

The Collapse of Enron

On December 2, 2001, Enron Corporation filed for bankruptcy. The company's sudden collapse—the largest business failure in U.S. history to date—came as a shock to many. Just months earlier, *Fortune* magazine had named Enron the most innovative company in America for the sixth consecutive year. The Houston, Texas-based firm, ranked seventh on the Fortune 500, was widely considered to be the premier energy trading company in the world. At its peak in 2000, Enron employed 19,000 people and booked annual revenues in excess of \$100 billion. At a meeting of executives in January 2001, chairman and CEO Kenneth Lay had said the company's mission was no longer just to be the world's greatest energy company; rather, its mission was to become simply “the world's greatest company.”¹

The pain caused by Enron's abrupt failure was widely felt. The company immediately laid off 4,000 employees, with more to follow. Thousands of Enron employees and retirees saw the value of their 401(k) retirement plans, many heavily invested in the company's stock, become worthless almost overnight. “We, the rank and file, got burned,” said one retiree, who lost close to \$1.3 million in savings. “I thought people had to treat us honestly and deal fairly with us. In my neck of the woods, what happened is not right.”² Shareholders and mutual fund investors lost \$70 billion in market value. Two banks—J. P. Morgan Chase and Citigroup—faced major write-downs on bad loans. Not only did Enron creditors, shareholders, and bondholders lose out, confidence also fell across the market, as investors questioned the integrity of the financial statements of other companies in which they held stock.

In the aftermath, many struggled to unravel the messy story behind Enron's collapse. Congressional committees initiated investigations, prosecutors brought criminal charges against Enron executives and their accountants for obstruction of justice and securities fraud, and institutional investors sued to recoup their losses. Some blamed Arthur Andersen, Enron's accounting firm, for certifying financial statements that arguably had wrongfully concealed the company's precarious financial situation; some blamed the board of directors for insufficient oversight. Others pointed to a go-go culture in which self-dealing by corrupt executives was condoned, or even admired, while others faulted government regulators, industry analysts, and the media for failing to uncover the company's weaknesses. It would likely take years for the courts to sort through the wreckage.

Enron Corporation

Enron Corporation was formed in 1985 through a merger of Houston Natural Gas and InterNorth of Omaha, Nebraska. The union created a midsized firm whose main asset was a large network of natural gas pipelines. The company's core business was distributing natural gas to utilities.

The central figure from the outset of Enron's history was Kenneth L. Lay. The son of a Baptist minister from rural Missouri, Lay trained as an economist at the University of Missouri and the University of Houston and briefly taught college-

level economics. After a stint with Exxon, Lay accepted a post in the Nixon administration, serving in the Federal Energy Commission and, later, in the Interior Department as deputy undersecretary for energy. Following the Watergate scandal, Lay returned to the private sector in 1974, taking the first in a series of executive positions at various energy companies. Lay became CEO of Houston Natural Gas in 1984, and he assumed the top job at Enron in 1986, shortly after the merger. One observer described Lay as a man of “considerable charm, homespun roots, and economic expertise” who tended to play an “outside” role, leaving the day-to-day management of his company in the hands of others.³

A strong proponent of free markets, Lay felt that the deregulation of the 1980s presented an opportunity for the fledgling company. Historically, the U.S. energy industry had been highly regulated. Utilities were granted monopolies for specific regions, and regulators controlled the prices of electricity and natural gas. Pipeline operators could transport only their own natural gas, not that of other producers. In the 1980s, however, a series of legislative actions at both federal and state levels removed many of these restrictions. For the first time, energy producers were free to compete, buy and sell at market prices, and use each other’s distribution networks. The promise of deregulation, touted by lawmakers at the time, was that competition would lead to greater efficiencies, lower prices, and better service for consumers.

Deregulation caused problems for both producers and users of energy, however, because prices for the first time became highly volatile. In the past, energy users (an industrial company or regional utility, for example) could buy extra natural gas or electricity from producers on the spot market on an as-needed basis. Once prices were free to fluctuate, however, this approach became riskier for both parties. The customer did not want to be forced to buy when prices were high, and the producer did not want to be forced to sell when prices were low.

Enron moved to provide an ingenious solution: The company would leverage its large network of pipelines to set up a “gas bank” that would act as the intermediary in this transaction, reducing market risk. Enron would sign contracts with producers to buy their gas on a certain date at a certain price and other contracts with users to sell them gas on a certain date at a certain price. Presuming that both parties were willing to pay a slight premium to insure against risk, Enron could make money on the spread. Enron had clear advantages as a market maker in natural gas: It owned pipelines that could be used to transport the product from producer to user, and it had strong institutional knowledge of how markets in the industry operated.

The idea man behind this innovation was Jeffrey Skilling. A graduate of the Harvard Business School and a partner in the consulting firm McKinsey & Company, Skilling had been brought in by Lay in the late 1980s to advise Enron on the company’s response to deregulation. The gas bank, in itself, was a clever idea, but Skilling went further. He developed a series of other products, called energy derivatives, for Enron’s trading partners. These products included *options*, which allowed companies to buy gas in the future at a fixed price, and *swaps*, which allowed them to trade fixed prices for floating prices and vice versa. In 1990, Skilling left McKinsey to become CEO of Enron Gas Services, as the gas bank came to be known. In 1996, he was promoted to the position of president and chief operating officer of Enron and, in February 2001, to CEO.⁴

We Make Markets

Enron’s core gas services division was highly profitable, but by the mid-1990s its growth had begun to level out, as competitors entered the market and both buyers

and sellers became more sophisticated and thus able to drive harder bargains. The challenge, as Skilling saw it, was to maintain Enron's growth by extending the business model that had worked so well in natural gas into a range of other commodities. As he later explained this strategy to an interviewer: "If you have the same general [market] characteristics, all you have to do is change the units. Enron has a huge investment in capabilities that can be deployed instantly into new markets at no cost."⁵

In particular, Skilling sought to trade commodities in industries with characteristics similar to those of natural gas—ones that were undergoing deregulation, had fragmented markets, maintained dedicated distribution channels, and in which both buyers and sellers wanted flexibility.⁶

- *Electricity.* One of the most obvious markets for Enron to enter was electric power. Deregulation of electric utilities in many states—most notably, California—presented an opportunity for Enron to use its trading capabilities to buy and sell contracts for electricity. Enron already owned some gas-fired power plants, and it moved to build and buy facilities designed to supply electricity during periods of peak demand. Enron also moved to expand this business internationally, especially in nations undergoing energy deregulation or privatization.
- *Water.* In 1998, Enron acquired Wessex Water in the United Kingdom and changed its name to Azurix, with the ambitious goal of operating water and wastewater businesses globally.
- *Broadband.* The company formed Enron Broadband Services in January 2000. Portland General Electric, which Enron acquired in 1997, provided the core fiber optic network for this service. The idea was to supply customers with access to bandwidth at future dates at guaranteed prices. Enron believed these contracts would appeal to customers who did not want to rely on the public Internet or build their own telecommunications networks.
- *Pulp, paper, and lumber.* Enron launched *clickpaper.com*, an online market for the purchase of contracts for the delivery of wood products, and bought a newsprint company to ensure a ready source of supply.

