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Corporate Social Responsibility

Introduction

Through their market activities firms contribute to social well-being by meeting consumer demand, providing jobs, developing new products, and paying taxes that fund public programs. Through their nonmarket activities firms shape their environment by, for example, supporting free trade and socially efficient approaches to environmental protection. Firms also give representation to stakeholders whose interests might not otherwise be represented in public processes. Although some market and nonmarket activities may at times raise concerns, business remains the principal engine for improving social well-being.

Many firms go beyond what is required by their market and nonmarket environments and attempt to serve directly the needs of their stakeholders or, more broadly, of society. For these firms, successful performance requires not only compliance with the law and public policies but also requires fulfilling broader responsibilities. Firms make charitable contributions, provide direct assistance to community organizations, support schools, provide employee and community education programs, establish programs to aid the disadvantaged, and take measures beyond those required by law to protect the environment and the safety of employees and customers. Firms vary considerably in the scope of these activities, however. That scope depends on their conception of the role of business in society and of corporate social responsibility.¹

The previous chapters provide a basis for addressing issues in the market and nonmarket environments of business. In these chapters the objective of a firm was assumed to be the maximization of its market value, and the focus was primarily on the nonmarket challenges that various interests directed at firms. Social responsibility focuses less on pressures from interests and more on normative principles that identify duties based on conceptions of well-being, rights, and justice. These principles may require an objective broader than market value maximization. This chapter examines the role of business in society and considers several conceptions of the objectives and responsibilities of business. The content of social responsibility is developed in the following chapters in terms of ethics systems and their application in management, and Chapters 21 and 22 address the implementation of ethics systems and concepts of corporate responsibility.

The next section examines the dimensions of the corporate social responsibility (CSR) issue, and the following section considers the role of business in society and identifies two different conceptions of CSR. One is that of Milton Friedman, who argues that the CSR of business is to maximize profits, and the other argues that business is to be responsive to the needs of the stakeholders. The strategic use of CSR is then considered along with a consideration of corporate social performance. A framework for reasoning about CSR is then presented, and a set of examples is given to illustrate the use of the framework. The chapter concludes with a consideration of corporate governance and the market for control of firms.

The Corporate Social Responsibility Issue

The concept of corporate social responsibility is poorly defined. For some firms its content is a moral commitment to certain principles or to the altruistic redistribution of corporate wealth from shareholders to others. For other firms it is currently fashionable rhetoric for communicating with external stakeholders; for others it is a thin disguise for profit maximization. There is no conclusive empirical analysis on the relation between actions taken in the name of CSR and corporate financial performance (CFP), as measured, for example, by competitiveness and profitability. Even if there were an empirical correlation, the direction of causality would have to be established. That is, do socially responsible actions lead to superior financial performance or does superior financial performance enable a firm to afford taking socially responsible actions?

Advocates of CSR argue both that normative principles demand redistribution by firms and that if firms do not meet the expectations of society with regard to their social performance they will be faced with government action. The first argument pertains to a moral motivation, whereas the second argument pertains to a response to, or anticipation of, a threat. A third argument made by some advocates is that firms that voluntarily take actions in the cause of CSR will be rewarded in the marketplace, for example, by increased demand for their products. Firms thus can adopt policies labeled as CSR for a variety of reasons. Some may do so because they believe it will increase profits. Others may do so for altruistic reasons. Others may do so defensively to avoid external pressure from interest groups and activists. One objective of this chapter is to distinguish among motives resulting from self-interest, normative principles, and threats.

This chapter also distinguishes between socially responsible policies and policies that simply represent sound business practice. Attention to consumer demand is a sound business practice and requires no justification other than the remuneration it provides. Similarly, creating a culture that builds mutual commitment between the firm and its employees requires no justification beyond the benefits it provides. In contrast, responding to a community need for low-income housing goes beyond the scope of sound business practice. The strategic use of corporate social responsibility to increase profits thus should be distinguished from morally motivated actions. The motives for taking an action are also important for distinguishing between socially responsible actions and actions that are forced on the firm by its environment. Bargaining with an activist group to minimize the damage it could impose should be distinguished from an action taken voluntarily by a firm. The dolphins example illustrates this distinction.

The Role of Business in Society

This section presents and critiques perspectives on the role of business in society and the following section presents two contrasting conceptions of corporate social responsibility.
TUNA AND DOLPHINS

Environmental and animal rights groups protested the use of purse seine nets to catch yellowfin tuna in the Eastern Pacific fishery. In the Eastern Pacific, tuna swim underneath dolphins, and fishing boats cast their nets around the dolphins knowing that the tuna will be caught. Environmental groups estimated that more than 100,000 dolphins a year were being caught in the nets and drowned. However, August Felando, president of the American Tuna Boat Association in San Diego, argued that the 30-vessel U.S. fleet accounted for the deaths of only 12,643 dolphins in 1989, compared with the U.S. limit of 20,500 established by the Marine Mammal Protection Act of 1972. He added that the number had been decreasing because U.S. fishermen had become skilled in freeing the dolphins from the nets. All U.S. tuna boats carried U.S. observers to monitor fishing practices. The United States also attempted to enforce its regulations on foreign boats, with 30 percent of foreign tuna boats, mostly from Latin America, also carrying U.S. observers.

On April 12, 2000, H. J. Heinz President Arthur O’Reilly announced that its StarKist Seafood Company would purchase only “dolphin-safe” tuna and would no longer use tuna caught in purse seine nets.\(^1\) StarKist planned to market its tuna under a “dolphin-safe” label. Heinz and other tuna companies had been under pressure for some time. The “save the dolphins” project had been working to convince tuna companies to change their practices and had led a national boycott of yellowfin tuna products. The Humane Society, Greenpeace, the Earth Island Institute, and the Dolphin Coalition were also pressuring the tuna companies. The key event in the boycott campaign was a videotape taken by a biologist who had signed on as a crew member on a tuna boat. The videotape showed dolphins drowning in purse seine nets. The videotape was broadcast by the national television networks, and suddenly the public became involved. Earth Island Institute, which had helped organize the boycott of StarKist, took out newspaper advertisements calling on Heinz to stop the “dolphin massacre.” Some consumers responded. School children boycotted tuna, and the boycott even found its way into movies such as *Lethal Weapon 2*. Politicians also became interested in the issue, introducing legislation to require “dolphin-unsafe” labels on cans containing tuna caught with purse seine nets. O’Reilly said that his children had asked him to stop killing dolphins.

In 1988 Hobee’s restaurants, a popular and growing chain, switched from yellowfin to Tongol tuna, which is not caught in a manner that contributes to dolphin deaths. In early 1990 the 10 Hobee’s restaurants in the San Francisco Bay area began a boycott of all tuna products. Hobee’s replaced many of its tuna items with chicken placed pamphlets on each table explaining its policy, and provided training to its servers so that they could provide more information on the subject if asked. Hobee’s also began a boycott of all Heinz products, substituting other brands for such staples as Heinz ketchup. The boycott sent a signal to Heinz.\(^2\)

Is Hobee’s or Heinz, or both, acting in a socially responsible manner? This question will be addressed later in the chapter, after the role of business in society and alternative conceptions of social responsibility have been considered.

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\(^1\) O’Reilly’s announcement was included in the film “Where Have All the Dolphins Gone?” produced by the Marine Mammal Fund and the American Society for the Prevention of Cruelty to Animals and narrated by George C. Scott and Charles Coburn. Shortly thereafter, Bumble Bee Seafoods and Van Camp Seafood Company, producer of Chicken of the Sea brand tuna, announced that they would do likewise. Bumble Bee was owned by Unicord of Thailand, and Van Camp was owned by the Nam Trust of Indonesia.

\(^2\) Hobee’s lifted its ban on other Heinz products after the April 12 announcement, but it continued its boycott of StarKist tuna, awaiting implementation of Heinz’ program.
THE EFFICIENCY PERSPECTIVE

The classical view of the role of business in society is based on the economic principle that human well-being is served by the efficient use of society's resources and that the free enterprise system is the best means of achieving that efficiency. Particularly in a period of rapid technological progress, innovation, and the globalization of markets, efficiency and competitiveness are necessary for improvements in the social well-being—or even its maintenance. The best means of achieving economic efficiency is through the private enterprise system with incentives provided by the institution of private property, as implemented through the corporate form, with markets as the institution for organizing economic activity. The failure of the economies of the former Soviet Union and Eastern Europe and the extensive privatization of government-owned corporations in both developed and developing countries reflect the conclusion that private enterprise and the reliance on markets are the keys to economic growth and well-being.

As Adam Smith (1776) concluded, the surest way to achieve well-being was to place resources in the hands of individuals and allow them to compete in markets in response to consumer demand. Not only are markets the best means of allocating scarce resources to society's needs, but they are also a source of protection for consumers who can turn to other suppliers if they become dissatisfied with a product or service. Markets also allow decentralized decision making and, coupled with the protection of private property, encourage innovation. Smith concluded that it was better to rely on the profit incentives that private ownership provides than to rely on goodwill:

It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of their own necessities but of their advantages.

The corporate form is important to efficiency because share ownership and the limited liability of owners allow ownership and management to be separated. This allows a person working in one field to provide capital for enterprises in other fields with the capital market coordinating the allocation of capital between investors and business opportunities. Management of an enterprise is then an agent of the owners—the providers of capital—and serves their interests by maximizing the value of the capital they provide. When markets are competitive, value maximization by firms results in economic efficiency and maximizes aggregate societal well-being.

From this perspective, the role of business in society is to generate well-being through economic efficiency. Private property, the corporate form, and markets are the principal institutions for organizing economic activity. The maximization of market value—or long-term profit maximization—is the objective that provides the strongest incentives, and competition directs those incentives toward efficiency.

CONCERNS ABOUT THE EFFICIENCY PERSPECTIVE

The efficiency perspective leaves unresolved a number of issues about the role of business in society. First, market imperfections as considered in Chapters 9, 10, and 11 can cause a divergence between private and social costs and can warrant a role for government institutions such as regulation and antitrust. Institutions such as incentive-based regulation and the liability system also are intended to align private and social costs and direct economic activity toward efficiency.

Second, the reliance on private ownership and markets to generate well-being is justified by the moral philosophy of utilitarianism, considered in Chapter 19. Other
conceptions of morality, such as those based on rights and justice, are also important. They may call for limitations on private property, the restructuring of incentives, and government intervention for purposes other than the correction of market imperfections. For example, principles of distributive justice may warrant the redistribution of wealth and income to those who are less advantaged, and basic rights may require that the fair equality of opportunity be provided in society. Third, just as markets can be imperfect, so too can government. Because government may be ineffective in correcting market imperfections and assuring property rights, some critics of the efficiency perspective argue that business has an affirmative duty to address societal needs unfulfilled by government.

**MARKET CAPITALISM AND MANAGERIAL CAPITALISM**

The corporate form involves a separation of management from ownership. This separation is essential for the efficient allocation of capital, but it also gives managers a degree of discretion to pursue interests other than those of owners. The separation of ownership from management and the resulting managerial discretion means that Adam Smith's market capitalism—the reliance on markets to direct the allocation of resources—coexists with managerial capitalism—the reliance on managers for the allocation of resources.

The market for the control of firms, considered later in the chapter, provides one means of aligning the interests of managers with those of owners. Managers who do not serve the interests of shareholders can be replaced, either directly by the board of directors or through a takeover or proxy contest. Some corporations, however, are protected from the market for control by anti-takeover charter provisions and poison pills. The alignment of the interests of managers with those of owners then must come from the incentives provided by managerial compensation systems such as performance bonuses and stock options.

In principle, managerial capitalism could be more efficient than market capitalism. It allows the accumulation of resources through retained earnings and their allocation within the firm without having to incur the transactions costs of raising funds in the capital markets. It may also have advantages if management has information whose value would be dissipated if disclosed in order to raise capital. Managerial capitalism, however, can result in inefficiency when the incentives of management are not structured properly. For example, some firms cross-subsidize losses in one line of business with profits from another line of business. The more open are domestic and international markets, the stronger is competition, and the more active is the market for control, the greater are the pressures for efficiency and competitiveness, leaving less discretion to managers.

**THE SOCIAL RESPONSIBILITY PERSPECTIVE**

The social responsibility perspective focuses on roles for business identified by concerns that extend beyond economic efficiency. Those roles may stem from societal needs not otherwise adequately addressed or from the consequences of market imperfections such as externalities. They may also stem from concerns that government is either unable or unwilling to address. For example, some companies have voluntarily instituted programs to reduce carbon dioxide emissions in response to global climate change. From this perspective social responsibilities arise from the needs and legiti-

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1Berle and Means (1932) first called attention to the issue of the separation of ownership and control and to its implication. Fama and Jensen (1983) provide a contractual perspective on the issue.

mate concerns of individuals, and business must assess those needs and concerns to determine the extent of its responsibilities.

Business leaders advocate corporate social responsibility for a variety of reasons. Some argue that there are societal objectives that can be achieved only through direct corporate action. Business, for example, may be more efficient than government or educational institutions at training workers for certain jobs. Other business leaders call for restraint on the pursuit of profits and for self-regulation in the hope that it will forestall additional government intervention and regulation. These calls are viewed by some as a necessary response to pressures arising from the nonmarket environment, which if ignored could lead to more serious threats to the free enterprise system. Some calls for corporate social responsibility are directed to the public with the intent of increasing public support for business. Some who call for corporate social responsibility believe that unless business uses the rhetoric of social responsibility, more onerous intervention by government will result. That intervention could not only harm business interests but would also impair efficiency, competitiveness, and the well-being of society.

Conceptions of the Social Responsibility of Business

THE LAW

Any conception of the social responsibility of business must include compliance with just laws. Both civil and criminal law apply to firms and their managers. Criminal prosecution can occur under the antitrust laws, securities and exchange laws (as with insider trading), certain environmental laws, and many others. Individual managers and corporations are also subject to fines and can be liable for damages under both statutory and common law. These laws proscribe actions that legislatures and/or the courts have held to be socially unacceptable.

