Cases

PART FIVE

CASE 1

Wal-Mart: The Challenge of Managing Relationships with Stakeholders

Wal-Mart Stores Inc.—the world's largest retailer—is possibly the most controversial business in America. With sales over $312,000 billion in 2006 and approximately 1.7 million employees worldwide (of these, 1.3 million are U.S. employees), managing stakeholder relationships is a major challenge. The Wal-Mart that saves the average family an estimated $2329 per year has its critics. There are concerns about Wal-Mart's treatment of employees, suppliers, the environment, and the overall economic impact on communities. Feminists, human rights activists, anti-sprawl activists, and labor unions believe that Wal-Mart has engaged in misconduct to provide low prices to consumers. The company that banishes magazines with racy covers and CD's with edgy lyrics is seen as attempting to dictate its vision of American culture.

Wal-Mart claims that it is committed to improving the standard of living for their customers throughout the world. The key strategy is a broad assortment of quality merchandise and services at everyday low prices (EDLP) while fostering a culture that claims to reward and embrace mutual respect, integrity, and diversity. Wal-Mart has three basic beliefs: respect for the individual, service to their customers, and striving for excellence. How well the firm implements these beliefs is the focus of this case.

Wal-Mart, one of the most amazing success stories in the history of American business, has also shaped debate over the relationships between corporations and their stakeholders. Wal-Mart has excelled at market orientation, which is focusing on consumers, defeating competitors, and increasing shareholder value. Only recently has shareholder value lagged behind the major stock market–index performance. Other stakeholders such as employees, suppliers, and communities have been viewed as secondary to low prices for consumers. For example, the *Fortune* 100 best companies to work for does not include Wal-Mart. Number one in 2005 and number two in 2006 on the *Fortune* list was Wegmans Food Markets, with the very unusual motto of em-

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This case was prepared by Melanie Drever, University of Wyoming, under the direction of O. C. Ferrell, for classroom discussion rather than to illustrate either effective of ineffective handling of an administrative, ethical, or legal decision by management. All sources used for this case were obtained through publicly available material and the Wal-Mart website.

ployees first and customers second. Starbucks with its generous employee benefits, even for part timers, was number two in 2005 but dropped to twenty-ninth in 2006.

The story of Wal-Mart and its low prices shows both good and bad outcomes for society. The company has grown from a small chain to over five thousand stores in ten countries, making its early investors and some employees financially successful. It has been estimated that Wal-Mart saves consumers $100,000 billion a year. Wal-Mart's entrance into some markets lowers food prices 25 percent, including savings from competitors' price cuts. As competing supermarkets close, their union employees sometimes lose their jobs. One study found that total payroll wages per person declined by almost 5 percent where Wal-Mart stores are located due to Wal-Mart driving down wages. In 2005 an internal document made public by Wal-Mart Watch showed that 46 percent of Wal-Mart employees' children were on Medicaid or uninsured. Michael Hicks, an economist at the Air Force Institute of Technology found that Wal-Mart increased Medicaid costs an average of $1898 per worker. Armed with these alleged facts, the Maryland General Assembly passed the "Wal-Mart Bill" requiring employers with more than 10,000 workers to spend at least 8 percent of their payroll on employee health care or pay into a fund for the uninsured. Wal-Mart challenged the law; it appears that the law is not going to be implemented. Sarah Clark a Wal-Mart spokesperson was quoted in *USA Today:* "Wal-Mart does believe that everyone should have access to affordable healthcare, and this legislation adds nothing to accomplish this goal." The debate goes on with the question of the real costs to society for low prices.

HISTORY AND GROWTH OF WAL-MART

Wal-Mart's principal offices are in Bentonville, Arkansas. In 1945 in Newport, Arkansas, Sam Walton, the store's founder, opened a franchise Ben Franklin variety store. In 1946 his brother opened a similar store in Versailles, Missouri. Until 1962 the business was devoted entirely to the operation of variety stores. In 1962 the first Wal-Mart Discount City was opened, which was the first Wal-Mart discount store. In 1984 the first three Sam's Clubs were opened, and in 1988 the first supercenter opened. In 1999 the first neighborhood market was opened. Today the family of Wal-Mart founder Sam Walton has a combined fortune estimated at $90 billion.

The Wal-Mart business model includes two main segments: Wal-Mart Stores and Sam's Clubs. The Wal-Mart Stores come in three sizes: discount stores, which are about 100,000 square feet; supercenters, which are about 187,000 square feet; and the neighborhood markets, which are about 43,000 square feet in size. Sam's Clubs are membership warehouse clubs, which average 128,000 square feet and aim to provide exceptional value on brand-name merchandise at "members only" prices for both small businesses, nonprofit organizations, and personal use, especially large families.

Wal-Mart has continued to expand from its small roots in Arkansas, opening new stores at an accelerated rate. At present, Wal-Mart operates 2640 discount stores, 2396 supercenters, 670 Sam's Clubs, and 435 neighborhood markets in the United States. It has continued to open new stores every year, not only in the United States but also abroad. Much of the expansion overseas has been through acquisitions of existing operations in other countries.

Over 138 million people visit Wal-Mart every week, and 84 percent of Americans have shopped at Wal-Mart in the past year. People living in households with incomes of less than $30,000 a year give Wal-Mart its highest marks, proving that those who value Wal-Mart most need Wal-Mart's low prices the most.

Wal-Mart's first international initiative started in 1992 with a 50 percent joint venture in Mexico with Cifera discount stores. In 1998 they acquired control of Cifera and changed its name to Wal-Mart de Mexico. The first international venture was so successful that today Wal-Mart has 774 stores in Mexico. In addition, the company operates stores in Argentina (11), Brazil (295), Canada (278), Germany (88), South Korea (16), Puerto Rico (54), and the United Kingdom (315). Their joint ventures in China and Japan provide Wal-Mart with over 450 stores.

Wal-Mart became the largest grocery chain in 2002 with revenue larger than Safeway and Albertson's combined. It became the first retailer to be number one on the *Fortune* 500 list in 2005, with sales over $300 billion; in 2006 Wal-Mart was number two behind Exxon Mobil. Sales climbed 10 percent in 2005, and profits rose 13 percent to more than $10 billion. In addition to being number two on the *Fortune* 500, Wal-Mart was also named the "most admired company in America" in 2003 and 2004; in 2005, however, it slipped and ranked fourth on the list behind Dell, General Electric, and Starbucks; in 2006 it was ranked twelfth. Wal-Mart is the world's largest retailer as well as the largest employer.

RELATIONSHIPS WITH SUPPLIER STAKEHOLDERS

Wal-Mart is focused on keeping its costs low for its EDLP. It does this by streamlining its company and insisting its suppliers do the same. Wal-Mart is well known for its operational excellence in its ability to handle, move, and track merchandise, and it expects its suppliers to continually improve their systems too. It demands that its suppliers consistently lower prices of products from one year to the next by at least 5 percent; if a supplier is unwilling or unable to do so, Wal-Mart will no longer carry the product or will find another supplier for the product at the price they want.

Technology is a driving force in operational efficiency that lowers costs. The merchandise-tracking system—radio-frequency identification (RFID)—ensures that a product can be tracked from the time it leaves the supplier's warehouse to the time it enters and leaves a Wal-Mart store. In 2004 Wal-Mart insisted that its top one hundred suppliers ensure that all their pallets and products being shipped to Wal-Mart had RFID by January 2005. The cost to suppliers was much larger than the cost to Wal-Mart because suppliers needed to continually buy the RFID tags while all Wal-Mart needed was a system to read the tags. It has been estimated that the cost to one supplier could be $9 million to install and implement the RFID technology. Smaller Wal-Mart suppliers also have to install the tags, but they had until 2006 to comply.

RFID tags help Wal-Mart keep their shelves stocked and curbs the loss of retail products as they travel through the supply chain. RFID at Wal-Mart has directly resulted in a 16 percent reduction in stock-outs and a 67 percent drop in replenishment times. As customers go through checkout, the RFID system swiftly combines point-of-sale data on their purchases with RFID-generated data on what's available in the stockroom to produce pick lists that are automatically created in real time, based on sales. It also ensures that suppliers are notified when products are sold and can ensure that enough of a product is always at a particular store. This strategy also results in time and labor savings because associates (as employees are called at Wal-Mart) no longer need to scan store shelves to determine what is out of stock, nor do they have to scan cartons and cases arriving at the stockroom. The scanners tag incoming pallets and translate the data into supply chain–management database-forecasting models to address out-of-stock items and reduce stock–restocking mix-ups.

The power Wal-Mart has over its suppliers is more to do with its size and volume of products it needs than anything else. For example, Dial Corporation does 28 percent of its business with Wal-Mart. If it lost that one account, it would have to double its sales to its next nine customers just to stay even. Other companies that depend on Wal-Mart for sales are Clorox, which does 23 percent of its business with Wal-Mart; Revlon, 22 percent; Proctor & Gamble, 17 percent; Kraft Foods, 12 percent; General Mills, 12 percent; and Kellogg, 12 percent. This ensures that Wal-Mart dictates terms to its vendors rather than the other way around. However, there are benefits to suppliers because they become more efficient and streamlined, which helps their other customers too, as they improve their system for Wal-Mart.

Many companies believe that supplying Wal-Mart is the best thing for their business; there are the few, however, who believe that Wal-Mart is hurting their business and decide to no longer do business with them. An example of this is Snapper, a company with a 50-year heritage of making high-quality residential and commercial lawn equipment. CEO Jim Weir believed that Wal-Mart was incompatible with the company's strategy of high quality and, compared to Wal-Mart's typical lawn mowers, high prices. He felt that the long-term survival of the company meant that he should no longer sell to Wal-Mart. Wal-Mart tried to convince him that making a low-cost version of Snapper mowers specifically for Wal-Mart would be a good compromise, as Levi's did with their Levi's Signature brand made specifically for the Wal-Mart market. However, Weir would have none of it.

Weir said no to Wal-Mart and told his other customers about the decision. Wal-Mart accounted for 20 percent of his business, but he wanted to focus more on the other 80 percent of the independent dealers. The other dealers were happy with Weir's decision, and Snapper got much of the lost business back from the independent dealers by winning their hearts.

The constant drive by Wal-Mart for lower prices affects its suppliers in a more ominous way too. Many suppliers have had to move production from the United States to cheaper locations, such as China, to remain suppliers to Wal-Mart and maintain their business. Wal-Mart imports over $18 billion dollars worth of goods from China and encourages its suppliers to move their production operations to China to systematically lower cost. China and Wal-Mart have developed a unique partnership, and Wal-Mart accounts for 10 percent of the U.S. trade deficit with China. China's annual exports amount to $583 billion, and Wal-Mart ranks as China's eighth-largest trading partner, ahead of Australia, Canada, and Russia. Rubbermaid, once *Fortune*'s most admired company, has gone out of business, and much of its manufacturing equipment was sold to a Chinese company. Although the Rubbermaid brand name lives on, former Rubbermaid managers claim that the low prices that Wal-Mart demanded, including their reluctance to allow Rubbermaid to increase prices when the cost of raw materials increased, caused them to close and sell to a competitor. Companies such as Master Lock, Fruit of the Loom, and Levi's—as well as many other Wal-Mart suppliers—have all moved production overseas at the expense of U.S. jobs and all in the name of low prices for consumers.

ETHICAL ISSUES INVOLVING WAL-MART STAKEHOLDERS

Employee Stakeholders

DISCRIMINATION The U.S. Equal Employment Opportunity Commission (EEOC) has filed fifteen lawsuits against Wal-Mart since 1994. Of these, ten are still pending, and five have been resolved.

FEMALE EMPLOYEES Although women account for more than 67 percent of all Wal-Mart employees, women make up less than 10 percent of top-store managers. Wal-Mart insists that it adequately trains and promotes women, but in 2001 a Wal-Mart executive conducted an internal study that showed the company paid female store managers less than men in the same position.

In June 2004, a federal judge in San Francisco granted class-action status to a sex-discrimination lawsuit against Wal-Mart. It is the largest class-action lawsuit and involves 1.6 million current and former female employees at Wal-Mart. It claims that Wal-Mart discriminated against women in promotions, pay, training, and job assignments. Even Wal-Mart concludes in its annual report that if the company is not successful in its appeal of the class-action certification of the case, the resulting liability could be material to the company.