Skilling told an interviewer from "Frontline" in March 2001: "We are looking to create open, competitive, fair markets. And in open, competitive, fair markets, prices are lower and customers get better service.□.□.□.□ We are the good guys. We are on the side of the angels."⁷

By 2001, Enron was buying and selling metals, pulp and paper, specialty chemicals, bandwidth, coal, aluminum, plastics, and emissions credits, among other commodities. At the height of its power, 1,500 traders housed in Enron's office tower in Houston were trading 1,800 different products. As *The New York Times* later noted in an editorial, Enron was widely viewed as "a paragon of American ingenuity, a stodgy gas pipeline company that had reinvented itself as a high-tech clearinghouse in an ever-expanding roster of markets."⁸ Reflecting the general enthusiasm, Skilling replaced his automobile vanity license plate, which had read WLEC (World's Largest Energy Company) with WMM (We Make Markets).⁹

Insisting on Results

In his 1999 letter to shareholders, Lay described the company's attitude toward its employees this way: "Individuals are empowered to do what they think is best.□.□.□.□ We do, however, keep a keen eye on how prudent they are.□.□.□.□ We insist on results."¹⁰

Enron used a recruitment process designed to hire individuals who were smart, hardworking, and intensely loyal. The company preferred to hire recent graduates. After an initial screening interview, candidates were brought to the Houston office for a “Super Saturday,” during which they were individually interviewed for 50 minutes by eight interviewers, with only 10-minute breaks between interviews.

Even candidates who survived this strenuous hiring process, however, could not count on job security. Within the company, management used a “rank and yank” system in which new recruits were ranked every six months, and the 15 or 20 percent receiving the lowest scores were routinely terminated. Enron’s highly competitive and results-oriented culture “created an environment,” in the words of one observer, “where most employees were afraid to express their opinions or to question unethical and potentially illegal business practices.”¹¹

Executive compensation was also results-based. According to Enron’s 2001 proxy statement:

“Enron’s compensation philosophy is based on performance that creates long-term shareholder value. This pay-for-performance tenet is embedded in each aspect of an executive’s total compensation package. Additionally, the philosophy is designed to promote teamwork by tying a significant portion of compensation to business unit and Enron performance.”¹²

Executive compensation was primarily composed of salary, bonus, and stock options, as shown in Exhibit 1. In addition, the company routinely lent money to top executives, forgiving the loans if the terms of their contracts were fulfilled. Enron also awarded some executives equity stakes in various business units, which could be converted into stock or cash under certain conditions. For example, Skilling held a 5 percent stake in the retail energy unit, which he converted into \$100 million worth of stock in 1998.¹³

Politics as Usual

Political action was an important part of Enron’s overall strategy. The company’s primary policy goal was to promote deregulation and reduce government oversight in the range of markets in which it traded. It maintained an office in Washington, D.C., staffed by over 100 lobbyists and also used outside lobbyists for specialized assignments. The company spent \$2.1 million on lobbying in 2000 alone.¹⁵ Enron was also a major campaign contributor. From 1994 on, Enron was the largest contributor to congressional campaigns in the energy industry, giving over \$5 million to House and Senate candidates, mostly to Republicans (see Exhibit 2). In 2000, it gave \$2.4 million in political contributions.

Enron CEO Kenneth Lay also had close personal ties with the Bush family. In 1992, Lay had chaired the host committee for the Republican National Convention in Houston at which George H. Bush was nominated to run for a second term as president. Enron donated \$700,000 to George W. Bush’s various campaigns between 1993 and 2001. Lay and his wife personally donated \$100,000 to the younger Bush’s presidential inauguration.

Over the years, Enron’s efforts to influence policy making enjoyed significant success, as illustrated by the following examples:

- *Commodities Futures Regulation.* The job of the Commodities Futures Trading Commission (CFTC), a federal agency, is to regulate futures contracts traded in an exchange. From 1988 to 1993, the CFTC was chaired by Wendy Gramm, an economist and wife of then-Congressman Phil Gramm (Republican, Texas). In 1992, Enron petitioned the CFTC to exempt energy derivatives and swaps—

such as those in which it was beginning to make a market—from government oversight. In January 1993, just days before President Clinton took office, Wendy Gramm approved the exemption. The following month, after she had left office, Gramm was invited to join Enron’s board of directors. According to Enron’s filings with the SEC, Gramm received somewhere between \$.9 and \$1.8 million in salary, fees, and stock option sales and dividends for her service on the board between 1993 and 2001.¹⁶

- *Securities and Exchange Commission (SEC)*. In 1997, the SEC granted Enron an exemption for its foreign subsidiaries from the provisions of the Investment Company Act of 1940, a law designed to prevent abuses by utilities. The law barred companies it covered from shifting debt off their books, and barred executives of these companies from investing in affiliated partnerships. After it had failed to win the exemption it wanted from Congress in 1996, Enron hired the former director of the investment management division at the SEC as a lobbyist to take the company’s case directly to his former colleagues. He was successful. The year 1997 was the last in which the SEC conducted a thorough examination of Enron’s annual reports.¹⁷
- *Commodity Futures Modernization Act*. This law, passed by Congress in late 2000, included a special exemption for Enron that allowed the company to operate an unregulated energy trading subsidiary. Senator Phil Gramm, chair of the powerful banking committee, was instrumental in getting this provision included in the bill despite the opposition of the president’s working group on financial markets. Over the years, Enron had been the largest single corporate contributor to Gramm’s campaigns, with \$260,000 in gifts since 1993.¹⁸

Reviewing the history of Enron’s efforts to limit government oversight, one reporter concluded, “If the regulators in Washington were asleep, it was because the company had made their beds and turned off the lights.”¹⁹

Off the Balance Sheet

Beginning in 1997, Enron entered into a series of increasingly complex financial transactions with several Special Purpose Entities, or SPEs, evidently with the intention of shifting liabilities (debt) off its books. After the bankruptcy, these transactions were investigated by a special committee of the Enron board, which released its findings in a document now known as the Powers Committee Report.