In addition to proscribing actions, the law assigns certain duties to firms and managers. For example, the Americans with Disabilities Act assigns an extensive set of duties to firms to provide for the disabled in the workplace. Duties assigned by law are not necessarily the limits of social responsibility, however. As considered later in this chapter and in subsequent chapters, duties also arise from moral considerations. The law thus is an essential guide for responsible management, but reliance solely on the law is not sufficient.

To address the issue of whether firms have responsibilities beyond those imposed by the law and the interests of shareholders, the perspectives of Milton Friedman and the Business Roundtable are considered next. Friedman may be thought of as an advocate of market capitalism, whereas the Business Roundtable reflects the perspective of managerial capitalism.

CORPORATE SOCIAL RESPONSIBILITY AS PROFIT MAXIMIZATION

Friedman (1970) argues that corporate responsibility is "to conduct the business in accordance with [owners'] desires, which generally will be to make as much money as possible while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom." The objective of a corporation thus is the maximization of its profits, or market value, subject to the constraints imposed by the rules of society. Friedman concludes that those who argue that a "corporate executive has a 'social responsibility'... must mean that he is to act in some way that is not in the interest of his employers": that is, the shareholders.

He argues further that corporate executives who serve some social purpose are acting as civil servants by imposing taxes on shareholders and making expenditures that shareholders would not approve. They act as if "political mechanisms, not market
mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses." According to Friedman, that amounts to socialism rather than capitalism. Furthermore, calls for a broader social responsibility may, in Friedman's view, actually promote that which corporations should seek to avoid. That is, by calling for the adoption of objectives other than profit maximization, managers are advocating the use of the political process to direct the allocation of corporate resources. Friedman believes that these calls for social responsibility will weaken the free enterprise system and the well-being that flows from it.

From Friedman's perspective, a corporation is a voluntary association of individuals who have joined together for a mutual purpose. That purpose may be the generation of profits in which they will share or the achievement of some social or nonprofit objective. In the case of a for-profit corporation, shareholders have a property right to its assets and hence to the return on its assets. As indicated in Figure 18-1, shareholders are owners and hence principals and have the rights to the profits earned by the corporation. The corporation is managed by agents—the managers—who are to operate it in the best interests of the principals. In an efficient capital market, shareholders will unanimously prefer that the firm be operated to maximize its market value. If one shareholder prefers to donate all his returns to charity and another prefers to spend all her returns on consumption, both will prefer that the firm be operated to make those returns as great as possible. If management does not maximize the value of the firm, the market for control through a takeover or proxy contest will replace that management—if shareholders have not already done so.

From this perspective, the corporation engages in voluntary transactions with both providers of resources and customers. As Figure 18-1 illustrates, labor and resource markets intermediate between resource providers and the corporation, and product and services markets intermediate between customers and the corporation. If markets are competitive, value maximization by the firm will be consistent with economic efficiency and the greatest aggregate well-being for society.

According to Friedman, then, the responsibility of managers acting as agents of their employers, the owners of the firm, is to maximize profits (market value) by engaging in free and open competition. In that competition, firms engage in voluntary exchanges with others, while abiding by the law and ethical custom.

**FIGURE 18-1** Friedman's Conception of a Corporation

![Diagram of Friedman's Conception of a Corporation](image)
The Role of Government

It is impossible to have a conception of the responsibilities of business without having a conception of the responsibilities of government. In Friedman’s view, government is to impose taxes and determine expenditures, and the judiciary is to mediate disputes and interpret the law. Even when there are market imperfections and private costs diverge from social costs, the role of governments is to assign clear entitlements and protect them with a property or liability rule, as considered in Chapters 11 and 12. The Coase theorem then applies, and individuals will internalize the social costs of their actions and reach efficient decisions through private bargaining. When transactions costs are high, the government may equate private and social costs through market-like mechanisms such as tradable permits for pollution control, as considered in Chapter 11. These functions are reserved for government, and its coercive powers are limited by a system of checks and balances, individual rights, and the popular election of representatives. According to Friedman, a call for corporate social responsibility “amounts to an assertion that those who favor the taxes and expenditures in question have failed to persuade a majority of their fellow citizens to be of like mind and that they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures.”

Friedman does not indicate whether and to what extent firms should participate in political processes to influence government policies. The natural extension of his perspective, however, is that competition in political processes moves government toward social efficiency just as competition in markets drives firms toward social efficiency.4

Philosophical Underpinnings

Friedman adopts the view of a corporation as a voluntary association of individuals that maximizes the value of their property not only because of economic efficiency considerations but also because it is consistent with a philosophy of individual liberty and responsibility. From this perspective, society is a collection of individuals with differing interests, who can be free only if they can own private property and act voluntarily in markets. The role of government then is to protect private property. Since individual liberty and voluntary actions take priority over government direction, resource allocation is to take place through markets rather than through a political process.5 In this philosophy, competition not only promotes efficiency but also allows people to protect themselves by providing alternatives in the marketplace.

The Social Responsibility Label

A firm operating under this perspective may directly benefit others if doing so increases its market value. A value-maximizing firm may make philanthropic contributions because it increases public support for business and strengthens the firm’s community, thereby helping it to attract and retain employees. A firm may institute worker participation programs to improve productivity and lower costs by enhancing worker

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4See Becker (1983).
5See Friedman (1962, Chapter 8). The moral underpinnings of Friedman’s conception of corporate social responsibility based on a system of individual liberty and property rights are similar to those of individualism. Lukes (1975) characterizes individualism as consisting of four elements: (1) accepting the intrinsic moral worth of individual human beings, (2) advocating the autonomy of individual thought and action, (3) acknowledging the existence and importance of individual privacy, and (4) expressing self-development or self-regulation as a desirable goal.
satisfaction. A firm may design high-quality products and inform consumers of their safety and performance features because doing so reduces liability costs and increases profits. According to Friedman, when such actions increase the market value of the firm, they should not be given the label of social responsibility. Social responsibility must have a cost to the firm and its shareholders or else it is simply another component of a strategy of profit maximization.

From Friedman's perspective a conception of corporate social responsibility that differs from value maximization can have only two interpretations—either a political process is to be used by the firm to make decisions or managers are to act as principals rather than as agents. In the former case, such political processes are appropriate for government but not business. In the latter case, managers are determining who should bear the cost of that responsibility. When the markets in which the firm operates are competitive, the costs of social responsibility must ultimately be borne by shareholders. If shareholders prefer that a firm not maximize its value, it may become the target of a takeover attempt by investors who would operate it to maximize its value. In principle, unless it is restricted, the market for control would drive the firm toward value maximization.

THE BUSINESS ROUNDTABLE STATEMENT ON SOCIAL RESPONSIBILITY

The Business Roundtable was founded in 1972 to "examine public issues that affect the economy and develop positions which seek to reflect sound economic and social principles." The Roundtable is composed of the CEOs of major corporations with a combined employment of 10 million in the United States. In 1981 one of its task forces issued a "Statement on Corporate Responsibility." This statement reflects a constituency perspective and states that business is to "serve the public interest as well as private profit." The Roundtable states that "some leading managers . . . believe that by giving enlightened consideration to balancing the legitimate claims of all its constituents, a corporation will best serve the interest of its shareholders."

The Roundtable's basic view of the firm is illustrated in Figure 18-2. The Roundtable identifies seven constituencies: customers, employees, financiers, suppliers, communities, society at large, and shareholders. "Responsibility to all these constituencies in total constitutes responsibility to society, making the corporation both an economically and socially viable entity." The corporation thus is an entity whose existence depends on society's support. That is, a corporation is a legal entity granted certain privileges, including limited liability, indefinite life, and special tax treatment such as depreciation allowances. In exchange for these privileges, the corporation has a responsibility to the society that granted them.

According to the Roundtable, customers have "a primary claim for corporate attention," so in Figure 18-2 they are represented separately as the providers of revenue for the firm. Shareholders also "have a special relationship to the corporation" but are viewed as "providers of risk capital" rather than as principals, as Friedman views them. The Roundtable goes further and criticizes institutional investors because "a high proportion of [shareholders] is made up of institutionally-grouped and often unidentified short-term buyers most interested in near term gain. This has affected their role among business constituencies." Ownership of the firm is never mentioned in the Roundtable statement, which suggests that the corporation exists as a legal entity independently of shareholders, who are simply providers of risk capital. In contrast to Friedman's perspective, the principals in the Roundtable's view are management.

The objective of a corporation is not as clearly identified in the Roundtable statement as it is in Friedman’s theory. Instead, managerial decision making involves “weighing the impacts of decisions and balancing different constituent interests. . . .” The statement adds, “The shareholder must receive a good return but the legitimate concerns of other constituencies also must have the appropriate attention.” Although the terms “legitimate” and “good” are not defined, this balancing is presumably different from value maximization. Management is to ensure that the corporation remains viable, but beyond a reasonable return on investment all constituents can have a claim to its resources and returns. The Roundtable statement intentionally provides little guidance about how a corporation makes tradeoffs between the interests of various constituencies, since that is the responsibility of managers as principals.\(^7\) As Vogel (1991, p. 114) notes, part of the “universal appeal of the concept of corporate social responsibility rests on the concept’s ambiguity,” allowing management to formulate its own more specific objectives.

Although the Roundtable argues that the legitimate concerns of constituents are to be taken into account, it does not want those constituents to participate in managerial decision making. Although “[i]t is important that all sides be heard . . .”, management is to give attention to constituents’ interests and decide whether and how much to respond to those interests.

According to MacAvoy (1981), the Roundtable’s concern for constituents “implies that the large corporation is a political entity subject to the votes of interest groups, rather than an economic organization subject to the market test for the efficient use of resources.” He continued, “Political interests should not be served from corporate investment returns. If the stockholder wishes to support the local schools, or solutions to international problems, then he or she should do so with his or her own dividends.” If managers operate their firms otherwise, they are acting as “politicians of the Roundtable,” according to MacAvoy.

In a later statement “Corporate Governance and American Competitiveness,” the Business Roundtable (1990, p. 5) states, “It is important that all stakeholder interests be considered, but impossible to assure that all will be satisfied because competing claims may be mutually conflicting.” In this statement, the Roundtable argues that corporate governance differs from political governance on several dimensions, including

\(^7\)The absence of specifics increased the support for the statement among members of the task force.
the speed and boldness with which businesses must act and the means through which shareholders can influence the course of management.

**THE STAKEHOLDER CONCEPT**

As the Business Roundtable emphasizes, a firm interacts with a number of constituencies, including employees, suppliers, customers, the communities in which its facilities are located, and the public in general. To the extent that these constituencies have an interest, or “stake,” in their relationship with the firm, they may be referred to as stakeholders.\(^8\)

A stakeholder relationship centers on an exchange, as when an employee provides labor services to a firm in exchange for wages. Both parties presumably benefit from the continuation of such an exchange relationship. Employees who have developed firm-specific human capital may earn a higher wage with their current employer than if they reentered the labor market.\(^9\) Similarly, the firm may have a stake in the relationship with employees to the extent that wages are less than the value of employees’ contributions plus the costs of finding and training replacements. Both the firm and the employees then have incentives to take into account the interests on the other side of the relationship. Their stakes are voluntarily maintained through bargaining and the labor market.

The Business Roundtable’s conception of corporate social responsibility identifies a set of stakeholders whose interests are to be taken into account for managers acting as principals. This conception leaves open the issue of the extent of that responsibility to stakeholders and whether it extends to the stakeholders of its stakeholders and to social issues beyond the stakeholder relationships. The chapter case *Advanced Technology Laboratories, Inc.* raises some of these issues. These issues are considered in more detail in Chapters 21 and 22 and in the Chapter 21 case *Levi Strauss & Co. Global Sourcing Guidelines* and the Chapter 22 case *University Games, Inc.*

### Strategic Corporate Social Responsibility

Some firms use the rhetoric of corporate social responsibility strategically to maximize their profits. From a defensive perspective, some firms act to reduce the likelihood that stakeholders will damage the firm either through actions taken in markets or in the nonmarket environment. Consumers may stop buying a product such as canned tuna: employees or communities may sue to block the closing of a plant; and consumer and environmental interest groups may intervene in regulatory proceedings. Conversely, if consumers will pay a premium for green products or for organic foods, a firm that supplies those products is responding to market forces and may be motivated by self-interest. Supplying those products then has little to do with social responsibility. If Internet users are hesitant to purchase online because of a concern for privacy, an ISP may invest in technology and practices to increase the security of information on its site, protect personal information, and limit anonymous online profiling. These policies may have nothing to do with social responsibility and everything to do with profit maximization. Similarly, an e-commerce company that adopts a strong privacy policy because of aggressive criticism by activists may be doing so defensively. Activists may

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\(^8\)See Freeman (1984) for an examination of stakeholder concepts and business strategy and Pfeffer and Salancik (1978) and Thompson (1967) for organizational perspectives.

\(^9\)The magnitude of a stake is determined relative to the opportunities the stakeholder has through alternative relationships. For example, the stake of a supplier is the profits or rents earned on the resource committed to the relationship relative to the opportunity cost of those resources.
be quite willing to praise a firm when it concedes to pressure, but if the motivation for the policy was to avoid the harm brought by activists, the firm can simply be maximizing profits. In contrast, CSR involves going beyond profit maximization. Nevertheless, strategic corporate social responsibility may be effective in increasing profits.

Policies that respond to the interests of stakeholders or advocacy groups can also build support in the market and the nonmarket environments. Firms may develop loyal customers, suppliers, and local communities whose support they can call on if they need to expand their facilities or influence government policy. For example, a firm may cooperate with stakeholder groups to attain greater efficiency through worker involvement programs or seek political support in the form of tax incentives or protection from imports. Furthermore, if the firm has invested in its relationships with stakeholders and understands the nature and extent of their interests, it may be able to bargain more effectively with them.

