, Euro Disney, located in the outskirts of Paris, France, officially opened to the public amidst worldwide anticipation and speculation. Eisner had envisioned a Disney theme park with a distinctly European and French atmosphere. The company made a great effort to adjust and incorporate aspects of the local culture in the theme park design and marketing, departing much more from the classic Disney brand formula and approach than in any of its other theme parks. Euro Disney opened to great fanfare but tepid response from the French public. Disney encountered numerous complications and difficulties in launching and operating Euro Disney, which is only recently showing marked improvement in performance.

Tokyo Disneyland

Background. The Tokyo Disneyland project was not initiated by Disney; a Japanese company, the Oriental Land Co., Ltd. (OLC), a railway and development joint venture, approached Disney with the idea of an international theme park. Disney was not particularly interested and was reluctant to open discussions on this, as the company was focused on completing the Epcot Center project at the Disney World Resort in Florida, which had encountered numerous difficulties and challenges. They were particularly reluctant to direct strained funds toward an international theme park in Asia, where sales of Disney movies and products were not strong.[6]

The Oriental Land Company's proposal was to obtain a license from Disney to construct and operate the theme park. The company already had a location in mind in Urayasu-City in the Chiba Prefecture, located near the nation's capital, Tokyo.

Issues and Challenges. The current CEO of Disney at the time, Cardon Walker, later reconsidered the proposal as he needed additional funds to complete the Epcot Center project and believed the project with OLC could be done without taking substantial risk.[7] From his perspective, if Disney could convince OLC to accept a franchise agreement that substantially favored Disney without requiring much of its own capital outlay, Walker would accept their proposal for the Tokyo Disneyland project.

After protracted and difficult negotiations, Walker and OLC reached an agreement in 1979. The OLC agreed to pay 10% of admissions revenues and 5% of food and souvenir revenues as the royalty for Disney Productions. Disney Productions did not take any ownership and also did not contribute any financial support to the OLC in the development of the theme park project. Although Disney Productions didn't take substantial risk, if this project didn't work, it could deteriorate the Disney's brand equity. Moreover, this was the first offshore and the first franchise theme park. Thus, what they could do this situation was limited from the beginning.

The biggest challenge faced by the OLC as the sole owner and operator of such a huge facility was to successfully implement Disney's theme park concept in a completely different culture and context. Other challenges were the higher than average costs and the climate. Tokyo is as hot as Orlando in summer and as cold as Paris in winter, and also has a rainy season in early summer (see Exhibit 1).[8]

A Successful Formula: Japanese Ethos, Location, Entertainment and Merchandise

Unlike the French or Chinese, Japanese people generally do not consider foreign culture as a form of cultural pollution. Although Japan has a long history and its own original culture, at the same time, the Japanese are fond of enjoying foreign culture very much.

In doing business overseas, one of the most important points is to adjust a company's own culture to a specific region while respecting local culture. Doing so is obviously easier for a local company. OLC basically copied Magic Kingdom of Disney World and pasted it in Tokyo. However, at the same time, they successfully made some adjustments especially in marketing, food and souvenir goods.

Site selection was another important aspect of success. "Tokyo Disneyland has approximately a 30 million population within a 50 kilometer radius. Households in this area have higher income."[9] It is also conveniently connected to central Tokyo, just 15 minutes by commuter train from Tokyo Central Station.

One of the unexpected good results was the high percentage of repeat visitors. OLC estimated 75% of guests were repeat visitors in 1988. That is well above 50% of Disney's theme parks in U.S. The first time visitor ratio was continuously decreasing, on the other hand, more than 30 times visitor ratio was continuously increasing (see Exhibit 2). About 65% of visitors come from the neighboring Kanto region. Thus, repeat visitors from neighboring areas have been the key to attendance.

Another unanticipated positive outcome was the greater than expected amount of money spent by visitors in the park. Revenue per visitor has been averaging $90. That is also well above that of other Disney theme parks. In 1988, food and souvenir revenues, $569 million, were larger than that of admission revenues, $470 million.

Evaluation of Tokyo Disneyland and the Next Step

Tokyo Disneyland itself was generally regarded as a huge success for both Disney Productions and OLC (see Exhibit 3). It is a reasonable assessment because Disney Productions successfully made money, "$80 million royalty fee in 1988," without taking substantial risk or making significant efforts on cultural adjustment.[10] Moreover, regardless of the disadvantageous climate, the park realized consistent attendance figures throughout the year (see Exhibit 4). Some, however, took a contrarian view.

According to Tetsuo Anima, "Michael Eisner, who took over new CEO in 1984, considered Disney's passive commitment to Tokyo Disneyland as a big mistake."[11] He decided to become more involved in the next offshore venture, Euro Disney. Then the company decided to take a 49% ownership position. Disney's final alternatives were Paris, for its central location in Europe, and Barcelona, Spain, for its warmer climate. Tokyo Disneyland's success under similar unfavorable weather conditions was reportedly the tipping factor toward France over Spain.

Euro Disney

Background. Disney's tradition and successful formula of innovative park design, the rich history of its cartoon characters, the unique role that visitors play in the theme park and its renowned service quality and delivery were brought to work on the European continent. Would such an American concept be viable in Europe? What else might convince the European visitors who flock to the Walt Disney World Resort in Florida to instead choose Euro Disney? Many complex questions and issues faced Disney executives as they officially opened Euro Disney in April 1992, only to be met with a cool reception by the French.

Issues and Challenges. Euro Disney was based on the U.S. model, but localized and adjusted to suit the European location. This is a different strategy from Tokyo Disneyland, where the full American Disneyland experience is provided down to the cast members' use of English and American mannerisms. In contrast, Euro Disney's rides, attractions, foods, language and other elements were "localized" to better suit the French and European preferences, and the Disney culture was adjusted much more for the local culture.

One of the greatest challenges for Disney when it was starting the Euro Disney business in 1992 was to recruit more than 10,000 employees in six months.[12] Disney held to its usual U.S. recruitment process and criteria but found resistance from the French public due to a combination of its strict dress and grooming rules[13] and the dismissal of Disney as unsophisticated and a symbol of American cultural imperialism.[14]

Ultimately, Disney used a combination of recruiting Europeans who had worked in North America and local Europeans as well as relaxing their strict dress codes to address the criticism that it faced.[15] However, more than 1,000 employees left Disney employment during the first nine weeks following Euro Disney's opening,[16] with some employees claiming the cultural

indoctrination within Disney amounted to "Brainwashing."[17] In order to maintain a strong culture, selection of new staff that embrace an organization's values is critical therefore, it is unsurprising that Disney encountered these initial problems.[18, 19]

In Tokyo Disneyland, as the purpose is to provide as much of a genuine, authentic American Disneyland experience as possible, such guidelines and protocols were fully expected by the job applicants and cast members. Moreover, Disney's distinguishing feature of high-quality service and delivery is well-matched by the Japanese standards of service quality. Disney has had a far smoother relationship with its employees and the international venture with Tokyo Disneyland. How might the insights gained from Tokyo Disneyland and Euro Disney influence Disney's strategy for its third large-scale international venture, Hong Kong Disneyland?

Hong Kong Disneyland

Background. The Hong Kong government contributed a significant amount, HK$22.45 billion (US$2.88 billion), to the park development, which was the deciding factor that lured Disney to Hong Kong, beating out rival cities of Shanghai, China and Kuala Lampur, Malaysia. The park will be held by a joint venture, Hong Kong International Theme Parks, which will be formed with the Walt Disney Company and Hong Kong SAR. In return for their investment, the government will receive $4 billion subordinate shares and 57% ownership, giving a hefty 43% ownership to Disney. Many believe the government conceded too much in their negotiations with the Disney Company in their eagerness to lure the company.

The government maintains that by acquiring Disney, it will attract 3.4 million visitors in the first year, generating an additional $8.3 billion from tourists alone, and increasing to as much as $16.8 billion at the 20-year point and beyond.[20] The travel and tourism industry, which Hong Kong depends on for much of its revenue, was hit hard after the September 11, 2001 terrorist attacks and the Severe Acute Respiratory Syndrome (SARS) panic in 2003. The Hong Kong government believed that the Disney name would greatly boost tourism visits to Hong Kong and help bolster its faltering economy. The Hong Kong Disneyland theme park will provide 18,400 jobs upon its opening and is projected to boost the economy by more than $148 billion over a 40-year period.[21] The government has also loosened visa restrictions for China's mainland visitors and other countries to encourage travel to Hong Kong and has planned promotional strategies worldwide to highlight the full entertainment options available to park visitors.

The Hong Kong Disneyland Park will be based on the classic Disney approach of its U.S. parks, with separate areas named Tomorrowland and Frontierland and a mixture of rides and shows from all the Disney parks. This approach was an enormous success with Tokyo Disneyland and the company notes the general appeal of Disney characters and products in Asia. The company also does not want to dilute Disney's brand equity by changing too much of the Disney culture and experience. The concessions to its Asian location and Hong Kong's culture will be reflected mainly in the adjustments of the retail, entertainment and dining sector. The park performances will be presented in Cantonese, Mandarin and English.

The second stage of the project will include a 1,400-room Disney-themed resort hotel complex and an entertainment, dining and retail center at Penny's Bay, which the government has planned as a major entertainment area, enticing even more visitors and tourists, especially with the new international airport, Chek Lap Kok, located nearby and linked to several convenient transportation options to the park and the main cities.

The Hong Kong Special Administrative Region

The population of Hong Kong is close to 6.7 million and is one of the most densely populated locations in the world. Hong Kong is an expensive city to travel to, and it cannot solely focus on the Chinese market and the Hong Kong population.[22] To ensure long-term profitability and sustainability, it must determine strategies that will sufficiently entice and induce people from other countries to travel the long distance to Hong Kong.

Environmental groups have been active in voicing concerns over the theme park. A major concern for Hong Kong Disneyland and the government is the perpetual air pollution in Hong Kong. Dust particles from factories in the Southern China area are often blown into Hong Kong, but the lack of open space and numerous skyscrapers make air ventilation in Hong Kong almost non-existent in some cases. If both Hong Kong Disneyland and the government fail to address this problem, nightly fireworks in Disney can become potentially hazardous to both Hong Kong and the park. Smoke from fireworks will simply remain trapped in the city.[23] The theme park has also received criticism from fishermen who claim that the park would pollute the sea.

Despite the fact that Hong Kong is a unique place with a mixture of the East and West, there are still skeptics of how the city's population at large will feel about Hong Kong Disneyland. Many have grown disgruntled at the way the government has funded most of the park's project.[24] Others are more concerned that the presence of the American theme park would further dilute the Chinese culture in Hong Kong. There were legislators who believed that alternatives to Disney should be considered. The more worrying factor is that Japanese cartoon characters have a much stronger presence in Hong Kong than Disney characters. Thus, Hong Kong Disneyland may face challenges in promoting its icon to the general public.[25]

Hong Kong's Interests

Hong Kong, known as the Pearl of the Orient, is a major financial city in Asia whose uniqueness lies in its history as a British colony and its position as a financial gateway to China. The island has a GDP per capita of $28,800, greater than the GDP per capita of UK, which is $27,700.

After the Asian Financial Crisis of 1997, Hong Kong had trouble recovering from its recession. As China continues to open its cities to international investments, Hong Kong leaders proposed building a brand image theme park to turn the city into a world class tourist location. After discussions with both Disney and Universal Studios, Disney was chosen as the ideal theme park for Hong Kong to boost its tourist industry. Government officials said that few attractions could rival the international appeal of Disney and recapture the energy in Hong Kong.

Disney's Interests

Disney has its own set of incentives to build a theme park in Hong Kong. The vastness of the Chinese market potential is simply too great to ignore. The mix of culture in Hong Kong makes it an ideal place to test the possibility of other theme parks in the region. Having learned from mistakes in building Tokyo Disney and Paris Disney, the fact that the Hong Kong government was offering such lucrative incentives and risk sharing makes it seem that Hong Kong Disneyland would be a good bet. After a deal with Hong Kong was finalized, talks began with Shanghai in 2002 to explore opportunities there for an additional theme park.

Whereas Europeans largely oppose Disney's American icon image, Hong Kong should have no trouble embracing Mickey Mouse and associates. The people of Hong Kong are well known for their propensity for cultural assimilation. In particular, people are crazy about cartoon characters. During a McDonald's promotion program in 1999, adults queued for hours for snoopy dolls that came along as gifts with value meals. Hong Kong is also probably one of the few places in the world where one will find cartoon characters on credit cards. Therefore, Disney cartoon characters in Hong Kong can potentially be even a greater success than Tokyo Disney.

Location, Food, Entertainment

Hong Kong is just 1,092 km square, with little flat land for a good site to build a massive theme park. This also makes Hong Kong Disneyland a day-visit theme park similar to Tokyo Disneyland, as opposed to vacation destinations like Orlando Disneyworld. The Hong Kong Government and the Hong Kong Disneyland Group decided that the theme park should be situated at Penny's Bay on Lantau Island, a place that has been earmarked for tourism and recreational development.

While Hong Kong Disneyland will retain the strong tradition of Disney storytelling, it also will incorporate elements of Chinese culture into the theme park in order to make itself unique from others. The landscaping is based on story settings, which will include a jungle, a castle, fantasy themes and a journey through space. This pictorial scenery will be made possible with a magical setting of green mountains as its background and the blue South China Sea as its front steps. The idea is to make guests feel as if they belong to the story to create an unforgettable fairy-tale kingdom encounter for them.

Paul Comstock, director of Landscape Design of Walt Disney Imagineering, commented that Hong Kong Disneyland has borrowed ancient Chinese view principles with thousands of years of history. The principles include view farming, view hiding and water reflection. Such design will be based on hundreds of the Chinese Banyan and other native plants to accentuate the artistic milieu. Tom Morris, creative development vice president for Walt Disney, explained that a successful park in Asia must contain areas with plenty of shade and large pools of water. Specific plant materials are cast to "play roles" as characters in the story creating realistic and magical settings.[26]

When it comes to food, Hong Kong prides itself on the title "Food Heaven," where cuisine from around the world gathers. The people of Hong Kong love to eat, and will readily pay a premium for a fine dining experience. Therefore, only children and teenagers would be satisfied by fast food menus such as that offered by McDonald's. In response, Hong Kong Disneyland put a lot of effort in designing the menu for visitors.

"Hong Kong Disneyland's food will do more than bring people together; it will bring whole cultures together," said Klaus Mager, Hong Kong Disneyland Director Food & Beverage. "The Park's menu will feature a unique combination of Western, Chinese and Asian cuisines that will be an integral part of the magical experiences enjoyed by Park guests.[27] While the menu features a range of dishes across different cultures and continents, most dishes are primarily focused on Chinese and Japanese tastes, including Dan Dan noodles, cooked in Southern China's Sichuan Province; assorted sushi, prepared in Japanese style; Kashmiri Curry Chicken, cooked in Kashmiri Style.

Hong Kong Disneyland's diverse food menus will be offered at eight Park restaurants, three of which will be table service restaurants and five of which will be self-service eateries, totaling 2,900 seats. In accordance to HK Disneyland's mission to integrate food with amusement, each restaurant will be themed to match the unique, immersive atmosphere of its surroundings.[28]

Hotels and Resorts

Hong Kong Disneyland Hotel and Disney's Hollywood Hotel will be built inside Hong Kong Disneyland to provide customers with the magical paradise experience to stay in a Disney resort. There is only one real resort in Hong Kong, and most other hotels are high-rises, thus Disney strives to distinguish itself from other city-hotels. Hong Kong Disneyland plans to keep its hotels within eight stories in an effort to avoid the busy city image. Disney's Hollywood Hotel will capture the locals' fascination with motion pictures, while Hong Kong Disneyland Hotel will keep itself aligned with Disney's imaginations and fantasies.

"Disney's Hollywood Hotel will capture the fun of movie making with the allure of Hollywood's golden era in its Art Deco architecture and style," said Wing Chao, Hong Kong Disney's Executive, "With Hong Kong's love of motion pictures and its international reputation for filmmaking, creating a hotel that celebrates the history and glamour of motion pictures seemed like the perfect fit."[29]

Issues and Challenges

Hong Kong Disneyland has been trying to reveal only bits and pieces of what is going on in the park's development. Apart from regular media briefings, much has still been kept secret to retain the sense of mystery and preserve the Disney fantasies. There are, however, numerous channels to prepare for the grand opening of Hong Kong Disneyland.

In preparation for its grand opening in late 2005, Hong Kong Disneyland has begun a range of promotion campaigns. It has started cooperating with the Hong Kong Television Broadcasts Limited (TVB), the largest broadcasting network in Hong Kong, to start a series of Disney productions. Under the promotion campaign, TVB started to air three new Disney TV programs starting from July 2004. This marks the kickoff of Hong Kong Disneyland's pre-launch marketing and publicity efforts, which will increase gradually as the opening of the park draws nearer.[30]

The company has also signed Jackie Cheung, a local singer, to become a spokesman for Hong Kong Disneyland. Cheung has received awards for Hong Kong outstanding individuals, and portrays an image well suited to Disney's culture of honoring the family. He will offer a more wholesome and reputable image in promoting Hong Kong Disneyland. Another figure that Walt Disney is hoping to bring into its promotion campaign is Yao Ming, the most recognizable sports icon in China and who has been playing in the NBA for the last three years.[31]

Hong Kong Disneyland expects to serve customers from a vast array of different backgrounds. The dominant dialect in Hong Kong is Cantonese, while mainland Chinese widely speak Mandarin. Visitors from other parts of the world are expected to use English. Therefore, employees in Hong Kong Disneyland are expected to be fluent in all three languages.[32] Hong Kong SAR and Disney are faced with a mixture of the factors behind the successes and failures of both Tokyo Disneyland and Euro Disneyland. Irene Chan must ensure appropriate

communication of the Hong Kong SAR and Disney's shared vision of the joint venture. She must communicate the uniqueness of Hong Kong Disneyland to not only the Chinese public, but convince travelers worldwide of Hong Kong Disneyland as a complete vacation and entertainment resort.

Discussion Questions

1. What are the critical issues for Disney to launch the third offshore Disney theme park in Hong Kong?

2. Who are the principal stakeholders to launch this theme park?

3. What can Disney learn from the corporate communication lessons in Tokyo and Paris?

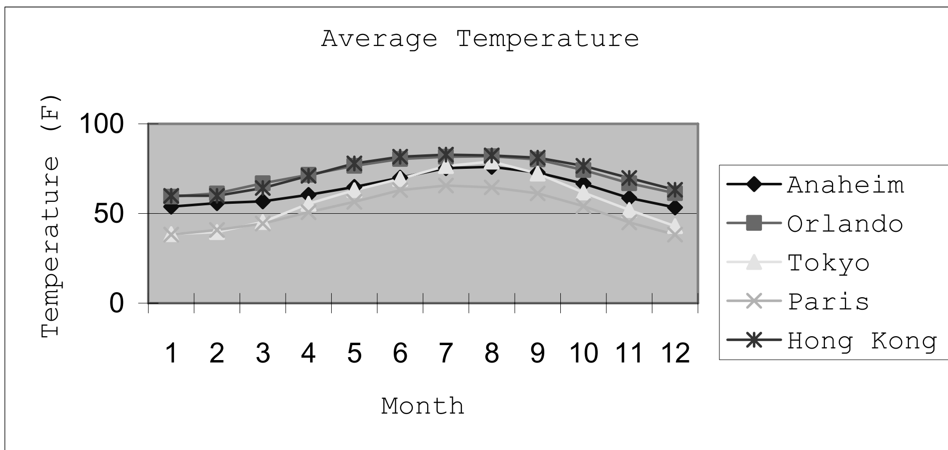
4. Who should mainly manage the project in Hong Kong, Disney itself or Hong Kong government as the local partner?

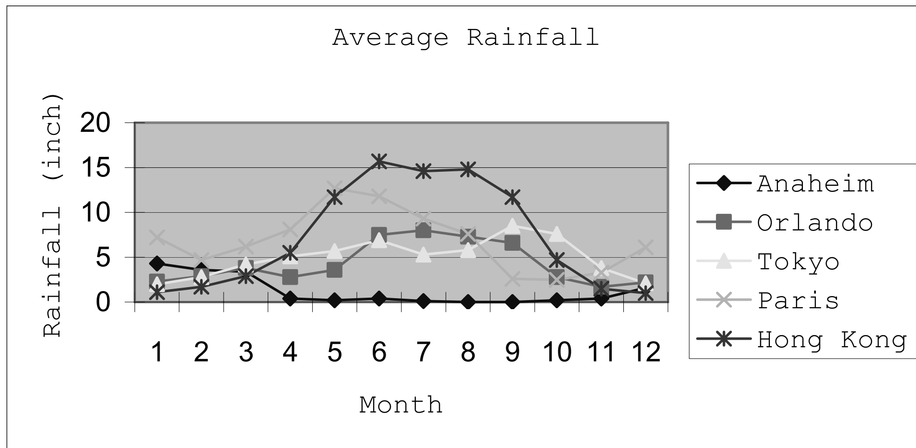
5. Which issue should Disney try to address first?

6. How can Disney balance its own identity or corporate culture and the local culture?

7. What actions should Irene Chan and Disney's Global Corporate Communications take to address these critical issues?

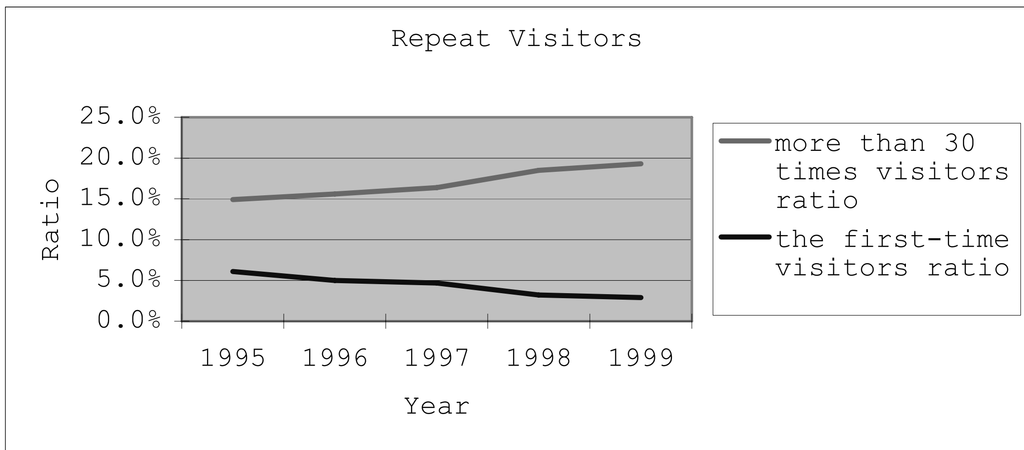
Exhibit 1: Average Temperature and Rainfall in Disney Theme Park Locations