Under standard accounting rules, a company could legally exclude an SPE from its consolidated financial statements if two conditions were met: (1) an independent party had to exercise control of the SPE, and (2) this party had to own at least 3 percent of the SPE’s assets. The independent party’s investment had to be “at risk,” that is, not guaranteed by someone else.²⁰ The obvious problem was that if Enron intended to burden the SPEs with debt, no truly independent party would want to invest in them.

A key figure in many of these transactions was Andrew S. Fastow. Described as a “financial whiz kid,” Fastow had joined Enron Finance in 1990. He developed a close relationship with Skilling and rose quickly, becoming chief financial officer (CFO) of Enron in 1998, at age 37. Speaking of Fastow’s selection, Skilling told a reporter for *CFO* magazine, “We needed someone to rethink the entire financing structure at Enron from soup to nuts. We didn’t want someone stuck in the

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The SPEs Enron set up in the five years leading up to its bankruptcy included the following:

- *Chewco*. In 1997, Enron created Chewco, an SPE named after the Star Wars character Chewbacca. Fastow invited a subordinate, Michael Kopper, to become the required “independent” investor in Chewco. Kopper and a friend invested \$125,000 of their own funds and, with Enron providing collateral, got a \$11 million loan from Barclays Bank. Between 1997 and 2000, Kopper received \$2 million in management fees for his work on Chewco. In March 2001, Enron repurchased Chewco from its “investors”; Kopper and his friend received more than \$10 million. The Powers Committee concluded, “Our review failed to identify how these payments were determined or what, if anything, Kopper did to justify the payments.”²²
- *The LJM Partnerships*. In 1999, Enron created two partnerships known as LJM1 and LJM2 (the initials of Fastow’s wife and children). Unlike Chewco, where he had delegated this role to a subordinate, Fastow himself served as general partner and invested \$1 million of his own money. Enron proceeded to transfer various assets and liabilities to the LJMs, in a way that benefited its bottom line. For example, in the second half of 1999, the LJM transactions generated “earnings” of \$229 million for Enron (the company reported total pretax earnings of \$570 million for that period).
- *Raptor Partnerships*. In 1999 and 2000, Enron established four new even more ambitious SPEs, collectively known as the Raptor Partnerships, with such fanciful names as talon, timberwolf, bobcat, and porcupine. In a series of extremely complex financial maneuvers in the final five quarters before declaring bankruptcy, Enron conducted various transactions with and among the Raptors and between the Raptors and the LJMs that generated \$1.1 billion in “earnings” for the firm. Among other actions, Enron loaned large blocs of its own stock to the Raptor partnerships in exchange for promissory notes, which were then posted to Enron’s balance sheet as notes receivable.

Fastow made out handsomely on these deals. According to the Powers Committee Report, he eventually received almost \$50 million for his role in the LJM partnerships and their transactions with the Raptors, in addition to his regular Enron compensation. In its review of Enron’s SPE transactions, the Powers Committee Report concluded:

These partnerships □.□.□.□ were used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve bona fide economic objectives or to transfer risk □.□.□.□ They allowed Enron to conceal from the market very large losses resulting from Enron’s merchant investments.²³

Manipulating Revenue

Moving liabilities off the books was one way to make the company’s financial condition look better than it was. Another way was to manipulate revenue. In the period preceding its collapse, Enron used a number of accounting practices apparently aimed at inflating revenues or reducing their volatility.

- *Mark-to-Market Accounting*. Mark-to-market (MTM) is an accounting procedure that allows companies to book as *current earnings* their expected *future revenue* from certain assets. The Financial Accounting Standards Board (FASB), the organization

that establishes generally accepted accounting principles, approved MTM in the early 1990s. Aggressively using this procedure, Enron counted projected profits from many deals in the year they were made. For example, in 2000 Enron entered into a partnership with Blockbuster to deliver movies on demand to viewers' homes over Enron's broadband network. The venture fell apart within a few months, after pilot projects in four U.S. cities failed. Nonetheless, Enron booked \$110 million in profits in late 2000 and early 2001, based on the anticipated value of the partnership over 20 years.²⁴ In 2000, mark-to-market gains accounted for over half of Enron's reported pretax earnings.²⁵

- *Sham Swaps.* In the wake of its collapse, Enron was investigated by the SEC for possible sham swaps. For example, on the last day of the third quarter 2001, as the company's stock price was falling, Enron entered into an agreement with the telecommunications firm Qwest to exchange assets. Qwest and Enron agreed to buy fiber optic capacity from each other, and the two companies exchanged checks for around \$112 million to complete the swap. According to *The New York Times*, "The deal enabled Enron to book a sale and avoid recording a loss on □.□.□.□ assets, whose value in the open market had dropped far below the price on Enron's books."
- *Prudency Accounts.* Enron traders routinely split profits from their deals into two categories—one that was added directly to the company's current financial statements, and the other that was added to a reserve fund. These so-called prudency accounts, according to Frank Partnoy, an expert in finance who testified before the U.S. Senate Committee on Governmental Affairs, functioned as "slush fund[s] that could be used to smooth out profits and losses over time." The use of prudency accounts made Enron's revenue stream appear less volatile than it actually was. As Partnoy noted, "Such fraudulent practices would have thwarted the very purpose of Enron's financial statements: to give investors an accurate picture of a firm's risks."²⁶

The Best Interests of the Company

The two groups most responsible for overseeing the legal and ethical integrity of the company's financial reporting were Enron's board of directors and its auditors, Arthur Andersen's Houston office. In January 2001, Enron's board was made up of 17 members. Of the 15 outside members, many had long personal and business associations with Lay and were considered loyal supporters of his policies. Although the board included only two insiders (Lay and Skilling), other members of top management frequently attended, sitting around the edge of the boardroom.²⁷ The full board typically met five times a year. Members of Enron's board were unusually well compensated. In 2001, for example, each director received \$381,000 in total compensation. (By comparison, the average director

compensation for the top 200 companies that year was \$152,000; and for companies in the petroleum and pipeline industries, \$160,000.)²⁸

The quality of the company's financial reporting was the responsibility of the audit and compliance committee. Chaired by Robert Jaedicke, emeritus professor of accounting and former dean of the Stanford Business School, the committee also included Wendy Gramm and four others.²⁹ The audit committee typically met for an hour or two before the regular board meetings, often for discussions with the company's professional auditors.