DISABLED EMPLOYEES In January 2000, Wal-Mart agreed to pay two deaf applicants $132,500. The two applied to work at a Wal-Mart in Tucson, Arizona, but were denied employment because of their disabilities. Wal-Mart agreed to hire the two men as part of the settlement and to make corporate-wide changes in the hiring and training of new employees who are deaf or hearing impaired. However, in June 2001, for failure to comply with the original court order, Wal-Mart was fined $750,200, ordered to produce and air a TV ad stating that it had violated the Americans with Disabilities Act (ADA), reinstate William Darnell (one of the disabled workers), and create computer-based learning modules in American Sign Language and provide ADA training.

Another EEOC case took place in December 2001. The lawsuit alleged that Wal-Mart's preemployment questionnaire "Matrix of Essential Job Functions" violated the ADA, and the EEOC resolved the suit with a $6.8 million consent decree. In 2002 Wal-Mart agreed to pay $220,000 for rejecting a pregnant applicant. In February 2005, Wal-Mart paid a $7.5-million jury-verdict fine to a disabled former employee in a class-action lawsuit.

SWEATSHOP WORKERS Another class-action lawsuit accuses Wal-Mart Stores Inc. of failing to monitor labor conditions at overseas factories that allegedly maintained sweatshop conditions. The plaintiffs are fifteen workers in Bangladesh, Swaziland, Indonesia, China, and Nicaragua who claim they were paid below minimum wage in their country, forced to work unpaid overtime, and in some cases even endured beatings by supervisors. It also includes four California workers who claim that Wal-Mart's entry into southern California forced their employers to reduce pay and benefits. The lawsuit could cover a class of anywhere from one hundred thousand to five hundred thousand workers.

ILLEGAL IMMIGRANTS In October 2003, federal officials raided Wal-Mart stores across the United States and arrested 250 illegal immigrants working on cleaning crews at sixty-one stores in twenty-one states. The undocumented workers were from Mexico, eastern Europe, and other countries and were employed by several contactors used by Wal-Mart.

The investigation by the U.S. Immigration and Customs Enforcement evolved out of two earlier immigration probes in 1988 and 2001 and ended in March 2005 with a landmark $11 million civil settlement. Twelve corporations that provided janitorial services to Wal-Mart stores agreed to forfeit an additional $4 million and to enter corporate guilty pleas to criminal immigration charges.

However, according to a *Wall Street Journal* article in November 2005, three top Wal-Mart executives knew that its cleaning contractors used illegal immigrants who worked as many as seven days a week for less than the minimum wage. The executives allegedly encouraged the cleaning contractor to make "shells" of the company so that they could continue to hire the contractor if one of the companies was closed for hiring illegal workers. (Shell companies are created for either hiding something illegal or unethical. The company is called a shell because outsiders see it as a company, but in reality, many are just mail drops.)

Even after agreeing to make sure that no people working for Wal-Mart were illegal immigrants, another raid by federal, state, and local authorities in November 2005 netted 125 illegal immigrants. The illegal immigrants were arrested at a Wal-Mart construction site. The workers had been building a 1 million-square-foot distribution center in eastern Pennsylvania. In December 2005, another 14 illegal immigrants were arrested while installing shelves at one of Wal-Mart's distribution centers in Nebraska.

LOW BENEFITS To work full time at Wal-Mart, an employee works a minimum of just 28 hours. Although wages tend to be higher than minimum wage, the few hours that employees are allowed to work ensures that associates can barely cover living expenses. This means that the taxpayer has to pay the difference. According to "The Case Against Wal-Mart," a typical Wal-Mart store with two hundred employees costs federal taxpayers $420,750 per year—about $2103 per employee. This pays for free and reduced lunches for Wal-Mart families, housing assistance, federal tax credits and deductions for low-income families, additional child tax credits, federal health-care costs of moving into state children's health insurance programs, and low-income energy assistance (electric and gas bills).

Wal-Mart fails to provide health insurance to more than 60 percent of its employees. Part-time employees are excluded from Wal-Mart's health program, and the company has an extra-long waiting period before employees become eligible for its health-care program. Even then, many are not eligible if they work part time, and those who are covered are underinsured. For employees who can get coverage, the deductibles can be prohibitively high for such low-income families, who then have to pay for most of the expenses themselves.

In a leaked Wal-Mart memo to the board of directors, Susan Chambers, Wal-Mart's executive vice president for benefits, described how 46 percent of Wal-Mart employees are uninsured or on Medicaid. The memo detailed how Wal-Mart's health plan requires such high out-of-pocket payments that the small number of employees hit by a very costly illness "almost certainly end up declaring personal bankruptcy." The memo also proposed that Wal-Mart rewrite job descriptions to involve more physical activity, in part to "dissuade unhealthy people from coming to work at Wal-Mart."

Another influence of Wal-Mart is the downward pressure on wages and benefits in towns when Wal-Mart enters the area. To compete against the retail giant, other stores in the area reduce their wages by about 3.5 percent. Overall payroll wages including Wal-Mart wages are reduced by 5 percent. But even with the decrease in wages, many stores still go out of business, causing many local residents to lose their jobs. According to the advocacy group Good Jobs First, Wal-Mart has received more than $1 billion in public subsidies just for building its stores (not counting the cost to state and local governments of picking up health-care costs of Wal-Mart employees).

WORKING CONDITIONS In December 2005, Wal-Mart was ordered to pay $172 million to more than one hundred thousand California employees in a class-action lawsuit that claimed that Wal-Mart routinely denied workers meal breaks. California has a law that requires a thirty-minute meal break within the first five hours of a shift or an extra hour's pay. The employees also allege that they were denied rest breaks and that Wal-Mart managers deliberately altered timecards to keep people from earning overtime. Hours were regularly deleted from time records, and employees were reprimanded for claiming overtime. Another similar case in New Mexico and Colorado in 2000 ended with Wal-Mart reportedly paying $50 million to sixty-seven thousand employees.

According to www.WalMartFacts.com, forty pending wage-and-hour cases are currently seeking class certification. Wal-Mart states that any manager who requires or even tolerates "off-the-clock" work would be violating policy and labor laws.

UNIONS Germany is the only place where Wal-Mart employees currently are unionized. Employees in German Wal-Mart stores have thirty-six days vacation a year and are paid overtime. Wal-Mart has, according to some sources, spent a considerable amount of money and resources on ensuring that Wal-Mart employees in the United States and the other fifteen countries in which it does business do not unionize. It has been alleged that when the word *union* surfaces in a Wal-Mart, the top dogs in Bentonville are called and action is taken immediately to thwart any union movements:

- In a Wal-Mart store in Loveland, Colorado, some employees in the Tire and Lube Express wanted to unionize. Wal-Mart found ways, according to some workers, to intimidate and brainwash its employees to pressure the few pro-union employees. Wal-Mart also hired more workers for the Tire and Lube Express to dilute the numbers who would vote for the union. The pressure ensured that once again Wal-Mart did not become unionized.

- In 2000 when seven of ten butchers in a store in Jacksonville, Texas, voted to join the United Food Workers Union, Wal-Mart responded by announcing that henceforth it would sell only precut meat in all of its supercenters, fired four of the union supporters, and transferred the rest into other divisions.
- In Canada, the United Food and Commercial Workers organized at Jonquiere, Quebec, Wal-Mart in 2004. In 2005 the retailer closed the store, claiming it was losing money and that union demands would prevent it from becoming profitable.

Wal-Mart is now facing a tough decision in China. If it wants to continue its growth into China, it might have to accept a union. According to some reports, employees in Chinese Wal-Marts were warned against speaking with trade-union officials during working hours. Poor working conditions in China and low wages are generating social unrest, and the government it trying to craft a new set of labor laws that give workers greater protection. These laws are likely to give greater power to the All-China Federation of Trade Unions. Whether Wal-Mart is forced to accept a union remains to be seen. As for Sam Walton, Wal-Mart's founder, he believed that unions were a divisive force and would make the company uncompetitive.

ETHICAL LEADERSHIP ISSUES: THOMAS COUGHLIN In January 2005, Thomas Coughlin, vice chairman of Wal-Mart Stores Inc., resigned but remained on the Wal-Mart board of directors. At one time as vice chairman—the second-highest-ranking executive at Wal-Mart—he was a candidate to become CEO. Coughlin was a legend at Wal-Mart—a protégé and hunting buddy of Sam Walton. Coughlin would often spend a week on the road with Walton as they expanded Sam's Clubs. His compensation was over $6 million in 2004.

In March 2005, Coughlin was forced to resign from the board of directors for stealing as much as $500,000 from Wal-Mart in the form of bogus expenses and reimbursements, along with the unauthorized use of gift cards. Coughlin had worked at Wal-Mart for twenty-seven years, five of them as the second-most-powerful executive at the company. The case created new concerns about leadership, corporate governance, and the ethical culture of Wal-Mart.

In January 2006, Coughlin pled guilty to federal wire-fraud and tax-evasion charges. Although Coughlin took home millions of dollars in compensation, he secretly had Wal-Mart pay for some of his personal expenses, including hunting vacations, a $2590 dog enclosure at his home, and a $1359 pair of handmade alligator boots.

Coughlin's deceit was discovered when he asked a lieutenant to approve $2000 in expense payments without any receipts. Jared Bowen, a Wal-Mart vice president, says Coughlin mentioned that the money was for the union project. Coughlin claims that he told the Wal-Mart board of directors that he was using money for anti-union activities, including paying union staffers to identify pro-union workers in Wal-Mart stores. Wal-Mart issued statements that there were no anti-union activities and the funds were misappropriated for Coughlin's personal use. Paying union staffers to identify pro-union workers would be a criminal offense under the Taft–Hartley Act. The following day after Bowen reported the alleged misconduct, Wal-Mart fired him. As a whistle-blower on the expense-payment abuses, he could not understand why he was fired. He said that Wal-Mart officials indicated that "he wasn't forthcoming" and there was "a general lack of confidence." Bowen has asked federal prosecutors to investigate whether the company violated corporate whistle-blowing laws in his firing. In the meantime, Wal-Mart has rescinded Coughlin's retirement agreement, worth more than $10 million. Coughlin faced up to twenty-eight years in prison after pleading guilty to five counts of wire fraud and one count of filing a false tax return. He was sentenced to 27 months of home detention and five years probation. Wal-Mart spokesperson Mona Williams says the experience has been "embarrassing and painful. Someone we expected to operate with the highest integrity let us down in a very public way."

Environmental Stakeholders

The Environmental Protection Agency (EPA) and the states of Tennessee and Utah allege that Wal-Mart and some of its construction contractors violated the EPA's stormwater regulations at specified sites around the country. Wal-Mart settled the dispute without admitting any wrongdoing or violations of the regulations by paying a $3.1 million civil penalty and agreeing to implement a Supplemental Environmental Project valued at $250,000.

In 2001 the state of Connecticut filed suit against Wal-Mart for violations of state environmental laws and for failing to obtain the appropriate permits or to maintain the required records relating to stormwater-management practices at twelve stores. In 2003 the state also filed an amended complaint alleging that Wal-Mart also discharged wastewater associated with vehicle maintenance activities and photo-processing activities without proper permits. The company settled these suits without admitting any wrongdoing or violations of the regulations by paying $1.5 million and implementing new compliance procedures.

The EPA has alleged that Wal-Mart violated certain air-quality restrictions at various locations in Massachusetts and Connecticut, including state and local restrictions on the amount of time that truck engines are allowed to idle. Wal-Mart settled those allegations by agreeing to pay a $50,000 civil penalty, to implement new compliance procedures, and to implement a Supplemental Environmental Project valued at $100,000.

The district attorneys for Solano County and Orange County, California, allege that the Wal-Mart's store in Vacaville failed to comply with certain California statutes regulating hazardous waste– and hazardous materials–handling practices. Specifically, that Wal-Mart improperly disposed of a limited amount of damaged or returned product containing dry granular fertilizer and pesticides on or about April 3, 2002, and January 24, 2005. The cases have not yet been settled.