Consideration of stakeholder interests is important because implicit relationships and contracts can in some cases be more efficient than explicit bargaining and contracting. This may involve the granting and honoring of trust and the creation of realistic expectations about how issues not covered by explicit agreements, such as labor contracts, will be addressed. To the extent that employees, customers, suppliers, and communities understand their mutual interests in the continuation of their relationships, all parties can benefit.

Policies such as allowing employees to volunteer in community organizations on company time can also improve employee morale and may be rewarded through higher productivity, lower turnover, or lower wage rates. Similarly, charitable contributions to local organizations can strengthen a community and improve employee satisfaction and morale as well as attract better employees. Company policies that embrace principles of responsibility based on moral standards can reduce the likelihood that an employee will violate a law or a widely shared ethics principle. This can reduce the likelihood of a challenge from the nonmarket environment and may better position the firm in that environment.

Policies regarding dolphin-safe tuna, environmental protection, or a commitment to particular principles may affect consumer demand for a firm's products or services. Consumers may prefer products produced from recycled materials or produced by a company with a reputation for environmentally friendly policies. This effect would likely be stronger for consumer products than for industrial products. The deregulation of electricity markets, however, allows consumers to choose their source of power generation, so consumers can choose power from sustainable sources such as wind or solar. The issue then is whether consumers are willing to pay a higher price for power from sustainable sources.

Responsible policies may provide better access to government institutions and their officeholders. This may increase the effectiveness of lobbying and other political strategies, which can result in more favorable government policies or decisions. Responsible policies may also result in activists having greater trust in the firm. This may provide an opportunity to communicate with them in the event of an emerging nonmarket issue. If the activists are willing to listen to the firm's position, the firm may be able to communicate its message in a less hostile environment.

Adopting socially responsible policies can carry risks. For policies to be sustainable, the firm must meet the expectations it creates, and if those policies establish high standards, the firm can be held accountable for them. Levi Strauss & Co. had set high standards and successfully sustained those standards for decades. In 1997 when it was forced to lay off over 6,000 employees in the United States because of a falling market
share for its jeans, the company was obliged by its reputation to provide generous severance packages for the employees who lost their jobs.

Reputations for socially responsible behavior can be dissipated. The Body Shop had promoted its cosmetics business by emphasizing its policies of protecting the environment and purchasing natural ingredients from indigenous peoples. As discussed in Chapter 3 and considered further in Chapter 21, the Body Shop came under attack from critics who argued that it had not met the expectations it had created.

In 1995 Shell Oil had an enviable environmental record and reputation. Within 6 months, however, its reputation had taken a battering. Its attempt to sink the Brent Spar oil rig in the North Sea generated a storm of protests in northern Europe. Its reputation also suffered from its role in environmental damage in Nigeria and its rejection of demands by human rights groups to intervene with the Nigerian government to stop the execution of nine dissidents from the region in which Shell and its Nigerian government partner produced.

The strategic use of corporate social responsibility, either offensively or defensively, for the purpose of increasing a firm's market value would be viewed by Friedman as just another strategy to maximize profits. If its actions reduced the value of the firm but increased the benefits to a stakeholder group, Friedman would view that as contrary to the role of business in society. From the Business Roundtable's perspective the strategic use of social responsibility would be viewed as responsible behavior, since it takes into account the interests of stakeholders.

The rhetoric of corporate social responsibility must be transformed into corporate social performance. The next section considers the empirical evidence on the relation between corporate social performance and corporate financial performance.

**Corporate Social Performance**

A number of researchers have investigated the relation between corporate social performance (CSP) and corporate financial performance (CFP). Griffin and Mahon (1997), Mahon and Griffin (1999), and Roman, Hayibor, and Agle (1999) provide classifications of these studies and interpretations of some of them. The authors conclude that although there are considerable differences among the studies in terms of methods, measurement, and findings, the weight of evidence supports a positive correlation between CSP and CFP. Griffin and Mahon, for example, studied six firms in the chemical industry and measured CSP with variables such as reputation and releases of toxic pollutants as measured by the Toxic Releases Inventory. The perspective of these assessments seems to be that CSP corresponds to providing to others benefits beyond those generated by economic transactions with the firm or required by law. For example, a firm may reduce its toxic emissions below the allowable level because it values the well-being of local residents more than the well-being of shareholders. Their classifications leave open the issue of the motivation for the observed social performance. Maxwell, Lyon, and Hackett (2000) empirically studied firms' actions with regard to

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11See the Chapter 4 case Shell, Greenpeace, and Brent Spar.

10This section is based on Baron (2001a).

12See also Ullman (1985) for a survey that reaches a different conclusion. Margolis and Walsh (2001) provide a summary of 75 studies of links between CSP and CFP. However, they do not attempt to assess the direction of causality. See Illitch, Soderstrom, and Thomas (1998) for a critique of the methods used in the literature. McGuire, Sundgren, and Schneeveis (1988) review the research on the relationship between economic performance and corporate social responsibility. The research is generally inconclusive. McGuire, Sundgren, and Schneeveis suggest that "It may be more fruitful to consider financial performance as a variable causal social responsibility than the reverse."
toxic emissions and concluded that the evidence is consistent with a theory that firms reduce their emissions below the levels allowed by environmental regulation so as to preempt more stringent regulations.

Waddock and Graves (1997) evaluated the relationship between CSP and CFP and the direction of causation: i.e., whether CSP causes better CFP or better CFP allows a firm to afford CSP. They measured CSP by an index of eight factors with weights determined by three members of the Social Issues in Management division of the Academy of Management.\textsuperscript{13} Whereas some of the factors, such as being a military contractor or participating in nuclear power, are curious inclusions apparently based on some particularly normative construct, lower weights were given to those factors than to factors such as employee relations and environmental performance. By regressing CSP on financial performance, controlling for a several factors such as size and financial structure, they concluded that good financial performance leads to good CSP. They also regressed CFP on lagged CSP, but the coefficient on the return on equity was statistically insignificant.\textsuperscript{14} Their study can best be viewed as supporting the notion that good financial performance allows firms to redistribute wealth from shareholders to others.\textsuperscript{15}

CSP in these studies is measured in terms of actions taken and independently of motivation. Three firms that reduce their toxic emissions below the allowable level can receive the same CSP evaluation. Yet, one firm may do so because of altruism, a second to preempt government regulation or because it faces an external threat by an activist group, and a third because doing so will increase the demand for its product. Researchers may evaluate all three firms as having good CSP, but assessing CSR through observed CSP should not be independent of motivation. The next section presents examples to provide additional insight into the concept of corporate social responsibility.

### Examples of Corporate Social Responsibility?

**UNOCAL CORPORATION AND THE DIRTY CAR BOUNTY**

Air quality in the Los Angeles basin has been among the worst in the nation, and stringent measures were being prepared to address the problem. Proposals included restricting driving and shutting down factories when air quality reached potentially hazardous levels. Some firms began to take steps on their own to address the problem.

Unocal announced a novel program in which it offered to pay $700 cash for 7,000 pre-1971 automobiles, which would then be scrapped.\textsuperscript{16} The scrap value of the cars was estimated to be $10 to $20, and their market value was believed to be considerably lower than $700.\textsuperscript{17} In addition, Unocal offered to provide free tune-ups for pre-1975 cars. The cost of the program was estimated to be nearly $10 million. Unocal Chairman and CEO Richard J. Stegemeier explained, "Sixty percent of smog comes from mobile sources, cars and trucks. Thirty percent is coming from pre-1975 automobiles. If you want to make a big impact in a hurry, this is by far the quickest and most cost-effective way."\textsuperscript{18} Although the impact on air quality depends on which modes of transportation replaced the old cars, Unocal estimated that emissions of pollutants would be reduced...
by 6 million pounds a year. Within months, more than 10,000 car owners had applied to the program. Unocal also encouraged other companies to participate in the program. In July 1990 Ford announced that it would buy 1,000 old automobiles in the Los Angeles area and would offer the sellers an additional $700 rebate on the purchase of a new Ford.

The fact that the South Coast Air Resources Board, a state regulatory agency, subsequently adopted an old car scrap plan indicates that Unocal's innovation benefited society. Unocal also benefited from the program. Goodwill was generated, and it earned emissions credits for reducing pollutants. The program also relieved pressure on environmental issues.

ARCO AND GASOLINE PRICE RESTRANTS

After Iraq invaded Kuwait in 1990, crude oil prices doubled, and the price increase was quickly reflected in higher gasoline prices. Three hours before President George H. W. Bush asked oil companies "to do their fair share to limit their price increases," ARCO announced that it would freeze prices for gasoline, diesel, and aviation fuel in the five western states in which it operated. Within 10 days ARCO was forced to withdraw its freeze on diesel and aviation fuel because its supplies were running out. The company, however, increased its wholesale gasoline price by only four cents a gallon, whereas gasoline on the spot market had increased by 20 cents a gallon. Demand was so strong that despite daily deliveries many ARCO stations ran out of gasoline every day for hours at a time. Within two weeks ARCO ended the freeze.

From the perspective of economic efficiency, a price below cost encourages consumption and dampens the incentives for exploration. The oil price controls imposed during the 1970s, for example, were estimated to have cost the United States billions of dollars a year by discouraging production, encouraging higher consumption, and strengthening the OPEC cartel. If ARCO had wanted to avoid taking advantage of a price increase resulting from a crisis, it could have priced at market levels to promote economic efficiency and given the additional profits to charity.

Some analysts speculated that ARCO's freeze was politically motivated to increase its standing at a time when it was engaged in a campaign to open the Arctic National Wildlife Refuge to oil exploration. Others viewed it as lessening the calls for oil price controls or a windfall profits tax, both of which had been imposed in the 1970s. Others pointed to the personal relationship between President Bush and ARCO's chairman, who had contributed $100,000 to the Republican Party in 1988.

MALDEN MILLS INDUSTRIES

In the 1980s employees at Malden Mills Industries discovered how to combine synthetic yarns to produce cloth with textured faces. The new synthetic fleece fabric, sold as Polartec, was featured in outerwear marketed by companies such as Patagonia, Lands' End, and L.L. Bean. The success of Polartec was interrupted in 1995 when a devastating fire destroyed the Polartec production facilities and a furniture upholstery unit at Malden's mill in Lawrence, Massachusetts. Aaron Feuerstein, owner of Malden Mills, pledged to get Polartec production restarted as soon as possible and quickly pur-

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19 Cars built before 1975, when catalytic converters were required on new automobiles, emit 50 grams of carbon monoxide per mile driven on average, whereas post-1975 models emit 20.7 grams per mile. Cars too old to have catalytic converters also emit many more hydrocarbons and nitrogen oxides than newer models.

20 Unocal sought to build goodwill by producing television commercials showing the crushing of old automobiles under its program.
chased new production equipment set up in a warehouse while the mill buildings were reconstructed. Feuerstein decided to rebuild in Lawrence rather than move production to a less expensive location with lower labor costs. He also rebuilt the mill’s facilities in the original nineteenth-century style, including expensive details and finishings. The rebuilding cost $430 million financed by $360 million in insurance payments and borrowing from GE Capital and other lenders. Feuerstein also pledged to reemploy 2,700 mill workers and paid $25 million to 1,380 laid-off workers while the facilities were being rebuilt. Feuerstein explained, “I feel that I am a symbol of the movement against downsizing and layoffs that will ultimately produce an answer. People see me as a turning of the tide.”21 A company spokesperson stated, “We have to be profitable in the long run. But with Aaron we don’t have to be two percentage points more profitable than the next guy. We are going to end up keeping more people than we would need if we were to run with flat-out efficiency.”22

The upholstery unit lost several major customers, which forced the unit to be closed, leaving Malden Mills with 1,200 employees. Fleece imports and production by U.S. textile companies with lower cost structures began to cut away at Malden’s sales. At the request of GE Capital Feuerstein brought in a new CEO to stem the losses. The earnings problems continued, and in November 2001 Malden Mills filed for bankruptcy in an attempt to reorganize and survive. The employees agreed to a wage freeze for 2 years and gave up their paid personal days. Mr. Feuerstein commented, “There are times in business when you don’t think of the financial consequences but of the human consequences. There is no doubt that the company will survive.”23

**AETNA AND HOUSING REHABILITATION**

In 1982 Aetna Life & Casualty was one of the largest insurers in the United States, and Chairman John H. Filer was a public advocate of corporate social responsibility. The insurance industry had been stung by allegations that it had engaged in a practice referred to as “redlining,” in which banks and insurance companies refused to lend or issue insurance to individuals living in certain geographic areas, often inner-city neighborhoods. In response to the concern that inner-city neighborhoods were being neglected, Aetna, in conjunction with neighborhood activist groups, undertook a National Demonstration Urban Neighborhood Investment Program. President William O. Bailey explained that Aetna “believes neighborhood revitalization to be good business. . . . The purpose of the demonstration program was to provide financial and technical support to the leading role taken by grassroots neighborhood organizations in implementing a housing development program in their communities.”

According to Aetna, the “demonstration program was undergirded by two key contextual themes. The first reflects a choice between two positions, one espoused by Milton Friedman, that ‘the only business of business is business,’ and the other by Kenneth Dayton, that ‘the purpose of business is to serve society.’ It is apparent that the intention . . . is to make Aetna a corporation that is sensitive and responsive to societal issues, and by so doing, improve Aetna’s business success and the environment in which it works.”24

Aetna’s approach was to become directly involved in neighborhood projects by providing management assistance and financing. During the first 2 years of the program, Aetna committed over $11 million of mortgage financing to the rehabilitation of

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24See Aetna Life and Casualty (1982, p. 3).
900 housing units in five neighborhoods. The company also provided direct grants of $425,000 to neighborhood groups. Aetna’s experience with the projects was mixed, and its provision of management assistance embroiled the company in at least one neighborhood squabble. Eventually, however, the company extended the program to include 12 neighborhood groups in 11 cities. The demonstration project resulted in 129 loans totaling nearly $30 million for the construction and renovation of 1,950 housing units. Three of the neighborhood groups experienced difficulties and some restructuring of projects was required, but no defaults or foreclosures resulted, according to Aetna. Although Aetna declared the demonstration program a success, it ended the program, and no other company started a similar program.