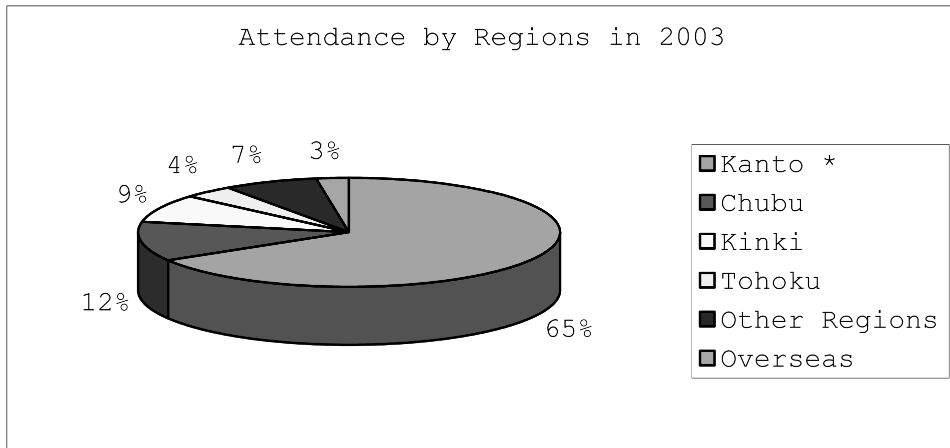




Data Source: http://www.worldclimate.com/

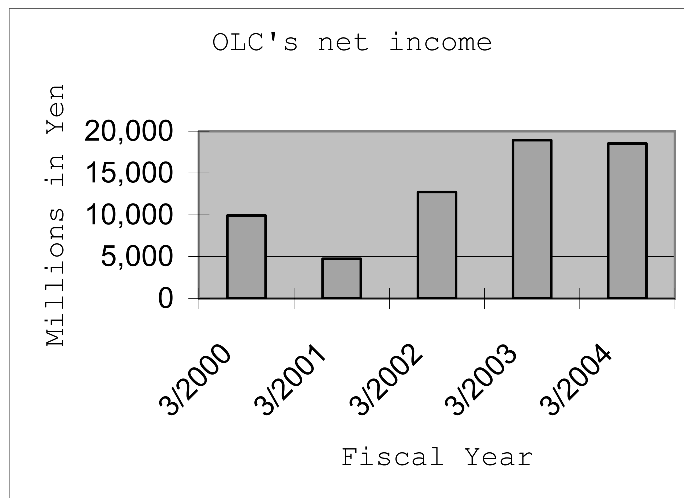
Exhibit 2: Attendance at Tokyo Disney





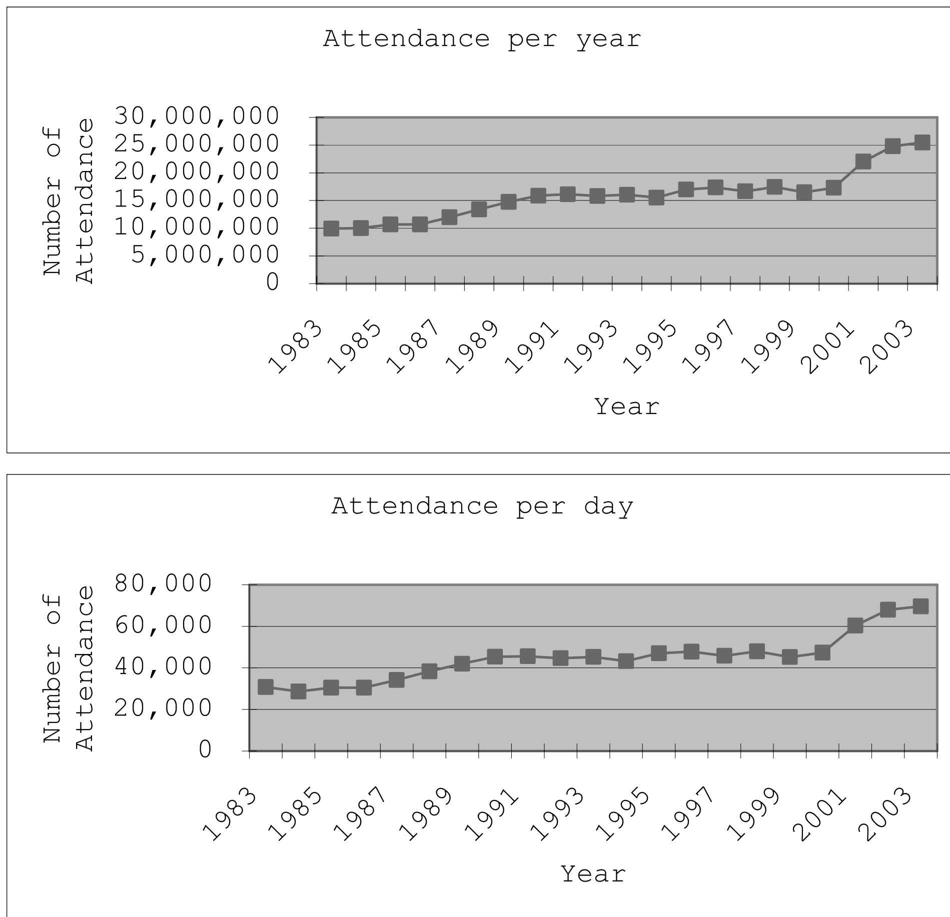
* Kanto consists of seven prefectures including Tokyo and Chiba.
Data Source: http://www.olc.co.jp/en/company/index.html

Exhibit 3: The Oriental Land Company's Net Income



Data Source: http://www.olc.co.jp/en/company/index.html

Exhibit 4: Tokyo Disney Attendance Figures



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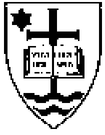
GlaxoSmithKline: Executive Compensation and a Shareholder Revolt
Eklund, J.; Frymoyer, S.; Yamabayashi, K.; and O'Rourke, J. S. (editor)

A series of controversies and market reversals begin to affect one of the world's largest pharmaceutical firms. As share price tumbles and market share erodes, CEO J.P. Garnier is awarded a very large compensation package early in 2003. Shareholders revolt, voting down the executive compensation package and threaten to take down the management team. GSK's Chairman, Lord Christopher Hogg, and Communications VP Jennie Younger must decide how to proceed in the face of mounting criticism and public outrage. 13 pp. Case #04-02. (2004)



Eugene D. Fanning Center for Business Communication **04-02**
Mendoza College of Business
University of Notre Dame

GlaxoSmithKline:
Executive Compensation and a Shareholder Revolt

May 19, 2003 had been a long day for Jennie Younger, Vice President of Corporate Communications for GlaxoSmithKline. It had not been a typical shareholder meeting for GSK that day. As she walked out of the Queen Elizabeth II Convention Centre in central London, she was rushed off into a waiting limousine to avoid the glare of the UK and world's press. Settling into her seat in the back of the car Jennie started to sketch out a few thoughts relating to how she planned to address the huge amount of negative attention recently poured upon GSK.

Months of prior press speculation had been realized on May 19th when shareholders voted against the board endorsed recommendations of the executive remuneration report.[1] This represented the first known case of shareholders actively rejecting a recommendation for executive pay.[2]

This shareholder revolt was unique in that, as well as relying on the support of a large number of private shareholders, large institutional investors had played a key role. For example, Morley Fund Management, which owns 1.78% of the company's shares, confirmed before the meeting that it would vote against the resolution. Response to the result from large institutional groups was also particularly damming. A spokesman for the National Association of Pension Funds (NAPF)[3], which represents pension funds that control 20% of shares on the London stock exchange, was quoted as responding positively to the result:

> "We are very pleased to see that people are taking note of good corporate governance because we believe it can lead to good corporate performance."

GSK was not alone in experiencing criticism related to their corporate compensation policies. This was a problem that had received much attention in the previous months in a range of companies on both sides of the Atlantic. It was also a symptom of the public's decreasing trust of large corporate enterprises.

This case was prepared by Research Assistants John C. Eklund, Scott A. Frymoyer, and E. Kaleo Yamabayshi under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Decreasing Public Confidence in Large Organizations

Many recent pieces of market research have illustrated the public's distrust of large enterprises. For example, in response[4] to the question "Does business balance profit and public interest," 70% of Americans responded yes in 1968 and only 30% in 1999. In the UK cynicism is even greater with eight out of ten people disagreeing that "Directors of large companies can be trusted to tell the truth."[5]

The general discontent with international business and private sector NGOs has been most violently expressed through mass demonstrations throughout the world such as the riots surrounding the World Trade Organization talks in Seattle in 1999[6], and the London May Day Riots of 2000.[7] Public dissatisfaction with large corporations has probably been most clearly expressed by Naomi Klein in her work *No Logo.* This book describes a number of human rights violations partaken by multinationals such as Shell Petroleum Company, Ltd. in Nigeria and Nike, Inc. in South East Asia.[8] More recent scandals such as Enron and WorldCom have only served to further decrease confidence and have led to government intervention such as the passage of the Sarbanes-Oxley Act[9] in 2002.

Organizations have begun responding to this onslaught by trying to develop their corporate social responsibility arms. A classic example is that of Shell Petroleum Company that has been vilified following the Brent Spar debacle, in which it was forced to abandon its plans to sink an expired oil platform in the North Atlantic by Greenpeace in 1995.[8] Following these events, Shell looked long and hard on itself and its business and poured vast resources into developing its corporate image through activities such as the "Listening and Responding Programme,"[10] that was designed as a consultation exercise with a range of its stakeholders.

Despite efforts along the lines of those above, public distrust still runs high and a key focal point for many attacks on corporations is their senior management. A 2002 PriceWaterhouseCoopers survey[11] of CEOs of large multinational corporations illustrated that many of the CEOs surveyed felt that confidence in corporations, auditors and market analysts in their country, as well as the capital markets in general had decreased. Yet, 72 percent of CEOs do not think public trust has declined in their company. This result hints at the fact that CEOs are generally oblivious of the key issues surrounding their own organization, a trap into which J.P. Garnier, CEO of GSK, and many others have fallen or will fall.

A Growing Divergence between Executive Compensation and Performance

An area that had received particular attention in the run up to the 2003 GSK annual shareholder meeting was that of executive compensation. This topic had become a focal point of criticism of large enterprises on both sides of the Atlantic. In the Netherlands, Anders Moberg's €6.8 million package as the new chief executive of global grocer Ahold NV raised many protests.[2]

The key issue at hand was the perception that poor performance was being rewarded with huge payouts. This was illustrated in a number of cases:

- The total compensation of Sun Microsystems CEO, Scott McNealy, rose 31% to $31.7 million while his shareholders' return plunged 74.7%.[3]

- In GSK's home country, the United Kingdom, two key examples of protests against excessive executive compensation hit the headlines prior to the May 2003 shareholder meeting in two of the FTSE100s largest companies:
  - The chief executive of oil giant BP, Lord Browne, was called the "biggest fat cat" after it emerged that a 58% pay rise has taken his salary to more than £3m from 2000 to 2001.[12]
  - UK telecoms giant Vodafone claimed it would review its pay arrangements after shareholders rebelled against directors' bonus arrangements, but did not vote against them.[13]

Even Free Market Doyen, Warren Buffett accused executives of greed in taking multi-million-dollar compensation packages that did not reward excellent performance and in fact paid for underachievement. This is best illustrated by the fact that despite the S&P500 plunging 22% in 2002, the median CEO compensation increased to $13.2 million. Although the average compensation dropped 23% to $15.7 million it was driven primarily by large decreases for some of the highest earning CEOs.[3]

In 2001, Britain's top directors received an average pay raise of 28%, more than five times higher than the rise in the UK's average wage and despite tumbling stock prices.[14] Despite chief executives in the UK being the best paid in Europe with an average package of £500,000 a year, their salaries lag well behind those of the USA.

As can be seen above, the issue of executive compensation was a hot topic in both the USA and Europe. However, Europeans were much more sensitive to the issues as much lower salaries generated a greater outcry due in these European social market economies.[15] Additionally, Richard Lamtey, from Mercer Human Resource Consulting,[2] claimed that Europe had a much stronger culture of not distinguishing between those at the top of businesses and those lower down. For a UK-based company such as GSK the European context was eventually going to contribute to their ultimate downfall.

The Regulatory Context in the UK

The British government was highly sensitive to the issues surrounding "fat cat" pay deals. In 2002 UK Secretary of State for Trade and Industry, Patricia Hewitt, launched the *Rewards for Failure* project.[16] This investigation project aimed to determine whether further measures were needed to ensure that executive pay reflected performance following termination of employment.

Additionally, in August 2002, the UK government enacted legislation (Directors Remuneration Report Regulations 2002) that empowered shareholders to be given the right to veto executive pay rises for company directors through the use of obligatory annual ballots.[17] This increased power resulted in substantial numbers of shareholders voting against executive compensation proposals, as illustrated in Figure 1.

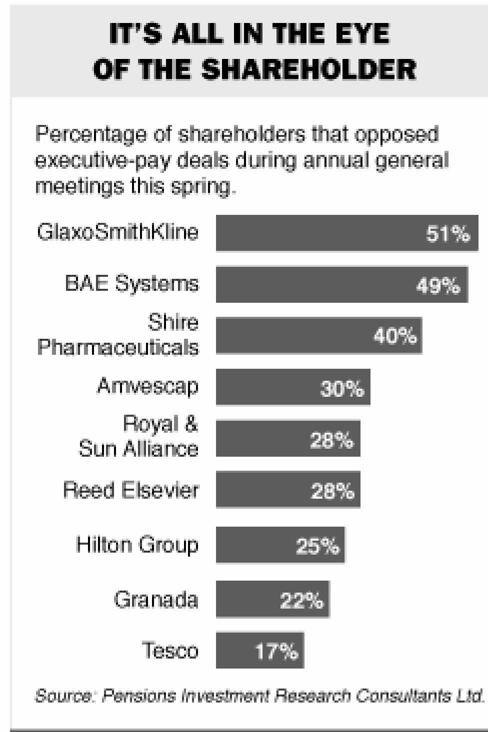


Figure 1: Summary of percentage votes against executive deals for leading UK Corporations during 2002/3. From reference 2

It can be seen through a combination of political motivation, cultural attitudes and increased shareholder power that any recommendations GSK made for executive remuneration, especially related to termination clauses, would meet stiff opposition.

History of GSK: A trilogy of mergers.

GSK has evolved from a series of mergers and traces its roots back to several parts of the world. It traces its history back to four key organizations. John K. Smith opened his first drugstore in Philadelphia in 1830, Mahlon Kline joined Smith in 1865. Thomas Beecham launched his Beecham's Pills laxative business in England in 1842. This business was so successful that he was able to open the world's first factory devoted to making medicines seventeen years later. In 1873 Joseph Nathan founded a general trading company in Wellington, New Zealand that was to become the foundation for the Glaxo Company. American pharmacists Henry Wellcome and Silas Burroughs created a company in their name in 1880.

Over the following 100 years, these four organizations became global players in the medical products and pharmaceutical industry through a range of successful product innovations. Key examples include:

- SmithKline Corporation developed such products as the H2 blocker Tagamet (cimetidine)
- The anti-ulcer treatment *Zantac* (ranitidine) was launched by Glaxo and became the world's top-selling medicine by 1986.
- Wellcome developed and launched the AIDS treatment Retrovir (zidovudine) in 1987.

- Beecham discovered amoxicillin and launched Amoxil which has become a widely-used antibiotic.

The key mergers began in 1989, when SmithKline Beckman and The Beecham Group PLC merged to form SmithKline Beecham PLC. Glaxo and Wellcome merged in 1995 to form Glaxo Wellcome, 23 years after the two companies had unsuccessfully tried to merge. Eventually in 2000, GlaxoSmithKline formed through the merger of Glaxo Wellcome and SmithKline Beecham. Dr Jean-Pierre Garnier assumed the CEO role at GSK in December 2000 upon completion of the merger.

Even following this merger, GSK has sought to increase in size through further mergers with companies such as Bristol-Myers Squibb[18] and American Home Products.[19] However, to date, no additional large mergers have come to fruition.

GSK Today

GSK claims to be the world's leading research-based pharmaceutical company, with a Research and Development budget of US$4 billion. Its headquarters are based in the United Kingdom and has major operations in the US. GSK was ranked 16th in *Business Week's 2003 Global 1000*[20] most valuable companies with a market value of $US 119 billion, and the third largest pharmaceutical company after Pfizer (ranked 4th) and Merck (ranked 15th). GSK is responsible for 7% of the worlds' pharmaceuticals market. GSK stock is listed both in the US and the UK.

In 2002, GSK registered sales of US$31.8 billion and a net income of $9.7 billion. The company has 100,000 employees, with 16,000 being employed in its huge R&D department. GSK's product portfolio falls into three key categories:

- Prescription Medicines
  - Includes antibiotic, antidepressant, gastrointestinal, dermatological, respiratory, cancer, and cardiovascular drugs. It owns a portfolio of key anti-AIDS drugs: AZT, 3TC and Ziagen.
- Vaccines
  - Includes hepatitis A and B, diphtheria, tetanus, whooping cough, and influenza.
- Consumer Healthcare
  - This makes up $5 billion in sales and includes ten $100 million brands.
  - Brands include Aquafresh, Nicorette, Contac, Citrucel, and TUMS.

A Series of Controversies Hit the New Firm

Since its creation in late 2000, GSK has made the headlines in the wrong way on a number of occasions. GSK, like many leading pharmaceuticals, has been continually dogged by claims that it makes excessive profits through the patent protection it receives for its drugs. A key example was the challenge of GSK and 38 other leading companies to South African law allowing the infringement of patents to create low cost anti-AIDS drugs in March 2001. However, significant global pressure from such figures as Nelson Mandela and various national governments resulted in GSK and Merck leading a humiliating retreat of the companies away from pursuing this legal challenge.[21] Ultimately, GSK tried to repair its image by selling cheaper versions of its drugs to South Africa.

The issue of overcharging for its drugs also became an issue in the USA as the Aids Healthcare Foundation, the largest non-governmental supplier of Aids treatment to US patients, made a $66 million damages claim against GSK in mid-2002.[22]

News emerged that GSK had allowed thousands of British babies to be inoculated with toxic whooping cough vaccines that had not passed safety tests.[23] GSK, in the form of SmithKlineBeecham, was accused of bribing German doctors to order its drugs in the late 1990s.

In 2002, however, the key issue that began to emerge as a problem for GSK was the salary packages that the management team and directors were receiving as well as the whole issue of corporate governance at GSK.

GSK Stock Tumbles: Where Are the New Products?

The first signs of discontent with GSK's corporate governance came to the surface in May 2002 during GSK's annual shareholder meeting in London. As a result of the merger between Glaxo and SKB, the number of non-executive directors on the board was 14, though at that the time of the meeting the number had dropped to 13 due to the retirement of Derek Bonham, who took over the chairmanship of the Prudential PLC. Shareholders felt that this was far too high a number, vastly outnumbering the two executives on the board, J.P. Garnier and John Coombe, Finance Director. However, further members of the board were to depart as investor pressure started to pile upon GSK.

In June 2002, GSK's share price dropped to its lowest level since December 1997 with a single day drop of 33p to £14.04.[24] This drop was fuelled by investors concern of a potential $70 billion bid for Bristol-Myers Squibb. Analysts felt that both companies were afflicted by the same problem, their lead drugs were starting to lose patent protection and neither had a strong new product pipeline. A merger between these two companies would not solve either's problems. The perception of an innovation issue at GSK was not helped with the resignation of three leading scientists in the organization on July 16, 2002. GSK's stock price tumbled a further 28p that day to a five-year low.[25]

Following the merger of Glaxo and SKB, J.P. Garnier initiated a cost-cutting program that resulted in the loss of 1,500 jobs by July 2002. Speculation about a lack of new products and badly perceived mergers resulted in its share price dropping to half of its value between July 2001 and July 2002. In order to appease investors, GSK stated its confidence of a 10 % earnings growth for the 2002 financial year. By the end of August 2002, though, its stock price was still only at £12.32.[26] By early November, GSK had announced a £4bn share buy back. Later that month rumors[27] were flourishing that GSK was poised to buy the German Pharmaceutical company, Bayer, for €8 billion, which would help to boost its new product pipeline.

It was in this environment that investors started to question the merit of a new salary package for CEO J.P. Garnier. He was already one of Britain's highest paid corporate leaders with £7 million in total earnings over the previous year.

Pressure Mounts on J.P. Garnier as Investors Balk at Proposed Pay Package

The proposals for J.P. Garnier's new compensation package reached the attention of shareholders in November 2002. As part of GSK's long-term incentive scheme, the French-born CEO's total proposed compensation package was valued at between £11 and £16 million.[28] This included:

- £935,000 basic salary
- £101,000 benefits
- 56,000 American depository receipts (ADRs), equivalent to 112,000 UK GSK shares. This would be received if total shareholder return was in the top 35% of peer group firms.
- Options to 820,000 (ADRs). This would be awarded if Earnings-per-Share were 9 % above inflation for three years.
- A further 268,000 ADRs dependent upon performance versus the FTSE100 index.

GSK defended the proposal on the basis that J.P. Garnier was underpaid compared to his U.S. equivalents. In comparison, in 2002 Pfizer chairman Henry McKinnell received a total package of $24 million (£14 million), roughly half of this came in the form of cashed in share options.[29] Ultimately, shareholders had to vote on whether the complete package would be accepted as it formed part of the Executive Remuneration report that was contained within GSK's 2002 annual report.[1]

Unions such as Amicus[30] led a charge against J.P. Garnier's proposed pay deal highlighting that in the year prior to the meeting 2000 UK GSK employees had been laid off and pay raises for GSK staff had been pegged to 3%.

The nature of the proposed package was receiving huge amounts of attention in the UK and global business press. It was in this environment that on November 26, 2002 GSK released a press statement describing that after lengthy discussions with investors the organization was reconsidering J.P. Garnier's long term incentive package.[31] Shareholders felt they had been victorious and that their opinions had been taken account of.

More Trouble on the Horizon for J. P. Garnier

After November 2002, GSK's stock price continued to fall. On February 12, 2003, J.P. Garnier faced the press stating that GSK had posted a 6% rise in 2002 post-tax profits that were now at a level of £6.5 billion.[32] At this press conference, referring to his proposed pay deal, Garnier revealed that it was "unfortunate the secrecy was broken." He defended the proposal stating that "There is a reality out there. If we want to keep our best executives and our best scientists we have to pay competitively."

Investor pressure continued to mount on J.P. Garnier in the light of continued poor stock price performance. The debate moved toward the nature of the exit clauses in his contract. This was estimated by the Pensions Investment and Research Consultancy to be in the region of £22 million, a figure that GSK disputed, since it included some £7 million of already vested share options. The remaining part of the exit package was made up of £15 million of cash and other benefits. By early May 2003, GSK was facing the realistic possibility of a shareholder revolt over its executive remuneration proposals.

By May 9, 2003, in an attempt to ward off the shareholder's ire, Sir Christopher Hogg, Chairman of GSK, wrote a letter to all major shareholders saying that the board had registered the shareholders' deep reservations.[33] Further, he promised that GSK would thoroughly examine executive pay by hiring Deloitte and Touche to conduct this review.

By the day of the Annual General Meeting on May 19th, 2003, speculation was still rife of the remuneration proposals being rejected. Ultimately, GSK's backtracking had no effect and the executive remuneration package was rejected with a backing of 50.7% of the shareholders;

another 10.3% of shareholders abstained in this vote. To rub salt into his wounds, 17% of shareholders voted against J.P. Garnier's re-election onto the board.[34]

What next for GSK?

Jennie Younger certainly had a fight on her hands. The key challenge that the executive team faced following the shareholder meeting was how to regain the faith of their shareholders and ensure that any future executive remuneration scheme was based upon sound performance and seen to be fair and equitable. However, how would Jenny communicate this? How would Dr. Garnier restore faith in his own leadership? So many questions and such a tight time frame, Jennie had to use all her corporate communication skills to address these issues.

Questions

1. Why did this happen to GSK specifically? Were they just unlucky with the timing of their shareholder meeting?

2. What key differences does this case highlight between European and U.S. business culture?

3. Who are the key stakeholders that GSK must consider when they start to address the issues associated with this case?

4. How can Dr. Garnier start to improve his image with his shareholders and the investment community as a whole? Was Dr. Garnier reasonable in his compensation requests? Why or why not?

5. Do GSK have any potential allies? If so how could they leverage them?

Appendices

(1) Extract Details of remuneration package ex- 2002 GSK Annual Report

Remuneration policy

GlaxoSmithKline's remuneration policy is to pay at industry competitive levels with a heavy emphasis on pay for performance and 'at risk' remuneration. The policy is designed to:

- focus on long-term sustained success
- focus on shareholder value through a strong emphasis on share plans
- set high levels of minimum achievement
- ensure integrated performance assessment throughout the management team to deliver concerted action towards success
- provide opportunities to earn globally competitive rewards, but only if performance is delivered.

The Remuneration Committee believe that both individual and team performance are directly linked to organisational success and are, therefore, critical to GlaxoSmithKline's future.

Global job evaluation for management level employees is monitored centrally to ensure consistency and the interlinking of performance objectives from top to bottom of the management chain and throughout the Group.

Dr J P Garnier

Dr Garnier has a service agreement with SmithKline Beecham Corporation dated 2nd December 1999. The agreement expires on 31st October 2007, being the last day of the month in which Dr Garnier reaches his 60th birthday. Dr Garnier's contract specifies the compensation to be paid on termination of his employment.

Dr Garnier's current basic salary is US$1,450,000 and will be increased to US$1,522,500 on 1st April 2003.

Dr Garnier may terminate the agreement on giving 12 calendar months' written notice, following which he is credited with an extra three years' pension contributions and he will be treated as if he is three years older than his actual age.

SmithKline Beecham Corporation may terminate the agreement on giving 24 calendar months notice. On termination by SmithKline Beecham Corporation, other than for cause, Dr Garnier is entitled to receive, within 30 days, a lump sum representing his salary and bonus for the notice period. The bonus is calculated on the basis of 'on target' performance which gives a bonus payout of 100 per cent of basic salary.

In addition, for the first 12 months of the notice period Dr Garnier is entitled to receive share entitlements, under stock and share incentive plans available to senior executives in the USA, except to the extent of any part of that period that would fall beyond his retirement date, and he can be awarded only one annual share option grant and Performance Share Plan grant after the date of the termination notice.

For pension purposes, he is provided with pension benefits such that he is treated, by way of additional pension contributions or otherwise, as if his employment had ended three years after the actual termination date, or three years after the expiry of his service agreement in the event that Dr Garnier's employment continues until the expiry of the service agreement. In addition, Dr Garnier and his spouse will be treated as if they are both three years older than their actual ages on the termination (other than for cause) or expiry of the service agreement, as applicable, for the purpose of calculating annuity rates on which the pension will be based.