In another environmental case, the EPA alleges that Wal-Mart and one of its construction contractors violated EPA stormwater regulations at a site in Caguas, Puerto Rico. The administrative complaint filed by the agency proposes an administrative penalty in the amount of $157,500. The parties are currently negotiating toward a resolution of this matter.

In November 2005, Wal-Mart received a grand jury subpoena from the U.S. Attorney's Office in Los Angeles seeking documents and information relating to the company's receipt, transportation, handling, identification, recycling, treatment, storage, and disposal of certain merchandise that constitutes hazardous materials or hazardous waste. Wal-Mart also received administrative document requests from the California Department of Toxic Substances Control requesting similar documents and information with respect to two of the company's distribution facilities. California local government authorities and the state of Nevada have also initiated investigations into this matter. The company is cooperating fully with the respective authorities.

Many activists are concerned about urban sprawl created by Wal-Mart stores. The construction of a Wal-Mart supercenter can stress a city's infrastructure of roads, parking, and traffic flows. In addition, there are concerns about the number of acres of green space in a city that can be devoured by Wal-Mart constructing a new store. Another issue is the number of abandoned stores that Wal-Mart deserts after it outgrows the small discount stores and moves to a new supercenter location. There are over 26 million square feet of empty Wal-Marts, enough empty space to fill up 534 football fields. The annual figure of empty Wal-Marts is between 350 and 400 per year. It has been alleged that Wal-Mart goes out of its way to prevent other retail stores from buying its abandoned stores, especially competitors like Target.

WHAT IS WAL-MART DOING TO IMPROVE ITS REPUTATION?

Global Ethics Office

The Global Ethics Office was established on June 1, 2004. On June 4, 2004, Wal-Mart released a revised "Global Statement of Ethics" to communicate their ethical standards to all Wal-Mart facilities and stakeholders. The Global Ethics Office provides guidance in making ethical decisions based on the "Global Statement of Ethics" and a process for anonymous reporting of suspected ethics violation by calling the Ethics Helpline. The Ethics Helpline allows for an anonymous and confidential way for associates to contact the company regarding ethical issues. Wal-Mart's "Guiding Ethical Principles," added to the revised "Global Statement of Ethics," were designed to assist Wal-Mart associates and suppliers with making the right decision and doing the right thing:

1. Follow the law at all times.
2. Be honest and fair.
3. Never manipulate, misrepresent, abuse, or conceal information.
4. Avoid conflicts of interest between work and personal affairs.
5. Never discriminate against anyone.
6. Never act unethically—even if someone else instructs you to do so.
7. Never ask someone to act unethically.
8. Seek assistance if you have questions about the "Statement of Ethics" or if you face an ethical dilemma.
9. Cooperate with any investigation of a possible ethics violation.
10. Report ethics violations or suspected violations.

Environment

Although Wal-Mart has recycling locations at each of its stores, it has tied itself to other initiatives over the past couple of years to improve its environmental impact.

EXPERIMENTAL STORES Wal-Mart opened two environmentally friendly stores—one in McKinney Texas, and the other in Aurora, Colorado. The two locations were chosen because they have different weather and climate considerations. The stores should provide examples of the way that building owners, scientists, engineers, architects, contractors, and landscape designers can work together to create stores that save energy, conserve natural resources, and reduce pollution. The stores are living laboratories, testing experimental technologies and products. Wal-Mart hopes to take what is learned at these two stores and use that at future stores.

The new stores include pervious pavement, experimental urban forest, water conservation, wildflower meadows, wind turbines, solar energy, recycling efforts, climate control, Xeriscape and bioswale (proenvironmental landscaping methods), and internal lighting and construction experiments.

WAL-MART ACRES FOR AMERICA In 2005 Wal-Mart partnered with the National Fish and Wildlife Foundation to conserve critical wildlife habitats for future generations. It has committed $35 million for the next ten years to conserve at least one acre of priority wildlife habitat for every acre developed for company use. This puts the minimum total acres to be protected at 138,000.

ENERGY CONSERVATION MEASURES There are three main ways that Wal-Mart is conserving energy:

- *Daylighting* (skylights/dimming): Most new stores include this feature, which enables the stores to dim or turn off lights as daylight increases and enters through the skylights, thereby reducing the demand for electricity during peak hours.
- *Heating* and *cooling:* The heating and cooling of Wal-Mart stores in the contiguous fory-eight states is centrally controlled in Bentonville, Arkansas, enabling Wal-Mart to actively control and manage energy consumption.

LIGHTING EFFICIENCY PROGRAM All new Wal-Mart stores and supercenters use T-8 low-mercury fluorescent lamps and electronic ballasts, a very efficient lighting system. By retrofitting older stores with T-8 lighting rather than the T-12 systems, the amount of energy used by each store will be reduced by approximately 15 percent. Wal-Mart started retrofitting its older stores in 2000 and plans to have completed the process by 2007.

PLASTIC SANDWICH BALE Wal-Mart partnered with Rocky Mountain Recycling in 2005 and introduced an innovation in the solid-waste and recycling industry. The Plastic Sandwich Bale is a new way to use existing equipment to reduce store waste. Plastic shopping bags, film from apparel bags, and shrink-wrap are "sandwiched" between layers of cardboard and then compacted for ease of plastic recovery within the store and transportation to end markets. From 2001 to 2006, Wal-Mart facilities in the United States have recycled 36,378 tons of plastic. In 2004 it launched a pilot program in 326 stores in Arizona, California, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, and Wyoming. It is proving to be a huge success and is keeping 5376 tons of plastic out of landfills per year.

KIDS RECYCLING CHALLENGE Wal-Mart introduced a recycling challenge for schools and children, which ran until May 2005. Over thirty-five schools participated, and for each sixty-gallon bag of plastic bags, schools received $5 from Wal-Mart. In the first six months of the program, over two thousand bags of bags were collected, and Wal-Mart gave over $28,000 to schools. The program was such a success that Wal-Mart has extended it, hoping to do it every school year.

2005 *WASTE NEWS* ENVIRONMENTAL AWARD Wal-Mart won the 2005 *Waste News* Environmental Award. *Waste News* editor stated that Wal-Mart had made the most significant environmental progress of any business in 2005.

IMPROVING ITS IMAGE AMONG CUSTOMERS

In 2005 Wal-Mart introduced a website (www.WalMartFacts.com) to counter claims made by its critics. The website has information about the litigation that Wal-Mart faces and what it thinks about the claims and lawsuits as well as information about the actions it is taking to help the environment. There are sections on community impact, an associate center, key topics, "Do You Know?" and "Talk with Us," as well as a list of all the awards and recognition that Wal-Mart has achieved. All of this is aimed at reducing misperceptions about Wal-Mart and ensuring that customers are better informed about all the "misleading" news that they hear about the retail giant.

In 2005 Wal-Mart also launched a full-page ad in more than one hundred newspapers across the country. The ad was a direct letter from Wal-Mart CEO H. Lee Scott, which said it was time for the public to hear the "unfiltered truth" about Wal-Mart and time for the company to stand up on behalf of a work force that includes 1.2 million Americans. Scott called for Congress to increase the minimum wage and said that Wal-Mart has increased spending on health insurance for its workers. The firm says it insures six hundred thousand associates and more than three-fourths of Wal-Mart associates have health insurance.

Wal-Mart has also hired the public relations firm Hill and Knowlton and dozens of communications specialists to help it improve its overall image. This was combined with an aggressive advertising campaign publicizing the millions of dollars that Wal-Mart contributes to local community organizations, as well as focusing on other key concerns such as how Wal-Mart treats its employees and its employee diversity. Walmart has one of the most diverse work forces in the United States and is a leading employer of senior citizens in the United States, employing 164,000 workers aged 55 years or older. Of the fifteen board of director members, two Latinos sit alongside two women. It also employs 139,000 Hispanic associates, 208,000 African American associates, and 775,000 women. More than 76 percent of the management team at

Wal-Mart started as hourly associates, and as of 2006, the Wal-Mart website reports that more than 40 percent of Wal-Mart store management are women.

WAL-MART AND THE ECONOMY

Wal-Mart is a driving force in the U.S. economy. Wal-Mart saves working families $2329 a year, on average, according to a study analyzing the national and regional economic impact of Wal-Mart. The consumer savings continue to be especially meaningful to lower-income and retired consumers. Low prices are due to Wal-Mart's higher levels of capital investment in distribution and inventory-control assets, operational excellence, advanced information technology, low import prices from China, and greater efficiency in its whole supply chain.

The study by Global Insight, an independent economic analysis firm, concluded that the efficiencies that Wal-Mart has fostered in the retail sector have led to lower prices for the U.S. consumer. The expansion of Wal-Mart over the 1985–2004 period can be associated with a cumulative decline of 9.1 percent in food-at-home prices, a 4.2 percent decline in commodities prices, and a 3.1 percent decline in overall consumer prices as measured by the Consumer Price Index. The 3.1 percent decline in prices was partially offset by a 2.2 percent decline in nominal wages, but there was still a net increase in real disposable income of 0.9 percent. Wal-Mart also created 210,000 jobs nationwide.

In Dallas, Fort Worth, and Arlington, Texas, Wal-Mart's effect has been considerable. The cost savings have been 4 percent, and Wal-Mart has provided sixty-three hundred more jobs and a 2.6 percent increase in real disposable income in the Dallas–Fort Worth area.

For a new store with about 150 to 350 employees in an area, Wal-Mart typically increases employment in the area by 137 jobs in the short term, which levels off in the long term to an increase of 97 jobs. This is due to the net job decline in food, apparel, and accessory stores but an increase in building materials, garden supply, and general merchandise store jobs. Although Wal-Mart displaces other retail establishments in the short term, it stimulates the overall development of the retail sector, which leads to an overall positive impact (in terms of retail employment) for the countries in which Wal-Mart has expanded. Wal-Mart has contributed modestly to lower import prices because it has been able to purchase imported goods for 5 percent less than traditional retailers due to the high volume and distribution efficiencies.

HURRICANE KATRINA

Wal-Mart's response to Hurricane Katrina was fast, efficient, and significant. Wal-Mart contributed $17 million in cash to the hurricane relief effort, more than $3 million in merchandise, $15 million to the Bush–Clinton Katrina Fund, $1 million to the Salvation Army, and $1 million to the American Red Cross. Wal-Mart also provided more than $8.5 million in cash assistance to impacted associates through Wal-Mart's Associate Disaster Relief Fund. They gave $20,000 in cash donations to assist various animal shelters and organizations taking in lost animals in hurricane-impacted areas. In addition they also dispatched 2450 Wal-Mart truckloads, donated 70 pallets of clothes to help evacuees, set up donation centers in various shelters to help arriving evacuees needing personal health and beauty products, clothing, food, and water. For example, at the Houston Astrodome, Wal-Mart provided five trucks of relief supplies, forty-five associate volunteers, and a computer, fax machine, TV, VCR, and children's movies.

Wal-Mart donated one hundred truckloads of water and other supplies to the afflicted area. They also donated food for one hundred thousand meals and the promise of a job for every one of its displaced workers. Cliff Brumfield, executive vice president of the Brookhaven–Lincoln County Chamber of Commerce, said he was impressed with Wal-Mart's preparations: "They were ready before FEMA was." Scott, Wal-Mart's CEO, appeared on *Larry King Live* to discuss the chain's response to the storm and was singled out and praised by former Presidents George H. W. Bush and Bill Clinton.

These measures have attempted to stem the tide of negative publicity that has focused on the company. Although it has tried to address all the major concerns of its various stakeholders, only time will tell whether these measures prove effective and whether Wal-Mart can overcome the negative publicity. Consumers always vote with their money.

THE FUTURE

Wal-Mart indicates it is willing to accept the challenge of improving stakeholder relationships. The firm claims that it is being singled out because of its large size. Moves by the company to enter into the banking industry were rejected due to the banking industry's fears that the retailer would quickly dominate the field.

Wal-Mart has also faced criticism for encouraging suppliers to join a group called Working Families for America, an organization that has more than one hundred thousand members and is helping Wal-Mart counter the wave of negative publicity. But because the group is funded in part by Wal-Mart, its suppliers are worried that if they don't join they will face repercussions. Wal-Mart has denied these claims and says that suppliers who do not join will not face any adverse consequences.