**SOUTH SHORE BANK AND COMMUNITY DEVELOPMENT**

In contrast to Aetna’s direct involvement in the rehabilitation of housing, several corporations, foundations, and other organizations, including the Ford Foundation, Allstate Insurance, and the Episcopal Church, formed the Shorebank Corporation to purchase the South Shore Bank in 1973. The coalition’s objective was for the bank to participate with neighborhood groups in the renewal of local communities in Chicago. The bank also opened branches in the Austin neighborhood. Over 90 percent of the residents in the South Shore and Austin communities were minority group members, and the housing stock was primarily apartment buildings.

Working with neighborhood groups, by 2001 South Shore Bank had been involved in the rehabilitation of over 1,000 multi-family buildings and had loaned over $600 million to 13,000 families and businesses. In recent years, it has emphasized lending to small commercial establishments that might not qualify for regular bank loans. The Bank gave up profits to serve its communities. The Bank also helped form affiliated banks and development corporations in Cleveland, the Upper Peninsula of Michigan, Washington’s Willapa Bay, and Portland, Oregon. Similar organizations were started in other communities.

South Shore Bank was the inspiration for the federal government’s Community Development Financial Institution (CDFI) program to support financing for people who do not have access to conventional financing. The program administered by the Treasury Department provides subsidized financing and grants to CDFIs that finance housing and businesses in poor areas. By 1998 approximately 350 CDFIs were in operation with lending capacity of over $2 billion. Through 2001 the Treasury had provided grants of $534 million to support CDFIs.

**Social Responsibility: Motives and Causality**

Actions taken in the name of corporate social responsibility can have three general types of motivation. The motive for strategic CSR is to increase the profits of the firm in the absence of an external threat. A second motive for CSR is to reduce threats to the firm from its nonmarket environment, as from activists and governments. This may involve making concessions to activists or voluntarily exercising restraint in the pursuit of profits by reducing toxic emissions more than required by regulations. The third motive is moral. This motive may, for example, involve altruism under which the firm voluntarily responds to the needs of others without a compensating profit. In reasoning about whether actions, such as the examples in the previous section, constitute real corporate social responsibility, it is useful to assess motives as well as consequences.

Why does motive matter in reasoning about CSR? If the objective is to assess corporate social performance, then actions and not motives matter. It should not matter
whether a firm takes an action because it maximizes profits, is forced to take the action because of a threat from an activist group, or responds to a moral principle. Activists and politicians may praise a firm that gives in to their pressure, but they may do so because of the firm’s actions and not its motives.

If the objective is to predict the future behavior of firms, then the motive matters. A firm that practices only strategic CSR will act when there is an opportunity for profits. A firm that takes an action only when forced to do so by its nonmarket environment will not take an action in the absence of pressure. A firm that takes an action because of a motive to serve society’s interests even at the expense of its shareholders can be expected to act in the absence of a profit opportunity or of nonmarket pressure. From the perspective of predicting when a firm will act, it is important to understand motive as well as profit opportunities and pressure.

Observing the motive is difficult, however. If a firm takes an action that makes shareholders worse off but makes society better off, the firm presumably was motivated by a concept of social responsibility. Malden Mills is privately owned, so Mr. Feuerstein is the only shareholder, but his actions may have cost the providers of capital, himself and lenders, a substantial amount so as to benefit the remaining employees. Whether society as a whole is better off is not clear. Most firms probably would not have acted as he did. In the case of ARCO the shareholders were worse off and customers were better off as a result of the price freeze. Society, however, was worse off because gasoline was priced below its cost.

If a firm takes an action that increases its profits and benefits some stakeholder group, it may be difficult to determine from the action alone whether the firm was simply maximizing its profits or responding to some moral motivation. Motive is best revealed by a consistent pattern of actions and by the adoption of processes that give attention to the interests of society. British Petroleum (BP) has undertaken an aggressive program to reduce greenhouse gas emissions and has instituted an internal process of social responsibility to support that and other programs. Chapter 21 and the case British Petroleum (C): Social Responsibility in that chapter expand on its process and programs.

Heinz’s decision not to purchase tuna caught in purse seine nets served the interests of various constituencies, and ethical consensus in society may well have supported that decision. Moreover, given the pressure it faced in its nonmarket environment, shareholders were likely better off than they would have been had Heinz continued to resist the pressure. Both shareholders and external interests thus benefited from the decision. Heinz’s motive appears to have been to reduce the actual and potential damage. Heinz was aware of the fishing practices in the Eastern Pacific and the number of dolphins being killed. The company also understood the widespread concern about the issue once the videotape was broadcast in March 1988. That Heinz took 2 years to change its policy and not until it had become a boycott target suggests that its motive was to reduce the pressure.²⁵

In contrast, Hobee’s restaurants did not act in response to pressure. Its actions benefited those seeking to protect dolphins and probably reduced Hobee’s profits. The motive for the actions was likely to have been based on a moral principle.

²⁵In an interview in the film referenced in footnote 4, O’Reilly said: “I think it would be a poor chief executive officer that was not attentive to his customers . . . because of the affection children have for Flipper . . . there was a growing barrage of criticism, well-orchestrated, which I think served to convey a growing sentiment among schoolchildren that the previous fishing methods were no longer acceptable.”
Similarly, the Unocal old car program likely benefited society but made shareholders worse off, since it provided a public good with only limited ability to capture benefits sufficient to cover the cost of its provision. Unocal identified an innovative alternative to more costly measures of reducing automobile emissions. The program has been adopted elsewhere by private parties and by governments and has become a serious instrument in pollution control programs. A study by Dixon and Garber (2001) concluded that continuing to scrap old cars and light trucks “would improve air quality in the greater Los Angeles area at a reasonable cost.”

Shorebank is also in the morally motivated category because its founders did not receive a market return for their original contributions, and the bank clearly focuses on maximizing lending to the local communities rather than maximizing profits. Aetna’s program may also be in this category, although the fact that other companies did not implement similar programs suggests that the program may not have been cost effective. In terms of motive Aetna’s chairman was a vocal advocate of corporate responsibility, but Aetna was also under pressure because of the complaints about redlining. The Shorebank model that relies on members of the community to identify and manage housing rehabilitation projects seems more effective both in theory and in practice.

To relate these examples to the perspectives on corporate social responsibility, recall that Friedman’s perspective is based on an alignment of the interests of shareholders with those of society. That is, in a world in which markets are competitive and in which private bargaining and government-structured incentives are used to internalize externalities, the interests of shareholders are aligned with those of society. An action that benefits shareholders thus benefits society as well. Friedman would not refer to such actions as corporate social responsibility. If shareholders, acting as principals, were to direct the firm to take an action that benefited society at their expense, Friedman would call it individual, rather than corporate, social responsibility.

To the extent, however, that markets are not competitive, that transactions costs impede bargaining, and that government policies do not align private and social costs, shareholders’ interests can diverge from society’s interests. Then, corporate social responsibility, as the Business Roundtable perceives it, could require the firm to take an action if society’s interests would be served even if shareholders would be worse off. The limits to this principle come from the need for the firm to earn a “reasonable return.” Similarly, actions that would harm stakeholder interests would be taken only when they are necessary to allow the firm to earn a reasonable return.

For firms such as Levi Strauss & Co., Ben and Jerry’s, Cummins Engine, Johnson & Johnson, and Malden Mills, concepts of corporate social responsibility are ingrained in the companies’ operating principles and practices and are said by the companies to contribute to successful economic performance, or at least as so integrated with market activities that the direction of causality is difficult to identify. Other companies, particularly small businesses early in their development, often emphasize economic performance, and if they succeed, may implement programs in the social responsibility domain. Programs implementing conceptions of social responsibility are considered in Chapter 21. The chapter cases Advanced Technology Laboratories, Inc., Delta Instruments, Inc., and Headquarters Relocation: Kimberly-Clark and the State of Wisconsin provide opportunities to consider corporate social responsibility in more detail.

See, however, the Chapter 20 case Environmental Justice and Pollution Credits Trading Systems.

Charitable contributions made in the absence of pressure are similar.

Levi Strauss & Co. and Malden Mills are privately owned, and Ben & Jerry’s was 42 percent owned by its founders.
Consideration of motives is useful for clarifying the corporate social responsibility issue, but there are additional aspects of the issue. In particular, the focus on the interests of stakeholders and society may give inadequate attention to considerations such as liberties and rights and to principles of justice. These moral dimensions are considered in subsequent chapters and provide an additional basis for guiding and evaluating corporate actions.

Corporate Governance

CONSTITUENT REPRESENTATION?

If corporations are to take into account stakeholder and broader public interests as the Business Roundtable suggests, should stakeholders be represented in corporate decision-making processes? One approach would be to allow them to participate in corporate decision making at the board of directors level, with board members selected by and representing the principal constituencies. During the Carter administration activists supported an unsuccessful legislative effort, referred to as the “corporate democracy act,” that would have required board representation of stakeholder groups.

Most firms oppose board representation of constituent groups. The Business Roundtable (1990. p. 18) stated: “We reject the notion of so-called constituency directors. Individual directors responsible to particular claimant groups would introduce into the board a divisive and adversary atmosphere which would obstruct the effective performance of the enterprise. Moreover, the notion that the board as a whole has a direct responsibility to groups other than share owners would mean that there was no clear measure of board performance.”

The Roundtable prefers that managers consider the interests of constituents rather than allow them to participate in decision making.

A few firms have included union leaders on their boards, but some union leaders subsequently resigned because of concerns that their independence might be compromised. In other countries such as Germany, however, legislation gives labor representation on supervisory boards and for large companies on the management board. The United Automobile Workers union received a seat on the management board of DaimlerChrysler when the two companies merged.

Hillman, Keim, and Luce (2001) studied the relation between stakeholder directors and corporate social performance. Their statistical analysis revealed no aggregate relation between corporate social performance and board representation, and when they disaggregated the components of CSP and types of board representatives, they also found little evidence of a relation. Even if an empirical relation had been found supporting a link between constituent representation and CSP, the direction of causality still would be unclear. For example, as Hillman, Keim, and Luce note, firms with poor CSP could be the ones that added constituent directors.

SOCIAL ACCOUNTABILITY

Accountability continues to be an issue for firms that adopt corporate social responsibilities. Some firms experimented with independent “social audits” of their efforts, and some published those audits. The call for social audits faded in the 1980s as the impact of such reports was questioned, but in the mid-1990s they began to receive increased attention. As indicated in Chapter 3, the Body Shop decided to have an independent

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29This statement was written by a different task force from the one that wrote the statement on social responsibility.
30Performance was measured using the same data used by Waddock and Graves.
social audit conducted as a means of quelling criticisms that its practices fell short of its pronouncements. This social audit is considered in Chapter 21.

Many firms now conduct their own assessments of social performance. Some of these assessments are comprehensive, and some focus on the environment or employee safety. BP provides an extensive and detailed report on its greenhouse gas emissions, including a report on an independent audit of its individual facilities. Dow Chemical provides a detailed report on its environment, health, and safety performance. In 1999 Ford began providing a report on its social performance and its commitments to future goals.

Accountability is not only assessed by firms but also involves external monitoring and evaluation of performance by activist and interest groups. A number of “socially responsible” mutual funds have been established and refuse to hold shares in cigarette companies, weapons manufacturers, or firms that damage the environment. Several independent organizations provide institutions, such as universities and pension funds, with evaluations of the social performance of firms. In 1994 Franklin Research & Development withdrew its highest rating for the Body Shop. Other organizations such as the Investor Responsibility Research Center provide evaluations on corporate policies on particular issues that are the subject of shareholder resolutions voted on at annual shareholder meetings.

THE DUTIES OF BOARDS OF DIRECTORS

Corporations are “managed under the direction” of their board of directors, and board members have fiduciary responsibilities. The legal obligations of directors generally fall into categories referred to as the duty of loyalty and the duty of care. The duty of loyalty pertains to conflicts of interest and requires that directors serve the interests of the corporation and its shareholders. According to Clark (1985, p. 73), “Case law on manager’s fiduciary duty of care can fairly be read to say that the manager has an affirmative, open-ended duty to maximize the beneficiaries’ wealth . . . .” The duty of care requires directors to take care in their direction of the corporation under the “prudent person” standard and to make informed decisions. (Officers of the corporation have the same duty.) Directors are not expected to participate in the day-to-day management of the corporation.

The courts judge the discharge of the obligations of directors according to a common law standard referred to as the “business judgment rule.” Under this standard, actions taken by the board generally are not subject to judicial review if they are taken in accord with the duty of loyalty and the duty of care. The business judgment rule is based on the view that courts have no special expertise in second-guessing business decisions and that business decision making would be unduly hampered if it were subject to judicial review. Furthermore, the courts are likely to be less effective in monitoring managerial decisions than is the market for control.31

If directors do not exercise due care, they may be held liable.32 In Smith v. Van Gorkom (1985), 488 A.2d 858 (Del.), the Delaware Supreme Court held that the directors of Trans Union Corporation were grossly negligent, and hence not protected by the business judgment rule, because they failed to independently value the firm in a leveraged buyout.33 A subsequent case, Hanson Trust PLC v. ML SCM Acquisition (1986), 781 F.2d 264 (2nd Cir. 1986), established that being adequately informed is not

32See Bagley (1999), Chapter 21.
33Corporations are incorporated under state law, and Delaware is the most popular state for incorporation.
sufficient to be protected by the business judgment rule. Directors must be well informed when they make decisions. Consequently, boards now seek the advice of independent experts in any valuation decision and in many other decisions as well. Reliance on experts is not sufficient, however, and directors are required to inquire into the content and quality of the reports given by management. The Van Gorkom and Hanson decisions caused the cost of directors and officers insurance to increase sharply. Most states responded by enacting statutes that allowed shareholders to limit the liability of directors and officers.

In addition to legal requirements, boards have a number of specific roles and functions. The Business Roundtable (1997, pp. 4–5) identified five principal functions of the board:

(i) Select, regularly evaluate and, if necessary, replace the chief executive officer, determine management compensation, and review succession planning.