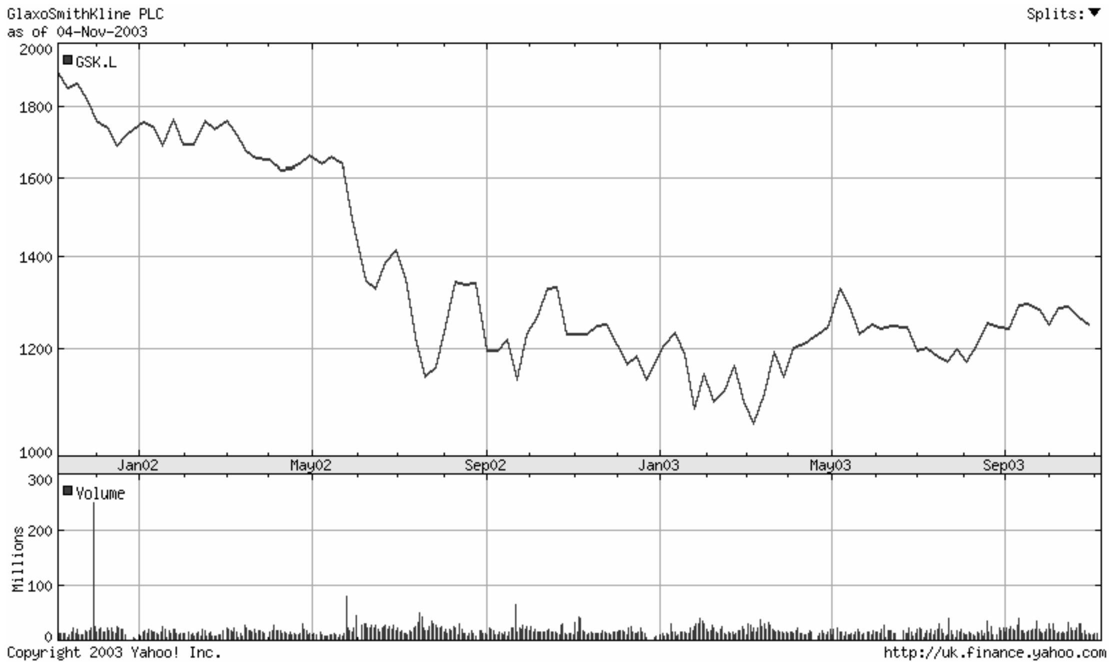
He would also receive outplacement counselling and financial planning and advice for two years following termination, but this shall be limited to $20,000 per year and he can choose to have life assurance cover which will provide a benefit of two times his salary until his 65th birthday.

Dr Garnier will continue to receive his benefits, or their cash value, during the notice period. If Dr Garnier's agreement is terminated by reason of disability he will be treated as if still employed for the purposes of his pension benefits until his retirement date.

In addition, if any payment or distribution to or for the benefit of Dr Garnier would be subject to excise tax, or any interest or penalties are incurred, Dr Garnier is entitled to receive an additional cash payment so that he is in the same after-tax position as if no such additional tax had been imposed.

In the event of retirement on the expiry of his service agreement or in the event of termination of his employment by SmithKline Beecham Corporation (other than for cause) or in the event of Dr Garnier not being elected or retained as a Director of GlaxoSmithKline (or any merged company), or as a result of a change of control of GlaxoSmithKline (provided that such resignation occurs on or within 30 days after the first anniversary of such change in control), then (a) all share option grants will vest immediately and will remain exercisable until the expiry of the option period as if Dr Garnier had still been employed by SmithKline Beecham Corporation and all performance and time conditions shall be deemed to have been satisfied, and (b) final awards under the Performance Share Plan will be determined after the end of the full performance period originally specified for the relevant participation without any proportionate reduction because of such retirement, termination or resignation. In respect of Dr Garnier's participation in the SmithKline Beecham Senior Executive Bonus Investment Plan, provided that his agreement is terminated other than for cause, any deferred amount and any income, gains and losses, are automatically distributed as soon as administratively practicable after his termination. If Dr Garnier resigns, retires or the termination is for cause then any deferred amount is not distributed until the end of a minimum three year deferral period.

(2) Stock Price chart
UK Listed Stock (FTSE100)



US Listed Stock (NYSE)

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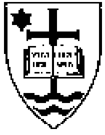
Merck & Co., Inc.: A Recall of Vioxx®
Bartucci, G.; Gust, A.; and O'Rourke, J. S. (editor)

Influenced by the preliminary results of an internal clinical trial, Raymond Gilmartin, CEO of Merck, announced that the company was pulling its blockbuster arthritis drug Vioxx® from the worldwide market on September 30, 2004. Merck & Company, Inc., once the world's largest pharmaceutical company, saw its stock price plummet 27% in value after the recall announcement. Facing recent sales declines, a barrage of lawsuits, and two separate government investigations, Merck is losing its once-stellar reputation in the pharmaceutical industry. (A) Case: 10 pp. (B) Case: 5 pp. (2005)



Eugene D. Fanning Center for Business Communication
Mendoza College of Business
University of Notre Dame

05-01(A)

Merck & Company, Inc.: The Recall of Vioxx® (A)

On the afternoon of Friday, September 24, 2004, Joan Wainwright, Vice President of Public Affairs at Merck & Company, sat in the jury waiting room in a Baltimore, Maryland courthouse. "One last time," she thought, as she checked her Blackberry for e-mail, just to see if there were any last-minute issues to address before the weekend. It was 3:00 p.m., eastern daylight time.

An urgent message asked her to call Merck's General Counsel about news from the Data and Safety Monitoring Board. Wainwright asked the court bailiff for permission to use the phone and quickly returned the call. What she learned wasn't good: the latest clinical study on Merck's blockbuster arthritis drug, Vioxx, had produced strongly unfavorable results. The Data and Safety Monitoring Board recommended stopping the Vioxx study with eight weeks remaining, citing an increased risk of heart attack and stroke in patients taking the drug.[1]

Following the court's adjournment for the day, Wainwright rushed home to participate in a 5:00 p.m. conference call with other Merck executives, including the General Counsel and Chief of the U.S. Marketing Group. The conference call discussed scenario planning, leaving Merck with two viable options: leave Vioxx on the market with a "black box" warning or pull the drug.

While Wainwright spent the weekend contemplating the logistics of communicating the company's decision to many different audiences, Merck's Chief Executive Officer, Raymond Gilmartin, assigned Dr. Peter Kim, the company's Research and Development Chief, full authority to make a decision on Vioxx based on patient safety.[2] Regardless of the decision Dr. Kim would soon make, Joan Wainwright knew that life in the near term would change dramatically for the Communications and Pubic Affairs team at Merck.

History of Merck & Company

With a lineage that can be traced as far back as 1668, Merck & Company, Inc. began as a modest chemical firm opened by Frederic Jacob Merck in Darmstadt, Germany. In 1891, George Merck

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This case was prepared by Research Assistants Andrew M. Gust and Grant D. Bartucci under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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brought the company to the United States and set up shop in New York. Originally established as a fine chemicals supplier, Merck & Co., Inc. began to conduct pharmaceutical research by the early 1930s. In 1953, the company entered into a merger with pharmaceutical specialty firm Sharp & Dohme, creating a company known as Merck Sharp & Dohme. Forty years later, Merck acquired Medco Containment Services, Inc., a leading pharmacy benefits management company in the United States.[3]

Today, the firm known as Merck & Co., Inc. is headquartered in Whitehouse Station, New Jersey. The company still operates in many countries under the name Merck Sharp & Dohme. Today, Merck is a global research-driven pharmaceutical company that discovers, develops, manufactures and markets a broad range of human health products. By 2004, the company would have about 70,000 employees in 120 countries and 31 factories worldwide. Today, Merck & Co., Inc. sells its products in more than 200 countries.[4]

Merck & Company Public Affairs

Joan Wainwright, who has been a Merck & Co. vice president since June of 2000, directs a public affairs team at the company's headquarters that consists of approximately 100 people who are organized into a Corporate Communications Group, a Media Relations Group, and support for each of the company's divisions. Those include a Worldwide Human Health Public Affairs Group, U.S. Human Health Public Affairs Group, Merck Manufacturing Public Affairs Group, Merck Research Public Affairs Group, and a Merck Vaccine Division Public Affairs Group. She also supervises a Merck Washington, D.C. office responsible for monitoring federal relations and policy.[5]

What is Vioxx?

Discovered in a Merck research facility in 1994, Vioxx (known generically as rofecoxib) is one among a class of drugs called Cox-2 inhibitors. This class of painkilling drugs was developed to reduce pain and inflammation in the human body. Cox-2 inhibitors compete with another class of drugs known as nonsteroidal anti-inflammatory drugs (NSAIDs) that are used as analgesics to reduce pain. Although Cox-2 inhibitors are also a part of the NSAID class, they were developed to reduce pain while eliminating the most common side effects of other NSAIDs, such as ulcers and gastrointestinal bleeding.[6] Vioxx was approved in 1999 by the United States Food and Drug Administration (FDA) for the treatment of pain, inflammation, and stiffness caused by arthritis. The drug was later approved for use in the treatment of rheumatoid arthritis in both children and adults.[7] Vioxx is the only Cox-2 inhibitor which is proven to have a benefit for ulcers and gastrointestinal bleeding.

The Recall

After the initial notification of Vioxx risks by the Data and Safety Monitoring Board on September 24, 2004, Peter Kim had to decide what to do about the drug's future. With overwhelming results showing Vioxx's cardiovascular risks, Dr. Kim made the final decision to pull the drug from the market on Monday, September 27, citing patient safety as the motivation for the decision. For the next three days, Joan Wainwright and a team of 25 Merck officials assembled in a "war room" to discuss the communication of the recall.

On September 30, 2004, Raymond Gilmartin, Merck & Company CEO, made an announcement that would change the face of Merck and the entire pharmaceutical industry. Gilmartin announced that Merck was pulling its popular arthritis painkiller Vioxx from the worldwide market. At the time of the recall, about two million people were taking Vioxx. Since the drug's approval in 1999, more than 100 million prescriptions had been written for the drug.[8]

The decision to pull Vioxx from the worldwide market was based on data from a clinical trial that Merck had instituted to test whether Vioxx had alternative uses, principally the prevention of potentially cancerous growths in the human colon. With eight weeks left on the study, the External Data Monitoring Board notified Merck officials that the preliminary results revealed that people who took the drug for more than 18 months had double the risk of heart attack or stroke than if they took a placebo. According to Dr. Kim, "Beginning after 18 months, there was a discernible and unexpected increase in cardiovascular disease rates."[9] The preliminary results of Merck's study, along with the presence of two other competing Cox-2 inhibitors, Pfizer's Celebrex and Bextra, were the major factors that influenced Merck's ultimate decision to pull Vioxx from the market.[10] Gilmartin defended Merck's decision saying that, "withdrawing the drug was going to be the responsible thing to do."[11]

Warning Signs

Merck had known about the possible serious risks associated with Vioxx years before the company recalled the pain medication. In 2001, a research team at the Cleveland Clinic published a paper in *The Journal of the American Medical Association* that discussed the serious increased heart attack risk of taking Vioxx.[12] The study found that Vioxx produces a risk of heart attack five times greater than naproxen sodium, a frequently used over-the-counter anti-inflammatory drug with comparable benefits.[13] Merck replied that early conclusions were inconsistent and that naproxen had an unproven protective effect.[14]

In another study called VIGOR (Vioxx Gastrointestinal Outcomes Research), Merck found similar results and submitted its findings to the FDA in June 2000.[15] The VIGOR study found that Vioxx users had an increased risk of heart attacks and strokes compared to naproxen users.[16] These results, along with findings of other Vioxx studies, forced the FDA to require Merck to implement labeling changes about the increased risk of heart attacks and strokes in April 2002.[17] The fact that the FDA required a label change due to the overwhelming amount of data showing the risks of Vioxx, should have caused major concern for Merck and Vioxx users.

Other studies show that higher dosages of Vioxx can increase a patient's risk of cardiovascular events even further. In August 2004, Kaiser Permanente, a large, nonprofit health maintenance organization, reviewed its patient records of 1.4 million people who were taking one of the many nonsteroidal anti-inflammatory drugs, including 26,748 patients who were taking Vioxx. Kaiser found that patients taking Vioxx in dosages greater than 25 milligrams faced a threefold increased risk of cardiovascular problems.[18] Merck refuted this study, saying it was a survey based on patient records rather than a clinical trial measuring the drug's effectiveness and side effects against a control group taking a placebo.[19]

E-mails within the company further suggest that Merck knew about the dangers of Vioxx even before the FDA approved the drug. In February 1997, Briggs Morrison, a Merck official, wrote that patients taking Vioxx would "get more thrombotic events" (blood clots) unless they took aspirin, as well.[20] Another Merck research employee, Alise Reicin, responded in an e-mail, saying that Merck was in a "no-win situation" because taking aspirin and Vioxx together would

increase cardiovascular events.[21] With all of these internal and external warning signs, many people wonder why the drug was approved in the first place and why it took so long to pull the drug off the market.

Merck's Study Backfires

With all of the negative studies pointing to Vioxx's dangers, Merck attempted to prove the drug's benefits to patients with colon polyps through its APPROVe [Adenomatous Polyp Prevention on VIOXX] trial. Merck conducted this random trial of 2,600 patients with colon polyps, expecting to find that Vioxx helped their affliction. Much to Merck's disappointment, the study found that 3.5% of Vioxx users in the study suffered heart attacks or strokes after taking the medicine for 18 months, compared to only 1.9% of the participants taking a placebo.[22] This change appears to be small as it is only a 1.6% increase in the absolute risk of cardiovascular events. However, the relative risk increases by 84% from taking Vioxx, which means Vioxx almost doubles a person's chance to suffer a heart attack.

The FDA Approval Process

The United States Food and Drug Administration acknowledges that no drug is completely risk-free. The FDA approves a drug only after it undergoes thorough laboratory, animal, and human testing. The human testing portion of the approval process is the most extensive and important. The table in Exhibit 1 summarizes the three different phases of human testing. After successful clinical trials of approximately 5,000 patients, the FDA originally approved Vioxx in May 1999. The agency claims that its original safety database on Vioxx did not show an increased risk of heart attack or stroke from consuming the drug. However, the FDA does admit, "Vioxx received a six-month priority review because the drug potentially provided a significant therapeutic advantage over existing approved drugs due to fewer gastrointestinal side effects, including bleeding."[23]

Exhibit 1: Phases of Human Testing

	Number of Patients	Length	Purpose	Percent of Drugs Successfully Tested
Phase 1	20-100	Several months	Mainly safety	70 percent
Phase 2	Up to several hundred	Several months to 2 years	Some short-term safety but mainly effectiveness	33 percent
Phase 3	300-600 up to several thousand	1-4 years	Safety, dosage, effectiveness	25-30 percent

Source: "From Test Tube To Patient: New Drug Development in the United States" (1995).[24]

Complaints about the lack of long-term studies have bombarded the FDA due to the quick approval process of Vioxx and other drugs. The pharmaceutical industry, according to observers and critics, routinely pressures the FDA for swift approval of new drugs, despite

clinical trials that study too few patients for too short of a time for side effects to emerge.[25] "More than half of all drugs introduced have a new side effect after approval with the current system," says Curt Furberg, a public health sciences professor at Wake Forest University School of Medicine.[26] Crystal Rice, an FDA spokeswoman responded, "Our job is to appropriately balance our decisions, based on the risk-benefit profile for a drug and the societal need and desire for new drugs."[27] Richard Horton, editor of *The Lancet*, a British medical journal, claims the FDA is accountable for failing to act after a 2001 study demonstrated Vioxx's dangers. Mr. Horton has requested a comprehensive renovation of the agency's process for reviewing drug safety.[28]

Silence at the FDA?

Perhaps the FDA, or at least officials within the agency, did try to act after learning of the cardiovascular dangers of Vioxx. Dr. David J. Graham, associate director for science in the FDA Drug Center's Office of Drug Safety, said he faced firm opposition within the agency to his findings that high doses of Vioxx tripled risks of heart attacks and stroke. Dr. Graham spoke with members of the Senate Finance Committee on Thursday, October 7, 2004. In a statement made after Finance Committee investigators interviewed the researcher, Senator Chuck Grassley, (R-Iowa) said, "Dr. Graham described an environment where he was 'ostracized,' 'subjected to veiled threats' and 'intimidation.'"[29] Senator Grassley added, "Merck knew it had trouble on its hands and took action. At the same time, instead of acting as a public watchdog, the Food and Drug Administration was busy challenging its own expert and calling his work 'scientific rumor.'"[30]

Wider Scrutiny of All Drugs

When knowledge of the dangers of a drug surface, other similar drugs face increased scrutiny. Vioxx is a Cox-2 inhibitor, part of the family of non-steroidal anti-inflammatory drugs (NSAIDs). Acting FDA Commissioner Dr. Lester M. Crawford stated that the FDA would closely monitor similar non-steroidal anti-inflammatory drugs. "All of the NSAID drugs have risks when taken chronically, especially of gastrointestinal bleeding, but also liver and kidney toxicity. They should only be used continuously under the supervision of a physician."[31] Two pain-relieving medicines in the same class as Vioxx that the FDA said they would re-examine data on are Pfizer's Celebrex and Bextra.[32] Pfizer says it will most likely add a "black-box" warning – the very strongest kind – to the label of Bextra.

Spurred by heavy advertising, COX-2 inhibitors took off faster than any other group of drugs after Celebrex and Vioxx went on sale in 1999. Critics say that these industry advertisements do not sufficiently emphasize the drugs' potential risks.[33] Vioxx's situation may result in a constriction of medical advertising rules, just as they stood to be relaxed.[34] Only weeks after Merck pulled Vioxx off the market, the FDA ordered Pfizer to pull certain Viagra ads that did not disclose any of its known risks.[35]

Federal regulators are now more likely to require longer-term studies before approving Merck's new drug Arcoxia, which is considered a successor to Vioxx and is now available for sale by prescription in 47 other countries.[36] The FDA has postponed approval on Merck's Arcoxia due to the Vioxx recall and requested additional data.

Merck's Problems Go Beyond Vioxx

For seven consecutive years in the 1980s, Merck had been rated "Most Admired Company in American business" by a *Fortune* magazine corporate reputation survey. After the withdrawal of Vioxx, many people thought that this reputation would be tarnished, not knowing that Merck had already begun to run into problems before the recall. For most of the company's existence, Merck had an impeccable reputation and was perceived to be the "gold standard" in the pharmaceutical industry. Now that reputation is being questioned, and the Vioxx recall is not the only reason.[37]

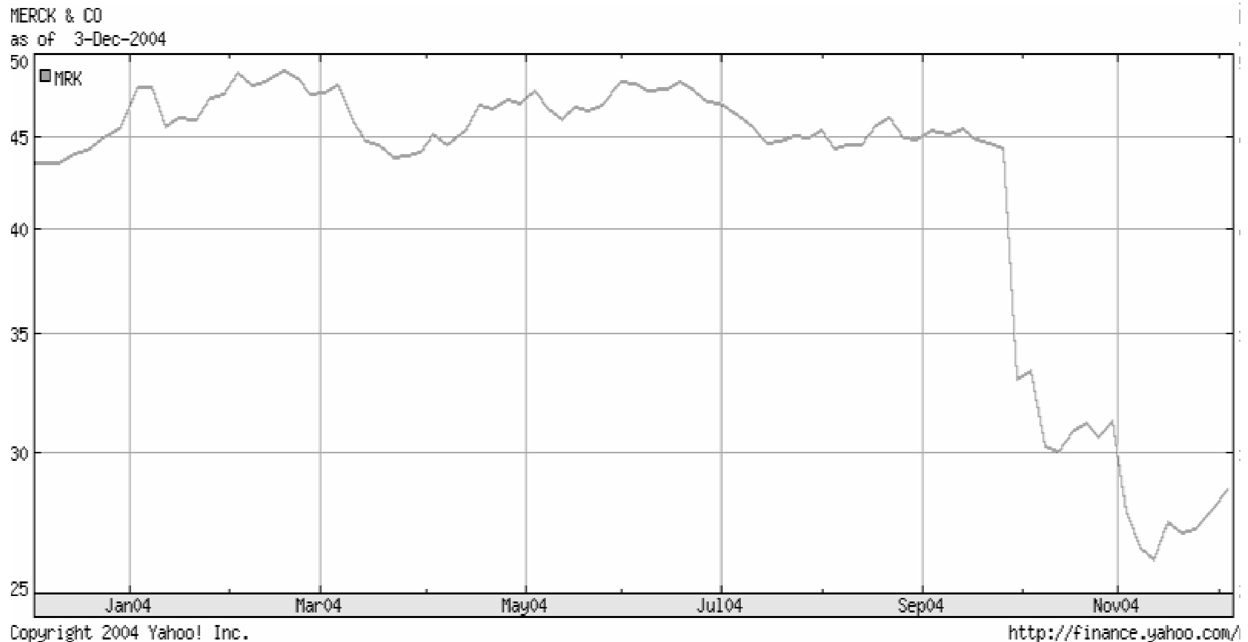
As recently as 2003, Merck faced problems with two major new drugs that the company expected to be blockbusters. Under the direction of Merck's former research chief, Edward Scolnick, Merck scientists were developing two new drugs for treatment of diabetes and depression. However, the company was forced to discontinue work on both drugs after unsuccessful animal studies and clinical trials. In addition, Merck's popular anticholesterol drug Zocor, which accounts for roughly $5 billion in annual revenues, twice that of Vioxx, loses patent protection in 2006, allowing generic anticholesterol drugs to flood the market.[38]

Merck had also been experiencing problems financially since the year 2000. After the company's stock price peaked in 2000 at $95 per share, Merck watched its market capitalization fall by $150 billion with the company's shares losing just over half their value between 2001 and 2003. Merck's earnings have been in decline since 2001 and the company saw one of its worst financial years ever in 2003. Even though sales grew by 5%, Merck experienced a decline in net income for the second straight year with a decrease of 4.5%. Merck, once the world's largest pharmaceutical company, is now just number six on the list.[39]

Financial Effects of the Recall

The September 30th recall of Vioxx caused Merck to lose a drug that accounted for $2.5 billion in sales, accounting for about 11% of the company's total revenue in 2003. According to analysts, Vioxx contributed even more to the company's overall net income. Analysts estimate that sales of Vioxx contributed $1.2 billion, or 18%, to Merck's $6.59 billion net income in 2003. The scene on Wall Street was even worse for the company. On the day of the recall, Merck's shares dropped $12.07, a 27% decline in value, down to $33 per share, which was the company's lowest closing price in eight years.[40] Merck also caused Wall Street's blue chip stocks to suffer a loss.

Representing 3.27% of the Dow Jones Industrial Average, Merck's surprise recall caused a 0.6% decrease in the Dow on September 30th.[41] As a result of Merck's news, the New York Stock Exchange traded at 27 times its normal level, 144.5 million shares.[42]



In addition, Merck had informed analysts that the company was likely to take a charge against earnings in the second half of 2004 of between $700 and $750 million because of the Vioxx withdrawal, causing Merck's annual earnings to decline by 50 to 60 cents per share. The charge against earnings would be taken to account for the costs of customer returns of pills, lost future sales and obsolete inventory associated with the recall.[43]

Merck Faces Criminal Probe and Lawsuits

In a quarterly regulatory filing on November 8, 2004, Merck disclosed that the U.S. Department of Justice subpoenaed the company as part of a criminal investigation into Merck's handling of Vioxx. The company acknowledged that the Justice Department requested information from Merck regarding the company's research, marketing and selling activities for Vioxx as part of a federal healthcare investigation under criminal statutes.[44] The focus of the investigation could be centered on whether or not Merck misled regulators or even caused federal health programs to pay for Vioxx when its use was unwarranted.[45] The company also announced that the U. S. Securities and Exchange Commission was launching an informal inquiry into Merck concerning Vioxx. The inquiry is expected to investigate whether Merck properly informed investors about the results of clinical trials and other probing research that exposed the drug's risks.[46]

In addition to the U.S. Government investigations, Merck has begun to quantify litigation that the company already faces concerning Vioxx. Incentives for the litigation have been sparked by a report on the FDA website that concludes that over 27,000 deaths could be attributed to the use of the drug.[47] The company is a defendant in about 375 personal injury lawsuits, some of which were filed before the drug's recall, involving more than 1,000 plaintiff groups.[48] Groups of plaintiff's lawyers began conducting conferences at various locations around the U.S. on Vioxx litigation in order to discuss specific strategies for the lawsuits. According to plaintiff's lawyer Daniel E. Becnel Jr., who has led such organizations in the past, "we can't compete with big pharmaceutical companies by ourselves, but when we get together, we can become

formidable."[49] At the end of 2004, the wave of lawsuits was expected to increase, while the company believed that some of them might go to trial as early as 2005.[50]

Are Others at Fault?