The board's first substantive involvement with the SPEs run by Fastow and his associates came in 1999.³⁰ Fastow's dual roles as both CFO and general partner of the LJM partnerships potentially violated Enron's code of ethics, which prohibited an officer from owning or participating in "any other entity which does business with □.□.□.□the company." An exception could be made if the participation was disclosed to the chairman and CEO and was judged not to "adversely affect the best interests of the company." Accordingly, in June and again in October, the board reviewed and approved the LJM partnerships and voted to suspend its code of ethics in this instance to permit Fastow to run the partnerships.

However, the board seemed sufficiently concerned that it put additional controls in place; it required both an annual board review and that the chief accounting officer and chief risk officer review all transactions with the partnerships. In October 2000, the board added additional restrictions, including provisions that Skilling personally sign off on all related approval sheets. In May 2001, an Enron attorney discovered that Skilling had not signed these documents, as the board had required, so he sent a message to the CEO that he needed to sign the papers at his convenience. Skilling never replied.³¹ As for the mandated board review, the Powers Committee later concluded that although the audit committee had periodically reviewed the SPEs, "these reviews appear to have been too brief, too limited in scope, and too superficial to serve their intended function."³²

In its oversight function, the board and its audit committee relied heavily on the professional advice of Enron's auditor, Arthur Andersen, which repeatedly told the board it was "comfortable" with the partnership transactions. Founded in 1913 and Enron's auditor since 1985, Andersen was one of the Big Five accounting firms. Since the early 1990s, Andersen's Houston office had acted both as the company's external and internal auditors, in an arrangement called an "integrated audit," in which Enron subcontracted much of its "inside" work to the firm.³³ Andersen also did considerable consulting and nonauditing work for its client. All told, Enron was a very important client of the Houston office. In 2000, for example, Andersen received \$25 million for audit and \$27 million for nonaudit services from Enron. Between 1997 and 2001, Andersen received around \$7 million for its accounting work on the Chewco, LJM, and Raptors transactions.

Relations between Enron and Arthur Andersen were unusually close. Many Andersen accountants had office space at Enron and easily mingled with their co-workers. "People just thought they were Enron employees," said one former Enron accountant.³⁴ Moreover, mobility between Andersen and its client was high; indeed, at the time of the bankruptcy, the company's chief accounting officer, Richard Causey, had formerly been in charge of Andersen's Enron audit.

Andersen's own structure gave considerable autonomy to local offices like the one in Houston. Like other big accounting firms, Andersen had a professional standards group (PSG) at its corporate headquarters whose job was to review difficult issues that arose in the field. Unlike others, however, Andersen's PSG did not have the authority to overrule its field auditors in case of disagreement. An investigation by *BusinessWeek* showed that on four different occasions, the Enron audit team went ahead despite PSG objections to various aspects of its accounting for the Enron partnerships. Finally, Enron requested that its chief critic be removed from the PSG. Andersen headquarters complied.³⁵

Later, responding to criticism of its actions as Enron auditors, Andersen simply stated that it “ignored a fundamental problem: that poor business decisions on the part of Enron executives and its board ultimately brought the company down.”³⁶

A Wave of Accounting Scandals

On March 5, 2001, *Fortune* magazine published a cover story, written by reporter Bethany McLean, under the title “Is Enron Overpriced?” In the article, McLean challenged the conventional wisdom that Enron stock—which had returned 89 percent to investors the previous year and was selling at 55 times earnings—was an attractive buy. Calling Enron’s financial statements “nearly impenetrable,” she interviewed a number of stock analysts who, although bullish on Enron stock, were unable to explain exactly how the company made money. One called the company’s financial statements “a big black box.”³⁷

What *Fortune* did not know at the time was that the fragile structure of partnerships Enron had constructed rested on the high price of the company’s stock. Much of the partnerships’ assets consisted of Enron stock or loans guaranteed by Enron stock. If the share price declined too far, this would trigger a need for more financing from the company. Before Enron’s announcement of first-quarter 2001 results, and then again prior to the second-quarter results, Andersen worked furiously to restructure the partnerships to prevent the necessity of consolidating them with Enron’s books. The Powers Committee later commented that these efforts were “perceived by many within Enron as a triumph of accounting ingenuity by a group of innovative accountants. We believe that perception was mistaken. . . . [The] Raptors were little more than a highly complex accounting construct that was destined to collapse.”³⁸

In late July, Enron’s stock slid below \$47 a share—the first “trigger” price for the partnerships. On August 14, Skilling abruptly resigned as president and CEO, citing undisclosed personal reasons. Lay, who had been serving as chairman, resumed the role of CEO. In a memo to Enron employees that day, Lay assured them:

I have never felt better about the prospects for the company. All of you know that our stock price has suffered substantially over the last few months. One of my top priorities will be to restore a significant amount of the stock value we have lost as soon as possible. Our performance has never been stronger; our business model has never been more robust; our growth has never been more certain; and most importantly, we have never had a better nor deeper pool of talent throughout the company. We have the finest organization in business today. Together, we will make Enron the world’s leading company.³⁹

The following day, Sherron S. Watkins, an accountant and Enron vice president who worked under Fastow, wrote a memo to Lay to express her concerns about the company’s accounting practices. She stated frankly:

I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my résumé; the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for “personal reasons” but I think he wasn’t having fun, looked down the road; and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

She added:

I have heard one manager . . . say, “I know it would be devastating to all of us, but I wish we would get caught. We’re such a crooked company.”

After a detailed review of the “questionable” accounting practices of the SPEs, Watkins recommended that Lay bring in independent legal and accounting experts to review the propriety of the partnerships and to prepare a “clean-up plan.”⁴⁰

Lay followed Watkins’s advice—to a point. He brought in attorneys from Vinson & Elkins, the Houston law firm that had long been Enron’s outside counsel and that had helped prepare the legal documents for the partnerships. In his instructions, Lay indicated that he saw no need to look too closely into the accounting. The lawyers interviewed Fastow, Enron’s auditors, and several others, and then reported back to Lay on September 21 that although the accounting was “creative” and “aggressive,” it was not “inappropriate from a technical standpoint.”