(ii) Review and, where appropriate, approve the major strategies and financial and other objectives and plans of the corporation.

(iii) Advise management on significant issues facing the corporation.

(iv) Oversee processes for evaluating the adequacy of internal controls, risk management, financial reporting and compliance, and satisfy itself as to the adequacy of such processes.

(v) Nominate directors and ensure that the structure and practices of the board provide for sound corporate governance.

The Roundtable also argued that board attention should focus on strategic decisions and the social impacts of corporate decisions, although it drew considerably narrower boundaries on social responsibility than did the task force statement on corporate social responsibility.

The Roundtable recommended a board composed of "a substantial majority of . . . outside (nonmanagement directors)." It also recommended inclusion of more women and minorities on boards. The Roundtable also stated that "it is highly desirable for a board to have a central core of experienced business executives." Many corporations assign only nonmanagement directors to the audit, compensation, and nominating committees of their boards to ensure that the shareholders' interests are being served by management.

The Investor Responsibility Research Center (1993) surveyed institutional investors regarding their voting on corporate governance issues. A majority of the 85 institutional investors, which managed nearly half a trillion dollars of investments, responded that they routinely voted for shareholder proposals for a board with a majority of independent directors, a compensation committee composed entirely of outside directors, an independent nominating committee, and the annual election of directors. By 1994 outside directors were a majority on the boards of 86 percent of U.S. corporations and 91 percent of financial institutions. A 1996 study by Korn/Ferry International reported that 36 percent of the largest industrial companies surveyed had a "lead director," 98 percent regularly evaluated the performance of a CEO, and 73 percent had outside directors meet without the CEO. Institutional investors clearly cast their votes for market capitalism. Dalton, Daily, Ellstrand, and Johnson (1998), however, surveyed 54 studies of the relation between CFP and board composition measured in terms of

34The other institutional investors generally vote on a case-by-case basis.
independent and inside directors. They were unable to find any empirical relation between board composition and CFP.

The duty of loyalty supports both Friedman's position and the strategic use of corporate social responsibility. The business judgment rule, however, means that management and the board have a substantial range of discretion in deciding the extent of that responsibility. For example, Ben & Jerry's donated 7.5 percent of its pretax profits to charities and paid a premium for milk from dairy farmers who pledged not to use the bio-engineered hormone rBGH. 35 Ben & Jerry's also decided not to enter the Japanese market after a leading Japanese company offered to distribute its products. CEO Robert Holland, Jr., explained, "The only clear reason to take the opportunity was to make money." Holland resigned less than 2 years after being recruited, reportedly because of disagreements with the company's founders over policies. The company's poor financial performance led to an acquisition by Unilever, which pledged to continue some of Ben & Jerry's policies.

Concerns about managerial capitalism and the objectives that management pursues have resulted in direct pressure from institutional investors for a more independent board of directors. The nation's largest fund, the California Public Employees Pension Fund (CalPERS), for example, put pressure on firms to have more independent boards and improve their financial performance. CalPERS's approach was to go directly to the outside board members, bypassing management. TIAA-CREF, a $113 billion pension fund for teachers and professors, joined with CalPERS in seeking changes in boards of directors of companies such as Heinz, arguing that the board was not sufficiently independent.

THE MARKET FOR CONTROL

The market for control supervises the actions of management and directors through mergers, acquisitions, hostile takeovers, and proxy contests and thereby disciplines management by providing incentives to serve shareholder interests. 36 However, many managers prefer to be insulated from the market for control, arguing that they are best able to chart the firm's course. 37 Investors often disagree and favor the discipline of the market to the discretion of management; that is, they prefer market capitalism to managerial capitalism. For example, through a series of acquisitions, United Airlines, which was renamed Allegis, had included in its system Hertz Rent-A-Car, Westin Hotels, and Hilton International. Pressure on Allegis for better financial performance caused its board of directors to replace its CEO. Under new management Allegis was broken up, with UAL, Inc. the surviving entity. In his letter to shareholders, the new chairman and CEO wrote: "My objective . . . has been . . . enhancing near-term stockholder values and the goal of permitting United Airlines to operate successfully and gain in value in the future in a very competitive environment . . . We have determined to proceed immediately with the sale of all of our non-airline businesses—Hertz, Westin, and Hilton International—and to distribute the net proceeds from those sales to stockholders." 38

Institutional investors are an increasingly important force in the market for control. During the 1970s and most of the 1980s, institutional investors were relatively pas-

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35 The company had to negotiate a settlement with the State of Illinois requiring it to state its policy on its ice cream containers along with the statement: "The FDA has said no significant difference has been shown and no test can now distinguish between milk from rBGH treated and untreated cows."
36 See Weston, Chung, and Hoag (1990) for a comprehensive treatment of the market for control.
38 April 25, 1987, letter to Allegis Corporation stockholders from Frank A. Olson.
sive and seldom attempted to influence the management of the firms whose shares they held. Shareholder resolutions tended to focus on issues such as operating in South Africa, and institutional investors seldom initiated resolutions. Most institutions voted with management on proxy issues. With institutions now holding a majority of the shares of U.S. corporations, compared with slightly over 20 percent in 1970, institutional investors have been crucial in forcing management changes in companies such as General Motors and Eastman Kodak. Pension funds, such as CalPERS, in particular have been concerned about the return on their investments and have increasingly opposed management on proxy challenges, anti-takeover charter amendments, and shareholder resolutions directed at forcing management to improve profitability. In addition, the Department of Labor has instructed pension fund managers to vote on proxy issues in the best interests of their beneficiaries. In 1992 the Securities and Exchange Commission issued rules giving shareholders new powers, such as calling special meetings and maintaining confidentiality on proxy measures, that make it easier for shareholders to take action against management. Nevertheless, although the market for control is active and provides discipline to managers and considerably limits the exercise of managerial capitalism, the imperfections in the market for control leave some, and in many cases considerable, room for management to guide a firm’s decisions as it chooses.

Under pressure from a number of corporations and organized labor, Pennsylvania enacted an anti-takeover law intended to protect its firms and the jobs they provided in the state. This event provided evidence on both the market for control and managerial responses to the protection of firms and their management. A unique feature of this law was that it gave corporations a window during which they could opt out of one or more of the law’s protective provisions. The capital market reaction to the law occurred soon after the bill was introduced in the state legislature. The price of a market basket of 60 companies incorporated in Pennsylvania fell over 5 percent relative to the Corporate Standard & Poor’s 500 index. As the likelihood increased that the bill would pass, the gap increased—by January 1990, when the state senate passed the bill, the gap was 6.9 percent. Since some firms were expected to opt out of the law, the decrease in market value for those firms that were expected to choose the protection of the law was considerably higher. The capital market penalizes those companies that protect management from the market for control.

Summary

The role of business in society and the extent of its social responsibilities remain subjects of disagreement. The duties of care and loyalty and the business judgment rule leave considerable discretion to directors and management, but management is not free to rely on its personal preferences for charting the paths of the firms they control. Management and directors face continuing pressure for improved financial performance, which limits management’s discretion to pursue social objectives. The chapter case The Collapse of Enron: Governance and Responsibility addresses the responsibilities of directors when management pushes the envelope of acceptable practices.

In assessing what constitutes corporate social responsibility, it is important to consider the motive for an action, whether it was taken based on principles, in response

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39 The Department of Labor has regulatory authority under the Employee Retirement Income Security Act of 1974.
40 See Karpoff and Malatesta (1989).
to pressure, or to maximize profits. Actions taken to benefit shareholders by responding to pressure and actions that maximize profits differ from actions taken in response to the needs of constituents or to moral principles. Moreover, using the interests of constituents or moral arguments to justify actions taken independently of those considerations is not social responsibility. That is, it is necessary to look behind the rhetoric of social responsibility to its content and motives.

The relation between social responsibility and economic performance remains unclear, but many companies argue that the two can, and do, go hand in hand. Even Friedman's dictum to maximize profits is subject to the limits of the law and ethical custom, both of which leave a gray area between what is clearly responsible and what is clearly irresponsible. On such issues managers obtain guidance from two primary sources. The first is government, which proscribes as well as prescribes certain actions and provides incentives to adopt certain types of policies. The tax deductibility of philanthropic contributions and the tax advantages provided for hiring disadvantaged youths are examples of such incentives. The second source of guidance is ethics. Ethics provides a basis for reasoning about and evaluating actions and policies. The content of social responsibility ultimately is found in those principles and their moral foundations. Moral foundations, however, do not always provide unambiguous prescriptions nor are the prescriptions provided by different ethics frameworks necessarily the same. The following chapters develop these frameworks and consider applications within the scope of the social responsibility debate.
The Collapse of Enron: Governance and Responsibility

In an interview with PBS in March 2001 when doubts were being raised about Enron, President and CEO Jeffrey Skilling said, "We are the good guys. We are on the side of the angels."

Addressing Jeffrey Skilling in a House hearing, Representative Edward J. Markey (D-MA), said, "You are employing the Sergeant Shultz defense of 'I see nothing. I hear nothing.'" (Sergeant Shultz was a character in the television series Hogan's Heroes.)

Representative James Greenwood (R-PA) referred to Enron CFO Andrew Fastow as the "Betty Crocker of cooked books."

INTRODUCTION

Enron was a great business success soaring to a market capitalization in excess of $60 billion and ranking seventh on the Fortune 500 list. It was frequently voted one of the most admired companies and one of the best companies to work for. Enron also had a cutthroat corporate culture in which pushing the envelope was routine and failure led to departure.

The company built its success on natural gas pipelines, energy production, and an innovative energy trading business. Some of its investments were failures, however. One was the Dabhol electric power generation plant that was subject to contentious contract disagreements with the government of India. Enron decided to walk away from the contract in 2000. Enron also acquired Portland General Electric and attempted to grow its Internet unit into a nationwide fiber optics system. Enron acquired Wessex Water in the United Kingdom but failed in its attempt to develop it into a new line of business. Enron also invested in a broadband company that collapsed with the bursting of the broadband bubble.

Enron was creative in its financial arrangements, entering into numerous partnerships with a variety of entities. The purpose of some of the partnerships and their related-party transactions was to transfer certain assets and their associated borrowings and their profits, and more often losses, to the partnership. This allowed Enron, with the approval of its auditor Arthur Andersen, to keep losses off its income statement and debt off its balance sheet. Many of the partnerships were organized by Enron executives, some of whom invested in them with guaranteed returns. Negotiations with the partnerships were thus not at arms-length, with Chief Financial Officer Andrew Fastow both representing Enron and participating through limited partnerships in deals with Enron. Fastow and several lower-level employees "were enriched, in the aggregate, by tens of millions of dollars they should never have received."

The participation of the employees other than Fastow had not been approved by the Chairman and CEO.

The partnerships allowed Enron to keep substantial losses off its financial statements. From the third quarter of 2000 through the third quarter of 2001 Enron reported a before-tax profit of $1.5 billion, but if certain partnerships referred to as Raptors had been consolidated into its financial statement its earnings would have been $429 million. Although Enron stated that the partnerships protected the company from risk, the risk was actually borne by Enron through guarantees to the Raptors. As Enron's share price declined in 2001 the Raptors' ability to protect Enron's earnings disappeared. CEO Jeffrey Skilling resigned abruptly in August 2001, while proclaiming that Enron was in good health.

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41 Special Report, p. 3.
Under increasing pressure from its own failed investments, facing difficulty in obtaining financing, and under scrutiny from Wall Street, on October 16 Enron reported a third-quarter pre-tax loss of $710 million and subtracted $1.2 billion from shareholders’ equity. One billion dollars of the write-down was due to the correction of “accounting errors,” and $200 million was due to the termination of the Raptors. In November Enron restated its earnings back through 1997. The restatements of earnings included the consolidation of a number of partnerships that had been used to keep debt and earnings fluctuations off Enron’s financial statement. Fastow was asked to leave the company on October 23, and the Securities and Exchange Commission began an investigation. Revelation of the hidden losses destroyed any remaining confidence in the company and its share price continued its decline from its peak of $81.39 on January 25, 2001, to less than a dollar in December 2001. Enron filed for Chapter 11 bankruptcy on December 2. A flurry of class action and other lawsuits were filed against Enron and Andersen for securities fraud and other violations.

HISTORY OF THE COMPANY

After stints as a corporate economist, assistant professor, Federal Power Commission staff member, and under secretary of the Department of Interior, Kenneth Lay became vice president of Florida Gas and then of the Continental Group. He then became president and CEO of Transco, a Houston-based gas company, and then of Houston Natural Gas. In 1985 he arranged the merger of Houston Natural Gas and Internorth, and the merged companies subsequently became Enron. Enron operated fixed assets in power generation and natural gas transmission and organized an energy trading market in which it traded electricity and natural gas. Enron also had a large merchant investment business in structured transactions in fixed assets and trading. Enron was an aggressive advocate of deregulating energy markets.

In 2000 Enron had sales of $101 billion and assets of $47.3 billion. Enron operated 30,000 miles of pipelines, 15,000 miles of fiber optic cable, and had 19,000 employees in 2002.

SPECIAL PURPOSE ENTERPRISES
AND ACCOUNTING STATEMENTS

A central component of Enron’s strategy was to utilize subsidiaries and special purpose entities including partnerships for the funding and structuring of projects. Enron was estimated to have 5,000 partnerships and subsidiaries. Enron had over 140 subsidiaries in the Netherlands, where tax laws gave favorable treatment to holding companies with subsidiaries in other countries. The holding companies could loan funds to subsidiaries such as Enron Columbia Energy BV, and the interest on the loan was not taxable.