Although Merck heavily marketed Vioxx and the FDA never recalled the drug despite many studies demonstrating its dangers, many people feel other parties are culpable. Some have blamed doctors, insurance companies, and the American health-care system for the number of heart attacks caused by Vioxx. Only a small portion, about 15%, of Vioxx users were benefiting from its lower incidence of stomach bleeding, which is the main benefit of the drug, as opposed to the use of common, over-the-counter naproxen.[51] Many patients were angry with their doctors for not informing them that Aleve or Advil would work just as well as Vioxx, if they were not susceptible to stomach bleeding from naproxen.[52]

If so few people benefit from taking Vioxx over naproxen, why did the company spend $100 million a year in direct-to-consumer advertising for the drug?[53] Some critics attribute the problem to a regulatory system that drives the cost of developing new drugs to exorbitant levels, which encourages large pharmaceutical firms to heavily market medicines to "over-insured baby boomers."[54]

Patients may even be at fault for taking a drug with no significant benefits greater than an over-the-counter medicine. Even if doctors did offer patients not susceptible to stomach bleeding the option of over-the-counter naproxen, most patients would see the prescription drug as superior. Doesn't an expensive prescription drug that insurance pays for somehow seem like a better treatment than an inexpensive over-the-counter drug that can be taken without a physician's approval?

What's Next for Merck & Company?

For Joan Wainwright, "every day is a new day." This statement has emerged as the mantra of officials at Merck & Co., Inc. in their struggle to deal with the surprising recall of Vioxx and its numerous consequences. Ever since the recall in September 2004, Merck has been the center of attention in the pharmaceutical industry. The company has lost considerable market share on Wall Street, in addition to declining sales and profit levels since the year 2000. Merck is facing a barrage of lawsuits and is the subject of two separate government investigations. With all these issues on the doorstep, Joan Wainwright, along with her communication team, must determine how Merck & Company can regain public trust and rebuild the firm's reputation once again as the "gold standard" in the pharmaceutical industry.

Questions

1. What are the critical issues in this case and who are the stakeholders?

2. What stakeholders should Merck target first in its corporate response? What should be Merck's initial response?

3. How should Merck handle the criminal investigation and lawsuits?

4. Who should communicate Merck's message to the public?

5. Should Merck retain an external firm to assist in creating an effective response? What role should such external counsel play?

6. Should Merck work with the FDA on improving the drug approval process? If not, should Merck concentrate on changing its own research methods?

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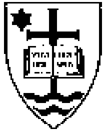
Wyeth Pharmaceuticals:
Premarin®, Prempro® and Hormone Replacement Therapy.
Huang, K. I. C.; Vanaelstyn, M; and O'Rourke, J. S. (editor)

Millions of women worldwide between the ages of 45 and 55 experience the effects of menopause and have sought both treatment and relief in the form of hormone replacement therapy. Wyeth Pharmaceuticals, a division of Wyeth, Inc., is the market leader in prescription drug treatment for menopause with Premarin®, a blend of natural estrogens (for women who have had a hysterectomy); and Prempro®, a one-tablet hormone replacement therapy consisting of natural estrogens plus progestin. A stunning set of results from the Women's Health Initiative, released in the summer of 2002, however, challenges conventional approaches to treatment and poses a significant threat to Wyeth share price and market leadership. (A) case, 12 pp. (B) case, 4 pp. Case #03-05. (2003)



Eugene D. Fanning Center for Business Communication
Mendoza College of Business
University of Notre Dame

03-05(A)

Wyeth Pharmaceuticals

Premarin®, Prempro® and Hormone Replacement Therapy (A)

> "These results [from the Women's Health Initiative] are valuable new data with significant implications. However, it is also important to recognize the critical role that combination Hormone Replacement Therapy (HRT) plays in treating the symptoms of menopause is the *number one* reason that women start therapy. In a recent survey, doctors report that management of symptoms is a treatment goal for nine out of ten new patients starts with combination HRT."
>
> *Victoria Kusiak, M.D.*
> *V.P., Clinical Affairs and North American Medical Director*
> *Wyeth Pharmaceuticals, July 2002*

On a hot, humid morning in early July in Madison, New Jersey, Justin Victoria, Vice President of Investor Relations at Wyeth, listened intently to a conference call. In Philadelphia, Pennsylvania, Natalie de Vane, Vice President of Corporate Communications, and her team just dialed into the same call. Executives at Wyeth Pharmaceutical had recently returned from an "emergency meeting" with researchers at the National Heart, Lung, and Blood Institute (NHLBI), a division of the National Institutes of Health (NIH). The NHLBI, in conjunction with other divisions of the NIH, was conducting a study regarding the risks and benefits associated with the long-term use of HRT. Wyeth had supplied the HRT used during the WHI trials – Premarin was used in the estrogen alone trial, and Prempro was used in the estrogen-plus-progestin trial.

The information they were sharing caught everyone by surprise. During the conference call, Wyeth executives explained that the Data and Safety Monitoring Board (DSMB) of the Women's Health Initiative (WHI) study had decided to discontinue the estrogen-plus-progestin, or combination HRT arm of the study, citing increased risks of cardiovascular disease and, over time, an increased risk of breast cancer.

The NIH claimed there were noteworthy benefits of using Prempro in the long-term, including fewer cases of hip fractures and colon cancer. The clinical trial for the combination

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This case was prepared by Research Assistants Kathryn I. C. Huang and Megan E. Vanaelstyn under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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HRT arm of the study was terminated more than a month earlier. The long-term benefits of hormone replacement therapy, including the prevention of heart disease did not turn up as expected.

The Wyeth executives continued their disheartening news by noting that *The Journal of the American Medical Association (JAMA)* would release the results of the study in its July issue, which would be available to the medical community the following week. In response, Wyeth's communication team immediately alerted physicians by sending out 550,000 letters informing them of the study and the facts of the findings. The letter also included a copy of the article that would appear in *JAMA.* In anticipation of queries from patients and physicians, Natalie de Vane and her team established separate toll-free numbers for physicians who prescribe the medication and for patients who use the medication.

The History of Wyeth Laboratories

Wyeth began as a small drug store called "John Wyeth & Brother," founded in 1860 in Philadelphia, Pennsylvania. In 1931, American Home Products Corporation (AHP) purchased Wyeth and began acquiring other pharmaceutical companies including, Ayerst, McKenna & Harrision, and Lederle Laboratories. By March of 2002, after being known as AHP for 76 years, the company changed its name and trading symbol to Wyeth (NYSE:WYE). During the previous decade, Wyeth had seen steady increases in its share price, peaking at more than $60 per share. With more than 52,000 employees, Wyeth is today composed of four divisions: Wyeth Pharmaceuticals, Wyeth Research, Wyeth Consumer Healthcare, and Fort Dodge Animal Health.[1]

Wyeth Pharmaceuticals manufactures and markets numerous well-known brands, including Premarin, Advil, Effexor, and Centrum. Wyeth's portfolio of popular women's health drugs – the Premarin family of products – is aimed at preventing symptoms of menopause and is Wyeth's largest and most successful group of treatments[2]. In 2001, more than 11 million women used a Premarin product for menopausal symptoms and osteoporosis.[3]

The Premarin family of products, which includes Premarin, a blend of natural estrogens (for women who have had a hysterectomy); Prempro, a one-tablet hormone replacement therapy consisting of natural estrogens plus progestin (for post-menopausal women with an intact uterus); and Premphase, a blend of natural estrogens plus progestin (given 14-days out of the cycle) generated sales of more than $2 billion in 2001 and accounted for 14% of total net revenues.[4]

Menopause

For most women, the most basic and personal definition of menopause is the cessation of menstruation. Underlying that change on a basic biological level is the disappearance of a woman's eggs from her ovaries. That loss does not occur abruptly, but over the decades of a woman's life leading up to menopause. A baby girl comes into the world with about 2 million immature eggs. By age 12, the count is already down to 300,000 eggs, and by the time a woman reaches her late 30's, the count is down to 25,000. A woman experiences barely 400 menstrual cycles in her life, yet finds her ovaries eggless by middle age. [5] No one in the scientific or medical community truly understands all aspects of this phenomenon.

The Unspoken Effects of Menopause

Menopause can be extremely bothersome for some patients, and debilitating for others.[6] Menopause causes a woman's body to slow down the production of estrogen, which is a natural hormone, produced by the ovaries. By the time natural menopause is complete – usually between the ages 45 and 55 – hormone output has decreased significantly. The reduction in the amount of estrogen in a woman's body can have wide-ranging effects – from symptoms such as hot flashes, night sweats, fatigue, irritability and mood changes, to underlying effects like an increased risk of osteoporosis.[7]

The most dramatic side effect is the hot flash, a clear signal that the estrogen receptors of the brain are in uproar. Typically, as the first hot flash occurs, calcium pours out of the bones and bone cells begin degenerating tissue at a faster pace than the tissue is replaced. The cardiovascular system loses its protection from hardening of the arteries that had been offered by pre-menopausal ovaries. Varying in intensity and lasting for seconds to minutes, a sudden flush makes a woman feel overwhelmingly hot, sometimes with drenching perspiration, palpitations, and even a wave of anxiety, followed by a shiver. Soaked clothing and bed linen can be annoying and embarrassing. Such hot flashes usually subside over time, though, and most are gone within a year or two.[8]

What is Hormone Replacement Therapy?

For years, doctors have recommended Hormone Replacement Therapy as a method to help women manage the symptoms of menopause, as well as to help postmenopausal women maintain healthy hormone levels. Since estrogen loss is thought to put more women at risk for additional serious health problems, doctors were quick to prescribe HRT. Taking HRT for a short time (perhaps a few years) is thought to help women relieve the annoying symptoms associated with menopause. Taking hormone supplements for a longer time was thought to help against such serious problems as stroke, osteoporosis, as well as the leading cause of death for women over the age of 50: heart disease.

The Controversy of HRT

The HRT area remains controversial, with clinical results often painting a contradictive and confusing picture on the relative safety profile of drugs such as Premarin and Prempro. Despite decades of accumulated evidence, the balance of risks and benefits for hormone use in healthy postmenopausal women remains uncertain.

The NIH's recent findings are not the first study to suggest that a woman's risk of breast cancer rises the longer she is on HRT. In 1997, researchers reported a substantial increase in the risk of breast cancer among women, particularly older women on HRT, and noted that the addition of progesterone, which was commonly thought to decrease the risk of breast cancer, actually failed to reduce any risk.[9] Exhibit I details the trials and tribulations of HRT in the United States.

The Medical Disconnect

The first estrogen, estrone, was synthesized in Germany in 1928. In 1959, two doctors argued that simply replacing the body's lost estrogen could reverse all the negative symptoms associated with menopause. Estrogen sales soared. In 1975, prevalent medical opinion was thrown into a tailspin when the *New England Journal of Medicine* published two studies showing that women who took estrogen had four or more times as great a risk of developing endometrial cancer as those who did not. Among women who took the hormone longer, the cancer risk increased. As a result, estrogen sales plummeted.[10]

To combat the declining sales, in 1985 Wyeth conducted an aggressive media relations campaign to create public awareness of osteoporosis, a bone loss disease that affects 25% of post-menopausal women and leads to high risk of fractures. Osteoporosis was (and remains) a deadly disease for which HRT was thought to be one possible remedy. Wyeth urged women to consult with their doctors.[11] In addition to providing prevention for Osteoporosis, researchers realized if hormones were shown to protect the cardiovascular system, then HRT could be promoted as a beneficial treatment for heart disease.

Initial results regarding HRT's effect on heart disease were somewhat unclear, as there appeared to be inconsistencies with the long-term benefits of using HRT. That soon changed when researchers began releasing positive studies supporting hormones in preventing heart attacks, and bone loss, while not increasing cancer, stroke, or blood clots.[12] Based on these observational studies, Wyeth asked the FDA to approve a label change to include heart disease prevention in women without a uterus. In June 1990, Wyeth was granted the label change. Notably, the standard *Physicians' Desk Reference* at that time suggested that estrogen should not be prescribed to women with heart disease, hypertension, or diabetes.

That same year, the NIH launched a significantly large clinical trial on women's health – which would later be globally recognized as The Women's Health Initiative – covering heart disease, breast and colon cancer, bone fractures, and the roles of hormone therapy, diet, vitamins and calcium in preventing these diseases. Women, doctors, and even researchers were confused and increasingly concerned about the long-term use of HRT and the risks associated with various forms of cancer.[13]

Prempro

Estrogen was the dominant hormone used in HRT until the increased risk of endometrial cancer led to the addition of progestin for women with an intact uterus. Since the mid 1980s, combined estrogen/progestin use steadily increased. Progestin is a synthetic form of the natural hormone progesterone. In 1995, Wyeth began marketing Prempro as the first estrogen-plus-progestin HRT pill approved by the FDA. In addition to countering the negative side effects of menopause, Prempro reduces the risks of colon cancer and hip fracture by about one-third. That same year, Wyeth's Prempro sales soared to $22 million.

By 2001, approximately 22.3 million prescriptions were written each year for Prempro. Domestic sales increased by 9.29% from $686.3 million in 2000 to $749.7 million in 2001. However, after the WHI study was made public, Credit Swiss First Boston analysts estimated that sales for Prempro would decrease by 13.4% in 2002, 38.1% in 2003, and 15.8% in 2004.[14] Analysts at Dredsner Kleinwort Wasserstein reported that prescriptions for both Premarin and Prempro had been strongly affected by the WHI study (see Exhibit II).

National Institutes of Health

The National Institutes of Health, or NIH, is one of the agencies of the Public Health Services that is part of the U.S Department of Health and Human Services. Composed of 27 separate divisions, mainly Institutes and Centers, the NIH occupies 75 buildings on more than 300 acres in Bethesda, Maryland. The expressed goal of all NIH research is to acquire new knowledge to help prevent, detect, diagnose, and treat disease and disability, from the rarest genetic disorder to the common cold.[15]

The Women's Health Initiative

The Women's Health Initiative (WHI), sponsored by NIH, was a 15-year study focusing on the prevention of heart disease, breast and colorectal cancer, and osteoporosis. The study was scheduled to conclude in 2005. The WHI, which consisted of a set of clinical studies and an observational study, began in 1991 and involved healthy, postmenopausal women. Two specific drugs were used during the study, Premarin and Prempro, both supplied by Wyeth.

On May 31, 2002, the DSMB, charged with reviewing the results of the clinical trials and ensuring participant safety, recommended that the trials of the estrogen plus progestin arm of the study be stopped. WHI decided to discontinue the Prempro arm of the study, citing an increased risk of invasive breast cancer as the main factor. The NIH stated that there was currently no evidence of increased risk of breast cancer in women taking estrogen alone (Premarin) in the trial. Therefore, that part of the trial would continue through 2005.

Specifically, the Prempro arm of the clinical study involved 16,608 healthy women who took either estrogen-plus-progestin or a placebo. The women were between the ages of 50 and 70 and each had an intact uterus. The principal goal of the study was to see if the therapy would help prevent heart disease and hip fractures. An additional goal was to see if these potential benefits were greater than the possible risks for breast cancer, endometrial cancer, and blood clots. The aim of the study was not to determine whether HRT was effective in treating symptoms associated with menopause. The study, which was scheduled to run for 8.5 years, was stopped early. After just 5.2 years, researchers felt the therapy's risks overshadowed the benefits.

The study results showed that combination HRT therapy resulted in a 26% increase in breast cancer. While no deaths from breast cancer occurred as a direct result of the combined therapy, this factor alone was reason enough to immediately halt the study. The Estrogen-plus-progestin therapy compared to the placebo group also produced a number of significant results, including:

1. 41% increase in strokes.
2. 29% increase in heart attacks.
3. Doubled rates of blood clots in legs and lungs.[16]
4. 37% reduction in colorectal cancer.
5. 34% reduction in hip fractures.

Stated differently, after an average of 5.2 years, the study indicated that if 10,000 postmenopausal women were taking estrogen and progestin, 8 more would have invasive breast cancer versus the placebo group – 38 women versus 30 women – which reflects a 26% increase. Seven more women would have a heart attack – 37 women versus 30 women – which reflects a

29% increase. Eight more women would have a stroke – 29 women versus 21 women – which reflects a 41% increase. And eighteen more women would develop blood clots, compared with those women who were not taking combination HRT.[17]

On the other hand, the study indicated that women taking estrogen-plus-progestin would see a reduction of colorectal cancer by 37% – 10 women versus 16 women taking a placebo – and a reduction of hip fractures by 35%, 10 versus 15 women taking a placebo. See Exhibit III for the relative and absolute risk benefits of the study, as adapted from the WHI findings.

Physicians Put the Risks of HRT in Perspective

While middle-aged women across the country began to panic as they tried to understand what this study meant to them personally, doctors began admitting that, perhaps, they had been too quick to prescribe hormone replacement therapy for symptoms common in middle-aged women.

"This study hasn't changed my practice. We've known of breast cancer risk associated with HRT for some time, and we've known that women with heart disease didn't get much benefit from HRT," said Steven Goldstein, professor of obstetrics and gynecology at NYU School of Medicine. "This study never addressed the women who come to menopause with terrible symptoms. Women should still take HRT in the short term, but on a case-by-case basis. Patients are individuals and should be treated one at a time."

"For women who suffer with heart palpitations, mood swings, night sweats or dryness of tissues, HRT can be a Godsend," said Cardiologist Stephen Sinatra, founder of the New England Heart and Longevity Center in Manchester, Connecticut. "If a woman takes HRT, it must be for quality of life issues. It's important to realize that the stress from these symptoms alone can precipitate coronary disease. It really is a double-edge sword."[18]

"The NIH study in question showed a slight increase for the risk of cancer and heart disease in less than one tenth of one percent of the women studied," responded Dr. Judith Reichman, author of *Relax, This Won't Hurt.* "We thought that estrogen was going to help protect our hearts. What we found out was that Prempro does not; there are questions if estrogen, in general, will. But the thought of just giving everyone hormones and saying, 'Here, dear, take this forever and this will prevent all diseases,' we now realize is not true."[19]

The Problem Escalates

On July 9, 2002 at 9:30 a.m. Eastern Time, the NIH formally released its findings to the public in a press release.[20] At nearly the same time, Wyeth issued a press release to "Inform Physicians of the WHI findings."[21]

Within hours, the national online media outlets picked up the story. Gynecologists' offices across the United States were swamped with calls as their patients tried to understand how soon they should stop taking HRT. By the next morning, headlines were screaming from coast to coast and across the world, sending millions of women into a panic. Typical of the headlines in U.S. newspapers were these:

- "Halted HRT study raises questions" (*USA Today,* July 10, 2002).[22]
- "Hormone Therapy Harm Found Risks for Women Seen in Long Term" (*The Boston Globe,* July 10, 2002).[23]
- "Wyeth Stock Falls 24% after Report" (*The New York Times,* July 10, 2002).[24]

- "Dangers of Popular Prempro Worry Doctors and Patients" (*The Houston Chronicle,* July 10, 2002).[25]
- "HRT Trial Cancelled Over Cancer and Stroke Fears" (*The Guardian,* July 10, 2002).[26]

Later that afternoon, the Philadelphia-based law firm Schiffrin & Barroway, specializing in consumer class action litigation, began an investigation into possible legal actions against Wyeth.[27]

Not Just Another Day at Work

After another exhausting conference call, Justin Victoria and Natalie de Vane returned to their offices to find the media furiously drafting and publishing HRT stories, many of which were inaccurate and none which reflected the true findings of the study. Victoria began to focus his attention on Wyeth's share price in the hope that the market would not further punish the company on the conclusions of the WHI study. As shown in Exhibit IV, share prices of WYE dropped to $38 dollars per share since the release of the *JAMA* article the previous day. Natalie de Vane and her team knew they had to communicate immediately that the NIH study *did not* evaluate the use of combination HRT for the treatment of menopausal symptoms or vaginal atrophy, the principal reasons for which HRT is prescribed. Additionally, the team knew the importance of the fact that an increase in the relative risk of breast cancer did not occur until the patient had been on the drug for longer than four years.

Questions

1. How should Wyeth Pharmaceuticals respond to the findings of the NIH study?

2. What are the issues for Natalie de Vane and the corporate communications team to address at this point?

3. Who are the key audiences that Wyeth should try to reach and through what means?

4. Who are the relevant stakeholders?

5. Over the years, numerous scientific and medical sources have reached different conclusions on HRT. Armed with the new WHI data, how should Wyeth move forward?

6. If, in fact, HRT poses a greater threat than benefit to women in the long term, is it ethical for the company to continue the marketing of this product? What are the corporate ethical issues involved when a pharmaceutical company attempts to market its products into market segments that have not been scientifically or medically founded?

Exhibit I: The Trials and Tribulations of HRT

1942	Wyeth's Premarin, the nation's first hormone replacement drug, hits the market.
1959	Study shows that estrogen protects bones and relieves menopausal symptoms.
1962	Medical expert Robert Wilson claims that estrogen during menopause reduces breast and genital cancers.
1966	FDA says that Wilson's recommendations go beyond approved data and that it will no longer support his data.
1973	*Harper's Bazaar* declares: "There doesn't seem to be a sexy thing that estrogen can't and won't do to keep you flirtatiously feminine for the rest of your days…. a real package deal that spruces up your vagina."
1975	More than 30 million prescriptions for estrogen are written every year. Half of all menopausal women are using HRT for a median of five years.
	Two studies published in the *New England Journal of Medicine* show that post-menopausal estrogen use increases endometrial cancer risk four to 14 times.
	Wyeth's Premarin is the fifth most frequently prescribed drug.
1976	*The New England Journal of Medicine* publishes the first study showing a link between menopausal estrogen and breast cancer.
1980	The Journal of *Obstetrics and Gynecology* reports that adding progestin to estrogen led to a decline in endometrial cancer.
1982	Medical experts claim that estrogen-progestin combination may help osteoporosis and may "have protective effects against cardiovascular disease." At the same time, experts claim that menopausal hormones are a major factor in cancer in the medical periodical *Cancer Research.*
1989	*The New England Journal of Medicine* releases findings that show a slight increase in breast cancer among those who took estrogen. When women switched to combination HRT, their breast cancer risk more than doubled.
1990/95	Wyeth's Premarin is the most frequently prescribed prescription drug in the U.S.
1995	Wyeth's Prempro, the first estrogen-plus-progestin HRT pill, is approved by the FDA.
2000	The Women's Health Initiative tells study participants that some women are experiencing heart attacks and strokes and offers them the opportunity to drop out.
2002	The Women's Health Initiative combined HRT study is stopped because of continuing heart events and an increased risk of invasive breast cancer.[28]

Exhibit II. Prescriptions for Wyeth HRT

Total Weekly Rx for Wyeth HRT

Week	Premarin	Premphase	Prempro	Total
5-Jul	729,910	33,685	352,212	1,115,807
12-Jul	731,572	31,909	331,219	1,094,700
19-Jul	661,839	27,479	271,410	960,728
26-Jul	626,384	27,858	248,727	902,969
2-Aug	679,904	28,915	253,948	962,767
Q4 01 Avg:	785,434	37,694	387,083	1,210,211
Q1 02 Avg:	776,916	37,128	384,424	1,198,468
Q2 02 Avg:	762,233	35,801	376,522	1,174,556
Q3 02 Avg:	685,922	29,969	291,503	1,007,394

Total New Rx for Wyeth HRT

Week	Premarin	Premphase	Prempro	Total
5-Jul	183,056	7,902	82,313	273,271
12-Jul	194,095	7,545	78,056	279,696
19-Jul	175,191	6,203	59,943	241,337
26-Jul	166,748	6,018	52,137	224,903
2-Aug	176,091	6,306	52,282	234,679
Q4 01 Avg:	233,586	9,275	95,558	338,419
Q1 02 Avg:	227,110	9,343	98,753	335,206
Q2 02 Avg:	206,323	9,134	92,155	307,612
Q3 02 Avg:	179,036	6,795	64,948	250,779

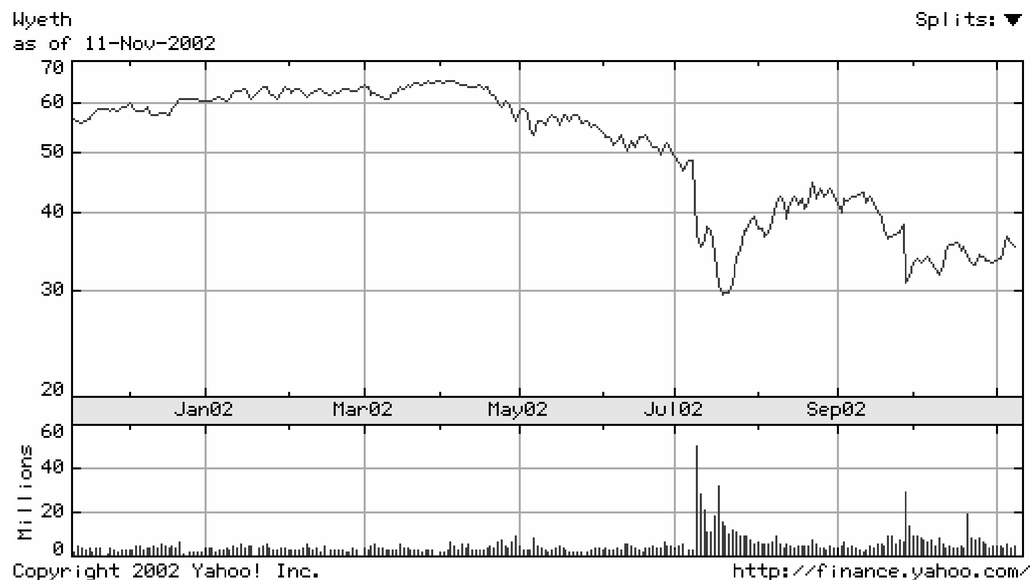
Source: Dredsner Kleinwort Wasserstein, *Hormone Replacement Therapy*, August 12, 2002
See Exhibit III for the relative and absolute risk benefits of the study as adapted from the WHI findings.