Yet, despite these assurances, the partnerships were unraveling as Enron’s stock price dropped (see Exhibit 3) and could no longer be supported by even the most aggressive accounting. On October 16, under pressure from its auditors, Enron announced a charge against earnings of \$544 million and a reduction in shareholders’ equity of \$1.2 billion related to transactions with the LJM partnerships. On October 22, the SEC initiated a probe of the SPEs; Fastow was fired the following day. Then, on November 8, Enron further shocked investors by restating *all* of its financial statements back to 1997 because “three unconsolidated entities [i.e., the partnerships] should have been consolidated in the financial statements pursuant to generally accepted accounting principles.” These restatements had the effect of reducing income for 1997 to 2000 by \$480 million, reducing shareholders’ equity by \$2.1 billion, and increasing debt by \$2.6 billion.⁴¹

Company executives frantically went searching for a white knight to purchase the company. Dynegy, another Houston-based energy trader and longtime rival, initially agreed to buy Enron for \$8.9 billion on November 9. After Dynegy’s CEO and board had taken a careful look at Enron’s books, however, they changed their minds and withdrew the offer. The rating agencies immediately downgraded Enron to junk status, and the stock dropped below \$1 a share and was delisted from the New York Stock Exchange.

As the company imploded, Enron tried to call in its political chits in one last Hail Mary move. Lay and other top executives placed urgent calls to Commerce Secretary Donald Evans, Treasury Secretary Paul O’Neill, and other administration officials, reportedly asking them to lean on banks to extend credit to the company. They declined to do so. Later asked why he had not helped Enron, Evans said it would have been an “egregious abuse” to have intervened. O’Neill simply stated, “Companies come and go. . . . Part of the genius of capitalism is, people get to make good decisions or bad decisions, and they get to pay the consequence or enjoy the fruits of their decisions.”⁴²

Discussion Questions

1. Who were the key individuals involved in the collapse of Enron? How do you think the company could have been managed differently to avoid this outcome?
2. Considering the various factors that contributed to the collapse of Enron, how do you think the company could have been managed differently to avoid this outcome?
3. What steps should be taken now by corporate managers, stakeholders, and policy makers to prevent a similar event from occurring in the future?

October 30, 1996, was a cool, fall day in Half Moon Bay, California, a coastal town an hour’s drive south of San Francisco. At the headquarters of Odwalla, Inc., a modest, two-story wooden structure just blocks from the beach, company founder and chairman Greg Steltenpohl was attending a marketing meeting. Odwalla, the largest producer of fresh fruit and vegetable-based beverages in the western United States, had just completed its best-ever fiscal year, with sales of \$59 million, up 40 percent over the past 12 months.

The company's CEO, Stephen Williamson, urgently knocked on the glass door and motioned Steltenpohl into the hall. Williamson, 38, a graduate of the University of California at Berkeley and a former investment banker, had served as president of Odwalla from 1992 to 1995, when he became CEO.

It was unlike him to interrupt a meeting, and he looked worried. "I just got a call from the King County Department of Health," Williamson reported. "They've got a dozen cases of E. coli poisoning up there in the Seattle area. A number of the families told health officials they had drunk Odwalla apple juice." E. coli O157:H7 was a virulent bacterium that had been responsible for several earlier outbreaks of food poisoning, including one traced to undercooked Jack-in-the-Box hamburgers in 1993.

Steltenpohl was puzzled. "What do they know for sure?"

"Right now, not a whole lot. It's just epidemiology," Williamson replied. "They don't have any bacteriological match-ups yet. They said it might be a while before they would know anything definitive."

"We'd better see what else we can find out."

Steltenpohl and Williamson returned to their offices, where they began placing calls to food safety experts, scientists at the Food and Drug Administration and the Centers for Disease Control, and the company's lawyers. A while later, Steltenpohl came out to speak to his next appointment, who had been waiting in the lobby for over an hour. "I'm awfully sorry," the chairman said apologetically. "I'm not going to be able to see you today. Something important's happening that I've got to deal with right away."

History of Odwalla, Inc.

Odwalla, Inc., was founded in 1980 by Steltenpohl; his wife, Bonnie Bassett; and their friend Gerry Percy. Steltenpohl, then 25, was a jazz musician and Stanford graduate with a degree in environmental science. The group purchased a used hand juicer for \$200 and began producing fresh-squeezed orange juice in a backyard shed in Santa Cruz, California. They delivered the juice to local restaurants in a Volkswagen van. Steltenpohl later said that he had gotten the idea from a book, *100 Businesses You Can Start for under \$100*. His motivation, he reported, was simply to make enough money to support his fledgling career as a musician and producer of educational media presentations. The company's name came from a jazz composition by the Art Ensemble of Chicago, in which Odwalla was a mythical figure who led the "people of the sun" out of the "gray haze," which the friends chose to interpret as a reference to overly processed food.

During the 1980s, Odwalla prospered, gradually extending its market reach by expanding its own distribution and production capabilities and by acquiring other juice companies. In 1983, the company moved into a larger production facility and added carrot juice to its product line. In 1985—the same year Odwalla incorporated—the company purchased a small local apple juice company, Live Juice. With apple added to the line, the company expanded its distribution efforts, moving into San Francisco and further north into Marin County. In 1986, Odwalla purchased Dancing Bear Juice Company in Sacramento and assimilated that company's juice products and distribution network in central California.

The company financed its rapid growth in its early years through bank loans and private stock offerings in 1991, 1992, and 1993. In December 1993, the company went public, offering for sale 1 million shares of common stock at an initial price of \$6.375 a share. The proceeds of the initial public offering were used in part to construct a 65,000-square-foot state-of-the-art production facility in Dinuba, in California's agricultural Central Valley.

The company also made additional acquisitions. In June 1994, the company acquired Dharma Juice Company of Bellingham, Washington, to distribute its products in the Pacific Northwest. In January 1995, Odwalla purchased J. S. Grant's, Inc., the maker of Just Squeezed Juices, which became the distributor for Odwalla products in the Colorado market. The strategy appeared to be successful. By 1996, Odwalla, which already controlled more than half the market for fresh juice in northern California, had made significant inroads in the Pacific Northwest and Colorado and was poised to extend its market dominance into New Mexico, Texas, and southern California.

Product Line

The company considered its market niche to be "fresh, minimally processed juices and juice-based beverages."