There is no doubt that Wal-Mart's size and rapid growth has put it at the center of a debate about its impact on workers, unions, suppliers, local communities, competition, and the environment. Wal-Mart's push to import most of its products from China and to force its suppliers to manufacture in China creates an issue that significantly affects the U.S. economy. However, Wal-Mart is continuing to move into new areas, increasing its focus on organic foods and even moving into more expensive products for upscale clientele.

Wal-Mart remains controversial and there are different points of view. Consider these quotes:

> Some well-meaning critics believe that Wal-Mart Stores today, because of our size, should, in fact, play the role that is believed that General Motors played after World War II. And that is to establish this post–World War middle class that the country is so proud of. . . . The facts are that retail does not perform that role in the economy.—Wal-Mart CEO H. Lee Scott

This is one of our nation's great companies. . . . The story of Wal-Mart exemplifies some of the very best qualities in our country—hard work, the spirit of enterprise, fair dealing and integrity.—Vice President Dick Cheney

It is extremely troubling when the vice president . . . praises a company that pays low wages and benefits, discriminates on the basis of gender, locks its own workers into stores at night, busts unions and violates child-labor laws.—Representative George Miller (D., Calif.)

It's time for Wal-Mart to understand that their company practices run counter to the very values that make this country great—fairness, opportunity and equality.—Senator Edward Kennedy (D., Mass.)

QUESTIONS

1. Evaluate how Wal-Mart has ranked and responded to various stakeholders.
2. Why do you think Wal-Mart has had a recent number of ethical issues that have been in the news almost constantly?
3. What do you think Wal-Mart could do to develop an improved ethical culture and respond more positively to its diverse stakeholders?

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The Coca-Cola Company Struggles with Ethical Crises

Coca-Cola has the most valuable brand name in the world and, as one of the most visible companies worldwide, has a tremendous opportunity to excel in all dimensions of business performance. However, over the last ten years, the firm has struggled to reach its financial objectives and has been associated with a number of ethical crises. Warren Buffet served as a member of the board of directors and was a strong supporter and investor in Coca-Cola but resigned from the board in 2006 after several years of frustration with Coca-Cola's failure to overcome many challenges.

Many issues were facing Doug Ivester when he took over the reins at Coca-Cola in 1997. Ivester was heralded for his ability to handle the financial flows and details of the soft-drink giant. Former-CEO Roberto Goizueta had carefully groomed Ivester for the top position that he assumed in October 1997 after Goizueta's untimely death. However, Ivester seemed to lack leadership in handling a series of ethical crises, causing some to doubt "Big Red's" reputation and its prospects for the future. For a company with a rich history of marketing prowess and financial performance, Ivester's departure in 1999 represented a high-profile glitch on a relatively clean record in one hundred years of business. In 2000 Doug Daft, the company's former president and chief operating officer, replaced Ivester as the new CEO. Daft's tenure was rocky, and the company continued to have a series of negative events in the early 2000s. For example, the company was allegedly involved in racial discrimination, misrepresenting market tests, manipulating earnings, and disrupting long-term contractual arrangements with distributors. By 2004 Daft was out and Neville Isdell had become president and worked to improve Coca-Cola's reputation.

We appreciate the work of Kevin Sample, who helped draft the previous edition of this case and Melanie Drever, who assisted in this edition. This case was prepared for classroom discussion rather than to illustrate either effective of ineffective handling of an administrative, ethical, or legal decision by management. All sources used for this case were obtained through publicly available material and the Coca-Cola website.

HISTORY OF THE COCA-COLA COMPANY

The Coca-Cola Company is the world's largest beverage company, and markets four of the world's top five leading soft drinks: Coke, Diet Coke, Fanta, and Sprite. It also sells other brands including Powerade, Minute Maid, and Dansani bottled water. The company operates the largest distribution system in the world, which enables it to serve customers and businesses in more than two hundred countries. Coca-Cola estimates that more than 1 billion servings of its products are consumed every day. For much of its early history, Coca-Cola focused on cultivating markets within the United States.

Coca-Cola and its archrival, PepsiCo, have long fought the "cola wars" in the United States, but Coca-Cola, recognizing additional market potential, pursued international opportunities in an effort to dominate the global soft-drink industry. By 1993 Coca-Cola controlled 45 percent of the global soft-drink market, while PepsiCo received just 15 percent of its profits from international sales. By the late 1990s, Coca-Cola had gained more than 50 percent of the global market in the soft-drink industry. Pepsi continued to target select international markets to gain a greater foothold in international markets. Since 1996 Coca-Cola has focused on traditional soft drinks, and PepsiCo has gained a strong foothold on new-age drinks, has signed a partnership with Starbucks, and has expanded rapidly into the snack-food business. PepsiCo's Frito-Lay division has 60 percent of the U.S. snack-food market. Coca-Cola, on the other hand, does much of its business outside of the United States, and 85 percent of its sales now come from outside the United States. As the late Roberto Goizueta once said, "Coca-Cola used to be an American company with a large international business. Now we are a large international company with a sizable American business."

Coca-Cola has been a successful company since its inception in the late 1800s. PepsiCo, although founded about the same time as Coca-Cola, did not become a strong competitor until after World War II when it began to gain market share. The rivalry intensified in the mid-1960s, and the "cola wars" began in earnest. Today, the duopoly wages war primarily on several international fronts. The companies are engaged in an extremely competitive—and sometimes personal—rivalry, with occasional accusations of false market-share reports, anticompetitive behavior, and other questionable business conduct, but without this fierce competition, neither would be as good a company as it is today.

By January 2006, PepsiCo had a market value greater than Coca-Cola for the first time ever. Its strategy of focusing on snack foods and innovative strategies in the non-cola beverage market helped the company gain market share and surpass Coca-Cola in overall performance.

COCA-COLA'S REPUTATION

Coca-Cola is the most-recognized trademark and brand name in the world today with a trademark value estimated to be about $25 billion. The company has always demonstrated a strong market orientation, making strategic decisions and taking actions to attract, satisfy, and retain customers. During World War II, for example, company president Robert Woodruff committed to selling Coke to members of the armed services for just a nickel a bottle. As one analyst said later, "Customer loyalty never came cheaper." This philosophy helped make Coke a truly global brand, with its trademark brands and colors recognizable on cans, bottles, and advertisements around the world. The advance of Coca-Cola products into almost every country in the world demonstrated the company's international market orientation and improved its ability to gain brand recognition. These efforts contributed to the company's strong reputation.

However, in 2000 Coca-Cola failed to make the top ten of *Fortune*'s annual "America's Most Admired Companies" list for the first time in a decade. Problems at the company were leadership issues, poor economic performance, and other upheavals. The company also dropped out of the top one hundred in *Business Ethics*' annual list of "100 Best Corporate Citizens" in 2001. For a company that spent years on both lists, this was disappointing, but perhaps not unexpected, given several ethical crises.

Coca-Cola's promise is that the company exists "to benefit and refresh everyone who is touched by our business." It has successfully done this by continually increasing market share and profits with Coca-Cola being the most-recognized brand in the world. Because the company is so well known, the industry so pervasive, and a strong history of market orientation, the company has developed a number of social responsibility initiatives to enhance its trademarks. These initiatives are guided by the company's core beliefs in the marketplace, workplace, community, and environment. For example, Coke wants to inspire moments of optimum through their brands and their actions, as well as creating value and making a difference everywhere they do business. Their vision for sustainable growth is fostered by being a great place to work where people are inspired to be the best they can be, by bringing the world a portfolio of beverage brands that anticipate and satisfy peoples' desires and needs, by being a responsible global citizen that makes a difference, and by maximizing return to shareowners while being mindful of their overall responsibilities.

SOCIAL RESPONSIBILITY FOCUS

Coca-Cola has made local education and community improvement programs a top priority for its philanthropic initiatives. Coca-Cola foundations "support the promise of a better life for people and their communities." For example, Coca-Cola is involved in a program called "Education on Wheels" in Singapore where history is brought to life in an interactive discovery adventure for children. In an interactive classroom bus, children are engaged in a three-hour drama specially written for the program. It challenges creativity and initiatives while enhancing communication skills as children discover new insights into life in the city.

Coca-Cola also offers grants to various colleges and universities in more than half of the United States, as well as numerous international grants. In addition to grants, Coca-Cola provides scholarships to more than 170 colleges, and this number is expected to grow to 287 over the next four years. It includes 30 tribal colleges belonging to the American Indian College Fund. Coca-Cola is also involved with the Hispanic Scholarship Fund. Such initiatives help enhance the Coca-Cola name and trademark and thus ultimately benefit shareholders. Each year 250 new Coca-Cola Scholars are designated and invited to Atlanta for personal interviews. Fifty students are then designated as National Scholars and receive awards of $20,000 for college; the remaining 200 are designated as Regional Scholars and receive $4000 awards. Since the program's inception in 1986, a total of over twenty-five hundred Coca-Cola scholars have benefited from nearly $22 million for education. The program is open to all high school seniors in the United States.

The company recognizes its responsibilities on a global scale and continues to take action to uphold this responsibility, such as taking steps not to harm the environment while acquiring goods and setting up facilities. The company is proactive on local issues, such as HIV/AIDS in Africa, and has partnered with UNAIDS and other nongovernment organizations to put into place important initiatives and programs to help combat the threat of the HIV/AIDS epidemic.

Because consumers trust its products, and develop strong attachments through brand recognition and product loyalty, Coca-Cola's actions also foster relationship marketing. For these reasons, problems at a firm like Coca-Cola can stir the emotions of many stakeholders.

CRISIS SITUATIONS

The following documents a series of alleged misconduct and questionable behavior affecting Coca-Cola stakeholders. These ethical and legal problems appear to have had an impact on Coca-Colas financial performance, with its stock trading today at the same price it did ten years ago. The various ethical crises have been associated with turnover in top management, departure of key investors, and the loss of reputation. There seems to be no end to these events as major crises continue to develop. It is important to try to understand why Coca-Cola has not been able to eliminate these events that have been so destructive to the company.

Contamination Scare

Perhaps the most damaging of Coca-Cola's crises—and the situation that every company dreads—began in June 1999, when about thirty Belgian children became ill after consuming Coca-Cola products. Although the company recalled the product, the problem soon escalated. The Belgian government eventually ordered the recall of all Coca-Cola products, leading officials in Luxembourg and the Netherlands to recall all Coca-Cola products as well. The company eventually determined that the illnesses were the result of a poorly processed batch of carbon dioxide. Coca-Cola took several days to comment formally on the problem, which the media quickly labeled a slow response. Coca-Cola initially judged the situation to be minor and not a health hazard, but by that time a public relations nightmare had begun. France soon reported more than one hundred people sick and banned all Coca-Cola products until the problem was resolved. Soon after, a shipment of Bonaqua, a new Coca-Cola water product, arrived in Poland, contaminated with mold. In each instance, the company's slow response and failure to acknowledge the severity of the situation harmed its reputation.

The contamination crisis was exacerbated in December 1999 when Belgium ordered Coca-Cola to halt its "Restore" marketing campaign in order to regain consumer trust and sales in Belgium. A rival firm claimed that the campaign strategy that included free cases of the product, discounts to wholesalers and retailers, and extra promotion personnel was intended to illegally strengthen Coca-Cola's market share. Under Belgium's strict antitrust laws, the claim was upheld, and Coca-Cola abandoned the campaign. This decision, along with the others, reduced Coca-Cola's market standing in Europe.

Competitive Issues

Questions about Coca-Cola's market dominance started government inquiries into its marketing tactics. Because most European countries have very strict antitrust laws, all firms must pay close attention to market share and position when considering joint ventures, mergers, and acquisitions. During the summer of 1999, Coca-Cola became very aggressive in the French market. As a result, the French government responded by refusing to approve Coca-Cola's bid to purchase Orangina, a French beverage company. French authorities also forced Coca-Cola to scale back its acquisition of Cadbury Schweppes, another beverage maker. Moreover, Italy successfully won a court case against Coca-Cola over anticompetitive prices in 1999, prompting the European Commission to launch a full-scale probe of the company's competitive practices. PepsiCo and Virgin accused Coca-Cola of using rebates and discounts to crowd their products off shelves, thereby gaining greater market share. Coca-Cola's strong-arm tactics proved to be in violation of European laws and once again demonstrated the company's lack of awareness of European culture and laws.