In partnerships named Marlin and Osprey, Enron formed an investment trust, lending its stock to the partnerships for use as collateral. The partnership raised small amounts of outside equity and raised most of its funds by issuing debt with the Enron stock as collateral. The partnership then formed a joint venture with Enron in which Enron provided real assets to the joint venture in exchange for funds used to pay off debt on the assets. The debt in the joint venture did not appear on Enron’s books, but if the joint venture were to fail or be unable to repay its debt obligations, Enron would have to provide shares to cover the debt payments. These partnerships were disclosed only in the fine print of Enron’s annual report. In marketing such structured transactions Citigroup described one of the benefits as removing “certain items from ‘plain view,’ thus enhancing the appearance of the balance sheet.”

Enron used a variety of other means to keep debt off its books, one of which was a prepaid swap. For example, in December 2000 Enron signed a contract to deliver natural gas to Mahonia Ltd. over a 5-year period and simultaneously signed a contract with Stonehill Aegean Ltd. to purchase the gas to be delivered to Mahonia. In the deals Mahonia prepaid the fair value of the contract, while Enron’s payment to Stonehill was to be spread over 5 years. This in

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42 Subsequent to filing for bankruptcy Enron agreed to a merger with Dynergy, but Dynergy backed out of the agreement shortly thereafter.
effect gave Enron a loan of $330 million at a 7 percent interest rate, but the loan did not appear on Enron’s balance sheet. Mahonia and Stonehill were affiliated companies linked to J.P. Morgan Chase, which structured the swap. Citigroup reportedly loaned $2.4 billion to Enron through a series of prepaid swaps.

Enron also established special purpose enterprises that participated in related-party transactions to keep certain assets and debt off its balance sheet and shield its earnings. Accounting for the enterprises was subject to generally accepted accounting principles. Enron could avoid having to consolidate these special purpose enterprises in its financial statements if they satisfied two conditions. One was that the enterprises were independently controlled, and the other was an SEC requirement that 3 percent of its assets be at risk; that is, outside equity of at least 3 percent was required.

**CHEWCO**

In 1993 Enron established a partnership named JEDI (Joint Energy Development Investments) with the California Employees’ Retirement System (CalPERS) as the limited partner. JEDI initially invested in natural gas pipelines and was not consolidated in Enron’s financial statements because Enron and CalPERS exercised joint control.

In 1997 CalPERS wanted out of JEDI, and Fastow established Chewco Investments LP to buy CalPERS’ interest for $383 million. Accounting rules would have required disclosure of the partnership if an Enron senior executive, such as Fastow, were to manage Chewco, so Fastow assigned Michael J. Kopper, who reported to Fastow, to manage Chewco. Disclosure was not required because of Kopper’s rank.

Chewco was financed by a $240 million loan from Barclays Bank PLC guaranteed by Enron, and by an advance of $132 million from JEDI. To keep Chewco off Enron’s books, a minimum 3 percent equity investment, or $11.5 million, had to be invested. To provide the outside equity, Fastow and Kopper established Big River Funding as Chewco’s limited partner and Little River Funding was established to own Big River Funding. Kopper invested $125,000 of his own funds in the two entities and arranged to borrow the remaining $11.4 million “equity” from Barclays. The credit document was written so that Barclays could treat it as a loan and Enron could treat it as equity for accounting purposes. For example, instead of referring to interest, the credit document referred to “yield.” Barclays ultimately loaned only $6.8 million, so Chewco did not meet the SEC outside equity requirement. Chewco thus was incorrectly kept off Enron’s books with neither its debt nor its losses consolidated. Enron repurchased Chewco in March 2001, and Kopper and his partner Dodson received $10.5 million for their investment. In November 2001 Enron revealed Chewco when it revised its financial statements.

Enron also engaged in a variety of questionable accounting practices regarding revenue and income from JEDI and Chewco. For example, Chewco held 12 million shares of Enron stock, which was carried at fair value. As its stock appreciated, Enron recorded a share of the appreciation as its own income, which is contrary to generally accepted accounting principles. Moreover, as its stock price began to fall, Enron’s $90 million share of the loss on the shares held by Chewco was not recorded as a decrease in income. Arthur Andersen approved both the recognition of appreciation as income and not recognizing the depreciation in value as a reduction in income.

**LJM PARTNERSHIPS**

In 1999 Fastow proposed establishing a partnership LJM Cayman LP (LJM1) for the ostensible purpose of hedging Enron’s investment in Rhythms NetConnections by obtaining investments from outside investors. Fastow would be the general partner, since, he explained, that would help attract outside investors. He said he would personally invest $1 million in LJM1. The proposal was approved by Lay, Skilling, and the Board, which determined that Fastow serving as managing partner of LJM1 would not “adversely affect the interests of Enron.” Such a

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48 Following a Star Wars theme, there were partnerships named JEDI, Obi 1, and Chewco after Chewbacca.
49 Shortly thereafter, Kopper transferred his financial interests to his domestic partner William Dodson.
50 The remaining $6.6 million was funded from a distribution by JEDI from the sale of an energy company.
51 Fastow named the LJM partnerships using the first letters of his wife’s and children’s names.
determination was required by Enron's Code of Conduct.

Enron also sought to take advantage of the "embedded" value resulting from a forward contract with an investment bank to purchase Enron shares at a fixed price. Enron restructured the contract, releasing 3.4 million shares of its stock to be used as collateral. To "hedge" Enron's investment in Rhythms, LJM1 received these Enron shares in exchange for a note to pay $64 million to Enron. LJM1 then transferred the shares to a newly created limited partnership, Swap Sub, that gave Enron a put option on Enron's entire investment in Rhythms.32 The put option entitled Enron to sell its Rhythms shares to Swap Sub at $54 per share in June 2004.33 Enron had purchased its 5.4 million shares in Rhythms at $1.85 per share in March 1998, and when Rhythms went public in 1999 Enron's holding was valued at $300 million. This arrangement, however, did not provide a true hedge because if Enron's shares declined in value, Swap Sub would be unable to cover the put. In addition, Swap Sub did not have the required 3 percent equity investment. Arthur Andersen, which had not objected to the arrangement, concluded in October 2001 that it had made an error.

Enron began to unwind the hedging arrangement in the first quarter of 2000 in a series of complicated transactions. Five lower level Enron employees plus Fastow formed a limited partnership, Southampton Place LP, to participate with LJM1 in the unwind. Within two months a $25,000 investment returned $4.5 million funnelled into a "family foundation," whose limited partners were Fastow and the other five employees. Two of the five also invested $5,800 and received a return of $1 million in 2 months. These employees did not seek a determination from Lay and Skilling that their participation would not adversely affect the interests of Enron. The Report of the Special Committee established by the Board in the wake of the collapse stated, "Enron employees involved in the partnerships were enriched, in the aggregate, by tens of millions of dollars they should never have received—Fastow by at least $30 million, Kopper by at least $10 million, two others by $1 million each,...". The Special Committee report concluded, "We have not seen any evidence that any of the employees, including Fastow, obtained approval from the chairman and C.E.O. under the code of conduct to participate financially in the profits of an entity doing business with Enron. While every code violation is a matter to be taken seriously, these violations are particularly troubling."

LJM1 was also used to take certain assets off Enron's balance sheet and to increase its current income. Enron had a 65 percent interest in a Brazilian company building a power plant that was "experiencing significant construction problems." Enron sold a portion of its interest to LJM1, leaving it no longer technically in control of the company and allowing Enron to take its investment in the company off its balance sheet. This also allowed Enron to mark-to-market the value of a gas supply contract an Enron unit had with the Brazilian company. This increased Enron's income for the second half of 1999 by $65 million.34

On Fastow's recommendation the Board approved the establishment of a second (LJM2) partnership with Fastow as the general partner.35 LJM2 raised $394 million primarily from 50 limited partners, including Merrill Lynch, J.P. Morgan Chase, and Citigroup. In addition, Fastow and other Enron employees invested in LJM2 through two limited partnerships, one of which, Big Doe, was managed by Kopper, and the other by Fastow himself. The LJM partnerships were in a gray area of accounting standards and were not consolidated with Enron's financial statements.

RAPTORS

Raptor was Enron's name for a partnership used to "hedge" its merchant investments portfolio in projects and companies. The raptors were a result of the initial success of the Rhythms "hedge." Because its merchant investments were marked-to-market, changes in their value affected Enron's earnings on a quarterly basis. The first Raptor, named Talon, was

32 Enron could not sell its shares in Rhythms before the end of 1999.
33 PricewaterhouseCoopers reviewed the transactions and concurred that the arrangement was fair to the parties.
34 Special Report, pp. 136–137.
35 The LJM partnerships participated in 20 transactions with Enron.
established in April 2000. To provide the 3 percent equity required to keep Talon off Enron's balance sheet, LJM2 provided $30 million. LJM2 was guaranteed a payment of $41 million before Talon could engage in hedging. For accounting purposes the $41 million was treated as a return on LJM2's investment, leaving its $30 million to satisfy the 3 percent requirement. However, Enron, which contributed its shares to Talon, would keep 100 percent of its earnings. Talon's only assets were thus Enron's shares.

To pay LJM2 Enron signed a contract with Talon under which Enron paid $41 million in exchange for a put option, the right to sell Enron shares to Talon at a fixed price. Talon then paid the $41 million to LJM2, allowing Talon to begin operations. Enron and Talon then signed a contract under which Talon agreed to cover Enron's losses on certain investments in exchange for sharing in any appreciation of the investments. This protected Enron's income statement from losses on the merchant investments. The Rapto's ability to cover losses depended on the price of Enron shares, however. If Enron's share price were to decline to a $47 trigger, Talon would be unable to cover Enron's losses.

Four Raptors were used to keep $504 million of losses off Enron's books, but as its stock price fell, triggers were tripped that threatened their ability to protect Enron's reported earnings. Early in 2001 Enron restructured the Raptors to reestablish the façade that they were covering risks, but after the restructuring they were even more vulnerable. Within weeks of the restructuring Enron reported a profit of $425 million for the first quarter of 2001.

In referring to Talon the Board secretary wrote, "Does not transfer economic risk, but transfers P&L volatility." The Board Special Committee stated, "Enron still bore virtually all of the economic risk. In effect, Enron was hedging risk with itself." The Special Committee concluded, "Especially after the restructuring, the Raptors were little more than a highly complex accounting construct that was destined to collapse."

As the Raptors were collapsing, Enron and Andersen accountants discovered that Enron's accounting for three of the Raptors was wrong. The shares Enron contributed to the Raptors had been treated as an increase in notes payable and a corresponding increase in shareholders' equity. This increased shareholders' equity by $1 billion during the first half of 2001. In October and November Enron restated its income and balance statements and consolidated the LJM partnerships.

In August Skilling abruptly resigned. After the resignation Sherron Watkins, an Enron vice president, wrote to CEO Kenneth Lay warning of the "inappropriateness" of some transactions. She wrote, "To the layman on the street it will look like we recognized funds flow of $800 million from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years." She also wrote, "I am incredibly nervous that we will implode in a wave of accounting scandals."

As a result of Watkins' letter Enron asked its outside law firm Vinson & Elkins to prepare a report on its transactions. The report presented on October 15 concluded that nothing wrong had been done, although it noted that both Enron and Andersen agreed that the accounting had been "creative and aggressive." Although the law firm found nothing wrong, the report also stated, "Within Enron, there appeared to be an air of secrecy regarding the LJM partnerships and suspicion that those Enron employees acting for LJM were receiving special or additional compensation."

Not everyone was fooled by Enron. A few analysts issued warnings, but most analysts followed the herd. In a conference call with analysts, Enron released its first quarter 2001 earnings and proclaimed the quarter a great success. One skeptical analyst asked why the company was issuing an income statement without the accompanying balance sheet and cash flow statement. Skilling brushed aside the question, mocking the analyst.

Citigroup, a major lender to Enron, decided to hedge some of its risk. Fifteen months before Enron's collapse and again in May 2001 Citigroup sold 5-year notes to investors who were guaranteed a return plus their principal unless Enron went bankrupt or failed to repay a loan. In those events the investors would

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56 The reference to "P&L volatility" meant that the profit and loss effects would not appear on Enron's book.
57 Later in congressional testimony she referred to the culture at Enron as "arrogant."
be paid in Enron debt. This was the largest hedge Citigroup had ever taken against a company.

**401(k) PLANS AND DEFERRED COMPENSATION**

Enron employees participated in 401(k) retirement plans, and most of them held Enron shares. The company matched employee contributions with equal contributions of Enron shares, and employees were prohibited from selling their shares until age 55. Enron shares represented approximately 65 percent of the assets of the plans. During 2001 the company continued to tout its stock to employees as a good investment.

Enron’s collapse caused many employees to lose most of their retirement funds. Earlier, Enron had decided to change the outside management of its retirement plans and had long scheduled the change for October 2001. The switch required freezing the 401(k) plans for 16 days beginning October 26, 2001. During the freeze employees could not sell their Enron shares, which fell in value from $15.40 to $9.00. Some employees were confused by conflicting information from the company and believed the moratorium began on October 19 when the share price was $26.05. Enron officials had considered postponing the switch but decided not to do so, reportedly because of fear of possible lawsuits.

In addition to its 401(k) plans Enron had a deferred compensation plan under which managers could defer portions of their compensation. During 2001 prior to filing for bankruptcy a number of executives withdrew funds from their deferred compensation plans, but others, including executives who had already retired, did not do so. As a result of the bankruptcy filing, those participating in the plan became unsecured creditors of the firm with their compensation to be determined by the bankruptcy court. Allegations were made that current executives were able to withdraw funds from their deferred compensation plans and were paid their bonuses in November prior to the bankruptcy filing, while others were not allowed to do so.

During Enron’s slide in 2001 Kenneth Lay sold $100 million in Enron shares, including $70.1 million sold back to the company. Sales in public markets had to be disclosed in the month following the sale, whereas sales back to a company need not be disclosed until the following year.

Days before filing for bankruptcy, Enron paid $100 million in retention bonuses to 600 key employees deemed essential to the continued operation of the company. Enron also laid off 4,500 employees, giving them severance pay of $4,500.