The company produced a range of products from fresh juice, some single strength and some blended. Odwalla chose fun, clever names, such as Strawberry C-Monster (a vitamin C-fortified fruit smoothie), Femme Vitale (a product formulated to meet women's special nutritional needs), and Guava Have It (a tropical fruit blend). Packaging graphics were brightly colored and whimsical. Pricing was at the premium level; a half gallon of fresh-squeezed orange juice retailed for around \$5.00; a 16-ounce blended smoothie for \$2.00 or more.

Odwalla was committed to making a totally fresh product. In the company's 1995 annual report, for example, the letter to shareholders stated:

Our juice is FRESH! We believe that fruits, vegetables, and other botanical nutrients must be treated with respect. As a result, we do not heat-treat our juice, like the heavily processed products made by most other beverage companies.

The company's products were made without preservatives or any artificial ingredients, and the juice was not pasteurized (heat treated to kill microorganisms and to extend shelf life). Unpasteurized juice, the company believed, retained more vitamins, enzymes, and what Steltenpohl referred to as the "flavor notes" of fresh fruits and vegetables.

Although Odwalla did not pasteurize its juice, it took many steps in the manufacturing process to help protect the juice. The company did not accept ground apples, only those picked from the tree. Inspectors checked field bins to see if there was any dirt, grass, or debris; and bins with evidence of ground contact were rejected. The company's manufacturing facility in Dinuba was considered the most advanced in the industry. The plant operated under a strict code of Good Manufacturing Practices. At Dinuba, apples were thoroughly washed with a sanitizing solution of phosphoric acid and scrubbed with whirling brushes. All juice was produced under extremely strict hygienic standards.

Marketing

Odwalla marketed its products through supermarkets, warehouse outlets, specialty stores, natural food stores, and institutions such as restaurants and colleges.

Slightly over a quarter of all sales were with two accounts—Safeway, a major grocery chain, and Price/ Costco, a discount warehouse.

A distinctive feature of Odwalla's strategy was the company's direct store distribution, or DSD, system. Most sites, from supermarkets to small retailers, were provided with their own stand-alone refrigerated cooler, brightly decorated with Odwalla graphics. Accounts were serviced by route salespeople (RSPs), who were responsible for stocking the coolers and removing unsold juice that had passed its "enjoy by" date. RSPs kept careful records of what products were selling well, enabling them to adjust stock to meet local tastes. As an incentive, salespeople received bonuses based on their routes' sales, in addition to their salaries.

Although the DSD system was more expensive than using independent distributors, it allowed the company to maintain tight control over product mix and quality. Moreover, because the company assumed responsibility for ordering, stocking, and merchandising its own products within the store, Odwalla in most cases did not pay "slotting" and other handling fees to the retailer.

Corporate Culture

The fresh juice company was always, as Steltenpohl put it, "values driven." In 1992, around 80 Odwalla employees participated in a nine-month process that led to the creation of the company's vision, mission, and core values statements. These focused on nourishment, ecological sustainability, innovation, and continuous learning.

Concerned that rapid growth might erode common commitment to these values, in 1995 the company initiated annual three-day training sessions, held on site at multiple locations, known as Living Vision Conferences, for employees to talk about the application of the vision to everyday operating issues. An internal process the company called Vision Link sought to link each individual's job to the Odwalla vision. Managers were expected to model the company's values. The company called its values a "touchstone [for employees] in assessing their conduct and in making business decisions."

In addition, Odwalla instituted a "strategic dialogue" process. A group of 30 people, with some fixed seats for top executives and some rotating seats for a wide cross section of other employees, met quarterly in San Francisco for broad discussions of the company's values and strategic direction.

Social responsibility and environmental awareness were critical to Odwalla's mission. Community service efforts included aid to farm families in the Central Valley, scholarships to study nutrition, and gifts of cash and juice to many local community organizations. The company instituted a recycling program for its plastic bottles. It attempted to divert all organic waste away from landfills—for example, by selling pulp for livestock feed and citrus peel for use in teas and condiments and past-code juice for biofuels. In the mid-1990s, the company began the process of converting its vehicle fleet to alternative fuels. Odwalla's corporate responsibility extended to its employees, who received innovative benefits that included stock options, extensive wellness programs, and an allowance for fresh juice. The company won numerous awards for its environmental practices, and in 1993, *Inc.* magazine honored Odwalla as Employer of the Year.

During the Odwalla era, many of the world's leading tech companies used Odwalla juice. Steve Jobs, founder of Apple Computer, was said to have ordered unlimited quantities of Odwalla juice for all employees working on the original development of the Macintosh Computer.

The E. Coli Bacterium

The virulent strain of bacteria that threatened to bring down this fast-growing company was commonly known in scientific circles as *Escherichia coli*, or *E. coli* for short.

The broad class of *E. coli* bacteria, microscopic rod-shaped organisms, are common in the human intestinal tract, and few pose a danger to health. In fact, most *E. coli* play a beneficial role by suppressing harmful bacteria and synthesizing vitamins. A small minority of *E. coli* strains, however, cause illness. One of the most dangerous of these is *E. coli* O157:H7. In the intestine, this strain produces a potent toxin that attacks the lining of the gut. Symptoms of infection include abdominal pain and cramps, diarrhea, fever, and bloody stools. Most cases are self-limiting, but approximately 6 percent are complicated with hemolytic uremic syndrome, a dangerous condition that can lead to kidney and heart failure. Young children, the elderly, and those with weakened immune systems are most susceptible.

E. coli O157:H7 (or 157) lives in the intestines of cows, sheep, deer, and other animals. The meat of infected animals may carry the infection. *E. coli* is also spread to humans through fecal contamination of food. For example, apples may be contaminated when they fall to the ground and come in contact with cow or deer manure. Secondary infection may also occur, for example, when food is handled by infected persons who have failed to wash their hands after using the toilet. Unfortunately, only a small amount of 157—as few as 500 bacteria—is required to cause illness. As one epidemiologist noted, “It does not take a massive contamination or a major breakdown in the system to spread it.”