Exhibit III. The Relative and Absolute Risks / Benefits from HRT from WHI Study

Health Event	Relative Risk vs. Placebo Group at 5.2 Years	Increased Absolute Risk per 10,000 Women/Year	Increased Absolute Benefit per 10,000 Women/Year
Heart Attacks	1.29	7	
Strokes	1.41	8	
Breast Cancer	1.26	8	
Blood Clots	2.11	18	
Colorectal Cancer	0.63		6
Hip Fractures	0.66		5

Source: Wyeth Pharmaceuticals, Press Release, July 2002

Exhibit IV. Share Price Effect



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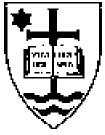
Alaska Airlines: Navigating through Crisis toward an Uncertain Future
Hein, C.; Tipps, T.; and O'Rourke, J. S. (editor)

On January 31, 2000, an Alaska Airlines MD-80 crashed in the Pacific off the coast of California. A company with a sense of independence and strong culture, Alaska Airlines responded quickly to the NTSB investigation of the accident and the media assault that focused on Alaska's sloppy maintenance records as a contributing factor to the crash. As a result of the company's strategy, brand equity, employee morale, and stockholder confidence emerged essentially unscathed. A little more than one year later, though, the entire airline industry, was forced to deal with the consequences of the September 11th tragedy. Today, Alaska Airlines is among the most recognized for service and quality in the industry, but is facing financial challenges as the industry moves toward a low-cost model. The test the company now faces is how to strengthen its financial position without sacrificing its service and quality. 10pp. Case #04-09. (2004)



Eugene D. Fanning Center for Business Communication **04-09**
Mendoza College of Business
University of Notre Dame

Alaska Airlines

Navigating through Crisis toward an Uncertain Future

January 31, 2000 was not a normal day for Lou Cancelmi, Vice President of Corporate Communications for Alaska Airlines. Cancelmi rarely left the corporate offices in SeaTac, Washington before 7:00 p.m., but that day he had a pressing obligation – a rare chance to see his son at an Italian language lesson in Seattle. As he settled in to enjoy the occasion, he turned off his cellular phone and started to relax. He closed his eyes, listened to the lesson, and thought about his son's progress. After the lesson, Cancelmi walked outside and turned on his phone. Much to his surprise, there were several messages left during the brief time he had it turned off and he wondered what they could be about. He dialed his voicemail, started listening, and had trouble believing what he was hearing. "Lou, we need you back at the office. We've lost an airplane." That was just the beginning of what would be many sleepless nights for Cancelmi and his teams at Alaska Airlines. [1]

Alaska Airlines

In 1932, Mac McGhee began flying his small, three-seat airplane from Anchorage to Bristol Bay, Alaska. Only a year later, McGhee Airways merged with Star Air Service to create the largest airline in Alaska. In 1944, the company became known as Alaska Airlines, and used surplus military aircraft to participate in the 1948 Berlin Airlift and the 1949 Operation Magic Carpet. By the 1960s, Alaska Airlines had merged with Alaska Coastal-Ellis and Cordova, allowing the company to fly an area spanning from Fairbanks to Seattle, and occasionally, even over to the Soviet Union.

Alaska Airlines expanded over the years but, when faced with financial difficulty in 1972, the company was saved by two business men, Ron Cosgrave and Bruce Kennedy. Both men worked toward setting goals and defining a vision for the company. Their work, combined with the construction of the Trans-Alaska Pipeline and deregulation of the airline industry,

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This case was prepared by Research Assistants Claire Hein and Tiffany Tipps under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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allowed Alaska Airlines to prosper. So much so, in fact, that in the 1980s their route system included Mexico and Russia, and the company had tripled in size. [2]

Shortly after the Airline Deregulation Act of 1978, Horizon Airlines formed to fill the shorter and more rural routes once served by the larger airlines. At the same time, Alaska Air Group formed as the holding company for Alaska Airlines. In 1987, the holding group acquired Horizon Airlines and the two became sister carriers. By the end of the 20th Century, the two airlines had made news as the first to book flights and sell tickets via the Internet, the first to use the "fog-busting" Head Up Guidance system, among the first to shoot an approach using the Global Positioning Satellite System (GPSS), the first to allow passengers to check in online and print their own boarding passes using airport kiosks, and the first commercial customer of the Boeing 737-900.

Today, Alaska Airlines is the ninth largest U.S. airline, and is the dominant West Coast carrier despite serving just 2% of all U.S. passenger traffic. Alaska Airlines departs most frequently out of Seattle, Anchorage, Portland, and Los Angeles, flies to nine international locations, and the most frequent of its 571 daily flights is Anchorage-Seattle. [3]

Flight 261

Shortly before Cancelmi left work to attend his son's Italian lesson, Flight 261 was departing from Puerto Vallarta, Mexico, piloted by Captain Ted Thompson and First Officer Bill Tansky. During the flight they experienced a warning about an inoperative horizontal stabilizer, not normally considered an emergency to well-trained pilots. Thompson and Tansky took measures to compensate for the problem and flew uneventfully for two hours.

At 4:03 p.m., however, the situation had worsened and the pilots contacted the dispatch control to request landing at Los Angeles International Airport which was closer than their scheduled destination in San Francisco. The pilots were trying to control the aircraft which had just taken a sudden nose-dive – dropping 6,500 feet in 60 seconds. After regaining control, the two men had a brief discussion about what course of action to take. Captain Thompson got on the public address system and calmly announced:

> "Folks, we've had a flight control problem up front here. We're workin' it . . . uh, that's Los Angeles off to the right there . . . that's where we're intending to go. We're pretty busy up here working this situation. I don't anticipate any big problems once we get a couple of sub-systems on the line, but we will be going into LAX, and I'd anticipate us parking there in about 20 to 30 minutes." [4]

Conscious of the severity of the situation, the two pilots headed the plane out over the bay to avoid populated areas. First flight attendant, Allison Shanks, entered the cabin and reported that loud bumps were heard from the rear of the plane and then returned to calm the passengers and prepare for landing. Just a few minutes, later the aircraft's jackscrew failed causing the plane to roll upside-down and pitch downward into the sea below. Tragically, all passengers and crew members perished in the crash. [5]

Aeroshell 33

In 2000, five FAA officials conducted a four-day hearing investigating the accident and Alaska Airlines' conduct. Two senior auditors involved in the post-accident audit confirmed that the company had taken all necessary precautions and followed all FAA mandated safety procedures, while a third auditor discovered incomplete safety documentation but concluded that it played no part in the accident and that the airline did have skilled employees.[6] Following the release of the audit, William Ayer, CEO and President of Alaska Airlines, said: "We all want to find out what happened to Flight 261 so we can take necessary steps to prevent it from happening again."[7]

The hearing, however, was not without controversy. Much of the discussion focused on the specific grease used to lubricate the MD-80 jackscrews. Alaska Airlines had been using Aeroshell 33, a multi-purpose grease invented and endorsed by Boeing. During the course of the accident investigation, it was discovered that a copper alloy in the grease is corrosive to the jackscrew assembly found in the plane gears and flight controls. Subsequently, Alaska Airlines switched back to Mobil 28, which they had used until 1997.

The audit also uncovered proof that the Maintenance Engineering Order for the initial switch in lubricants lacked all the required signatures, causing some to question Alaska Airlines' procedural effectiveness. The lack of proper documentation would have prohibited the switch but, despite the slip-up, witnesses in the hearing remained convinced that the error was ultimately unrelated to the accident. Also reported in the findings was the fact that the airline was lubricating the jackscrews every 2,500 flight hours, well under the FAA guideline lubrication interval of 3,600 flight hours. After the crash, the FAA mandated all airlines lubricate every 650 flight hours and Alaska Airlines complied. Public blame shifted between Alaska Airlines and Boeing following the investigation. Ultimately, both companies assumed legal liability following the investigation in 2003, and agreed to compensate survivors of the victims. [8]

Media Coverage

As in all commercial airline accidents, the media coverage of Flight 261 was relentless. Alaska Airlines was put under a microscope for months and was openly questioned in the local and national media about maintenance practices at their Oakland base. At first, the coverage focused on identifying the cause of the crash. Discussion and conjecture regarding the cockpit recording and the subsequent investigation transcripts became a nightly television ritual. Later, the exposure revealed that the company had been involved in a federal grand jury probe into their Oakland, California maintenance base operations since late 1998. The controversy stemmed from a former Alaska Airlines employee who prompted the FAA to investigate after relaying information regarding the company maintenance records on the MD-80 fleet. His allegations, coupled with the emotional response to the accident, painted a public picture of a negligent airline.

The media coverage was especially sensitive in Seattle. The accident made the front page of the local newspapers, and was the top story on the evening news for months. Balancing the media's duty to serve as a "watch dog" and Alaska Airlines' efforts to preserve their integrity made for an uneasy relationship between the company and local media outlets. Many stories blamed company culture for what appeared to be sloppy maintenance practices, and one newspaper printed a headline proclaiming the downed MD-80 had experienced mechanical problems on its way to Mexico – which was untrue. [9]

One newspaper even contended that Alaska Airlines had knowingly and intentionally slacked on safety protocol, and pressured the FAA to overlook the infractions. The article, headlined "U.S. looks into FAA's Alaska Air Oversight," ran in the *Seattle Post-Intelligencer* in April of 2000, and offered the opinion that "Such an investigation would focus on whether Alaska encouraged criminally improper maintenance practices that were either sanctioned by or ignored by the FAA . . . several FAA inspectors in the agency's Flight Standards Division office in Renton [Washington] say they have been pressured by superiors to take it easy on Alaska, and were punished when they tried to strictly enforce FAA regulations." The article went on to cite the 1998 investigation of Alaska Airlines' Oakland maintenance hangar for failing to perform certain safety procedures. [10]

Confounding the situation were reports that were easily misinterpreted by the public. For instance, a *USA Today* article stated on December 11, 2000 that the FAA found "exemplary programs at every airline except Alaska." The inference was that Alaska Airlines was not airworthy; however, the truth was Alaska Airlines was excluded from the audit since the FAA had done such an extensive investigation that spring following the crash. Similarly, an article in the *Tacoma News Tribune* said the FAA fined Alaska Airlines for putting an unairworthy aircraft back into service. The reality was that the FAA did fine the airline, but the infraction resulted from an April test flight carrying no passengers that took off without proper documentation. The media did not reveal that distinction, and the public was led to believe the fine was the result of an unsafe passenger flight. [11]

In June of 2000, the FAA threatened to shut down Alaska Airlines' major repair centers in Seattle and Oakland unless the carrier showed it could quickly improve maintenance practices.[12] While these threats never played out, the company feared its image was tarnished in the minds of its customers due to the months of negative publicity following the accident. In order to find out what effect the negative media coverage was having on its brand, the company contracted with an outside party to conduct research on customer perceptions. Remarkably, the survey showed no negligible effect on customers' perceptions of Alaska Airlines. [13]

Although most media coverage during the months following the crash was not flattering to the company, there were a number of stories that hailed the flight crew as heroes. The crew was praised for their professionalism and conduct during the emergency. In the year following the crash, the Air Line Pilots Association International awarded Ted Thompson and Bill Tansky the Gold Medal for Heroism because of their courage in responding to the emergency aboard their airliner.[14]

Nonetheless, the negative publicity took a toll on employee morale. In response, Cancelmi offered the following statement to employees:

> "Given the negative publicity . . . I'd like our employees to keep several things in mind. First is the outstanding way they all responded to the tragedy of Flight 261. Then there's the fact we have cooperated fully with every investigating agency that has made a request of us, not to mention the tremendous effort and progress we've made to improve our operation. The bottom line is, as a company, we have committed ourselves to becoming the model for safety and regulatory compliance in the commercial aviation industry." [15]

Crisis Management

When Alaska Airlines Flight 261 crashed off the coast of Southern California on January 31, 2000, there were 88 passengers and crewmembers onboard the airplane. Many passengers were from the Western Washington area, including 12 employees of the airline and its regional partner, Horizon Airlines. The company took great pride in taking care of its customers, and now they were faced with responding to the families of the customers who had died on their airplane. The media was unrelenting with requests for information, much of which was not even known to the company itself. At the same time, Alaska was cooperating with government agencies and labor groups involved in the crash investigation. Timely and clear communication was critical because of the sheer number and concern of stakeholder groups.

Victims' Families. The most important priority was addressing the needs of victims' families. Immediately following the tragedy, John Kelly, at the time Alaska Air Group CEO, made the trip to Southern California to meet personally with the families and to convey his condolences. He also pledged publicly that the company would do "everything possible to find answers" to the questions about their loss. The company also activated the *Family and Friends Care Team* to assist in helping people cope with such a difficult situation. The company felt that these actions constituted the "right thing to do," as opposed to tools that would help mitigate possible litigation or create good press.[16]

Customers. Although Alaska Airlines' world stopped spinning moments after the crash, there was still a company to run. With more than 1,000 daily departures, the company realized that it would be crucial to continue filling the seats in their airplanes, especially in light of the challenges they faced. The airline enjoyed fiercely loyal customers and had been recognized on numerous occasions as a leader in customer service by publications such as *Condé Nast Traveler* and *Travel + Leisure* magazine. [17] The company hoped the goodwill and strong feelings they had worked so hard to build over their 68-year history would serve as an insurance policy of sorts and keep customers flying the airline.

Employees. The Flight 261 tragedy literally shook the foundation of the organization. The integrity of the company was based on core values which included safety and performance, both of which were under scrutiny following the crash. In addition, 12 passengers on board Flight 261 were employees, and many people at the company were affected in a very personal way.

Together, Alaska and Horizon Airlines employed more than 16,000 people; making information available and accessible to staff was both a challenge and a priority. Among the company's principal means of communication with employees was the internal website, www.alaskaworld.com. This medium was mainly used to pass along information published and broadcast in the news media, as well as to keep everyone up-to-date on breaking news. The company also went on the road with a team of key managers to talk to employees in outstations about the accident and what they were doing to prevent future tragedies. Some supervisors at Alaska Airlines took it upon themselves to recommit their teams to the organizational values and held impromptu sessions with their direct reports to talk and listen to concerns. [18]

Community. Aviation has always been a cornerstone industry in the Puget Sound region, starting with William Boeing and the Boeing Company in the early 1900s and later with Alaska Airlines and Horizon Airlines in the 1930s. The company was proud of its Northwest heritage and being actively involved in the communities it served. It was important to the company that

the tragedy not negatively affect its relationship with the community. Rather, they hoped it would actually to bring them even closer to the people and places they served.

The FAA, NTSB, and ALPA

The Federal Aviation Administration (FAA), National Transportation Safety Board (NTSB), and the Air Line Pilots Association (ALPA) are all key players in the airline industry. These organizations and agencies are integral parts of the daily operations of every airline and play a more active role following accidents, as in the case of Flight 261.

Federal Aviation Administration. The FAA's mission is to provide a safe, secure, and efficient global aerospace system that contributes to national security and the promotion of U.S. aerospace safety. They are the leading authority in the aerospace community and promote aviation safety in the interest of the American public by regulating and overseeing the civil aviation industry. The FAA investigates airline policies and practices but is not directly involved in investigation airline accidents.[19] The policies and practices of Alaska Airlines at their Oakland maintenance base were part of an FAA probe prior to the crash of Flight 261. Some people within the FAA argued that the agency had a track record of treating Alaska Airlines with "kid gloves"[20] which led to speculation following the accident that the FAA should be forced to take some responsibility.

National Transportation Safety Board. The NTSB is an independent Federal agency charged by Congress with investigating every civil aviation accident in the United States and significant accidents in the other modes of transportation – railroad, highway, marine and pipeline – and issuing safety recommendations aimed at preventing future accidents. In the case of airline accidents, the agency investigates incidents that cause damage in excess of $10,000 or loss of life. The NTSB works with many different constituencies, and is responsible for the final report and causal analysis following their investigation.[21] The NTSB worked closely with Alaska Airlines in their investigation of Flight 261 and coordinated with the FAA to leverage the information they had obtained from their look into the airline's Oakland maintenance facility.

Airline Pilots Association. ALPA is a union representing 64,000 airline pilots at 42 U.S. and Canadian airlines. ALPA provides all of the traditional union representation services for its members, including lobbying airline pilot views to Congress and government agencies. The organization is also a proponent of aviation safety, with a network of more than 600 working airline pilots serving on local and national safety committees to carry out the safety work. ALPA is usually granted "interested party" status in most major airline accidents, which means that ALPA accident investigators assist National Transportation Safety Board staff at the on-site investigations and participate in the ensuing public hearings. ALPA has initiated or participated in most of the numerous safety improvements over the years that have made U.S. airline travel the safest mode of transportation.[22] Following the crash of Flight 261, the union (which does not normally criticize specific airlines for safety issues,) said that both Alaska Airlines and the FAA were to blame for the circumstances leading up to the accident. They essentially claimed Alaska Airlines fostered a culture that sacrificed safety for profits and said the FAA officials in Renton (near Alaska's company headquarters) had relationships with management at the airline that were "too close."[23]

The Alaska Airlines Brand

Customer service, safety and value are all principles core to the company's foundation. The concept of the "Alaska Spirit" is the essence of the Alaska Airlines brand.

> Alaska Spirit is the heart of Alaska Airlines. It springs from our rich heritage as a pioneer in a state where aviation plays a vital role in the life of every resident. Throughout our system, the Alaska Spirit defines the unique character of Alaska Airlines. Our fun loving, energetic, and adventurous personality flows from this spirit, as does our belief in service and community involvement. From our Alaska Spirit comes the pride, passion, and perseverance that sets Alaska apart.[24]

Alaska Airlines' company values are the Alaska Spirit, resourcefulness, integrity, professionalism and caring. Safety, continual improvement, quality people, profitability, quality service and reliability are all considered critical success factors to the company. The mission statement and critical success factors were developed by employees and are highly regarded as guidelines for the actual business model.

Changes Since Flight 261

One of the very first steps CEO Bill Ayer took following the accident was to create a position for the Vice President of Safety who reports directly to him, as well as to institute a safety committee within the Board of Directors, one of the few carriers to do so. Furthermore, the company employed 300 additional maintenance personnel, and increased the quality assurance staff five-fold. The company also conducted an internal self-audit of their safety and operational processes, and commissioned an outside review of their safety precautions. The external review recommended 175 specific changes, all of which were completed.

Critical Moments in Company History

The Flight 261 tragedy was not the first crossroads in company history. Airline deregulation in 1978 gave Alaska Airlines, which was then a small west coast carrier, a chance to grow and compete with the largest airlines in the world. The merger and acquisition frenzy that grew out of deregulation hit its peak in the 1980s, and Alaska Airlines avoided the fate of airlines such as AirCal, Ozark, Pioneer, Capitol Airlines, Jet America and many others. When code sharing became popular in the early 1990s, Alaska teamed with Northwest Airlines, American Airlines and Continental to form strategic relationships. The company also started its frequent flier program and became known as the "Switzerland of Airlines" for its ability to maintain friendly relationships with the competition while quietly competing at the same time.

The Persian Gulf War and the skyrocketing price of oil was the first sign to Alaska Airlines of the importance of managing costs in an industry with high operating leverage. Ray Vecci, CEO of Alaska Airlines at that time, proved to be visionary in his thinking. Vecci was convinced the marketplace was moving toward low fares and prices, and was able to lower costs and increase productivity at the company. His vision ultimately cost him his job, but Vecci returned the struggling airline to profitability.

After years of profitability and growth, the events of September 11, 2001 hit the airline industry hard. While furloughs and bankruptcy became common place in the industry, Alaska Airlines managed to keep their workforce intact and even expand to new cities in the down market. However, the airline was struggling to remain profitable. The company was forced to take government relief and management struggled with the inevitable question: how to reduce costs without compromising the Alaska Spirit?

Alaska Airlines Today

Three weeks after September 11, 2001, Ayer met with top management to discuss strategy for the future. While the implementation took a new direction, the goals themselves remained relatively unchanged:

- To be number one in safety compliance;
- To work together to build a company where everyone is valued, committed, and connected;
- To achieve a cost structure that supports profitable growth; and
- To differentiate to enhance revenue and customer satisfaction. [25]

The vision of creatively cutting costs while adding value for customers has taken the form of several new routes, promotional partnerships, and value-added services. In June of 2003, Alaska announced two new routes: Los Angeles-to-Reno and Vancouver-to-Anchorage. Later that year, Alaska Airlines offered additional flights to Denver, Portland, and Anchorage primarily targeting business travelers. In addition, after remaining almost exclusively in the Pacific Northwest, Alaska Airlines began twice daily service between Seattle and Chicago on April 26, 2004. In addition, Alaska's codeshare agreement with American Airlines allowed passengers dozens more cities, and expanded Alaska's east-west service, while their electronic ticketing agreement with Hawaiian Airlines simplified travel arrangements for customers flying to the Hawaiian Islands. In another strategic partnership move, the company partnered with Walt Disney World Resort in Florida to promote savings on vacation packages. These partnerships and expansions have propelled Alaska Airlines to become the nation's ninth largest carrier.

Alaska Airlines also led the industry in marketing and technology. They were named the 2003 Technology Leader of the Year by *Air Transport World* magazine, and Alaska Air Group Web sites (www.alaskaair.com and www.horizonair.com) received top ranking in the Online Customer Respect Study.[26] Most recently, the company has created an innovative, tongue-in-cheek promotional campaign centered on a fictional airline company, SkyHigh Airlines. The innovative commercials depict the worst-case flying situations, and the website paints a picture of an airline with high prices and horrible customer service. The campaign has enjoyed a small cult following, and increased awareness of Alaska Airlines.[27]

As testament to Ayer's teams' dedication to meeting their goals, Alaska Airlines was named second in the industry Airline Quality Rating for 2004.[28]

Financials

Following the Flight 261 tragedy, Alaska Airlines' stock price remained relatively stable. The day after the accident, the stock price hit $32.50, up from the previous week's price. However, the start of the economic downturn and the public scrutiny following the accident took its toll as the stock slowly lost 36% of its value and hit $20.81 in October of 2000. The stock managed to climb its way back to $30.40 on September 10, 2001. However, when the markets reopened following the terrorist attacks, the stock took a dive and hit a price of $18.70.

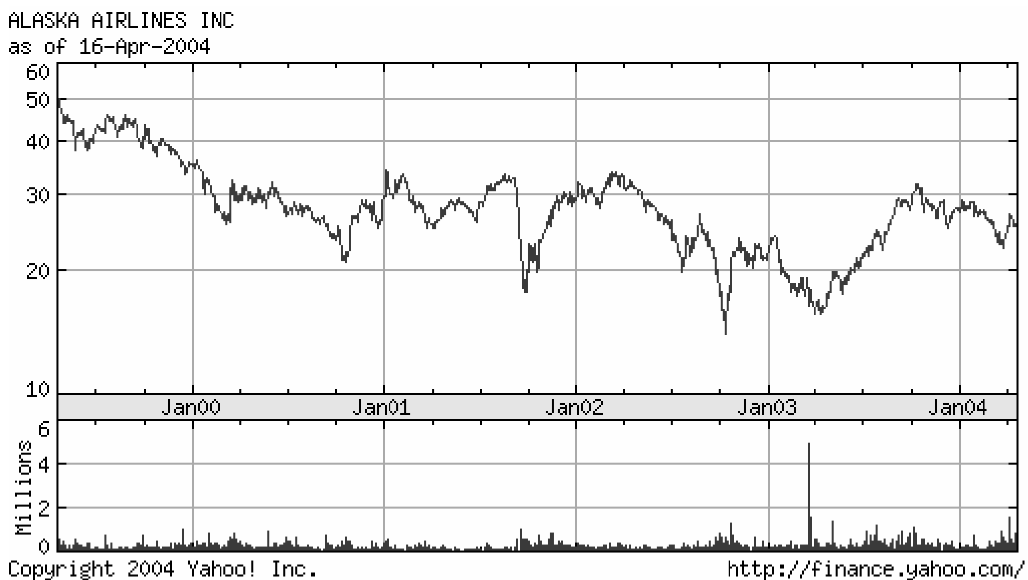

Figure 1: Alaska Airlines financial performance, Q2/1999 through Q1/2004.
Source: Yahoo Finance. Used by permission.

Alaska Airlines has also been hit hard on the income statement. The company posted operating losses of $126.3, $88.9, and $11.1 million in 2001, 2002 and 2003 respectively.[29] Much of the losses can be attributed to tough economic times, the post 9/11 decline in travel and the changing landscape of the industry.