**POLITICAL CONTRIBUTIONS**

Enron and its executives made substantial political contributions to members of Congress and state legislatures. Since 1989 it had given $5.7 million to members of Congress, with $2.0 million contributed in the 2000 election cycle. Approximately two-thirds went to Republicans. Approximately half the House and two-thirds of the Senate had received contributions from Enron executives. Enron also contributed substantially to state officeholders and parties. The company also lobbied intensely for the deregulation of energy markets and had participated in Vice President Richard Cheney’s energy task force. Enron had also implemented a plan to cultivate a relationship with Vice President Al Gore during his presidential campaign.

The contributions provided access in both Washington and state capitols for Enron’s lobbying campaign for deregulation. When it was collapsing, Enron executives sought relief from the Bush Administration. Although he and President George W. Bush were well-acquainted, Kenneth Lay went to the Secretaries of Commerce and Treasury, neither of whom contacted the President. Secretary of Commerce Donald Evans rejected Lay’s request for assistance. Evans commented on Meet the Press, “If I had stepped in, I think it would have been an egregious abuse of the office of Secretary of Commerce.” Lay also called Secretary of Treasury Paul O’Neill and enlisted Robert Rubin, former Secretary of Treasury in the Clinton Administration and currently a top executive at Citigroup, to call the Secretary urging assistance for Enron. Secretary O’Neill rejected Enron’s request.

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58 Contributions in stock and restrictions on when the shares could be sold were common features of corporate retirement plans.


60 Lay had been chair of then Governor Bush’s business council.

61 In 1999 Enron invited Rubin to join its board of directors, but he declined the offer.
Enron also attempted to lobby for deregulation with the Federal Energy Regulatory Commission headed by Pat Wood III, who had previously headed the Texas Public Utility Commission. Wood, however, was unresponsive to Enron and angered the company by imposing caps on wholesale prices of electricity in the West. "The people going after [Wood] are misguided Democrats who see partisan stuff, or utilities who are upset because he's being too tough on them," says Mark Cooper, research director for the Consumer Federation of America. Cooper added that Wood was "demonstrating the independence of an independent agency."62

THE BOARD OF DIRECTORS

The Board of Directors was responsible for the performance of the company and had a fiduciary duty to shareholders. As Enron increased its use of related-party transactions, the Board increased the control over those transactions and ordered annual reviews of all LJM transactions. The Special Committee (p. 12) concluded, however, "These controls as designed were not rigorous enough, and their implementation and oversight was inadequate at both the Management and Board levels." In addition, Enron's outside counsel "Vinson & Elkins should have brought a stronger, more objective and more critical voice to the disclosure process." Referring to Enron management and Andersen, outside director Robert K. Jaedicke, chairman of the Board Audit Committee, said in congressional testimony, "It now appears that none of them fulfilled their duty to [the Board]. We do not manage the company. We do not do the auditing. We are not detectives... I am not confident as I sit here today that we would have gotten to the truth with any amount of questioning and discussion."63

Throughout the rise and fall of Enron the Board apparently did not block the questionable transactions and financial arrangements that led to the collapse. The Board maintained that it was unaware of some of the deals and that data were withheld from it. For example, Chewco was approved by the Board during a telephone conference call without disclosure of the "equity" loan by Barclays to Chewco's limited partner. Kopper's management of Chewco was approved by Skilling, but Enron's Code of Conduct required it to be brought to the Board.

After the announcement of its third quarter 2001 loss, Enron named William Powers, Dean of the University of Texas School of Law, to its Board of Directors. The Board then appointed a Special Committee headed by Powers to produce a report on the collapse. The Special Committee concluded that the Board had failed in "its oversight duties."

The Special Committee assigned much of the responsibility to Kenneth Lay in his role as a Director. The report stated, "Lay approved the arrangements under which Enron permitted Fastow to engage in related-party transactions with Enron and authorized the Rhythms transaction and three of the Raptor vehicles. He bears significant responsibility for those flawed decisions, as well as for Enron's failure to implement sufficiently rigorous procedural controls to prevent the abuses that flowed from this inherent conflict of interest. In connection with the LJM transactions, the evidence we have examined suggests that Lay functioned almost entirely as a Director, and less as a member of Management. It appears that both he and Skilling agreed, and the Board understood, that Skilling was the senior member of Management responsible for the LJM relationship." In the initial congressional hearings on the collapse, five Enron executives, Lay, Fastow, Kopper, chief accounting officer Richard Causey, and chief risk officer Richard Buy, exercised their constitutional right under the Fifth Amendment to protection against self-incrimination.64 Jeffrey Skilling testified but had difficulty recalling what had happened.

ARTHUR ANDERSEN

Enron's auditor was Arthur Andersen, one of the big five accounting firms. Andersen also provided consulting services to the company. In 2000 Enron paid a total of $52 million to Andersen with approximately half for audit services. Enron paid $5.7 million to Andersen for nonaudit services provided to Chewco and the LJM partnerships.

Andersen issued no qualifications in its audit reports and apparently approved all transactions brought to them. Andersen claimed to be ignorant of

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63Six Board members including Jaedicke resigned in March 2002.
64Causey and Buy were fired in February 2002.
most of the questionable partnership arrangements, however. Andersen indicated that it was not given access to data on Chewco, and if it had been it would have required a restatement of earnings.\footnote{Andersen stated that if it had been told that Enron had guaranteed the Barclays’ loan used to finance Chewco it would have required consolidation.}

Andersen CEO Joseph Berardino subsequently testified before Congress that it had questioned $51 million in earnings in 1997 and considered requiring adjustments in reported earnings. Andersen, however, decided that the adjustments were not “material” and did not require them. Berardino stated that the adjustments were “less than 8 percent” of normalized earnings. In November when Enron corrected its financial statements back to 1997, the $51 million adjustment was made. Berardino also stated that the Chewco/JEDI arrangements involved “possible illegal acts.”

In October after the announcement of Enron’s third-quarter loss and the write-down in its shareholders equity, Andersen’s Houston office, which had the principal responsibility for the audits, began shredding documents associated with its audits.\footnote{The managing director of the Houston office asked the staff to work overtime so that the shredding would not delay service to other clients.} The managing director said that he had consulted with a lawyer in Andersen’s headquarters and had been advised to shred the documents. After the telephone conversation the lawyer had sent an e-mail reminding the Houston office that Andersen policy required the retention of certain audit documents and allowed the shredding of other documents. The managing director was subsequently fired. ■

SOURCE: This case was prepared by Professor David P. Baron from public sources including the Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., February 1, 2002 [Special Report]. Copyright © 2002 by David P. Baron. All rights reserved. Reprinted with permission. This case was written in February 2002 when facts were still being revealed.

### Preparation Questions

1. What factors led to the collapse of Enron?

2. Should Enron have used partnerships in the manner it did? What if anything is wrong with using partnerships such as the Raptors, Chewco, and the LJMs?

3. What responsibilities does the board of directors have in such situations? What responsibilities did and should Enron and its directors have for its employees’ 401(k) plans?

4. Why did Arthur Andersen and Vinson and Elkins not conclude that there were problems with Enron’s structuring of transactions?

5. Is there an inherent conflict of interest for an outside auditor that also provides other services to its client?

6. What if anything was wrong with Enron’s political contributions and lobbying? What assistance did the contributions buy Enron when it was collapsing?

7. How much of its financial arrangements should Enron have disclosed?

8. What responsibilities does an audit firm have?

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**Advanced Technology Laboratories, Inc.**

Advanced Technology Laboratories, Inc. (ATL), with worldwide headquarters in Bothell, Washington, and European headquarters in Munich, Germany, was a leader in digital diagnostic ultrasound technology and equipment. “Ultrasound is a noninvasive technology that uses high frequency sound waves to
image the body’s soft tissues, organs and fetal anatomy and to display blood flow in real time.\textsuperscript{67} ATL’s ultrasound systems were used by cardiologists, radiologists, vascular surgeons, obstetricians, and gynecologists. Applications of ultrasound technology in gynecology included diagnosis of ovarian cysts, endometrial hyperplasia, endometrium, and ovarian flow.

ATL ultrasound systems were sold in 100 countries to village clinics and world-renowned medical research centers. The worldwide ultrasound market was estimated at $2.5 billion. In 1996 ATL earned $21.8 million on sales of $419 million. Its competitors included such companies as General Electric and Siemens.

ATL’s principal subsidiaries were located in OECD countries as well as in Argentina and India. In other countries ATL sold its systems through agents. Demand in the United States was sluggish, and ATL’s worldwide competitors had introduced new products during the past 2 years. ATL looked to developing countries for growth.

The most attractive growth opportunities were in large countries with high growth rates of spending for medical care and health services. India, with a population of 800 million and a forecasted growth rate of 15 to 20 percent a year for medical devices, represented a particularly attractive market. ATL India, located in Madras, a joint venture with an Indian company that made low-end ultrasound instruments, was responsible for sales in India and Nepal. China, with a population of 1.2 billion, also represented an attractive market, and its installed base of ultrasound equipment was lower than in India. In 1997 ATL formed ATL China, where it had sold ultrasound systems since 1978. ATL also had a technology transfer agreement with the Shantou Institute of Ultrasonic Instruments.

In 1997 ATL introduced its HDI 1000 system, which replaced 50 percent of the hardware components with multitasking software, making digital ultrasound technology available at a substantially lower cost. ATL’s Handheld Systems Business Division had also developed its FirstSight\textsuperscript{TM} high-resolution digital imaging technology that would bring “highly portable, handheld ultrasound devices... to the examining table, the bedside and the field.” ATL Chairman and CEO Dennis C. Fill said, “We believe that in the next few years these handheld ultrasound devices could have the same impact on patient care as the stethoscope and have the potential to create entirely new markets across many medical disciplines.”\textsuperscript{68}

In certain cultures some parents valued sons more than daughters. In the 1990s ultrasound devices became an effective means of allowing parents to engage in sex selection. Ultrasound was capable of identifying the sex of a fetus as early as 16 weeks, and local ultrasound clinics began to spring up throughout a number of Asian countries. A study by the Indian government revealed that for every 1,000 baby boys born, only 929 baby girls were born. A study reported that of the 8,000 abortions performed at one Bombay hospital, all but one were female fetuses.

One explanation for the preference for boys was given in a CNN World News story. “Sons are favored in India because it is they who are expected to carry on the family name and take care of the parents in their old age. Daughters are seen as a liability, and an expensive one at that. Families pay small fortunes in dowries to get their daughters married... For those Indians too poor to afford tests, there is a grimmer option. Skakuntala admits to killing her newborn daughter several years ago. She already had two girls and didn’t want another. ‘We were poor,' she says, ‘I put my sari over her face and she stopped breathing. It was the only thing to do.’”\textsuperscript{69} CNN also reported that 25 percent of the girls born in India do not reach the age of 25, and in some families boys are given disproportionate shares of food, medical care, and education.

In 1994 India responded to the practice of using ultrasound to identify the sex and abort female fetuses by enacting the Pre-Natal Diagnostic Techniques (Regulation and Prevention of Misuses) Act. The law limited the use of ultrasound to women who were at high risk due to age or other factors and banned abortions of female fetuses identified by either amniocentesis or ultrasound. However, the use of ultrasound combined with abortion for purposes of sex selection continued unabated.

\textsuperscript{67} ATL Web site: www.atl.com.
\textsuperscript{68} ATL Web site: www.atl.com.
\textsuperscript{69} CNN World News, September 17, 1995.
services for nonmedical purposes, and the British Columbia College of Physicians and Surgeons issued guidelines urging doctors and sonographers not to reveal the sex of fetuses. Vancouver, which had a substantial population of Asian-Canadians, was concerned about people going to the United States for fetal sex identification and returning to Canada for an abortion paid for by the government. Dr. Dalip Sandhu said, “I tell them it’s a sin. But they’re not here to ask for my opinion. They want the information. They don’t get it from me. It doesn’t mean it stops them.” Shashi Assanand, director of the Lower Mainland Multicultural Family Support Services Centre in Vancouver, blamed the dowry system. “Besides paying for a lavish wedding, the bride’s family is expected to buy her a complete wardrobe and jewelry, as well as clothes and jewelry for the new son-in-law’s family, with whom their daughter will be living. ‘That’s the minimum,’ says Assanand. Those who can afford more are expected to give their new in-laws ‘cash, furniture, appliances, a car and even property.’”

Another group concerned with sex selection and women’s issues was the Women’s Environment and Development Organization (WEDO). WEDO and other women’s groups were concerned about what was becoming known as the “missing women” of Asia.

PREPARATION QUESTIONS

1. Identify the moral concerns in using ultrasound for sex selection.
2. What possible reactions might ATL encounter on this issue?
3. Does ATL have any responsibility regarding the use of its products in sex selection?
4. Should ATL introduce its FirstSight™ handheld product in India?
5. Develop a strategy for ATL, with respect to the issues discussed in the case. Be sure to include specific steps you would take to implement your strategy.

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[2] The ratio in South Korea was 114 to 100 and in Taiwan was 110 to 100.
Headquarters Relocation: Kimberly-Clark and the State of Wisconsin

Over 100 years ago, J. Alfred Kimberly and three friends founded the Kimberly-Clark Corporation in the small town of Neenah. nestled in the Fox River Valley of Wisconsin. Kimberly-Clark had since become the largest U.S. maker of consumer paper products and the largest corporation headquartered in Wisconsin. Its Kleenex tissues, Kotex tampons, Huggies diapers, and other consumer products generated sales of $2.96 billion and net profits of $197 million in 1982, placing it 134th and 74th on the respective Fortune 500 lists. In 1982 net income was down nearly 4 percent, and Kimberly-Clark placed only 248th on the Fortune 500 list in total return to investors. In the first quarter of 1983 net income declined another 9 percent even though sales had risen 10 percent.

Kimberly-Clark’s chairman and chief executive officer, Darwin E. Smith, had become concerned about the climate for business in the state of Wisconsin. For 80 years Wisconsin had had a reputation as a progressive state in the LaFollette tradition and had been a leader in innovative state regulation of business and in the provision of public services. In part it was the consequences of this tradition that concerned Smith and caused him to consider moving Kimberly-Clark’s headquarters from Wisconsin. Kimberly-Clark employed approximately 2,300 people at its headquarters and employed a total of 4,700 in Wisconsin.