E. coli O157:H7 is known as an emergent pathogen, meaning that its appearance in certain environments is viewed by researchers as a new phenomenon. The organism was first identified in 1982, when it was involved in a several outbreaks involving undercooked meat. Since then, poisoning incidents had increased dramatically. By the mid-1990s, about 20,000 cases of *E. coli* poisoning occurred every year in the United States; about 250 people died. Most cases were believed to be caused by undercooked meat. Although a serious threat, *E. coli* is not the most common food-borne illness. In the United States, 5 million cases of food poisoning are reported annually, with 4,000 of these resulting in death. Most cases are caused by mistakes in food preparation and handling, not by mistakes in food processing or packaging.

E. Coli in Fresh Juice

It was widely believed in the juice industry that pathogens like *E. coli* could not survive in an acidic environment, such as citrus and apple juice. Odwalla apple juice had a pH (acidity) level of 4.3. (On the pH scale, 7 is neutral, and levels below 7 are increasingly acidic.) Odwalla did conduct spot testing of other, more pH-neutral products. The Food and Drug Administration, although it did not have specific guidelines for fresh juice production, indicated in its Retail Food Store Sanitation Code that foods with a pH lower than 4.6 were not potentially hazardous.

In the early 1990s, however, scattered scientific evidence emerged that *E. coli* O157:H7 might have undergone a critical mutation that rendered it more acid-tolerant. In 1991, an outbreak of *E. coli* poisoning sickened 23 people in Massachusetts who had consumed fresh, unpasteurized apple cider purchased at a roadside stand. A second, similar incident occurred in Connecticut around the same time. In a study of the Massachusetts outbreak published in 1993, the *Journal of the American Medical Association* reported that *E. coli* O157:H7, apparently

introduced by fecal contamination of fresh apples, had unexpectedly survived in acidic cider. The journal concluded that *E. coli* O157:H7 could survive at a pH below 4.0 at the temperature of refrigerated juice. The journal recommended strict procedures for sanitizing apples used to make fresh juice, all of which Odwalla already followed.

Although the FDA investigated both instances in New England, it did not issue any new regulations requiring pasteurization of fresh juice, nor did it issue any advisories to industry. At the time of the Odwalla outbreak, neither the FDA nor state regulators in California had rules requiring pasteurization of fresh apple juice.

Considering the Options

In the company's second-floor conference room, later in the day on October 30, Steltenpohl and Williamson gathered the company's senior executives to review the situation.

King County officials had identified about a dozen cases of *E. coli* infection associated with Odwalla apple juice products. But as Steltenpohl later described the situation, "It was all based on interviews. They didn't yet have bacteriological proof." Washington health officials had not yet made a public announcement, nor had they ordered or even recommended a product recall.

Conversations with federal disease control and food safety specialists throughout the day had turned up troubling information. From them, Odwalla executives had learned of the two earlier outbreaks of *E. coli* illness associated with unpasteurized cider in New England. And they had been told that 157 could cause illness in very minute amounts, below levels that would reliably show up in tests. The FDA had indicated that it planned to launch an investigation of the incident but did not suggest that Odwalla had broken any rules.

Management understood that they had no *legal* obligation to order an immediate recall, although this was clearly an option. Another possibility was a nonpublic recall. In this approach, the company would quietly pull the suspect product off the shelves and conduct its own investigation. If a problem were found, the company could then choose to go public with the information.

The company carried general liability insurance totaling \$27 million. It had little debt and about \$12 million in cash on hand. The cost of various options, however, was hard to pin down. No one could be sure precisely how much a full or partial product recall would cost, if they chose that option, or the extent of the company's liability exposure.

Ordering a Recall

At 3 p.m., about four hours after they had received the first phone call, Steltenpohl and Williamson issued a public statement.

Odwalla, Inc., the California-based fresh beverage company, issued today a national product recall of fresh apple juice and all products containing fresh apple juice as an ingredient Our first concern is for the health and safety of those affected. We are working in full cooperation with the FDA and the Seattle/King County Department of Public Health.

The recall involved 13 products, all containing unpasteurized apple juice. At the time, these 13 products accounted for about 70 percent of Odwalla's sales. The company did not recall its citrus juices or geothermal spring water products.

“Stephen and I never batted an eyelash,” Steltenpohl later remembered. “We both have kids. What if it had turned out that something was in the juice, and we left it on the shelf an extra two weeks, or week, or even two days, and some little kid gets sick? What are we doing? Why are we in business? We have a corporate culture based on values. Our mission is nourishment. We really never considered *not* recalling the product. Looking back, I suppose the recall was the biggest decision we made. At the time, it seemed the only possible choice.”

Once the decision to recall the product had been made, the company mobilized all its resources. On Thursday morning, October 31, 200 empty Odwalla delivery trucks rolled out from distribution centers in seven states and British Columbia with a single mission: to get the possibly tainted product off the shelves as quickly as possible. Organizing the recall was simplified by the facts that Odwalla operated its own fleet of delivery vehicles and that, in most cases, the product was displayed in the company’s own coolers. The delivery drivers simply went directly to their own accounts and removed the recalled juices. In cases where the product was shelved with other products, Odwalla worked with retailers to find and remove it.

A group of employees in San Francisco, one of the company’s major distribution centers, later recounted the first day of the recall:

Every single person who is or was an RSP, express driver, or merchandiser, worked that first full day and the next.

What was amazing was there were a lot of people who we didn’t even have to call to come in. It might have been their day off, but they’d call to ask, “What can I do?”

Right. They’d ask, “When should I come in? Where do you need me to be?” . . . It was an amazing effort. . . . We were able to make it to every single account on that first Thursday. That’s a thousand accounts.

Within 48 hours, the recall was complete. Odwalla had removed the product from 4,600 retail establishments in seven states and British Columbia. “This is probably as speedy as a product recall gets,” a stock analyst commented. “They probably accomplished it in world-record time.”

On October 31, as it was launching its recall, the company also took several additional steps.

- The company announced that it would pay all medical expenses for E. coli victims, if it could be demonstrated that Odwalla products had caused their illness.
- The company offered to refund the purchase price of any of the company’s products, even those that had not been recalled.
- The company established a crisis communications center at its headquarters and hired a PR firm, Edelman Public Relations Worldwide, to help it handle the crush of media attention. It also set up a Web site and an 800 hot line to keep the public and the media apprised of the most recent developments in the case. Twice-daily media updates were scheduled.
- The company decided to extend the recall to include three products made with carrot juice. Although these products did not contain apple juice, carrot juice was produced on the same line. Until the company had determined the cause of the outbreak, it felt it could not guarantee the safety of the carrot juice products.