2003 was the fourth consecutive unprofitable year for Alaska Airlines. The company is now struggling to dramatically lower costs as price has become the primary factor in the consumer decision-making process. The challenge in the future will be to adjust the business model without compromising the high level of quality and service, culture, and values Alaska Airlines is known for.

Discussion Questions

In 1985, Alaska Airlines was a profitable airline with load factors at 50%; by 2003, the company was struggling to keep its head above water with load factors above the 70% level. The model of

the low-cost carrier seemed to be signaling the future of the industry. Could Alaska Airlines take the same route without sacrificing the service and quality they had become known for? How could they leverage their colorful history in the changing market place?

Retrospective Questions

- Did Alaska Airlines pursue the right set of actions following the crash of Flight 261?
- What did they do well? What could they have done better?
- Did the company correctly identify and prioritize the stakeholders?
- If you were Lou Cancelmi, what message would you have communicated to the public following the accident? What means would you have used to convey the message?
- What role did the media play in the events subsequent to the crash?
- How do you assess the assignment of blame and Alaska Airlines' position in the matter? What challenges surfaced with stakeholder relations given Alaska Airlines' insistence on their safety procedures?
- What metrics would you have used to measure the success of the company's stance?

Prospective Questions

- Going forward, what challenges does Alaska Airlines face?
- How can the company preserve its core values and identity while growing so rapidly?
- What actions can the company take to overcome tightened security, increased competition, downward trending stock prices, and increased costs?
- What do you predict will be the result of the new marketing strategy?
- Can Alaska Airlines form alliances to promote travel and tourism? With whom?

Figure 2: Alaska Airlines/Horizon Airlines Route Map (2002)

Alaska Airlines Financial Highlights 2002

(In Millions, Except Per Share Amounts)	2001	2002	% Change
Revenues and Income			
Operating revenues	$2,152.8	**$2,224.1**	3.3%
Operating expenses	2,279.1	**2,313.0**	1.5%
Operating loss	(126.3)	**(88.9)**	NM
Net loss before accounting change	(43.4)	**(67.2)**	NM
Net loss	(43.4)	**(118.6)**	NM
Basic and diluted loss per share(a)	(1.64)	**(4.47)**	NM
Average number of common shares outstanding — Basic and diluted	26.5	**26.5**	0.0%
Assets and Equity			
Total assets	$2,950.5	**$2,870.8**	– 2.7%
Total shareholders' equity	851.3	**655.7**	– 23.0%
Return on shareholders' equity	– 5.1%	**–18.1%**	– 13.0%
Book value per share	$ 32.09	**$ 24.68**	23.1%
Debt/equity ratio(b)	72%:28%	**77%:23%**	NA
Employees at year end	13,879	**13,618**	1.9%
Shareholders of record at year end	4,230	**4,243**	

NM = Not Meaningful

(a) For 2002, basic and diluted loss per share include $(1.94) per share for the $51.4 million cumulative effect of accounting change for the write-off of goodwill resulting from the adoption of Statement of Financial Accounting Standards No. 142.

(b) Debt/equity ratio assumes aircraft operating leases are capitalized at seven times annualized rent and excludes current portion of long-term debt and capital lease obligations.

Figure 3: Financial Highlights from 2002 Annual Report

Alaska Airlines Codesharing Agreements as of 2003

	Frequent Flyer Agreement	Codesharing— Alaska Flight # on Flights Operated by Other Airline	Codesharing— Other Airline Flight # On Flights Operated by Alaska/Horizon
Major U.S. or International Airlines			
American Airlines/American Eagle	Yes	Yes	No
British Airways	Yes	No	No
Cathay Pacific Airways	Yes	No	No
Continental Airlines	Yes	Yes	Yes
Hawaiian Airlines	Yes	Yes	Yes
KLM	Yes	No	Yes
Lan Chile	Yes	No	Yes
Northwest Airlines	Yes	Yes	Yes
Qantas	Yes	No	Yes
Commuter Airlines			
Era Aviation	Yes*	Yes	No
PenAir	Yes*	Yes	No
Big Sky Airlines	Yes*	Yes	No
Helijet International	Yes*	Yes	No

* This airline does not have its own frequent flyer program. However, Alaska's Mileage Plan members can accrue and redeem miles on this airline's route system.

Figure 4: Codesharing and Frequent Flyer Agreements

Alaska Airlines Fleet

Aircraft

The following table describes the aircraft operated and their average age at December 31, 2002.

Aircraft Type	Passenger Capacity	Owned	Leased	Total	Average Age in Years
Alaska Airlines					
Boeing 737-200C	111	8	1	9	21.9
Boeing 737-400	138	9	31	40	7.7
Boeing 737-700	120	16	—	16	2.6
Boeing 737-900	172	6	—	6	1.3
Boeing MD-80	140	15	16	31	12.0
		54	48	102	9.1
Horizon Air					
Bombardier Dash 8-100/200	37	—	28	28	4.8
Bombardier Dash 8-400	70	—	15	15	1.4
Bombardier CRJ 700	70	—	16	16	1.0
Fokker F-28	70	4	—	4	21.2
		4	59	63	4.1

Figure 5: Alaska Airlines Fleet

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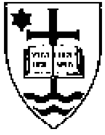
Amtrak Acela: The Challenge of High-Speed Passenger Rail Service
Benson, A.; Hermo, J.; and O'Rourke, J. S. (editor)

In August of 2002, maintenance workers find fractured locomotive brackets and brake discs on Amtrack's high-speed Acela line between Washington and Boston. As a result, the Acela is taken out of service for three years and Amtrak continues to lose money and struggle with funding for everything from infrastructure maintenance to passenger service amenities. CEO David Gunn is faced with the most critical circumstances in the 34-year history of the troubled passenger rail service. While Japanese and European high-speed train services continue their profitable operations, the United States has yet to devise a model that works. Brand strategy and building trust are at the center of the challenge for Amtrak. 9 pp. #06-05. (2006).



Eugene D. Fanning Center for Business Communication **06-05**
Mendoza College of Business
University of Notre Dame

Amtrak Acela:
The Challenge of High-Speed Passenger Rail Service

"The news of the crack in the Acela Express couldn't have come at a worse time for those hoping for the revival of passenger rail in the US. But having served on the Amtrak Reform Council, I wasn't surprised." [1]

John O. Norquist, the former mayor of Milwaukee, Wisconsin and a founding member of the Amtrak Reform Council, expressed his dismay when he heard the news of the broken Acela high-speed trains. In August 2002, Acela Express maintenance workers found fractured locomotive brackets on several of the trains while performing routine inspections.

The fractured brake discs caused the high-speed train service between Boston, New York, and Washington, D.C. to halt indefinitely, less than three years after the service began. Customer faith that Amtrak would ever consistency and conveniently provide high-speed train travel halted along with the Acela trains, costing Amtrak millions in desperately needed revenues for the struggling company. Overall, it would take Amtrak three years to fully restore the Acela Express service to the Northeast Corridor.

Indeed, the 34-year history of Amtrak has been characterized by foregone opportunities, lackluster customer service, Congressional disappointment, and an aging fleet of passenger cars. Pressure from legislators, government officials, and loyal Amtrak passengers is mounting, as Amtrak may lose the federal funding on which it has always depended. Amtrak must make critical decisions today to ensure a brighter, more profitable future than it has ever known throughout its history.

The Concept: High-Speed Trains

While steep gas prices and corporate financial woes shake up the airline industry, high-speed train travel has the potential to provide a viable alternative for both business and leisure travelers throughout the United States. Currently, high-speed train travel would be marketed heavily to

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This case was prepared by Research Assistants Ann Benson and Jessica Hermo under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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business commuters throughout major metropolitan areas, but could eventually be expanded overall to include interstate travel. Most of today's high-speed trains travel at a rate of approximately 150 miles per hour. High-speed train travelers demand reliable, timely, and frequent service between many epicenters of commerce throughout the United States. Today, Amtrak offers one high-speed train service, the Acela Express. Acela's updated Express Service operates 14 weekday round-trip routes between Washington, D.C. and New York City, as well as eight weekday round-trips between Boston, New York City, and Washington, D.C. In addition, Acela runs approximately 10 Saturday round-trips between the three Northeast Corridor cities. While the concept of high-speed train travel is not brand new, there is an increasing demand both in the United States and worldwide for alternatives to airline travel, and the potential for reliable, high-speed rail service is greater than ever before.

Acela: What Has Gone Wrong?

Amtrak's Acela high-speed train service has faced a number of hurdles to profitable operation. Disagreements regarding federal subsidies have created profitability issues for Amtrak as a whole; while Amtrak argues the government is not subsidizing rail travel enough in comparison to other forms of transportation, the U.S. government is considering eliminating funding to Amtrak altogether. Amtrak's inability to survive on current government-subsidized funding has led directly to Acela's sub-par fleet maintenance and unreliable service. Amtrak's cost structure is also causing strain on Acela's profitability. Amtrak's food service employees are paid well above the industry average, at a rate of approximately 3.5 times the $15,000 annual compensation average for restaurant workers.[2] These compensation and salary expenses are proving to be a heavy burden for Amtrak's profits. Amtrak has also been unable to return a profit on food and drink services on its Acela routes because of the high cost of union labor contracts and the time-consuming nature of preparing food supplies for the trains' trips.[3]

While the disruption of the Acela Express service due to cracked train brackets was critical for passenger safety, Amtrak swallowed huge losses by halting its high-speed service. Acela accounts for more than twenty percent of Amtrak's ticket sales. Amtrak estimates that the company lost roughly $1 million per week by withdrawing the Acela from service. Acela's brake problems and additional technical difficulties on its trains, including malfunctioning bathroom doors and other on-board glitches, have cost the high-speed service legitimacy and confidence among passengers. While Acela has been on hiatus for repairs, Metroliner trains have replaced the high-speed trains. The Metroliner trains travel at a slower rate than the Acela and add at least 15 minutes to a traveler's commute between Washington, D.C. and New York.[4] Critics now contend that Amtrak has been unable to sustain a healthy demand because of its inability to provide timely, reliable, comfortable services for passengers.

History of Passenger Rail Service

Throughout the 20th century, passenger train service has struggled to remain competitive with other forms of transportation. Between 1920 and World War II, ridership decreased significantly as automobiles became more popular. During World War II, passenger rail service experienced a surge in ridership, as automobile use was curtailed due to fuel and car materials rationing. The average number of miles traveled by passengers on intercity railroads was 67 billion miles per year during the war. The past average of miles traveled by passengers on intercity railroads in

the years before the war was 19 billion per year.[5] Figure 1 (below) shows the influx of passengers using rail service during the war years.

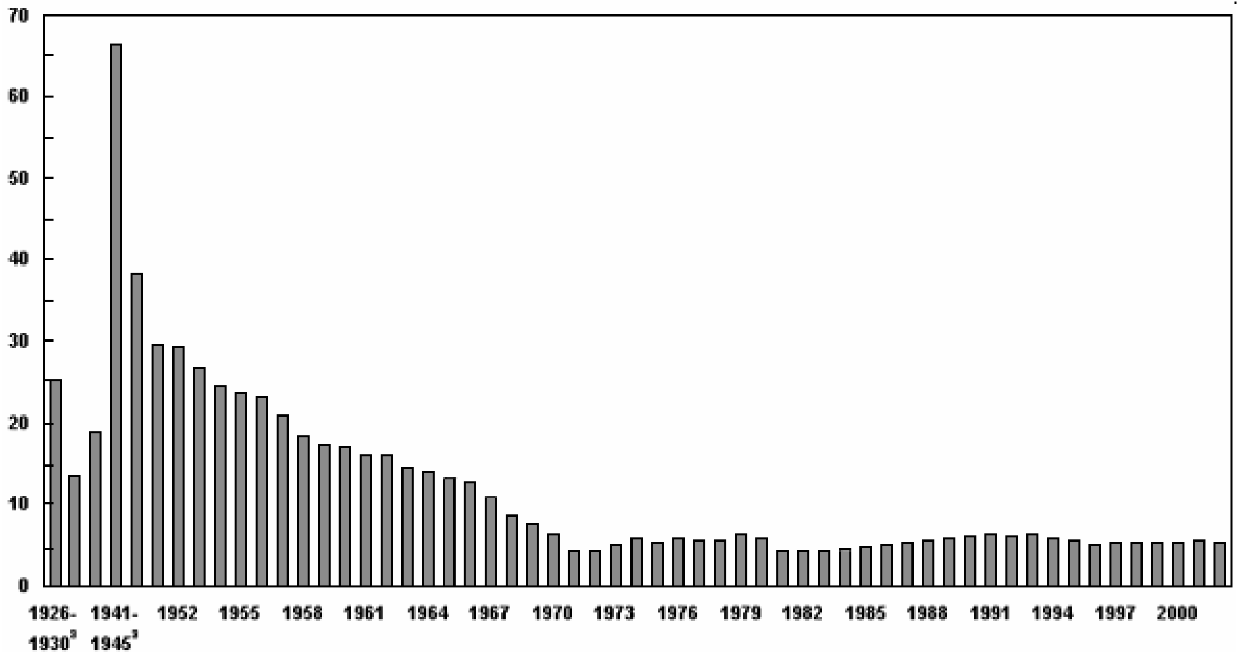

Figure 1: Intercity Railroad Passenger-Miles, 1926-2002

After World War II, passenger rail service returned to a low level of ridership. Most railroads offered both passenger and freight service, and both decreased in popularity during the mid-20th century. In 1956, the federal government began constructing the interstate highway system, making long distance automobile travel a more popular form of transportation. Long-distance trucking services became more convenient, threatening the popularity of freight train service. The airline industry also increased its popularity among travelers: by 1960, airlines provided 31 billion passenger-miles, compared to 17 billion passenger-miles for rail service. See Figure 2 (below) for a comparison of passenger-miles for airline, bus, and railway transportation for 1960-2000.[6] Both highways and aviation benefited from federal subsidies, whereas rail service did not.

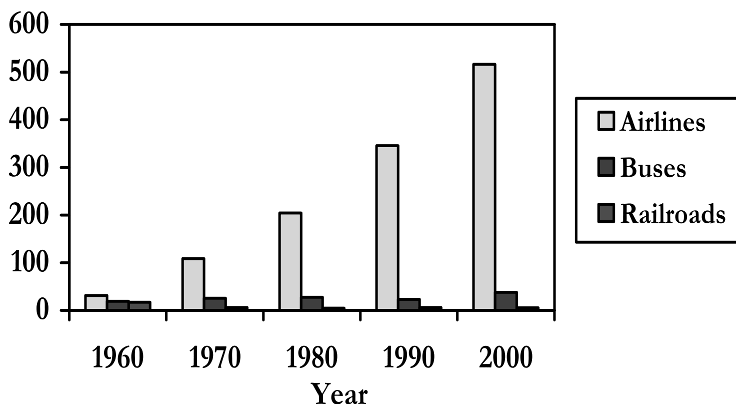

Figure 2: Domestic Intercity Travel by Air, Bus, and Rail, 1960-2000

With the rise in automobile and airline use, passenger railroads struggled to generate profits. In 1957, the two largest railroads in the country announced a merger to improve efficiency and eliminate excess capacity in regions overtaken by stiff competition from truckers. The Pennsylvania Railroad merger with New York Central was approved in 1962 and Penn Central was formed in 1968.[7] However, the promised efficiencies did not produce an increase in profitability. In 1970, Penn Central filed for bankruptcy due to struggles in merging the corporate cultures of the two firms. It was the largest corporate bankruptcy in U.S. history at that time.

Congress became concerned that the bankruptcy and loss of passenger rail service would cause the entire rail system to weaken, and the government wanted to relieve freight railroad companies of that burden. Thus, the Rail Passenger Service Act of 1970 created Amtrak. Amtrak began service on May 1, 1971.[8] The Congressional creators of Amtrak expected it to achieve self-sufficiency and operate as a private entity without subsidies within a few years. Then Secretary of Transportation, John Volpe, maintained that Amtrak "could be profitable in perhaps three years."[9]

Congressional optimism concerning the profitability of Amtrak was far from accurate. In 1972, Congress passed legislation granting Amtrak an additional $265 million in appropriations and $200 million in loans. In 1973, the Amtrak Improvement Act authorized an additional subsidy of $334.3 million and increased Amtrak's outstanding loan to $500 million. In 1976, the Railroad Revitalization and Regulatory Reform Act granted Amtrak the rights of way, tracks, and facilities between Boston and Washington, D.C. which comprised the "Northeast Corridor." Finally, by 1978, Congress had lost their optimism regarding Amtrak's self-sufficiency in the near future. The Amtrak Improvement Act amended Amtrak's legislative requirement that the company "shall be a for-profit corporation" to provide that the company be "operated and managed as a for-profit corporation."[10] Between 1971 and 2005, Congress awarded Amtrak a total of $30 billion in federal subsidies. In the same time period, Congress granted about $2 trillion to aviation and highways.[11] Currently, Amtrak is still dangerously close to bankruptcy.

High-Speed Models That Work

While Amtrak has yet to reach its full potential with the Acela service, many countries have been able to make high-speed train travel both successful and profitable. One of the most successful high-speed train models is the Shinkansen train of Japan. The Shinkansen provides on-time, reliable service to its passengers between Tokyo and Osaka. Observers say it is even possible to mistake the Shinkansen for a metro train because of its very frequent departures throughout the day, and the fact that the train stops for only 3-to-4 minutes at most stations.[12] The Shinkansen's reliable schedule and profitable cost structure are what set it apart from other current models of high-speed train travel, in addition to many special amenities to accommodate passengers. The cabins of the Shinkansen trains are spacious, equipped with reclining seats and satellite phones. Each car also has call buzzers, seat cleaners, and both hot and cold water. The inner surface of most doors have monitors displaying station names, and the train cars are doubly reinforced with aluminum alloy to block outside noises.[13]

High-speed train travel has also gained acceptance throughout Europe, with the Eurostar rail lines and France's TGV. The Eurostar serves the United Kingdom, France, and Belgium with affordable high-speed train routes. Both of these models boast on-time service and affordable rates for business and recreational travelers. Currently, the Eurostar is in the process of

segregating business and leisure travelers into different train cars in order to better serve each target market's needs. Even with Europe's low-priced economy airlines, Eurostar and the TGV are still able to remain in operation and provide reliable service to customers.

High-speed train travel is gaining popularity throughout the world as a viable alternative to other forms of mass transportation. Russia, Turkey, and South Africa are in the process of developing profitable high-speed railway models. Legislators in New York have discussed a high-speed route from New York City to Albany, and commuters in Florida have lobbied for high-speed rail service between popular Floridian metropolitan areas.

Alaskan Railways has created an innovative and successful model for profitable train travel through partnership with local tourism outlets. Alaskan Railways is currently running in conjunction with Alaskan cruise lines to provide train service throughout the Alaskan landscape to cruise passengers. In 2003, Alaska's railroad system was more profitable than 31 of Amtrak's 40 routes. While Alaskan Railways utilizes regular rather than high-speed trains, this partnership of train travel with tourism is an intriguing model for success.

Current Strategy

Amtrak CEO David Gunn began cutting costs upon his appointment as CEO in 2002. He has since cut the workforce by 5,000, terminated once-profitable mail and express operations, and eliminated three long distance train routes. Under his leadership, Amtrak boosted ridership from 22.5 million in 2000 to 25.1 million in 2004. Though this seems promising, the increased ridership of 12% corresponded to federal funding increases of 45% from 2002-2004.[14] In 2005, federal funding totaled $1.2 billion.[15]

In January 2005, Gunn implemented a strategy of delaying capital projects to stay within budget. A spokesman for Amtrak reported that any service cuts made would not provide the necessary funds for structural repairs needed, because service contracts required workers to be paid a minimum portion of their salary for several years into the future. Congress appropriated $1.207 billion for Amtrack in 2005, which amounts to $600 million less than Gunn insisted would be necessary for Amtrak to operate in 2005.[16]

Government leaders and Amtrak executives have differing views concerning how Amtrak should be handled in the future. In July 2005, President Bush proposed to sharply cut Amtrak's federal budget, causing Amtrak to either find state funding or become privatized.[17] Kenneth Mead, Department of Transportation Inspector General, believes Amtrak could reduce its operating costs by up to $158 million a year if it eliminated dining cars, sleeping cars, and other long-distance service amenities.[18] Mead suggests that Amtrak directors discuss options of outsourcing food, increasing food prices, or selling pre-packaged meals to cut costs. He maintains that Amtrak is wasting money on upgrading sleeping cars while ignoring crucial bridge, tunnel, and structural repairs in the Northeast Corridor. Congress has thus far resisted Amtrak spending cuts.

Amtrak has recently proposed a plan of reformation encompassing structural, operating, and legislative initiatives in order to make Amtrak a sustainable business model. Structural initiatives include better management controls with fewer management layers, an increased focus on core business goals, and capital programs to encourage cost savings. Amtrak is also looking to assign planning and reporting duties by business line, in order to more appropriately place performance accountability and to advance efficiency and competition. Through these structural

initiatives, Amtrak hopes to outsource some of its services to provide much-needed revenue and expense improvements.

Amtrak's operating initiatives include long term goals of state-led corridor development based on a federal capital matching grant program. Currently, Amtrak proposes an 80 percent - 20 percent split between federal and state funds, respectively. Amtrak is also urging states to agree to cover all operating losses incurred, excluding interest and depreciation. More short-term operational improvements include a more customer service-oriented workforce, many food service modifications, and a unit pricing scheme using an activity based costing system. Amtrak also hopes to achieve national long distance operations and better infrastructure management.

Amtrak's legislative goals include federal assistance with funding and reauthorization. Amtrak is seeking to utilize the 80%/20% federal-state matching program discussed above, as well as a better platform for competition among existing rail services. Amtrak says clearly in its strategic plan that without increased federal funding assistance, it will be unable to continue operations.[19]

Because of rising fuel prices resulting from Gulf Coast damage from Hurricanes Katrina and Rita, economists and capital markets experts think that the airline industry will be hardest hit. With the right strategy, Amtrak may be able to capitalize on increased airline and automobile travel costs, and therefore save itself from bankruptcy.

Recent Developments

On November 9, 2005, CEO David Gunn was unanimously and unceremoniously fired by Amtrak's Board of Directors. This decision came following resentment by Gunn to government cost-cutting proposals for Amtrak. Amtrak Chairman David M. Laney explained that Gunn was terminated because of "the things that David was not seeing done or resisting from being done that led us to conclude that he's not the right guy at the helm as we try to move forward."[20] David Hughes, Chief Engineer for Amtrak, is serving as an interim president and CEO until a permanent replacement is found. Amtrak's future has become more uncertain in light of the recent termination of Gunn, originally believed to be capable of ensuring a profitable future for Amtrak.

Discussion Questions

1. Who are the key stakeholders to which Amtrak must attend in order for the company to survive?

2. Consider Amtrak's current plan for restructuring. Is it sufficient? What are the plan's strengths? Weaknesses?

3. What is the best strategy for Amtrak to become profitable?

4. What are the responsibilities of Amtrak's communication team in this restructuring process?

5. What is Amtrak's brand strategy? What should it be?

6. How can Amtrak build trust in its Acela service?

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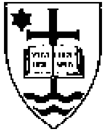
JetBlue: Balancing Passenger Privacy and Airline Security
Morales, S. M.; Somerville, N. R.; and O'Rourke, J. S. (editor)

In the aftermath of the attacks of 9/11, security on the nation's commercial airlines becomes a significant issue for the government, the carriers, and passengers who fly each day. In response to a request from a U.S. Defense Department contractor, JetBlue turns over detailed information about passengers traveling on the discount carrier, including travel dates, destinations, home addresses and credit card numbers. After initially denying the charge, JetBlue officials later defend their actions. Privacy advocates, homeland security officials, and other commercial airlines wait for public reaction to JetBlue's actions and statements. 9 pp. Case #04-06. (2004)



Eugene D. Fanning Center for Business Communication **04-06**
Mendoza College of Business
University of Notre Dame

JetBlue:
Balancing Passenger Privacy and Airline Security

On September 19, 2003, JetBlue Airways publicly acknowledged it had provided the travel records of five million customers to Torch Concepts, a private sub-contractor to the U.S. Department of Defense. The transfer of sensitive passenger data not only violated JetBlue's own privacy policy, but left JetBlue under investigation for violation of The Privacy Act and other Federal Privacy Laws. An investigation is still underway.

JetBlue: Not Your Typical Low Cost Airline

A low-fare, low-cost passenger airline, JetBlue offers a high level of customer service and convenience at a fraction of the price. Based out of New York City's John F. Kennedy International Airport, the start-up airline took their inaugural flight February 11, 2000 from Kennedy International to Ft. Lauderdale, FL. The brainchild of CEO David Neeleman, JetBlue launched with the largest capital funding in aviation history, close to $130 million. In an effort to reduce repairs and make passengers' overall flying experience more attractive, JetBlue purchased a fleet of spanking new Airbus A203s for its original fleet. Neeleman, reeling from a nasty experience in a urine soaked cloth seat, insisted on all-leather seats, with plenty of leg room. Coining itself, "First Class for Coach Costs," JetBlue equipped every seat with live satellite television and a personal remote for every passenger. JetBlue currently operates a fleet of 47 Airbus A320 aircraft to 26 major destinations throughout the United States.