Despite these legal tangles, Coca-Cola products, along with many other U.S. products, dominate foreign markets throughout the world. According to some European officials, the pain that U.S. automakers felt in the 1970s because of Japanese imports is the same pain that U.S. firms are meting out in Europe. The growing omnipresence of U.S. products, especially in highly competitive markets, is why corporate reputation—both perceived and actual—is so important to relationships with business partners, government officials, and other stakeholders.

Racial Discrimination Allegations

In the spring of 1999, initially fifteen hundred African American employees sued Coca-Cola for racial discrimination but eventually grew to include two thousand current and former employees. Coca-Cola was accused of discriminating against them in pay, promotions, and performance evaluations. Plaintiffs charged that the company grouped African American workers at the bottom of the pay scale, where they typically earned $26,000 a year less than Caucasian employees in comparable jobs. The suit also alleged that top management had known of the discrimination since 1995 but had done nothing. Although in 1992 Coca-Cola had pledged to spend $1 billion on goods and services from minority vendors, it did not seem to apply to their workers.

Although Coca-Cola strongly denied the allegations, the lawsuit evoked strong reactions. To reduce collateral damage, Coca-Cola created a diversity council and paid $193 million to settle the racial discrimination lawsuit.

Problems with the Burger King Market Test

In 2002 Coca-Cola ran into more troubles when Matthew Whitley, a mid-level Coca-Cola executive, filed a whistle-blowing suit, alleging retaliation for revealing fraud in a market study performed on behalf of Burger King. To increase sales, Coca-Cola suggested that Burger King invest in and promote frozen Coke as a child's snack. The fast-food chain arranged to test market the product for three weeks in Richmond, Virginia, and evaluate the results before agreeing to roll out the new product nationally. The test market involved customers receiving a coupon for a free frozen Coke when they purchased a Value Meal (sandwich, fries, and drink). Burger King executives wanted to be cautious about the new product because of the enormous investment that each restaurant would require to distribute and promote the product. Restaurants would need to purchase equipment to make the frozen drink, buy extra syrup, and spend a percentage of their advertising funds to promote the new product.

When results of the test marketing began coming in to Coca-Cola, sales of frozen Coke were grim. Coca-Cola countered the bad statistics by giving at least one individual $10,000 to take hundreds of children to Burger King to purchase Value Meals including the frozen Coke. Coca-Cola's action netted seven hundred additional Value Meals out of nearly one hundred thousand sold during the entire promotion. But when the U.S. attorney general for the North District of Georgia discovered and investigated the fraud, the company had to pay $21 million to Burger King, $540,000 to the whistle-blower, and a $9 million pretax write-off had to be taken. Although Coca-Cola disputes the allegations, the cost of manipulating the frozen Coke research cost the company considerably in negative publicity, criminal investigations, a soured relationship with a major customer, and a loss of stakeholder trust.

Inflated Earnings Related to Channel Stuffing

Another problem that Coca-Cola faced during this period was accusations of channel stuffing. *Channel stuffing* is the practice of shipping extra inventory to wholesalers and retailers at an excessive rate, typically before the end of a quarter. Essentially, a company counts the shipments as sales although the products often remain in warehouses or are later returned to the manufacturer. Channel stuffing tends to create the appearance of strong demand (or conceals declining demand) for a product, which may result in inflated financial statement earnings thus misleading investors.

Coke was accused of sending extra concentrate to Japanese bottlers from 1997 through 1999 in an effort to inflate profits. In 2004 Coca-Cola reported finding statements of inflated earnings due to the company's shipping extra concentrate to Japan. Although the company settled the allegations, the Securities and Exchange Commission (SEC) did find that channel stuffing had occurred. Coca-Cola had pressured bottlers into buying additional concentrate in exchange for extended credit, which is technically considered legitimate.

To settle with the SEC, Coca-Cola agreed to avoid engaging in channel stuffing in the future. The company also created an ethics and compliance office and is required to verify each financial quarter that it has not altered the terms of payment or extended special credit. The company further agreed to work on reducing the amount of concentrate held by international bottlers. Although it settled with the SEC and the Justice Department, it still faces a shareholder lawsuit regarding channel stuffing in Japan, North America, Europe, and South Africa.

Trouble with Distributors

In early 2006, Coca-Cola faced problems with its bottlers, after fifty-four of them filed lawsuits seeking to block Coca-Cola from expanding delivery of Powerade sports drinks directly to Wal-Mart warehouses beyond the limited Texas test area. Bottlers alleged that the Powerade bottler contract did not permit warehouse delivery except for commissaries and that Coca-Cola had materially breached the agreement by committing to provide warehouse delivery of Powerade to Wal-Mart and by proposing to use a subsidiary, CCE, as its agent for warehouse delivery.

The problem was that Coca-Cola was trying to step away from the century-old tradition of direct-store delivery, known as DSD, wherein bottlers drop off product at individual stores, stock shelves, and build merchandising displays. Coca-Cola and CCE assert they were simply trying to accommodate a request from Wal-Mart for warehouse delivery, which is how PepsiCo distributes its Gatorade brand. CCE had also proposed making payments to some other bottlers in return for taking over Powerade distribution in their exclusive territories. But the bottlers had concerns that such an arrangement would violate antitrust laws and claimed that if Coca-Cola and CCE went forward with their warehouse delivery, it would greatly diminish the value of the bottlers' businesses.

The problems faced by Coca-Cola were reported negatively by the media and had a negative effect on Coca-Cola's reputation. When the reputation of one company within a channel structure suffers, all firms within the supply chain suffer in some way or another. This was especially true because Coca-Cola adopted an enterprise resource system that linked Coca-Cola's once almost classified information to a host of partners. Thus, the company's less-than-stellar handling of the ethical crises has introduced a lack of integrity in its partnerships. Although some of the crises had nothing to do with the information shared across the new system, the partners still assume greater risk because of their relationships with Coca-Cola. The interdependence between Coca-Cola and its partners requires a diplomatic and considerate view of the business and its effects on various stakeholders. Thus, these crises harmed Coco-Cola's partner companies, their stakeholders, and eventually, their bottom lines.

International Problems Related to Unions

Around the same time, Coca-Cola also faced intense criticism in Colombia where unions were making progress inside Coke's plants. Coincidently, at the same time, eight Coca-Cola workers died, forty-eight went into hiding, and sixty-five received death threats. The union alleges that Coca-Cola and its local bottler were complicit in these cases and is seeking reparations to the families of the slain and displaced workers. Coca-Cola denies the allegations, noting that only one of the eight workers was killed on the premises of the bottling plant. Also, the other deaths, all occurred off premises and could have been the result of Colombia's four-decade-long civil war.

Coke Employees Offer to Sell Trade Secrets

A Coca-Cola administrative secretary and two accomplices were arrested in 2006 and charged in a criminal complaint with wire fraud and unlawfully stealing and selling trade secrets from the Coca-Cola Company. The accused contacted PepsiCo executives and indicated that an individual identifying himself as "Dirk," who claimed to be employed at a high level with Coca-Cola, offered "very detailed and confidential information." When Coca-Cola received the letter from PepsiCo about the offer, the FBI was contacted, and an undercover FBI investigation began. The FBI determined that "Dirk" was Ibrahim Dimson of Bronx, New York. Dirk provided an FBI undercover agent with fourteen pages of Coca-Cola logo-marked "Classified—Confidential" and "CLASSIFIED—Highly Restricted." In addition, Dirk also provided samples of Coca-Cola top-secret products. The source of the information was Joya Williams, an executive administrative assistant for Coca-Cola's global brand director in Atlanta, who had access to some information and materials described by "Dirk." Employees should be held responsible for protecting intellectual property, and this breach of confidence by a Coca-Cola employee was a serious ethical issue.

ETHICAL RECOVERY?

Despite Coca-Cola's problems, consumers surveyed after the European contamination indicated they felt that Coca-Cola would still behave correctly during times of crises. The company also ranked third globally in a PricewaterhouseCoopers survey of most-respected companies. Coca-Cola managed to retain its strong ranking while other companies facing setbacks, including Colgate-Palmolive and Procter & Gamble, were dropped or fell substantially in the rankings.

Coca-Cola has taken the initiative to counter diversity protests. The racial discrimination lawsuit, along with the threat of a boycott by the NAACP, led to Daft's plan to counter racial discrimination. The plan was designed to help Coca-Cola improve employment of minorities.

When Coca-Cola settled the racial discrimination lawsuit, the agreement stipulated that the company (1) donate $50 million to a foundation to support programs in minority communities, (2) hire an ombudsman who would report directly to CEO Daft, (3) investigate complaints of discrimination and harassment, and (4) set aside $36 million for a seven-person task force and authorize it to oversee the company's employment practices. The task force includes business and civil rights experts and is to have unprecedented power to dictate company policy with regard to hiring, compensating, and promoting women and minorities. Despite the unusual provision to grant such power to an outside panel, Daft said, "We need to have outside people helping us. We would be foolish to cut ourselves off from the outside world."

Belgian officials closed their investigation of the health scare involving Coca-Cola and announced that no charges would be filed against the company. A Belgian health report indicated that no toxic contamination had been found in Coke bottles, even though the bottles were found to have contained tiny traces of carbonyl sulfide, which produces a rotten-egg smell; the amount of carbonyl sulfide would have to have been a thousand times higher to be toxic. Officials also reported that they found no structural problems with Coca-Cola's production plant and that the company had cooperated fully throughout the investigation.

CURRENT SITUATION AT COCA-COLA

While Coca-Cola's financial performance continues to lag, one issue that may have great impact on the success of the company is its relationship with distributors. Lawsuits that distributors have launched against Coca-Cola for its attempt to bypass them with Powerade have the potential of destroying trust and cooperation in the future. Other issues related to channel stuffing and falsifying market tests to customers indicate a willingness by management to bend the rules to increase the bottom line.

Although Coca-Cola seems to be trying to establish its reputation based on quality products and socially responsible activities, it has failed to manage ethical decision making in dealing with various stakeholders. An important question to consider is whether Coca-Cola's strong emphasis on social responsibility, especially philanthropic and environmental concerns, can help the company maintain its reputation in the face of highly public ethical conflict and crises.

CEO Isdell developed a two-year turnaround plan focused on new products, and the company created one thousand new products, including coffee-flavored Coca-Cola Blak to be marketed as an energy beverage and soft drink. The company is also adopting new-age drinks such as lower-calorie Powerade sports drink and flavored Dasani water. These moves are an attempt to catch up with PepsiCo who has become the noncarbonated-beverage leader. Coca-Cola continues developing products such as bottled coffee called Far Coast and black and green tea drinks called Gold Peak. Although PepsiCo has outexecuted Coca-Cola since 1996, Coca-Cola still has a 50 percent market share, but PepsiCo has become the larger company in 2006 and Coca-Cola's long-term earnings and sales have been lowered. If so many ethical issues had not distracted Coca-Cola, would its financial performance have been much better?

QUESTIONS

1. Why do you think Coca-Cola has had one ethical issue to resolve after another over the last decade or so?
2. A news analyst said that Coca-Cola could become the next Enron. Do you think this is possible and defend your answer?
3. What should Coca-Cola do to restore its reputation and eliminate future ethical dilemmas with stakeholders?

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CASE 3

The Fall of Enron: A Stakeholder Failure

Once upon a time, there was a gleaming headquarters office tower in Houston, with a giant tilted "E" in front, slowly revolving in the Texas sun. The Enron Corporation, which once ranked among the top *Fortune* 500 companies, collapsed in 2001 under a mountain of debt that had been concealed through a complex scheme of off-balance-sheet partnerships and investor loss of confidence. Forced to declare bankruptcy, the energy firm laid off five thousand employees; thousands more lost their retirement savings, which had been invested in Enron stock. The company's shareholders lost tens of billions of dollars after the stock price plummeted. The scandal surrounding Enron's demise engendered a global loss of confidence in corporate integrity that continues to plague markets, and eventually it triggered tough new scrutiny of financial reporting practices such as the Sarbanes–Oxley Act in 2002. To understand what went wrong, let's examine the history, culture, and major players in the Enron scandal.