One concern about the business climate in Wisconsin was the regulatory burden. Smith noted that Kimberly-Clark was currently building a plant in Conway, Arkansas, that it had wanted to build in Wisconsin. A construction permit had taken only 8 weeks to obtain in Arkansas, and Smith said. "In Wisconsin, we were told, it would take eleven months to get a commitment to do anything."

Of greater concern to Smith were the high taxes on both corporate profits and personal income. The Wisconsin Taxpayers Alliance reported that in 1981 Wisconsin had the fifth highest per capita state tax load—$352 per person compared with the national average of $181. This difference was made more significant by the fact that wage rates in Wisconsin were substantially lower than in a number of the other high tax rate states, including California, Massachusetts, and New York. In addition, to balance the budget Wisconsin was expected to pass a $738 million tax increase, primarily in the form of a 10 percent surcharge on corporate and personal income taxes.

Smith was also concerned about the direction and policies of the newly elected state government. The new governor, Anthony Earl, was a liberal Democrat who had been the secretary of the state’s Department of Natural Resources and was believed by the business community in Wisconsin to be unfamiliar with the problems facing business. Governor Earl had proposed boosting the minimum tax rate from 3.4 to 3.6 percent and the maximum rate from 10 to 10.5 percent. In addition, the state legislature had taken actions that indicated possible future threats to business. In 1983 the Democratic majority leader of the state senate had introduced a bill to impose a 3-year moratorium on home-mortgage foreclosures. Although that bill was narrowly defeated, it was widely believed to be indicative of the sentiments of a large segment of the state legislature. In a 1982 study, Alexander Grant & Company, a Chicago accounting firm, had ranked Wisconsin as having the twelfth worst business climate among the 48 contiguous states. According to the state’s Bureau of Business Information Services, in the past 5 years 19 companies had moved out of Wisconsin. As State Senator Michael Ellis of Neenah said, “If Kimberly-Clark leaves, it acts as a signal to all business in the state that better times can be had outside of Wisconsin. It would be the start of the exodus from Wisconsin.”

An additional problem centered on the difficulty in recruiting professional and managerial talent to Wisconsin. As Smith said: “When you see our present highly talented employees and the younger generation that’s coming up behind them—highly trained.
highly skilled, technical people on the leading edge of know-how—they’re the type of people that we’ve got to pay a great deal of money to. And why do they want to come to the state of Wisconsin when they see a tax rate, already at 10 percent, put on their salaries and talk about going to 11 ½. It’s a question of recruiting and keeping good people. And I regret to tell—those of you who live in Wisconsin—that we’ve found it much easier to find skilled, highly trained people to live in other states than in Wisconsin.  

Rumors had begun to circulate about possible offers from Georgia and Texas to locate the headquarters in one of those states. In addition to what was perceived to be a more favorable business climate. Georgia had a corporate tax rate of 6 percent compared with Wisconsin’s 7.9 percent, and its maximum personal income tax rate was 6 percent on all income above $10,000 compared with 10 percent on income above $51,600 in Wisconsin. In 1981 Wisconsin had the seventeenth highest state and local property taxes, with an average of $41.78 per $1,000 of personal income, whereas Georgia was thirty-seventh with an average of $27.36. Georgia was believed to be a natural location for a paper products company because of the importance of the timber and wood products industry in the state. The nation’s largest timber and wood products company, Georgia-Pacific, was headquartered in Atlanta and was the state’s second-largest corporation after Coca-Cola. Many other timber, paper, and wood products companies also had operations in Georgia. During the past 10 years Kimberly-Clark had divested itself of significant timberland in Wisconsin and other Great Lakes states to concentrate its resources in the South and in Canada.

In 1980 Kimberly-Clark had established operations near Atlanta in Roswell, Georgia, and by 1983 had invested $34 million in office and research and development facilities, employing nearly 600 people. W.L. “Pug” Mabry, mayor of Roswell, stated, “We would certainly invite them to move their headquarters to Roswell.” he but added, “to my knowledge K-C has never indicated to the city that it intends to move its headquarters here.”  

The city had been accommodating when Kimberly-Clark first began to build there. Rumors of a move to the Atlanta area were fueled by the application of a subsidiary of K-C Aviation to provide commercial service between Appleton (serving Neenah) and Chicago and Atlanta.

Smith’s announcement became the biggest news item in Wisconsin, but Governor Earl said that the Kimberly-Clark story has gotten all out of proportion.” The governor emphasized the positive aspects of Wisconsin, including the high quality of its public services and the recently adopted tax exemption for equipment and machinery. He said that Wisconsin did not compare badly with other states when all factors were considered, although he added that he would like to see an improvement in “the relatively poor perception some legislators have of business and some businesses have of legislators. Some businesses think lawmakers are only interested in raising taxes and setting onerous regulations. Lawmakers sometimes think businesses only want to make excess profits.”

Governor Earl and Mr. Smith agreed to meet to discuss their concerns and scheduled a luncheon meeting in Kimberly-Clark’s headquarters in Neenah.

ASSIGNMENT

This assignment provides for a simulation of a fictitious discussion between a board committee of Kimberly-Clark and a working group from the state government. In preparation for the meeting with the governor, the Public Interest Committee of the Kimberly-Clark board of directors convened to discuss the possible headquarters location. A staff memorandum requested by Smith laid out several positions that might be taken in the discussion. One alternative was to commit the firm now to moving and announce it to the governor at the meeting as a fait accompli.

This alternative had the advantage of terminating what might otherwise be a lengthy series of discussions with state officials. This alternative would necessitate expediting negotiations with Georgia or Texas officials, but they were likely to be receptive because of the importance of the relocation. A second alternative was to decide now to move the headquarters but not tell Governor Earl until the negotiations there had been completed. The advantage of this alternative was that it would not tip Kimberly-Clark’s hand and hence would give the company more bargaining power with the states to which it might relocate. A variant of these two alternatives was to move only the portion of its
headquarters most plagued by the difficulty of attracting and retaining managerial talent, leaving the lower-level staff in Neenah. A third alternative was to use the meeting with the governor to bargain for tax concessions. If they were granted, the company might remain in Wisconsin. A fourth alternative was to seek a pledge from the governor to reduce taxes and lessen the regulatory burden on business in the state. A fifth possibility was to take Mr. Smith’s concerns about the business climate to the people of Wisconsin in a mass media campaign that would inform them of the problems of doing business in the state and urge them to pressure the governor and their state legislators.

Governor Earl also assembled a working group, including the state treasurer, the state secretary of Employment and Labor, the chairman of the Wisconsin Chamber of Commerce, and the chairman of the State Federation of Labor, who was also the president of the United Auto Workers of Wisconsin, to prepare the state’s position and meet with Kimberly-Clark.

The following small group assignments are fictitious and are identified to provide structure to the discussion.

**ROLE INFORMATION: KIMBERLY-CLARK’S PUBLIC INTEREST COMMITTEE**

*Darwin E. Smith, Chairman and CEO.* You are known to be seriously considering moving the headquarters, but you have not yet made a final decision.

*President and COO.* You are concerned about the profitability of the company and its need to raise capital to support new product development, test marketing, and nationwide marketing campaigns for new products. You were born and raised in Neenah and joined Kimberly-Clark after graduation from the University of Wisconsin.

*Vice President of Personnel.* You have been plagued by the difficulty in recruiting highly talented MBAs and other executives.

President of a large Wisconsin-based foundation that supports medical research. You are very concerned about the long-term “health” of the state.

*Partner, Morgan Stanley & Company.* You have warned Smith about the financial community’s concern with the company’s performance.

**ROLE INFORMATION: GOVERNOR’S WORKING GROUP**

The governor recognized that steps could be taken to improve the business climate in Wisconsin, but he was also aware that he had been elected to serve broader constituent interests.

*Anthony Earl, Governor.* You are very concerned by Kimberly-Clark’s possible move. Your objective is to persuade Smith not to move the headquarters, or, failing that, to delay the move for as long as possible.

*Treasurer.* Your concern is with the financial health of the state and the need to generate tax receipts to pay for the services the Earl administration wants to provide.

*Secretary of Employment and Labor.* You are concerned about the state’s ability to attract new industry to reduce unemployment. Unemployment had fallen from 12 percent in February to 9.3 percent now, but it remains a major concern because of the hardship on the unemployed and the resulting burden on the state budget.

*Chairman, Wisconsin Chamber of Commerce.* You have repeatedly warned the governor and the legislature about the business climate in the state. You have privately proposed that the state commission a consulting firm to do a study of the business climate in Wisconsin and how it could be improved.

*Chairman, State Federation of Labor and President, United Auto Workers of Wisconsin.* You are concerned about the flight of jobs from the state and have suggested to leaders of the state legislature that they consider adopting a strict plant-closing law.

**Delta Instruments, Inc.**

Delta Instruments, Inc. was founded in 1973 to produce a unique, patented mechanical pressure gauge for industrial and military use. The gauge design provided an accurate, long-life instrument that was extremely rugged and could be used in high vibration, pulsation, or corrosive service. Industrial applications were typically in the process industries, including power plants, refineries, and chemical
plants. Military applications were quite broad, with the U.S. Navy the largest user (e.g., on aircraft-servicing nitroglycerin carts, diving chambers, and magazine sprinkler systems). Delta made no other products in significant volume.

Delta’s total annual revenues were approximately $4.5 million. The firm employed 65 people in a single office-factory in Southern California. Approximately 45 employees worked in the factory. Delta had a three-person quality control department and a two-person engineering department. Delta was wholly owned by Jack Armstrong, who was actively involved in Delta’s day-to-day operations.

Since its inception, Delta had supplied the government both directly and through prime contractors. Currently, Delta sold about $250,000 per year of military-specified gauges to various government prime contractors and about $200,000 per year directly to 10 to 15 government agencies or facilities. The Defense General Supply Center (DGSC) was the largest customer. Government sales, both direct and subcontracts, were approximately 10 percent of Delta’s total revenues. The direct contracts with the government were each usually small (under $50,000) and were often for standard Delta products.

Late in 1989 the DGSC awarded 19 contracts to Delta, worth $876,142, for the production of pressure gauges built to unique and rigorous specifications. Both Armstrong and the director of engineering concurred that although the gauge specifications were among the most difficult Delta had ever encountered, the specifications could be met. As was typical, each contract required that prototype gauges be tested to ensure compliance with required specifications and that the results of these preliminary tests be reported to the DGSC in the form of a First Article Test Report (FATR). Approximately 90 percent of the testing was to be conducted by independent testing laboratories with the remaining 10 percent being done by Delta. According to normal procedure, the testing laboratories were to submit their findings to Delta, which would add its findings to complete the FATRs and then submit them to the DGSC.

By July 1990 Delta had purchased the materials needed for production and had begun the first article testing on prototype gauges for 6 of the 19 contracts. After five of the six FATRs had been submitted to DGSC, Delta’s presubmission review of the sixth FATR revealed several anomalous data points. (For instance, an entry that should have read 90 was reported as 9). Further inspection by the junior engineer and the quality control director revealed that the original reports furnished by an outside laboratory differed from the copied reports included in the FATR submitted by Delta. When confronted with this inconsistency, the director of engineering, who was responsible for compiling the FATRs, admitted that he had altered the outside laboratory data included in the sixth FATR by using liquid paper whitener, changing the data, and then reproducing the page to mask the change. The effect of these alterations suggested that the prototype gauge produced under the sixth contract had passed the testing when, in fact, it had failed.

Following this discovery, Delta began an internal investigation of the five previously submitted FATRs. It found that three of the five reports also contained alterations of the data and the test results of outside testing laboratories. In general, these alterations overstated the performance of the tested gauges and claimed compliance with contract specifications even though no such compliance had actually been found. In a subsequent interview with Armstrong, the director of engineering stated that he had altered FATR data on “one or more reports” had acted alone, had not been asked to falsify data by anyone, and that these were the only test data he had ever altered at Delta. Both the quality control director and the junior engineer claimed no knowledge of this or any other incident of data falsification having previously occurred at Delta. No gauges had yet been produced or delivered to the DGSC. Delta had received no payments, nor had any been requested. Moreover, the problems found in the prototype gauges were correctable and compliance with the original contract specifications achievable. Indeed, there appeared to be some method behind the director of engineering’s madness. The data alterations reflected the anticipated performance of the gauges. The opinions of Armstrong, the quality control manager, and other engineers at Delta confirmed that the performance anticipated by the director of engineering would indeed be met when the problems in the prototypes were addressed.

Armstrong was shocked and embarrassed by this incident. Delta had an immaculate reputation based chiefly on the quality of its products and the integrity of its organization. For nearly two decades, no other incident had the potential of impugning Delta’s reputation. Furthermore, there had never been any contract disputes with the U.S. government. There also had been no contracts terminated for default.
Moreover, the corporate culture at Delta embodied many of Armstrong's most deeply held values, including openness, honesty, and professionalism.

Armstrong was proud of his company's record and its culture and was anxious to preserve Delta's reputation. But how? Should he forget about the already submitted FATRs and strive to bring the gauges into compliance with the reported data? Should he simply withdraw the submitted FATRs, citing "technical difficulties" or "administrative errors," and resubmit the FATRs when the gauges performed as required? (An attorney claimed that both of these options were arguably within Armstrong's legal rights.) Or should he inform the DGSC of the inaccuracies in the FATRs, as well as the source of these errors?

Armstrong also felt a strong obligation to fairness in the treatment of the director of engineering. This obligation was enhanced by the fact that the director was a long-time friend, who often had accompanied Mr. Armstrong on skiing and fishing vacations. Moreover, he had recently developed a heart condition that required extensive, and sometimes expensive, medical treatments. Termination would deprive him of his medical insurance coverage and benefits. The director of engineering was an affable man, highly regarded and well liked by other Delta employees. ■

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PREPARATION QUESTION

1. Armstrong wanted to do the responsible thing. but what was responsible in this case?