Ascending the Podium, Again and Again

Since its inception, JetBlue has been the airline industry's annual prom queen. In 2000, the year the start-up airline first took flight, they were deemed the "It" airline by Vanity Fair's 2000 It List. In 2001, JetBlue was named "Best Domestic Airline - Coach" by Cónde Nast Traveler and "#2 Domestic Airline" by Zagat among others. 2002 saw similar awards for Jet Blue. "Best Domestic Airline" and "Best Value for Cost" by Cónde Nast Traveler, "#2 Domestic Airline,"

This case was prepared by Research Assistants Sabrina M. Morales and Nora R. Somerville under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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by Travel & Leisure, 2003 World's Best Awards, and "IPO of the Year," by Corporate Finance, as well as several awards from, "Outstanding In-flight Entertainment" to "Best Cabin Staff in North America."

David Neeleman: Not Your Typical CEO

JetBlue CEO, David Neeleman, is not your typical CEO. He often climbs aboard JetBlue flights, spending time each week passing out pretzels and chatting with his customers. Nor is he a newcomer to the low-cost air carrier industry.

In 1984, while in his 20s, Mr. Neeleman co-founded Morris Air, a small, low-fare carrier out of Salt Lake City, Utah. During this time, he developed and implemented the airline industry's first electronic ticketing system and pioneered a unique reservation system. This reservation system is now the foundation of JetBlue's call center, where all calls made to the reservation number are answered by reservationists working out of their homes.[1]

Morris Air was sold to Southwest Airlines for $129 million in 1993.[2] Neeleman briefly joined Southwest before parting with a non-competing contract stating he could not work for a contending airline for 5 years following his departure from Southwest. During this 5-year period Mr. Neeleman did consultative work for a new, low-fare Canadian airline, West Jet. He also helped to develop Open Skies, an innovative touch-screen check-in system which was sold to Hewlett Packard in 1999.[3] In that same year, Neeleman brought his vision of high quality service and low fares to one of the country's largest and most competitive aviation markets—New York City.

JetBlue Takes Flight

Based on his previous industry experience and proven track record, Neeleman was able to garner $130 million in capital funding from various investment institutions. Despite his successful fund-raising efforts, Neeleman had no management team, no planes, and no airport slots for take-off and landing. Neeleman scrambled to pull together a team of industry veterans. Dave Barger flew from Continental and signed on as COO; John Owen departed from Southwest to join JetBlue as CFO; and Ann Rhoades, also from Neeleman's days at Southwest, came on to handle JetBlue's human resources department.[4] Unusual for a start-up airline, Neeleman paid his management team more than their industry counterparts and offered them profit-sharing and stock options upon the airline's initial public offering as further incentive. "It's critically important to get everybody involved with the company," he said. The start-up airline became profitable 6 months later. [5]

Torch Concepts

Although there have been numerous accounts of what transpired prior to the data transfer, no definitive report has been issued. What is clear is that the Department of Defense, on behalf of the Army, requested a major military contractor, SRS Technologies, to sub-contract Torch Concepts to build a pattern recognition technology. Torch Concepts, a content management and information mining organization out of Huntsville, Alabama, was sub-contracted by the U.S. Department of Defense, through SRS Technologies, to compile and analyze random airline passenger data and create a risk assessment technology to determine the potential threat airline

passengers pose to domestic military base security. A press release issued by Torch Concepts May 8, 2002 stated the Torch-built system would identify "abnormal events or activities that may include rebel actions before damaging events occur." To do this, the contractor would apply "intelligent pattern recognition in identifying latent relationships and behaviors that may help point to potential terrorist threats." [6]

This military effort closely resembled methods used in The Defense Advanced Research Projects Agency's (DARPA), the central research and development agency for the U.S. Department of Defense, Terrorism Information Awareness program (TIA), to research "data search and pattern recognition technologies . . . based on the idea that terrorist planning activities or a likely terrorist attack could be uncovered by searching for indications of terrorist activities in vast quantities of transaction data."[7] However, DARPA affirms that TIA's research and testing activities only use data that is either (a) foreign intelligence and counter-intelligence information legally obtained and usable by the Federal Government under existing law, or (b) wholly synthetic (artificial) data that has been generated, for research purposes only, to resemble and model real-world patterns of behavior.[8]

JetBlue and Torch maintain that the intent of the study was to help the Department of Defense with a project regarding military base security. Army spokesman, Maj. Gary Tallman, said the information was used by Torch Concepts to test a prototype of a data-mining system designed to screen out terrorists who might want to infiltrate or attack Army bases worldwide and not for the TIA database.[9] DARPA spokeswoman, Jan Walker, also denied any connection between DARPA and the research involving JetBlue passenger data.[10] To many, it remains unclear how an airline passenger-screening feasibility study without any references to the military relates to an Army feasibility study.

The Data Transfer

In order to obtain the JetBlue passenger records to populate their risk assessment technology, Torch contacted the Transportation Security Administration (TSA), who then requested the information from JetBlue and facilitated the transfer of five million passenger records to Torch Concepts.[11] Personal passenger information including name, address and birthdate, along with flight data was then married with more detailed data extracted from private databases purchased from database management firm, Acxiom.[12] Torch Concepts explains that the JetBlue passenger information was authenticated and augmented with Axciom data in order to determine gender, home specifics (renter/owner), years at residence, income level, number of children, SSN, number of adults in the home, occupation, vehicles owned, and so on, for approximately 40% of the JetBlue passenger database.[13]

Acxiom

Acxiom is one of the largest data aggregating companies in the United States. Founded in 1969 in Little Rock, Arkansas, Axciom employs nearly 5,000 people and has offices all over the world. Acxiom uses collected customer data to build and sell consumer databases. Torch Concepts purchased an extensive database from Acxiom to augment JetBlue passenger records with information including: gender, whether the passenger was a home owner or renter, years at the residence, income, number of children, Social Security number, occupation and vehicle information. According to Dale Ingram, Acxiom spokesman: "Our policy clearly states that we

'provide information products which include financial information, Social Security number and other related information where permitted by law' and that this information is 'provided to government agencies for the purposes of verifying information, employment screening and assisting law enforcement.'"[14] Acxiom, however, is currently under investigation by the Federal Trade Commission for violating its own privacy policy by selling the JetBlue passenger information contained in private databases.

The TSA and CAPPS II

The Transportation Security Administration (TSA) is the federal agency in charge of airline and airport security. The TSA is responsible for managing information assessed by the Computer Assisted Passenger Prescreening System (CAPPS II), a controversial proposed government system to prevent terrorism by color-coding airline passengers according to their risk level. CAPPS II is designed to keep terrorists off commercial aircraft, while also flagging violent criminals with outstanding federal or state arrest warrants for law enforcement action.[15]

Torch contacted the TSA in the summer of 2002 for airline industry contacts and the agency complied with the request, but "that was the extent of our involvement," TSA spokesman Nico Melendez said.[16] Despite denials from the TSA, Torch, and JetBlue, widespread press speculation contends that JetBlue passenger data was requested to further the CAPPS II development.

Homeland Security: Airline Passenger Risk Assessment

The culmination of Torch's efforts and the extent of JetBlue's violation of passenger privacy were seen in February 2002 at a conference organized by the Tennessee Valley chapter of the National Defense Industries Association. Torch presented a paper at the conference under the title, "Homeland Security: Airline Passenger Risk Assessment." The paper, which JetBlue said was based on unauthorized use of their passenger data, included sensitive information from JetBlue passengers, and was later published on a web site, and left there for nearly 6 months.[17] The paper was discovered by a privacy activist and reported to *Wired* Magazine, which then published the groundbreaking article on September 16th.

A Patriotic Violation of Privacy?

The news of the JetBlue passenger data transfer broke in an article published on September 16th by *Wired* Magazine. Shortly thereafter, JetBlue customers began to raise concerns regarding the dissemination of their personal information and express betrayal by the company. JetBlue management confirmed that following the release of the *Wired* article, the airline received over 2,000 emails from angry passengers and privacy advocates demanding an explanation (and apology) for Jet Blue's violation of its own privacy policy.[18]

Angry passengers immediately began to take legal action against JetBlue. Class action lawsuits emerged in both Los Angeles and Salt Lake County Courts. Accusations against the airline included breach of contract, violation of policy, and fraudulent misrepresentation.[19] Privacy and human rights groups, including the Electronic Privacy Information Center and the American Civil Liberties Union, filed complaints with the Federal Trade Commission. In turn, the FTC was asked to further examine the situation, as JetBlue's privacy violations served as

grounds for an unfair business practice investigation and could be in violation of the Federal Trade Commission Act.

Legal Issues

JetBlue is currently under investigation by the Federal Trade Commission for violation of its own privacy policy. Under section 5 of the Federal Trade Commission Act, the FTC is responsible for guarding against unfairness and deception by enforcing companies' privacy promises about how they collect, use and secure consumers' personal information. In addition, both JetBlue and the TSA are under investigation by the Department of Homeland Security for violation of The Privacy Act. Provisions of the Privacy Act state that new government databases generally cannot be created in secret. Furthermore, there is ongoing inquiry into how JetBlue passenger data was relevant to the Army's mission of assessing the risk airline passengers pose to military base security.

JetBlue's Response

Less than one week after the news of the data transfer broke, JetBlue hired Deloitte & Touche to assist with the revamping of their privacy policy.[20] In an effort to further diffuse the situation, CEO David Neeleman personally responded to each of the 2,000+ passenger emails. In his email he offered an apology for JetBlue's decision to release the passenger records to the army sub-contractor.[21]

As a New York City-based airline, JetBlue felt it was their patriotic obligation to assist the Department of Defense in their anti-terror efforts, particularly following the September 11 attacks in 2001. Assuring passengers that JetBlue's actions were taken for patriotic reasons, Neeleman stated that his management team, "deeply regrets that this happened" and promised that "we have taken steps to fix the situation and make sure that it never happens again." Neeleman was also firm in explaining that the released data "did not include passenger social security numbers, credit card information, or personal financial information."[22] Neeleman also explained that JetBlue "had no knowledge" of the paper presented and published by Torch and "was deeply dismayed to learn of it." Neeleman apologized to angry customers for "shaking their faith in JetBlue," and promised that JetBlue management was "committed to making this right."[23]

JetBlue spokesman Gareth Edmonson-Jones also released statements that their motives were solely patriotic, explaining that JetBlue had made a special exception when the passenger information was released. Neeleman told reporters that "given the circumstances at the time, I totally understand why the decision was made." Reporters stated that the JetBlue security employee who released the passenger information to Torch Concepts was neither fired nor reprimanded for these reasons, with JetBlue management standing by their employee's patriotic decision.[24]

The Effect on JetBlue

Public Relations executives applauded JetBlue's communications plan (all of which was conducted in-house) following the release of the *Wired* article. Many believed that the airline's moves to make an immediate and public apology as well as to hire Deloitte & Touche to assist in

the restructuring of their privacy policy were smart moves.[25] Furthermore, financial analysts began to publicly predict that JetBlue's loyal customer following would not be repelled by the recent events, asserting that due to the brand loyalty "passengers will forgive the airline quickly."[26]

Although JetBlue's privacy violations initiated thousands of passenger complaints, some even filing lawsuits and federal complaints, JetBlue's share prices hit an all-time high on September 23—just seven days after *Wired's* news breaking article. Shares were trading at $60.09, more than double JetBlue's initial public offering price of $27 in April 2002. Furthermore, in October 2003, JetBlue announced that their net income had doubled for the 3rd Quarter (2003).[27]

Still Looking Good

In addition to financial success following the events of September 2003, JetBlue was recognized for their excellence in value and in service by industry publications and consumers. JetBlue won a *Cónde Nast Traveler*'s 2003 Business Travel Award for "Best Value for Cost" in October 2003 – only one month following the privacy violation articles, lawsuit filings, and emailed complaints. In November 2003, JetBlue won their second consecutive "Best U.S. Airline" award from a *Cónde Nast Traveler* Magazine reader's poll.[28]

JetBlue's quick-handling of these privacy violation issues and obvious determination to amend the situation was perhaps best applauded by Utah attorney James W. McConkie, who filed a lawsuit in Salt Lake County following the release of the *Wired* article in October 2003. The suit, filed on behalf of angry passengers, is now seeking compensatory, not punitive, charges. McConkie told reporters at the Wall Street Journal that he and his plaintiffs "got the sense that Mr. Neeleman wanted to make this right, so we commented in our lawsuit that we wanted to pursue the matter, but not in a way that would damage the financial viability of the company. It's a good company."[29]

Discussion Questions

1. Although JetBlue's immediate communication efforts kept customer complaints and financial damages to a minimum, lawsuits against the airline are still pending. What additional steps should David Neeleman and his communications team take to retain customer loyalty and strong financial stability?

2. How should the airline communicate the outcomes of these pending lawsuits and investigations to the media?

3. As an expanding company, how can JetBlue avoid damaging the trust of their investors while the airline is dealing with these lawsuits?

4. Should JetBlue be willing to make more "exceptions" and assist the government in their studies with the intention of serving the nation's anti-terror efforts?

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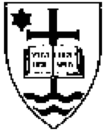
JetBlue: Competing for Marketshare in a Turbulent Industry.
Kellman, J.; Archer, T.; Beal, M.; and O'Rourke, J. S. (editor)

In the face of declining revenues throughout the airline industry, a struggling economy, and an overcrowded marketplace, David Neeleman decided in early 2000 to launch an entirely new airline. With $130 million in venture funding, JetBlue began daily operations from JFK in New York to Florida, California, Colorado, and Las Vegas. After September 11, 2001, industry analysts were asking whether a discounter who promised first-class service could sustain the brand promise. (A) case, 12 pp. Case #03-01. (2003)



Eugene D. Fanning Center for Business Communication **03-01**
Mendoza College of Business
University of Notre Dame

JetBlue

Competing for Marketshare in a Turbulent Industry

In early 2000, the airline industry's profitability model depended upon business travelers. The industry standard had become a shocking reality: Seats at the front of the plane cost six times more than coach tickets. When tightening corporate travel budgets forced many corporations to consider low-cost, low-frill transportation options, many of the largest carriers began to suffer a significant decrease in traffic, and in turn, they suffered a sharp decline in financial performance. Many believe that the commercial airline industry has shifted for good. In the year ended June 2002, traffic at the top-five domestic carriers declined 10%, compared to a year-over-year increase of 11% at low-cost carriers.[1]

Over the past few years, industry analysts have begun to question the dominant model in the industry. The major carriers "are bleeding red ink"[2] because of costly labor contracts and costly hub-and-spoke route systems, which feed a carrier's smaller city traffic into larger, centralized, high-traffic airports. The result of this poor planning has airlines re-thinking their operations. US Airways has filed for bankruptcy, and behemoth United Airlines has suffered a setback in labor negotiations, forcing it to file for bankruptcy on December 9, 2002.

The September 11th terrorist attacks exacerbated an already suffering industry. The public's general fear of flying, coupled with an economic downturn and increased federally-mandated security guidelines, led to complete turmoil. Analysts predict a $7 billion industry loss in 2002.[3] Michael Allen of BACK Aviation Solutions believes that this economic downturn—like ones of the past—will result in the loss of a few airlines to mergers and bankruptcies.[4]

In the midst of one of the worst economic climates in industry history, one airline has managed not only to weather the storm, but also to thrive. Just as negative press was engulfing most of the industry, JetBlue Airways received a landslide of laudatory praise beginning in late September 2002. The media praised everything about JetBlue: strategy, tactics, results, superior branding, and an assumed bright prospect for the future. PR Week began the litany of praise by exalting their branding strategy in a September 23rd article titled "JetBlue Soars on Strength of Branding." In early October, Forbes Magazine featured the young upstart on the cover, terming the company "Lord of the Skies." Only days later, CBS 60 Minutes II featured the three-year-old

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This case was prepared by Research Assistants Jason Kellman, Ted Archer, and Michael Beal under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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newcomer on its broadcast. And, on December 9th, 2002, *Ad Age* named JetBlue 'Marketer of the Year."[5] For JetBlue CEO David Neeleman, late 2002 appears to be a continuance of his company's rise to prominence.

JetBlue CEO David Neeleman

Co-founder of Salt Lake City-based Morris Air before his 30th birthday, David Neeleman quickly established himself as an airline industry pioneer. When Southwest Airlines purchased Morris for $20 million, he tried to work with his new parent company, but his restlessness soon led to his firing and a five-year non-compete clause.[6] Young, eager, and terminally restless, Neeleman invented an electronic ticketing system—all the while biding his time until the expiration of the non-compete agreement with Southwest.

As soon as the clause expired, Neeleman envisioned a low-cost carrier that would be based out of New York's John F. Kennedy International Airport. He started tentatively titled New Air[7] "on the premise of one-upsmanship over Southwest."[8] Now the company is JetBlue, and Neeleman manages with a personal flair. He is committed to his customers and frequently engages them in conversation. He flies about once a week and often uses his planes' overhead speakers to introduce himself to passengers during flights; then, he speaks personally with all of them.

At age 42 and with nine children, the executive with attention deficit disorder is constantly seeking challenge and new opportunity. He initially founded his own airline because he feared that others would not be willing to hire someone with such a short attention span. Now at the helm of JetBlue, he is determined to provide top-quality service, a premier brand, and ever-increasing shareholder returns. His collegial management style, front-line strategy, loyalty, and belief that "a fish stinks from the head"[9] all contribute to the reality that JetBlue's identity is inextricably linked to its founder and CEO. On one flight he made a personal commitment to his passengers: "I hope you realize we're trying a little harder than other lines to treat our customers well."[10]

Company Overview

JetBlue began as New Air in February 1999. With $130 million of venture funding from Wall Street connections and influential financier George Soros[11], David Neeleman started with a significant advantage over past start-up airlines. Never before had a commercial aviation enterprise had such incredible financial backing. Management's original strategy was to follow previous low-cost carrier's use of Boeing 737 planes (similar to Southwest and easyJet); however, Airbus saw JetBlue's potential and offered a deal that company management could not refuse. Thus, JetBlue commenced daily operations on February 11, 2000 with its inaugural flight from JFK to Fort Lauderdale, sporting brand new, leased Airbus A-320 planes.

In addition to a substantial contract with Airbus promising seventy-five planes for $4 billion, JetBlue received an unprecedented exemption at JFK airport (which had long sought a low-cost carrier) for seventy-five takeoff and landing slots.[12] Management carefully selected its other airports, choosing to avoid several of the largest airports in favor of smaller, underutilized airports just outside major metropolitan markets. For example, instead of flying into San Francisco, CA, JetBlue chose to operate out of Oakland, roughly thirty miles away. And, management preferred Long Beach to the larger Los Angeles, CA alternatives. This strategy fit

well with JetBlue's goal of balancing some short-haul routes with transcontinental flights.[13] These longer flights (with correspondingly larger aircraft) enable the airline to avoid congestion and reduce overall costs. JetBlue understood that point-to-point flights between major markets that create enormous pools of originating traffic would enable the carrier to charge lower fares, and hence, ensure high passenger loads.

After its first flight in early 2000, JetBlue expanded quickly. In the following seven months, the airline began to offer service out of Buffalo, Tampa, Orlando, Ontario (CA), Oakland, Rochester, Burlington, West Palm Beach, Salt Lake City, and Fort Meyers. On December 21, 2000—less than a year into operations—JetBlue flew its one-millionth passenger and reported $100 million in flown revenue.[14] The expansion continued: In 2001, JetBlue added service to Las Vegas, Seattle, Syracuse, Denver, New Orleans, Long Beach, and Washington D.C. The following year, in April 2002, JetBlue engaged in its initial public offering (IPO) and continued to expand to San Juan, Puerto Rico, its first international endeavor. In addition to adding destinations, JetBlue simultaneously increased the number of flights on existing routes. The company ended the third quarter 2002 with over eight million total passengers flown.[15]

This extreme expansion was accompanied by strong financial success. After the third quarter 2002, JetBlue's traffic approached five billion revenue passenger miles, an increase of 116% over the same period a year earlier.[16] In August 2002, JetBlue reported a monthly load factor of 90.5%; no U.S. airline had ever broken the 90% barrier.[17]

Throughout this successful expansion, JetBlue has dramatically increased its workforce to more than four thousand, and top management has remained intact. Looking forward, the company hopes to continue to expand at the rate of one plane per month[18] and has expressed interest in further geographical expansion.

The JetBlue Mystique

JetBlue's success is attributable to far more than good strategic planning and route mapping. Customers, insiders, and competitors alike have a difficult time expressing the exact qualities that make its brand so appealing. Regardless, there is something unique about the JetBlue brand—an identity that is different, special, and attractive. When asked to describe the company's brand, Eric Phillips, of Delta Airlines' Corporate Strategic Planning Department, praised the airline's leather seats and direct TV: "They're just cool; they're chic."[19] Eric Arnold of PR Week echoed this sentiment, exclaiming, "Their strength is the premier service."[20] In an article written in September, Arnold asked industry expert Rob Coburn of Magnet Communications to elaborate on the brand. He said, "JetBlue is extremely consistent in wanting to live and portray a very simple value proposition. In two words, they get branding. They're all about the branded customer experience."[21]

The mysterious and hot brand began with a vision to position the company as not only new, but also hip. The proposed names emitted a sense of freedom and separation from traditional airlines: Imagine Air, Liberty Air, Yes!, The Competition, Home, The High Road, Civilization, Fresh Air, Gotham, Taxi, The Big Apple, and more. Management was presented with three finalists: Blue, It, and Egg, names that were "contemporary, simple, clean, and memorable." Finally, after several derivations of "Blue," Neeleman decided on JetBlue because "*Jet* made it sound real . . . *Blue* had that association with the wild blue yonder." An early advertisement promised to "[infuse] the industry with new blood [and] bring humanity back to air travel."[22]

Born out of a trendy naming game, the resulting airline is hip, cool, and cutting-edge. For New Yorkers—and increasingly for each additional city—flying JetBlue is an experience, as opposed to merely a means of transportation. Management cut meals from its operations and provided passengers with leather seats, DirecTV, and a concentration on servicing passengers as valued guests. Never content with maintaining the status quo, JetBlue is continually updating its planes: Each year, the company adds one new tailfin design; also, the interior spaces of their new planes are frequently remodeled.[23] The goal is to appeal to its target customers—business travelers and everyone who wants to feel important and cared for as if they, too, are valued. Most importantly, these additional perks are provided by a low-cost carrier.

Beyond the formalized branding strategy that has developed these consistent, tangible qualities, there exists a commitment and passion shared by both customers and employees. Gareth Edmondson-Jones, Senior Vice President of Corporate Communications at JetBlue, said that they "approached it as customers would—it's the airline *you* would build." He happily admitted that flying JetBlue is "a slightly edgier experience" than management had originally imagined. Customers have often asked if their flight is "special" after observing the high morale and exuberant personal warmth among employees. In one such incident, an elderly woman asked a flight attendant for socks to warm her feet; though no corporate policy addressed such a request, the flight attendant reached into his own bag and handed her a new pair of socks.[24] This action only reached management's attention because the woman wrote a letter of gratitude.

Overall, JetBlue's premier brand has created a compelling demand. Chris Johnson of Magnet Communications summed up the experience by saying, "We've started to hear that people aren't just saying, 'Oh, I flew to Florida.' They say, 'I took JetBlue to Florida.' What that means to us is the JetBlue experience is special to customers."[25]

JetBlue Operational Dynamics

JetBlue's success is a product of more than its branding strategy. Taking notice of other airlines' route maps and procedures, JetBlue structured its route planning in direct opposition to conventional wisdom. The industry leaders operate on a hub-and-spoke system, using large, geographically centralized airports as distribution points where smaller aircraft feed passengers to larger aircraft. Management noticed that this system has devolved into a slow, cumbersome transition process in which multiple gates must be owned and staffed in order to support the numerous small incoming aircraft and the larger outgoing aircraft. In response, JetBlue modeled its operations after Southwest Airlines, Neeleman's former employer. While JFK often serves as somewhat of a hub for many of its flights, they are able to keep flight costs low because they often fly point-to-point; namely, they avoid the costly changeovers that have caused logistical nightmares for the larger airlines. Furthermore, JetBlue reduces its costs by targeting underutilized airports that are adjacent to major metropolitan areas. The result? JetBlue planes fly twelve hours per day, compared to nine hours per day at United, US Airways, and American.[26] Their longer flights enable them to charge lower fares per mile per passenger.