HISTORY

The Enron Corporation was created out of the merger of two major gas pipeline companies in 1985. Through its subsidiaries and numerous affiliates, the company provided products and services related to natural gas, electricity, and communications for its wholesale and retail customers. Enron transported natural gas through pipelines to customers all over the United States. It generated, transmitted, and distributed electricity to the northwestern United States and marketed natural gas, electricity, and other commodities globally. It was also involved in the development, construction, and operation of power plants, pipelines, and other energy-related projects all over the

We appreciate the work of Neil Herndon, who wrote the previous edition of this case under the direction of O. C. Ferrell, and Melanie Drever, who assisted in this edition. This case is for classroom discussion rather than to illustrate either effective of ineffective handling of an administrative, ethical, or legal decision by management. All sources used for this case were obtained through publicly available material and the Enron website.

world, including the delivery and management of energy to retail customers in both the industrial and commercial business sectors.

Throughout the 1990s, Chairman Kenneth Lay, chief executive officer (CEO) Jeffrey Skilling, and chief financial officer (CFO) Andrew Fastow transformed Enron from an old-style electricity and gas company into a $150 billion energy company and Wall Street favorite that traded power contracts in the investment markets. From 1998 to 2000 alone, Enron's revenues grew from about $31 billion to more than $100 billion, making it the seventh-largest company of the *Fortune* 500. Enron's wholesale energy income represented about 93 percent of 2000 revenues, with another 4 percent derived from natural gas and electricity. The remaining 3 percent came from broadband services and exploration. Enron-Online—the company's worldwide Internet trading platform—completed on average over five thousand transactions per day, buying and selling over eighteen hundred separate products online that generated over $2.5 billion in business every day.

There was every reason to believe that Enron was still financially sound in the third quarter of 2001, even though a bankruptcy examiner later reported a discrepancy in Enron's claimed net income and cash flow. This was done under certain accounting assumptions after the bankruptcy. For the third quarter of 2001, Enron's wholesale business generated a potential $754 million of earnings (before interest and taxes), an increase of 35 percent from the previous year. This represented over 80 percent of Enron's worldwide earnings. It was acknowledged by all parties that Enron's wholesale business was highly profitable and growing at a rapid rate. Even in the fourth quarter of 2001, Lay believed that Enron was still a growing viable company for the long run, based on physical volume moving through the pipelines.

A Timeline of the Enron Scandal

1985 Houston Natural Gas merges with Omaha-based InterNorth; the resulting company is eventually named Enron Corporation. Ken Lay, who had been CEO of Houston Natural Gas, becomes chairman and CEO the following year.

2000 Annual revenues reach $100 billion, and the Energy Financial Group ranks Enron as the sixth-largest energy company in the world, based on market capitalization.

February 2001 Jeff Skilling takes over as CEO. Lay remains chairman.

August 2001 Skilling unexpectedly resigns for "personal reasons," and Lay steps back into the CEO job. That same month, a letter from an Enron executive raises serious questions about the company's business and accounting practices.

October 2001 Enron releases third-quarter earnings, showing $1 billion in charges, including $35 million related to investment partnerships headed by Andrew Fastow, Enron's former CFO. Fastow is replaced as CFO.

October 22, 2001 Enron announces that the Securities and Exchange Commission (SEC) has launched a formal investigation into its "related party transactions."

November 8, 2001 Enron restates earnings for 1997 through 2000 and the first three quarters of 2001.

December 2, 2001 Enron files for protection from creditors in a New York bankruptcy court.

December 3, 2001 Enron announces that it is laying off four thousand employees.

January 9, 2002 The Justice Department announces that it is pursuing a criminal investigation of Enron.

(continued)

A Timeline of the Enron Scandal (continued)

January 14, 2002 U.S. House and Senate lawmakers return campaign contributions from Enron.

January 24, 2002 Lay resigns as chairman and CEO of Enron. The first of at least eight congressional hearings on Enron begins.

January 30, 2002 Enron names Stephen Cooper, a restructuring specialist, as acting CEO.

February 4, 2002 A report by a special committee of Enron's board investigating the energy trader's collapse portrays a company riddled with improper financial transactions and extensive self-dealing by company officials.

May 2, 2002 Enron announces plans to reorganize as a small company with a new name.

October 2, 2002 Fastow voluntarily surrenders to federal authorities after prosecutors indicate they will file charges for his role in the company's collapse.

October 31, 2002 Fastow is indicted on seventy-eight counts of masterminding a scheme to artificially inflate the energy company's profits.

February 3, 2003 Creditors of Enron sue Lay and his wife, Linda, to recover more than $70 million in transfers.

July 11, 2003 Enron finally announces a plan to restructure and pay off creditors after five deadline extensions.

July 2003 J. P. Morgan Chase and Citigroup pay nearly $300 million to settle allegations from the SEC, New York state and New York City, that they helped Enron manipulate its financial statements and mislead investors.

September 2003 Merrill Lynch avoids prosecution related to the Nigerian barge deal by acknowledging that some employees may have broken the law and by implementing reforms.

October 2003 Wesley Colwell, former chief accounting officer for Enron's trading unit, agrees to pay $500,000 to settle SEC allegations of manipulating earnings by using trading profits to offset massive losses in Enron's retail energy unit. He is still cooperating with the Justice Department but faces no criminal charges.

December 2003 Canadian Imperial Bank of Commerce avoids prosecution by accepting responsibility for crimes committed by employees who knowingly participated in complicated transactions that wrongly moved assets off of Enron's balance sheet so that the energy company could inflate earnings.

April 30, 2003 Fastow's wife, Lea, is charged with tax crimes and conspiracy for participating in husband's deals.

September 10, 2003 Former Enron treasurer Glisan pleads guilty to conspiracy and is sentenced to five years in prison.

January 14, 2004 Andrew Fastow pleads guilty to two counts of conspiracy and agrees to serve ten years in prison.

January 22, 2004 Causey pleads innocent to conspiracy and fraud charges.

February 19, 2004 Skilling, added to the Causey indictment, pleads innocent to more than thirty criminal counts including conspiracy, fraud, and inside trading.

May 6, 2004 Lea Fastow pleads guilty to filing a false tax form and is sentenced to the maximum sentence of one year in prison.

July 8, 2004 Lay surrenders after being indicted. He pleads innocent.

July 15, 2004 Bankruptcy judge confirms Enron's reorganization plan in which most creditors will receive about one-fifth of the about $63 billion they're owed in cash and stock.

October 19, 2004 Federal judge grants Lay a separate bank fraud trial but rules that Lay, Skilling, and Causey will be tried together on other charges.

February 2005 Raymond Bowen, Jr., finance chief at Enron from the aftermath of its failure through his resignation in October 2004, agrees to pay $500,000 to settle SEC allegations that he knew or should have known some assets were grossly overvalued to falsely inflate profits. Bowen did not admit or deny the allegations and faces no criminal charges.

May 31, 2005 The Supreme Court overturns the Arthur Andersen conviction.

December 28, 2005 Causey pleads guilty to securities fraud and agrees to serve seven years in prison in exchange for cooperating with the government.

January 30, 2006 The Lay and Skilling trail begins.

May 25, 2006 Lay and Skilling are convicted of conspiracy to commit securities and wire fraud. Lay is convicted in a separate bank fraud case.

July 5, 2006 Lay dies of a heart attack, erasing his conviction. A person who dies before an appeal is not considered convicted.

SOURCES: "A Chronology of Enron's Woes: The Accounting Debacle," *Wall Street Journal* online, March 20, 2003, http://online.wsj.com; "A Chronology of Enron's Woes: The Investigation," *Wall Street Journal* online, March 20, 2003, http://online.wsj.com; "Enron Timeline," *Houston Chronicle* online, January 17, 2002, http://www.chron.com/cs/CDA/story.hts/special/enron/1127125; Kristen Hays, "16 Cents on $1 for Enron Creditors," *Austin American-Statesman* online, July 12, 2003, http://statesman.com; "Key Dates Leading to Convictions of Lay, Skilling," *USA Today,* May 26, 2006, 3B; Associated Press; "Enron Who's Who," *USA Today* online, http://www.usatoday.com/money/industries/energy/2006-01-26-enron-whos-who_x.htm (accessed June 1, 2006).

ENRON'S CORPORATE CULTURE

When describing Enron's corporate culture, people like to use the words *arrogant* or *prideful,* perhaps justifiably. The firm employed competent, creative, and hard-working employees and recruited the best and brightest graduates from top universities. In 2001 *Fortune* magazine ranked Enron the twenty-second best company to work for in America. A large banner in the lobby at corporate headquarters proclaimed Enron "The World's Leading Company," and Enron executives blithely believed that competitors had no chance against it. Skilling even went so far as to tell utility executives at a conference that he was going to "eat their lunch." There was an overwhelming aura of pride, carrying with it the deep-seated belief that Enron's people could handle increasing risk without danger.

The culture also was about a focus on how much money could be made for many executives, at many levels, that shared in a stock option incentive program. For example, after the Enron collapse, it was alleged that Enron's compensation plans seemed less concerned with generating profits for shareholders than with enriching employee wealth. This may have been the result of the highly competent and aggressive employee culture that was motivated by the desire to improve their financial position. Enron's corporate culture reportedly encouraged risky behavior, if not breaking the rules.

Skilling appears to be the executive who created a system in which Enron's employees were rated every six months, with those ranked in the bottom 20 percent forced out. This "rank-and-yank" system helped create a fierce environment in which employees competed against rivals not only outside the company but also at the next desk. Delivering bad news could result in the "death" of the messenger, so problems in the trading operation, for example, were covered up rather than being communicated to management.

Lay once said that he felt that one of the great successes at Enron was the creation of a corporate culture in which people could reach their full potential. He said that he wanted it to be a highly moral and ethical culture and that he tried to ensure that people did in fact honor the values of respect, integrity, and excellence. On his desk was an Enron paperweight with the slogan "Vision and Values." Lay maintained that he was always concerned about ethics, and he continued to discuss the ethical and legal ramifications of the Enron disaster even after his conviction. The business ethics issue involved in his indictment was that he lied about the financial condition of Enron, but he continued to maintain that he had openly dealt with all issues that were brought to his attention. Some of the people inside Enron believed that nearly anything could be turned into a financial product and, with the aid of complex statistical modeling, traded for profit. Short on assets and heavily reliant on intellectual capital, Enron's corporate culture rewarded innovation and punished employees deemed weak. An important question is, How much does a CEO know about misconduct in a corporation?

Aggressive and highly intelligent Enron employees, in many divisions, were "pushing the limits" and bending the rules to achieve success. This highly competitive risk culture existed in a corporation that was trying to redefine how the energy industry did business. Lawyers, accountants, and the board of directors approved key decisions. As intelligent and creative as Enron's executives were, no one person, under Enron's organizational system of checks and balances, could orchestrate the schemes that created the demise of a company that large. The downfall took many layers of "pushing the envelope" and a great deal of complacency on the part of employees who, at many levels in the organization, saw wrongdoing and ignored it. To some extent, the Enron failure was the result of a free-enterprise system that rewarded risk taking and a corporate culture that pushed complex financial decisions to the edge. In addition, the right environmental conditions evolved in the financial markets, especially the dot-com bubble, contributing to Enron's stock collapse. Enron was the perfect corporate storm (or disaster) that required many failures by multiple stakeholders.

ENRON'S ACCOUNTING PROBLEMS

Enron's bankruptcy in December 2001 was the largest in U.S. corporate history at the time. The bankruptcy filing came after a series of revelations that the giant energy trader had been using partnerships, also called special-purpose entities (SPEs). These off-balance-sheet financing approaches are the heart of losses and write-offs that turned Enron into a disaster. In a meeting with Enron's lawyers in August 2001, the company's then CFO, Fastow, stated that Enron had established the SPEs to move assets and debt off its balance sheet and to increase cash flow by showing that funds were flowing through its books when it sold assets. Although these practices produced a very favorable financial picture, outside observers believed they might constitute fraudulent financial reporting because they did not accurately represent the company's true financial condition.