JetBlue's choice to operate only new Airbus A-320 aircraft (instead of the low-cost industry standard Boeing 737) enables the company to standardize flight patterns and logistical planning. Additionally, these aircraft have long-range fuel capacity, which enables pilots to fly alternative routes to arrive at the same destination; this convenience reduces delays, decreases costly changeovers, and minimizes operational headaches. By avoiding congestion, JetBlue adds more to its bottom line. Because JetBlue only uses one airplane type, substitution and pilot

training costs are further reduced.[27] One final advantage of utilizing these new aircraft is the negligible maintenance costs that JetBlue has incurred during its first years of operation—"Advances in aerodynamics have led to more efficient wing and airframe shaping, which reduce fuel burn, operating costs and emissions."[28]

These new Airbus A-320 planes have another industry-defying characteristic: a paperless cockpit. Unlike competitors, who give their pilots lengthy printed manuals that require frequent updates, JetBlue saves on paper, printing, and filing costs by equipping its pilots with laptops that automatically update flight manuals. Thus, instead of printing and distributing hundreds of inch-thick documents with each new change, JetBlue saves money by clicking a button.[29]

In addition to efficient planning and standardized aircraft, JetBlue also benefits from a labor force that is content to work on a non-unionized basis. Since the company's IPO, employees have received stock options and profit sharing as a portion of their compensation; this directly links corporate performance to personal wealth. In this manner, JetBlue keeps its human capital costs low, and hence, improves company cash flow.

Challenges Ahead

Given JetBlue's financial and strategic branding success, it is natural to ask what is in store for the company in the future. Because the company's success has heretofore been a result of a sense of mystique and the alignment of multiple strategic objectives, it is important to consider the potential obstacles going forward:

- **Low-Cost Competition**: JetBlue will soon enter markets that are presently dominated by Southwest Airlines, a company that has one of the highest brand loyalties in the industry. It is possible that there is sufficient budget traffic to support two carriers in these markets, but JetBlue must ensure that these expansion plans fit with their overall strategic objectives. Robert Lamb of NYU's Stern School of Business suggests that "if JetBlue has any sense, they'll try to avoid Southwest on many of their flights. At some point, it's a losing battle to compete on price against a discounter."[1] In addition to Southwest, JetBlue must consider Delta's November 20th announcement that it intends to enter the low-cost market, hoping to regain market share previously lost to low-cost carriers.
- **Continuing Brand Buoyancy:** How does JetBlue top being named 'Marketer of the Year'? Eric Arnold identifies the difficulty of maintaining a strong brand identity: "Once you've established yourself as an innovative brand—it's a constant evolution."[2]
- **Unionization:** While many outsiders believe that JetBlue would survive unionization,[3] JetBlue insiders believe that "any sort of third party arbitration would be considered a personal defeat."[4] In an industry where the Airline Pilots Association (ALPA) and International Association of Machinists and Aerospace Workers (IAM) wield significant power and collectively bargain away some airlines' profits, JetBlue must navigate these parties by transparently portraying its finances to its employees. While workers are presently content with equity-based incentives and profit sharing, this could change.[5]
- **Managing Operational Costs:** Will maintenance costs rise as planes age? Can JetBlue continue its high passenger load factor? Will the airline incur additional expenses in the future as it enters new markets? Will the cost of the federal government's new security measures significantly cut into margins?

- **Managing Growth and Execution:** JetBlue's brand and profitability model are dependent on the ability to maintain a particular culture. Gareth Edmondson-Jones comments on JetBlue's future growth: "The bigger we get, the more important it is that our focus on the customer remains." He nonetheless believes that they can maintain their corporate identity throughout its growth cycle via its frontline employees.[6]
- **Keeping Management Intact:** Because JetBlue's management team is composed of various industry professionals who left competitors, it is possible that management could suffer defection in future years. One industry observer notes, "I just don't see Neeleman around for the long run . . . he will get it up and sell it, just like he did with Morris."[7]

One Last Wrinkle

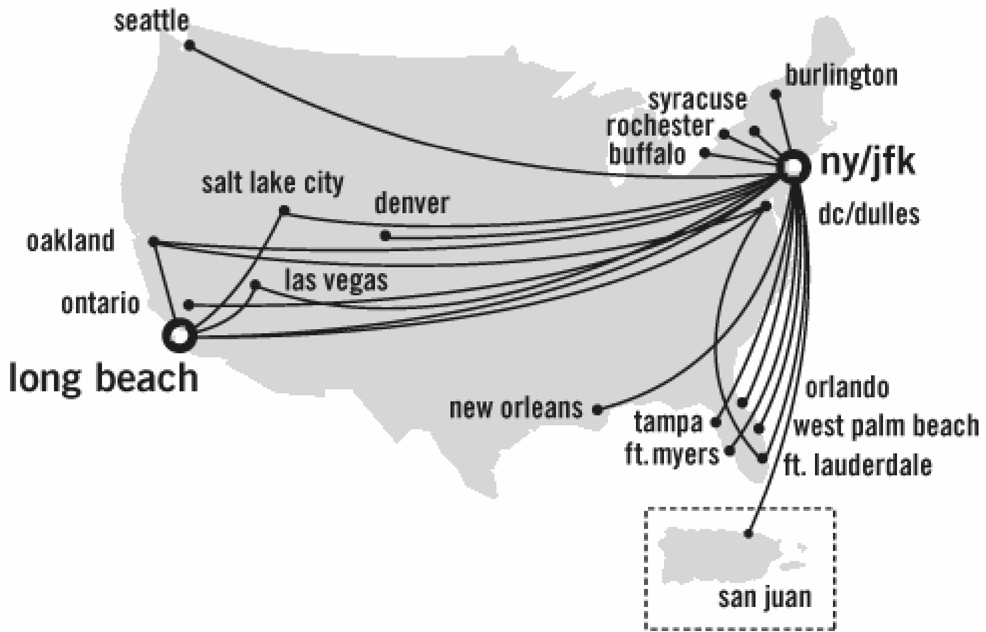
On the morning of October 9th, 2002, JetBlue management arrived at headquarters and learned that J.P. Morgan Chase—one of its largest shareholders and the investment bank that had taken the company public only months ago—had sold nearly half its 11% stake on the day that its lockup period expired. The result was a 17% drop in share price.[8] In the ensuing weeks, management hoped to combat this bad news with the overwhelmingly positive barrage of press proclaiming the discounter's dominant marketing. Going forward, JetBlue must consider how to keep its image and expansion rolling. David Neeleman, JetBlue CEO, expressed this concern:

> "JetBlue has been put together like no other airline has ever been put together before. It has the most capital, it has the best product, so now the question is, can you continue it? And that's what worries me. That's what keeps me up at night. How can we continue what we've started?"[9]

Questions

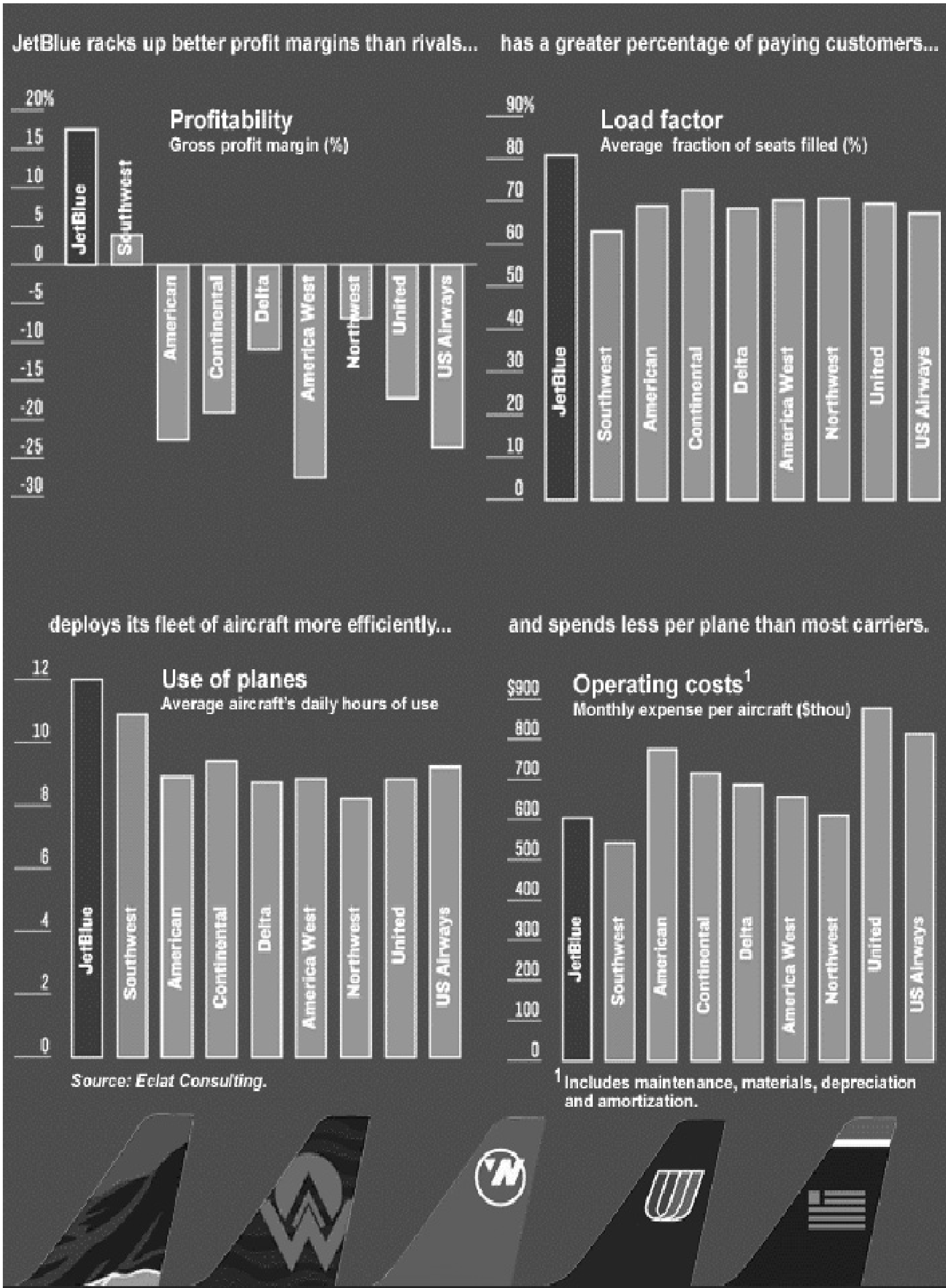
1. What do you foresee in JetBlue's future? Is the brand here to stay, or will expanding into additional markets reduce the small-company feel, alter the culture, reduce operational efficiencies, and increase costs?
2. How would you advise JetBlue's Corporate Communications Department to be able to maintain/increase/sustain this present obsession with the JetBlue brand and the company's high-flying profile?
3. What corporate strategy would be most effective from here?
4. Post-honeymoon, what conflicts or issues will confront JetBlue? How would you confront these issues?
5. How does JetBlue sustain its position as a premier brand and justify its position as a growth stock selling at 24 times projected 2003 earnings?
6. What additional value-added features can JetBlue offer now that it is a premier carrier?
7. Was J.P. Morgan Chase's share sale merely a result of venture capitalists taking profits, or was it foresight into JetBlue's future operating performance?

Appendix A: JetBlue Route Map
Source: http://www.jetblue.com/travelinfo/routemap.html



Appendix B: Stock Performance vs. Airline Sector Index
Source: http://bigcharts.marketwatch.com

Appendix C: Financial Performance
"Kicking Tail: JetBlue's Edge"
Source: http://www.forbes.com/forbes/2002/1014/130chart.html



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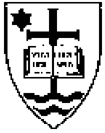
Northwest Airlines: Surviving a Turbulent Industry
Durkalski, D.; Peer, C.; Sawyer, A.; and O'Rourke, J. S. (editor)

On September 14, 2005, Northwest Airlines filed for Chapter 11 bankruptcy. During the weeks leading up to the decision, Northwest was burning through $4 million in cash a day, carried $8.1 billion in long-term debt, and had pension plans underfunded by $3.8 billion. With fuel prices increasing at record rates, a shortage for demand in the airline industry, and a mechanics strike leaving unfruitful negotiations, something had to be done. Under the protection of bankruptcy, CEO Douglas Steenland, believes that Northwest can settle labor issues and reorganize the firm's cost structure to compete with the discount airlines. Steenland hopes Northwest can emerge from the bankruptcy stronger than ever. Critics wonder what tactics Northwest might employ to survive this turbulent industry. 8 pp. (2005).



Eugene D. Fanning Center for Business Communication **06-02**
Mendoza College of Business
University of Notre Dame

Northwest Airlines:
Labor Relations in a Turbulent Industry

Introduction

On the morning of September 14, 2005, more than four years after the terrorist attacks of September 11, 2001 devastated the airline industry, Doug Steenland, Chief Executive Officer of Northwest Airlines, made a crucial decision. His company was overburdened by soaring fuel costs and still recovering from 9/11 and the outbreak in Asia of a disease known as Sudden Acute Respiratory Syndrom, or SARS. Northwest Airlines was burning through $4 million in cash a day, carried $8.1 billion in long-term debt, and had pension plans underfunded by $3.8 billion.[1] All these factors left Northwest searching for survival. With a $65 million pension payment due the following week, Steenland was left with few options. He decided that it was time for Northwest Airlines to file for Chapter 11 Bankruptcy.

Labor Strike

After failing to reach an agreement with Northwest Airlines, 4,400 mechanics and aircraft cleaners associated with the Aircraft Mechanics Fraternal Association (AMFA) union went on strike Saturday, August 20, 2005.[2] Northwest had been working with all of its workers' unions for months attempting to produce $1.1 billion in labor savings from pay cuts and layoffs. The pilots had supplied $265 million in annual savings by conceding to pay cuts, but none of the other employees cooperated.[3] Northwest had proposed a number of offers to the union workers, but the AMFA's counter-terms differed drastically from those of Northwest. See Exhibit 1, page 7. The final offer would have saved the airline $176 million through 25% pay and benefit cuts and layoffs of nearly half of the union's mechanics at Northwest.[4] But the union rejected the plan without even informing its members.

This case was prepared by Research Assistants Douglas Durkalski, Catherine B. Peer, and Andrew Sawyer under the direction of James S. O'Rourke, Concurrent Professor of Management, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Information was gathered from corporate as well as public sources.

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Northwest had known for quite some time that labor strikes could ensue as a result of cost-cutting negotiations. Therefore, when the strike occurred, a contingency plan was already in place.[5] Northwest had 1,900 trained replacement workers ready to take over the duties of the striking employees.[6] Operations could continue, but the transition would not be easy.

The use of replacement workers can cause numerous problems. Any instance of mechanical failures, delayed flights, or poor service would be attributed to the use of replacement workers, whether or not they were to blame. Striking workers spurn their replacements, yelling derogatory remarks at them as they arrive at work. Remaining workers may provide an unwelcoming environment to the new employees. Also, from a financial standpoint, the media can create a negative image of the company that could drive away customers. Unless Northwest can convince the public that its safety priorities and on-time performance have not been compromised, the strike may push the corporation into even deeper trouble.

Fortunately, due to the foresight of Mary Carroll Linder, Northwest's Senior Vice President for Corporate and Brand Communications, a significant part of the contingency plan was dedicated to public relations.[7] Ms. Linder was aware that many people would question the airline's use of replacement workers and devised a plan to field questions and put consumers' fears at ease. She created a page on Northwest's website dedicated to strike-related questions and answers.[8] The page reassures viewers that the replacement workers are qualified for their jobs and that the daily operations of Northwest will continue as usual.

Northwest's contingency plan was very successful in allowing the airline to continue its normal operations after the strike. Although the airline delayed over 4 percent of flights during the first couple of days after the strike, that number quickly shrunk to a mere 1 to 2 percent average for the three weeks that followed.[9] Northwest's target for completion is 97.5 percent.[10] Ironically, the numbers Northwest reported at the time of the strike show that the efficiency of operations actually *increased* after the strike.

History

Colonel Lewis Brittin founded Northwest Airways on September 1, 1926 and operated as the vice president and general manager.[11] The company began as an air mail carrier and was co-based in Minneapolis and Detroit. Two months after its inception, Northwest introduced the Stinson Detroiter, the first closed-cabin commercial plane. In 1927, they began flying ticketed passengers and became an international operation in 1928 with flights to Winnipeg.[12]

With help from the Mayo Clinic in Rochester, MN, Northwest developed the first oxygen mask in 1938, enabling high altitude flights. This helped the company to expand service into the Rocky Mountain region and the northwestern United States. With this expanding service and company growth, Northwest was traded publicly for the first time in 1941. Then, during World War II, Northwest worked on 11 governmental assignments and grew to more than 10,000 employees from 881 prior to the war.[13] This phenomenal growth in capacity helped Northwest continue to grow its service in the 1940s to New York City, Alaska, Hawaii, and parts of Asia.

The 1960s saw the introduction of the Boeing 707 and 727 aircraft at Northwest, which enabled the company to further build on its position as the leading U.S. airline in net profit. Over the next few years, Northwest continued to innovate and lead the airline industry. The Boeing 747 allowed the company to increase passenger load and flight lengths. This helped comfort many customers who now would be able to travel long distances directly.

As airplane technology began to level off, Northwest found other ways to be innovative. In 1973, the company started offering computerized ticketing and reservation services to and from Asia, resulting in more convenience for their customers when making travel plans. Northwest also became the first airline to ban smoking on all of its flights, further displaying its commitment to offering a safe and comfortable travel experience for passengers. It is this commitment that has enabled Northwest to remain one of the most traveled airlines in the world.

Since the 1990's, Northwest has worked continuously to improve their operations for the benefit of their travelers. As the first airline to introduce Internet reservations via www.nwa.com, Northwest again displayed the ability to change and adapt to societal demands and technological advances.

Douglas Steenland

Douglas Steenland has been the Chief Executive Officer of Northwest Airlines since October 1, 2004. He is faced with the difficult task of leading the company through its bankruptcy and a labor strike. However, Steenland has extensive experience with the company and is confident that Northwest will rebound. Referencing the decision to allow the mechanics to strike, Steenland said, "Change is never easy. This week we are making decisions that are especially difficult, but they are the right ones."[14]

Prior to joining Northwest in 1991, Steenland worked as a senior partner in the prestigious Washington, D.C. law firm of Verner, Liipfert, Bernhard, McPherson, and Hand. His primary focus there was on transportation, corporate law, and government relations, all vital in the airline industry. He also spent time in the Office of the General Counsel of the U.S. Department of Transportation. Since joining Northwest, Steenland has constantly used this experience to further the airline.

Steenland has served Northwest as a Vice President, Senior Vice President, Executive Vice President, Chief Corporate Officer, President, and Chief Executive Officer. During his 14 year tenure, Steenland has participated in a number of monumental decisions. He led the initial public offering in 1994 and followed that in 1997 by negotiating an alliance with KLM Royal Dutch Airlines. This alliance was precedent setting in the airline industry and required full cooperation and coordination with the U.S. government as well. The Northwest-KLM alliance is often seen as the standard in international travel arrangements.

Most important, however, is Steenland's experience in negotiating with large unions and creating cost-savings opportunities. In 2000, he settled a 14-day pilots' strike. He understood the importance of the pilots union to the airline and the benefits of settling quickly. The long-term collective bargaining agreement he negotiated displayed the company's trust in its employees and paved the way for other agreements with flight attendants and mechanics. After 9/11, Steenland helped to develop numerous programs designed to cut expenses for Northwest. By 2005, these programs were saving nearly $1.6 billion per year. With this experience and continued confidence, Steenland appears ready to drive Northwest out of bankruptcy and back into prominence.

The Airline Industry Since 1945

After World War II, the US civil air industry emerged due to an explosion of demand for air transport, for both passengers and cargo. Airlines were eager to invest in new flagship aircraft

such as the Lockheed Constellation and Douglas DC-6. These new airplanes were based on the design of American bombers such as the B-29. Military research during the war led to increased efficiency from added speed, greater payload, and pressurization.[15]

The 1950s spawned the age of the jet airplane. Planes like the Douglas DC-8 and the Boeing 707 allowed larger numbers of passengers to travel in shorter time. The years 1958 to 1968 were banner years for the airline industry.[16] Airliners and manufacturers were able to avoid price wars through government regulation. The Civil Aeronautics Board regulated fares and routes, creating a cozy government-business relationship. Employees, especially pilots, found themselves in a secure labor market.[17] In other industries, productivity advances had made it possible to reduce the labor force. But the pilots were tightly organized and resisted such cuts. Pilots had almost attained celebrity status in the public's eye.

Feeling comfortable in a regulated industry, airlines assumed profits were guaranteed and that economic changes were not a worry. Carriers began investing heavily in a new generation of airplanes, including the Concorde and the 747 Jumbo Jet. Airlines justified the investment on the basis of a 15% expected annual growth in passenger traffic.[18] Retrospectively, this was not a sensible growth figure and the airline industry became flooded with overcapacity. Other factors made the 747 jets even riskier. The original engines designed to propel the jets proved inadequate to the task, sometimes shutting down in mid-flight. With more powerful engines, the planes remained airborne but with a significant increase in fuel consumption. The overcapacity and increased costs of jumbo jets led to declining profits.

The 1970s brought serious problems to airlines and their suppliers. The oil crisis sharply increased the cost of fuel. Suppliers, such as Boeing, seemed to be caught off-guard by the hike in fuel costs. The company had spent hundreds of man-hours studying the economics of burning fuel at ten cents a gallon, but not a penny more. The airline industry, in general, suffered from economic downturn and shortsighted planning. Carriers and suppliers had become complacent in a regulated industry and found themselves operating inefficiently with a faltering demand.

To relieve such problems, the Civil Aeronautics Board asked Congress to dismantle the economic regulations and allow the airlines to operate under market forces. The Airline Deregulation Act of 1978 lowered barriers to entry and allowed a new wave of start-up airlines.[19] By relying on competition, the industry could correct inefficiencies, lower fares, and open new routes and services. The industry saw an explosive growth in demand, as millions who had never or rarely flown before became regulars. New services and higher frequencies meant that business fliers could fly to another city, do business, and return the same day. Between 1976 and 1990, average fares declined 30% in real, inflation-adjusted terms.[20] The savings to travelers ranged from $5 billion to $10 billion per year. By the 1980s, almost half of the total flying in the world took place in the United States.[21]

Toward the end of the century, a new style of low-cost, low-fare airline appeared. Carriers such as Southwest Airlines and JetBlue offered a consistent, high-quality service, at a well-received price. These airlines represented a serious challenge to the legacy carriers. Major airlines had to undergo cost restructuring to match wages set by low-cost competitors.

The aftermath of the 9/11 terrorist attacks has left the airline industry in an extremely poor financial position. From 2001 to 2003, the industry reported net losses of $23.2 billion.[22] Within the first year after 9/11, nearly half the jobs lost in the U.S. economy were either in aviation itself or within the broader travel sector. In addition to the 9/11 attacks, airlines have had to deal with economic slowdown, a sharp downturn in business travel, the SARS epidemic, and unprecedented levels of competition. To help improve their financial situation, many

airlines have cut costs by reducing labor expenditures and by decreasing capacity through cutting flight frequency, using smaller aircraft, or eliminating service to some regions. Despite these efforts, several airlines view bankruptcy as the only option for recovery.

Turbulent Times for Legacy Carriers

Within a financially troubled industry, the low cost carriers are applying serious pressure on the legacy airlines. Southwest is a perfect example of the “no frills” approach to operating a successful airline. Southwest saves money with “ticketless” reservations, unassigned seating, point-to-point flying, and alternative airports. The airline operates a single airframe, the Boeing 737, to reduce training costs for mechanics and speed up the turnaround time at airports.[23] Also, Southwest has utilized futures contracts to hedge against soaring fuel bills. Crude oil prices tripled from 2001 to the summer of 2005 and hit $60 a barrel. With futures, Southwest locked in much of its fuel at around $40 a barrel. This low-cost structure has made Southwest the only U.S. carrier to be profitable since 1972.[24]

The presence of competitors like Southwest has challenged the other legacy carriers such as US Airways, United Airlines, and Delta Airlines. US Airways filed for bankruptcy twice in two years. United set off the largest default in the history of the federal pension agency when it scrapped its traditional retirement plans. The airline has been operating under the protection of bankruptcy since December 2002. It has cut costs about $5 billion, including $2.5 billion from labor savings.[25] Delta, with $2 billion in bills to pay by the end of 2005 and only $1.7 billion in cash,[26] was forced to file for bankruptcy the same day as Northwest. With the competition brought on by discount airlines, the legacy carriers would need to reorganize their cost structure just to survive.

What’s Next for Northwest Airlines?

The question for Northwest Airlines now is how to survive these difficult times. Other airlines have used Chapter 11 bankruptcy in the past to overcome financial woes and emerge rejuvenated, but will Northwest be able to do the same? The airline industry has changed significantly in the last couple of years and is proving increasingly difficult for legacy airlines to compete in. To survive, Northwest needs to cut costs, increase efficiency, resolve labor disputes, and generate a strengthened balance sheet. The only question is how.

Discussion Questions

1. Who are the key stakeholders and how are they affected?

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