According to John C. Coffee, Columbia University law professor, once formed by Enron, the SPEs would then borrow debt from banks, and Enron would typically guarantee that debt. Although such guarantees are not unusual when SPEs are used, far less common (and indeed unique) was the fact that the principal asset of many Enron SPEs was Enron restricted stock. Thus, if Enron's stock price declined, the SPEs assets would be insufficient to cover the bank debt, and Enron would have to assume it.

In reality, these SPEs were legal entities, and many investment banks were involved as third-party investors becoming partners in these entities. Most companies engage in third-party transactions to move debt off the balance sheet. For example, a company builds its own plant or office building, sells it to a group of investors, and then leases back the property for its business purposes but still maintains some ownership. In other words, SPEs can be an asset that helps facilitate daily business operations.

Most of the SPEs at Enron were alleged to be entities in name only, and Enron funded them with its own stock and maintained control over them. This is not too different from leasing back property that can be used for storage, transportation, or other energy-related activities. After the crash of Enron's stock price, any assets associated with the SPE system had to be written off. Enron had to take a $1.2 billion reduction in equity in late 2001 because of the SPE write-off.

After Enron restated its financial statements for fiscal 2000 and the first nine months of 2001, its cash flow from operations dropped from a positive $127 million in 2000 to a negative $753 million in 2001. In 2001, with its stock price falling, Enron faced a critical cash shortage. Already shaken by questions about lack of disclosure in Enron's financial statements and by reports that executives had profited personally from the partnership deals, investor confidence collapsed, taking Enron's stock price with it.

For a time, it appeared that Dynegy might save the day by providing $1.5 billion in cash, secured by Enron's premier pipeline Northern Natural Gas, and then purchasing Enron for about $10 billion. But when Standard & Poor downgraded Enron's debt below investment grade on November 28, some $4 billion in off-balance-sheet debt came due, and Enron didn't have the resources to pay. Dynegy terminated the deal. On December 2, 2001, Enron filed for bankruptcy. Enron faced twenty-two thousand claims totaling about $400 billion.

Many complex accounting issues related to determining the value of Enron. For example, sometimes accounting rules changed, and different opinions emerged on which rules applied, such as the accounting rules governing goodwill. *Goodwill* is the difference between what a company pays for an entity and the book value of that company's net assets. For example, changes to the accounting rules governing goodwill required Enron to disclose impairments to certain of its assets including interests in Wessex Water, a business located in Bath, England. Companies such as Enron depend on accounting firms to determine what rules apply to valuing goodwill as well as other assets. The government alleged that Enron's claim of being committed to a water-growth strategy was flawed because it would require Enron to disclose impairments in certain of its assets related to goodwill. According to Lay, Enron's accounting firm, Arthur Andersen, communicated that the company was in compliance with the goodwill accounting rules and the governments claims of flawed disclosures were wrong.

THE WHISTLE-BLOWER

Assigned to work directly with Fastow in June 2001, Enron vice president Sherron Watkins, an eight-year Enron veteran, was given the task of finding some assets to sell off. With the high-tech bubble bursting and Enron's stock price slipping, Watkins was troubled to find unclear, off-the-books arrangements backed only by Enron's deflating stock. No one could explain to her what was going on. Knowing that she faced difficult consequences if she confronted then-CEO Skilling, she began looking for another job, planning to confront Skilling just as she left for a new position. Skilling, however, suddenly quit on August 14, saying he wanted to spend more time with his family. Chairman Lay stepped back in as CEO and began inviting employees to express their concerns and put them into a box for later collection. Watkins prepared an anonymous memo and placed it into the box. When Lay held a company-wide meeting shortly thereafter and did not mention her memo, however, she arranged a personal meeting with him.

On August 22, Watkins handed Lay a seven-page letter that she had prepared outlining her concerns. She told him that Enron would "implode in a wave of accounting scandals" if nothing was done. On the other hand, Watkins continued to perform her duties at Enron and participate in all business matters. Lay arranged to have Enron's law firm, Vinson & Elkins, look into the questionable deals. There is evidence that Lay followed up on Watkin's concerns with appropriate action. Watkins sold $30,000 worth of stock in August 2001 and some options in late September. She claimed that she was panicked by the 9/11 terrorist attacks and about the company. She sold another block and netted about $17,000. She had more information than most people, and it is possible the government could have charged her for insider trading if she truly believed Enron was going to become bankrupt.

Watkins alleges that her computer's hard drive was confiscated and she was moved from her plush executive office suite on the top floors of the Houston headquarters tower to a lower-level plain office with a metal desk. That desk was no longer filled with the high-level projects that had once taken her all over the world on Enron business. Instead, now a vice president in name only, she claimed she faced meaningless "make-work" projects. In February 2002, she testified before Congress about Enron's partnerships and resigned from Enron in November. Although Watkins claims to be a whistle-blower, most of her statements were made after Enron filed for bankruptcy and was a financial disaster. In addition, there is no factual evidence that her earlier claims and concerns had any merit.

THE CHIEF FINANCIAL OFFICER

CFO Fastow was indicted in October 2002 by the U.S. Department of Justice on ninety-eight federal counts for his alleged efforts to inflate Enron's profits. These charges included fraud, money laundering, conspiracy, and one count of obstruction of justice. Fastow pled guilty to two counts of conspiracy, admitting to orchestrating a myriad of schemes to hide Enron debt and inflate profits while enriching himself with millions. He surrendered nearly $30 million in cash and property and agreed to serve up to ten years in prison once prosecutors no longer needed his cooperation. He was a key government witness against Lay and Skilling. His wife, Lea Fastow, former assistant treasurer, quit Enron in 1997, first pled guilty to a felony tax crime, admitting to helping hide ill-gotten gains from her husband's schemes from the government. Withdrawing her plea, she then pled guilty to a newly filed misdemeanor tax crime. In July 2005, she was released from a yearlong prison sentence, followed by a year of supervised release.

Federal prosecutors argued that Enron's case is not about exotic accounting practices but fraud and theft. They contend that Fastow was the brain behind the partnerships used to conceal some $1 billion in Enron debt and that this led directly to Enron's bankruptcy. The federal complaints allege that Fastow defrauded Enron and its shareholders through the off-the-balance-sheet partnerships that made Enron appear to be more profitable than it actually was. They also allege that Fastow made about $30 million both by using these partnerships to get kickbacks that were disguised as gifts from family members who invested in them and by taking income himself that should have gone to other entities. Lay maintained that Enron found no visible flaws in Fastow's ethical background before hiring him as CFO and was taken by surprise when Fastow's personal gains from the off-balance-sheet partnerships were discovered. Lay believed that Fastow's manipulations of the off-balance-sheet partnerships were a key factor in the Enron disaster.

Fastow alleges that he was hired to arrange the off-balance-sheet financing and that Enron's board of directors, chairman, and CEO directed and praised his work. He also claims that both lawyers and accountants reviewed his work and approved what was being done and that "at no time did he do anything he believed was a crime." Skilling, chief operating officer (COO) from 1997 to 2000 before becoming CEO, reportedly championed Fastow's rise at Enron and supported his efforts to keep up Enron's stock prices.

The case against Fastow was largely based on information provided by the managing director, Michael Kopper, a key player in the establishment and operation of several of the off-the-balance-sheet partnerships. Kopper, a chief aide to Fastow, pled guilty to money laundering and wire fraud. He agreed to serve ten years in prison and to surrender some $12 million that he earned from his dealings with the partnerships. Others charged in the Enron affair were Timothy Belden, Enron's former top energy trader, who pled guilty to one count of conspiring to commit wire fraud and three British bankers—David Bermingham, Giles Darby, and Gary Mulgrew—who were indicted in Houston on wire-fraud charges related to a deal at Enron. They used secret investments to take $7.3 million in income that belonged to their employer, according to the Justice Department. The three, employed by the finance group Greenwich National Westminster Bank, were arrested in 2004, faced extradition, and pled innocent.

THE CHIEF EXECUTIVE OFFICER

Former CEO Skilling is widely seen as Enron's mastermind. He was so sure that he had committed no crime that he waived his right to self-incrimination and testified before Congress that "I was not aware of any inappropriate financial arrangements." However, Jeffrey McMahon, who took over as Enron's president and COO in February 2002, told a congressional subcommittee that he had informed Skilling about the company's off-the-balance-sheet partnerships in March 2000, when he was Enron's treasurer. McMahon said that Skilling had told him "he would remedy the situation."

Calling the Enron collapse a "run on the bank" and a "liquidity crisis," Skilling said that he did not understand how Enron went from where it was to bankruptcy so quickly. He also said that the off-the-balance-sheet partnerships were Fastow's creation. Skilling is also reported to have sold 39 percent of his Enron holdings before the company disclosed its financial troubles.

THE CHAIRMAN

Lay became chairman and CEO of the company that was to become Enron in February 1986. A decade later, Lay promoted Skilling to president and COO and then, as expected, stepped down as CEO in February 2001, to make way for Skilling. Lay remained as chairman of the board. When Skilling resigned in August 2001, Lay resumed the role of CEO.

Lay, who held a doctorate in economics from the University of Houston, contended that he knew little of what was going on even though he had participated in the board meetings that allowed the off-the-balance-sheet partnerships to be created. He said he believed the transactions were legal because attorneys and accountants approved them. In the late summer of 2001, he was reassuring employees and investors that all was well at Enron, based on strong wholesale sales and physical volume being delivered through the Enron marketing channel. Although cash flow does not always follow sales, there was every reason to believe that Enron was still a company with much potential. On February 12, 2002, on the advice of his attorney, Lay told the Senate Commerce Committee that he was invoking his Fifth Amendment rights not to answer questions that could be incriminating.

Prosecutors looked into why Lay began selling about $80 million of his own stock beginning in late 2000, even while he encouraged employees to buy more shares of the company. It appears that Lay drew down his $4 million Enron credit line repeatedly and then repaid the company with Enron shares. These transactions, unlike usual stock sales, do not have to be reported to investors. Lay said that he sold the stock because of margin calls on loans that he had secured with Enron stock and that he had no other source of liquidity.

VINSON & ELKINS

Enron was Houston law firm Vinson & Elkins' top client, accounting for about 7 percent of its $450 million revenue. Enron's general counsel and a number of members of Enron's legal department came from Vinson & Elkins. Vinson & Elkins seems to have dismissed Watkins's allegations of accounting fraud after making some inquiries, but this does not appear to leave it open to civil or criminal liability. Of greater concern are allegations that Vinson & Elkins helped structure some of Enron's special-purpose partnerships. Watkins, in her letter to CEO Lay, indicated that the law firm had written opinion letters supporting the legality of the deals. In fact, Enron could not have done many of the transactions without such opinion letters. Although the law firm denies that it has done anything wrong, legal experts say the key question is whether or not Vinson & Elkins approved deals that it knew were fraudulent.

Documents reviewed by *BusinessWeek*, indicate that their experts felt that Vinson & Elkins had concerns about the legitimacy of Enron's business practices. So far, the law firm has yet to pay any damages nor have any of its lawyers faced professional misconduct charges by the Texas bar. Enron's bankruptcy trustee is attempting to settle with Vinson & Elkins for $30 million. The Securities and Exchange Commission (SEC) continues to investigate the advice provided to Enron by the firm. In addition, there is an attempt to hold Vinson & Elkins liable for the $40 billion in investor losses resulting from the Enron collapse.

MERRILL LYNCH

The prestigious brokerage and investment banking firm of Merrill Lynch faced scrutiny by federal prosecutors and the SEC for its role in Enron's 1999 sale of Nigerian barges. Merrill Lynch allegedly bought the barges for $28 million, of which Enron financed $21 million through Fastow's oral assurance that Enron would buy Merrill Lynch's investment out in six months with a 15 percent guaranteed rate of return. Merrill Lynch went ahead with the deal despite an internal Merrill Lynch document that suggested that the transaction might not be appropriate. Merrill Lynch denies that the transaction was a sham and said that it never knowingly helped Enron to falsify its financial reports.

The barge deal was not among the financial blunders that pushed Enron into bankruptcy in 2001. However, prosecutors claimed that it showed Enron was willing to employ suspect financial practices to meet lofty earnings targets. Four former Merrill Lynch executives and two former mid-level Enron executives were charged with conspiracy and fraud related to the transaction. The defense attorneys disputed the government's claims. Enforcement Director Stephen Cutler said,

> Even if you don't have direct responsibility for a company's financial statements, you cannot turn a blind eye when you have reason to know what you are doing will help make those statements false and misleading. At the end of 1999, Merrill Lynch and the executives we are suing today did exactly that: They helped Enron defraud its investors through two deals that were created with one purpose in mind—to make Enron's financial statements look better than they actually were.

ARTHUR ANDERSEN LLP

In its role as Enron's auditor, Arthur Andersen was responsible for ensuring the accuracy of Enron's financial statements and internal bookkeeping. Andersen's reports were used by potential investors to judge Enron's financial soundness and future potential before they decided whether to invest and by current investors to decide if their funds should remain invested there. These investors would expect that Andersen's certifications of accuracy and application of proper accounting procedures were independent and without any conflict of interest. If Andersen's reports were in error, investors could be seriously misled. However, Andersen's independence has been called into question. The accounting firm was a major business partner of Enron, with more than one hundred employees dedicated to its account, and it sold about $50 million a year in consulting services to Enron. Some Andersen executives even accepted jobs with the energy trader.

Andersen was found guilty of obstruction of justice in March 2002 for destroying Enron-related auditing documents during an SEC investigation of Enron. As a result, Andersen has gone out of business. The U.S. Supreme Court overturned the obstruction-of-justice decision, but Andersen had closed its doors.

It is still not clear why Andersen auditors failed to ask Enron to better explain its complex partnerships before certifying Enron's financial statements. Some observers believe that the large consulting fees received from Enron unduly influenced Andersen. However, an Andersen spokesperson said that the firm had looked hard at all available information from Enron at the time. But shortly after she spoke to Enron CEO Lay, Watkins had taken her concerns to an Andersen audit partner, who reportedly conveyed her questions to senior Andersen management responsible for the Enron account. It is not clear what action, if any, Andersen took.

THE BREAKUP OF ENRON'S ASSETS

Enron's demise caused tens of billions of dollars of investor losses, triggered a collapse of electricity-trading markets, and ushered in an era of accounting scandals that precipitated a global loss of confidence in corporate integrity. Now companies must defend legitimate but complicated financing arrangements, even legitimate financing tools tainted by association with Enron. On a more personal level, thousands of former Enron employees struggle to find jobs, while many retirees have been forced to return to work in a bleak job market because their Enron-heavy retirement portfolios were wiped out. One senior Enron executive committed suicide.

In July 2003, Enron announced its intention to restructure and a plan to pay off its creditors. Pending creditor and court approval of the plan, most creditors would receive between 14.4 cents and 18.3 cents for each dollar they were owed—more than most expected. Under the plan, creditors would receive about two-thirds of the amount in cash and the rest in equity in three new companies, neither of which would carry the tainted Enron name. The three companies were CrossCountry Energy Corporation, Prisma Energy International Inc., and Portland General Electric.

CrossCountry Energy would retain Enron's interests in three North American natural gas pipelines. CrossCountry Energy, formed from Enron's domestic gas pipeline assets, was immediately placed on the market for creditor compensation. On September 1, 2004, Enron announced an agreement to sell CrossCountry Energy to CCE Holdings LLC (a joint venture between Southern Union Company and a unit of General Electric) for $2.45 billion. The money would be used for debt repayment and represented a substantial increase over the previous offer made by NuCoastal LLC earlier in 2004.

Prisma Energy International would take over Enron's nineteen international power and pipeline holdings, Prisma Energy International, formed out of Enron's remaining overseas assets, emerged from bankruptcy as a main-line descendant of Enron through a stock offering to Enron creditors. Currently, many of Prisma's assets remain under direct Enron ownership with Prisma operating in a management capacity.

The third company, Portland General Electric (PGE), was founded in 1889 and ranks as Oregon's largest utility. PGE was acquired by Enron during the 1990s and emerged from bankruptcy as an independent company through a private stock offering to Enron creditors.

All remaining assets not related to CrossCountry, Prisma, or PGE were liquidated. As of 2006, CrossCountry was under CCE Holdings ownership, while the PGE and Prisma deals remained to be consummated. Enron emerged from Chapter 11 bankruptcy protection in November 2004 but will likely be wound down once the recovery plan is carried out. Enron's remaining assets are grouped under two main subsidiary companies: Prisma Energy International and PGE, both of which will likely be spun off.

On November 14, 2004, all of Enron's outstanding common stock and preferred stock was canceled. Each person who was the record holder of Enron Corporation stock on that day was allocated an uncertificated, nontransferable interest in one of two trusts that held new shares of Enron Corporation. In the very unlikely event that the value of Enron's assets exceeds the amount of its allowed claims, distributions would be made to the holders of these trust interests in the same order of priority of the stock that they previously held.

According to the Enron website in 2006, it was in the midst of liquidating its remaining operations and distributing its assets to its creditors. Even with the conviction of Enron executives, the justice system will not reform the way that corporate America runs businesses. Many businesspeople see this as an event outside their lives and businesses, very much like passing the traffic accident and thinking it can never happen to them. To prevent future Enron-type failures, the corporate culture, corporate governance, and reward systems will have to change in many organizations. In most cases, a CEO acting alone cannot "sink the ship," and many of the structural, cultural, and corporate governance conditions that caused the collapse of Enron haven't been removed from corporate America.

THE LAY AND SKILLING TRIAL

On May 25, 2006, a Houston jury found Kenneth Lay and Jeffrey Skilling guilty on all counts of conspiring to hide the company's financial condition in 2000 and 2001. During the case, the judge dealt a blow to the two defendants when he told the jury that they could find the defendants guilty of consciously avoiding knowing about wrongdoing at the company. Many former Enron employees refused to testify because they were not guaranteed that their testimony would not be used against them at future trials convicting them. Many questions about the accounting fraud remained after the trial. The verdict was a total victory for federal prosecutors who had spent four years building a criminal case against the two men who had played a key role in building

Enron as a role model for the energy industry. Sean M. Berkowitz, director of the Justice Department's Enron Task Force, said "You can't lie to shareholders, you can't put yourself in front of your employees' interests, and no matter how rich and powerful you are you have to play by the rules." The verdict was a blow to Lay and Skilling who testified that "Enron was a fundamentally sound company brought low in a market panic spurred by short sellers and negative media reports." On the other hand, the government maintained that Enron used deceptive accounting and bogus claims of the growth potential of new business units.

The jury found Lay, 64 years old, guilty of six counts of conspiracy and fraud. Skilling, 52 years old, was convicted on eighteen counts of conspiracy and securities fraud but acquitted on nine out of ten counts of illegal insider trading. On the way out of the courtroom, Lay said he was "shocked" by the verdict. "I firmly believe I am innocent of the charges against me as I've said from day one." Then juror Wendy Vaughan said, "I felt it was their duty to know what was going on." Outside the courthouse, prosecutors said the trial should send a message to executives who manipulate their companies' earnings.

Many people don't feel much sympathy for Skilling and Lay because so many people lost a lot of money, but there is an alternative viewpoint. A number of law professors and lawyers have concerns about the Enron Task Force's prosecution of Lay and Skilling, accusing the government of "criminalizing corporate agency costs." In other words, the government is accused of misusing criminal laws to punish questionable business transactions and bad management decisions. In a civilized society, do we imprison people for the rest of their lives because they may have made some bad business decisions?

No doubt, this was a very complex case, and even the most hard-core antibusiness types are queasy with the conclusion of this tragedy. There was not conclusive evidence that there was intent to defraud investors, although investor losses were massive. The important question is, Was there complacency at all managerial levels about rule bending among some employees or was there massive corruption at all levels? One of the key prosecution elements was complacent negligence, that Skilling and Lay just turned a blind eye.

The truth is that the jury would have had to understand the entire corporate culture as well as many systemic embedded business decisions at Enron to know for sure that Lay and Skilling were guilty of their charges. Bad business decisions were made, but there is uncertainty as to the true involvement and intent of many of the CEO's decisions. Society and the courts tend to simplify events and blame all that goes wrong on just a few individuals. At this stage of understanding, there are few people who understand how an organizational culture can evolve with complacency and constant reinforcement from coworkers driving bad decisions. In our society, we are taught that the opinion of trusted professionals such as accountants and lawyers can be followed in business decisions. In this case, the accounting firm Arthur Andersen, internal and external attorneys, as well as the board of directors approved the key decisions at Enron.

Lay said he never intended to harm anyone; in fact, he came back as CEO after Skilling stepped down and at the insistence of the Enron board of directors to provide leadership and attempt to save the company. A decision that he and his wife both regretted. As CEO, Lay was responsible for thirty thousand employees operating in thirty countries. He managed an exceptional group of employees, as eluded to in the film *Enron: The Smartest Men in the Room*. Great leaders are often given accolades for their accomplishments, and Lay was no exception in the "heyday" of Enron. But most will acknowledge that the heart of their success, or in this case, ultimate failure, is the people with whom they surround themselves and place in positions of authority. The people who Lay trusted, such as Fastow (convicted former CFO), were key operatives in the day-to-day decision making at Enron. It was a complex maze of events that caused the failure of Enron.

On July 5, 2006, Ken Lay died of a heart attack in Aspen, Colorado. He was awaiting sentencing and still maintaining his innocence. Lay had endured a five-month trial but was working hard to develop an appeal of his conviction. He did not feel that it was possible to get a fair trial in Houston and indicated that the jury had not even read his indictment. He thought he was convicted because as CEO he was charged with responsibility for what happened at Enron, even if he was unaware of wrongdoing. The heart of the case against Lay was that he allegedly lied about the financial condition at Enron. Federal courts, including the Fifth Court of Appeals, hold that a defendant's death erases a conviction. Lay stated that he wanted to be of use to society and would continue to do that in anyway possible. In the five weeks before his death, he read several drafts of this case and tried to provide insights about what happened at Enron. He wanted to share his knowledge and perspective about Enron with future business leaders.

QUESTIONS

1. How did the corporate culture of Enron contribute to its bankruptcy?
2. Did Enron's bankers, auditors, and attorneys contribute to Enron's demise? If so, what was their contribution?
3. What role did the CFO play in creating the problems that led to Enron's financial problems?

SOURCES: Personal conversations with Ken Lay between May 27, 2006, and June 20, 2006, by O. C. Ferrell and Linda Ferrell; Associated Press, "Enron Who's Who," *USA Today* online, http://www.usatoday.com/money/industries/energy/2006-01-26-enron-whos-who_x.htm (accessed June 1, 2006); Mark Banineck and Mary Flood, "Enron's Top Execs Are Guilty, Guilty," *San Antonio Express News,* May 26, 2006, 1A; Alexei Barrionuevo, Jonathan Weil, and John R. Wilke, "Enron's Fastow Charged with Fraud," *Wall Street Journal,* October 3, 2002, A3–A4; Eric Berger, "Report Details Enron's Deception," *Houston Chronicle,* March 6, 2003, 1B, 11B; Maria Bartiromo, "The Ones Who Got Away," *BusinessWeek* online, June 12, 2006, http://www.businessweek.com/magazine/content/06_24/b3988122.htm?campaign_id=search (accessed June 7, 2006); Christine Y. Chen, "When Good Firms Get Bad Chi," *Fortune,* November 11, 2002, 56; Andrew Dunn and Laurel Brubaker Calkins, "Death to Hinder Feds," *Denver Post,* July 6, 2006, C1; Peter Elkind and Bethany McLean, "Feds Move Up Enron Food Chain," *Fortune,* December 30, 2002, 43–44; John R. Emshwiller, "Enron's Kenneth Lay is Dead at 64," *Wall Street Journal* online, July 6, 2006, A1, http://online.wsj .com/article_print/SB115210822917098397.html (accessed July 6, 2006); "Enron's Last Mystery," *BusinessWeek* online, June 12 2006, http://www.businessweek.com/magazine/content/06_24/ b3988056.htm?campaign_id=search (accessed June 7, 2006); Enron Website, for facts about Enron, www.enron.com (accessed

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