On October 31, as the company’s route salespeople were fanning out to retrieve the juice, Odwalla’s stock price was plummeting. The company’s stock lost 34 percent of its value in one day, falling from 18³/₈ to 12¹/₈ on the NASDAQ exchange. Trading volume was 20 times normal, as 1.36 million shares changed hands.

Tracking the Outbreak

Over the next few days, the full extent of the outbreak became clearer. In addition to the cases in Washington, new clusters of *E. coli* poisoning were reported by health authorities in California and Colorado. As the company received reports about individual cases, Steltenpohl and Williamson attempted to telephone families personally to express their concern. They were able to reach many of them.

On November 8, a 16-month-old toddler from a town near Denver, Colorado, who had developed hemolytic uremic syndrome, died following multiple organ failure. Tests later showed antibodies to O157:H7 in the girl's blood. It was the first, and only, death associated with the *E. coli* outbreak. Steltenpohl immediately issued a statement that read:

On behalf of myself and the people at Odwalla, I want to say how deeply saddened and sorry we are to learn of the loss of this child. Our hearts go out to the family, and our primary concern at this moment is to see that we are doing everything we can to help them.

Steltenpohl, who had spoken with the girl's parents several times during her hospitalization, flew to Denver, with the family's permission, to attend the child's funeral. The girl's father later told the press, "We don't blame the Odwalla company at all. They had no bad intentions throughout all this, and they even offered to pay all of [our child's] hospital bills. I told them yesterday that we don't blame them, and we're not going to sue."

By the time the outbreak had run its course, 61 people, most of them children, had become ill in Colorado, California, Washington, and British Columbia. Except for the Colorado youngster, all those who had become ill, including several children who had been hospitalized in critical condition, eventually recovered.

Investigation of the Outbreak

As the outbreak itself was running its course, the investigation by both the company and federal and state health authorities proceeded. On November 4, the FDA reported that it had found *E. coli* O157:H7 in a bottle of unopened Odwalla apple juice taken from a distribution center in Washington State. As it turned out, this was the only positive identification of the pathogen in any Odwalla product. Eventually, 15 of the 61 reported cases (5 in Colorado and 10 in Washington) were linked by molecular fingerprinting to *E. coli* found in the Odwalla juice sample. The origin of contamination in the other 46 cases remained unknown.

Meanwhile, federal and state investigators converged on Odwalla's Dinuba manufacturing plant, inspecting it from top to bottom, in an attempt to find the source of the pathogen. On November 18, the FDA announced that it had completed its review of the Dinuba facility and had found no evidence of *E. coli* O157:H7 anywhere in the plant. The investigators then turned their attention to the growers and packers who supplied apples to the Dinuba plant, on the theory that the company might have processed a batch of juice containing some ground apples contaminated by cow or deer feces. In their interim report, the FDA noted that although no *E. coli* was found at Dinuba, "microbial monitoring of finished product and raw materials used in processing [was] inadequate." Odwalla sharply challenged this conclusion, noting that the FDA did not have any requirements for microbiological testing.

Searching for a Solution

The recall placed enormous financial pressure on the company and challenged its executives to decide how and when to reintroduce its products to the market.

As a short-term measure, Odwalla announced on November 7 that it would immediately reintroduce three of its recalled products, all juice blends, that had been reformulated without apple juice. These products would continue to be produced at Dinuba, but not on the apple processing line. In announcing the reformulation, Steltenpohl told the press, “Until we are assured of a completely safe and reliable method of producing apple juice, we will not include it in our juices.”

But the reformulation of a few blended juice smoothies was hardly a long-term solution, since apple juice was a core ingredient in many of the company’s top-selling products. Odwalla urgently needed to find a way to get apple juice safely back on the market. How to do so, however, was not obvious.

To assist it in finding a solution to the problem, Odwalla assembled a panel of experts, dubbed the Odwalla Nourishment and Food Safety Advisory Council, to recommend ways to improve product safety. In late November, with the help of these experts, Odwalla executives conducted detailed scenario planning, in which they reviewed a series of possible options. Among those they considered were the following:

- **Discontinue all apple juice products.** In this scenario, the company would eliminate all apple juice and blended juice products until it could be fully assured of their safety.
- **Improve manufacturing processes.** In this scenario, the company would take a number of steps to improve hazard control at various points in the production process, for example, through modified product handling procedures, multiple antiseptic washes, routine sample testing, and stricter controls on suppliers.
- **Modify labeling.** Another option was to disclose risk to the consumer through product labeling. For example, an unpasteurized product could be sold with a disclaimer that it was not suitable for consumption by infants, the elderly, or those with compromised immune systems, because of the very rare but still possible chance of bacterial contamination.
- **Use standard pasteurization.** Standard pasteurization involved slowly heating the juice to a point just below boiling and holding it at that temperature for several minutes. The heat killed dangerous microorganisms and also had a side benefit of extending the shelf life of the product. Standard pasteurization, however, also destroyed many of the nutritional benefits of raw juice.
- **Use ultra-high temperature pasteurization.** Ultra-high temperature pasteurization involved heating the juice to a point just below boiling and holding it at that temperature for several minutes. The heat killed dangerous microorganisms and also had a side benefit of extending the shelf life of the product. Ultra-high temperature pasteurization, however, also destroyed many of the nutritional benefits of raw juice.
- **Use aseptic processing.** Aseptic processing involved filling the juice into sterile containers in a sterile environment. This method allowed the juice to be stored at room temperature without the need for refrigeration.

A key factor in the decision, of course, was what customers wanted. The company commissioned some market research to gauge consumer sentiment; it also carefully monitored public opinion as revealed in calls and letters to the company and discussions on public electronic bulletin boards, such as America Online.

The company also had to consider its financial situation. Remarkably, despite the recall, sales for the quarter ending November 30, 1996, were actually 14 percent ahead of the same period for 1995 because of excellent sales prior to the outbreak. The E. coli incident, however, had caused significant operating losses. By the end of November, the recall had cost the company about \$5 million.

Expenses had included the cost of retrieving and destroying product, legal and professional fees, and increased marketing costs. At the end of the fiscal quarter, Odwalla had a cash position of about \$9 million, down from \$12 million at the time of the outbreak.

On December 5, Odwalla announced that it had decided to flash pasteurize its apple juice. In a statement to the press, Williamson stated:

Odwalla's first priority is safety. After much consideration and research, we chose the flash pasteurization process as a method to produce apple juice. It is safe, yet largely preserves the great taste and nutritional value allowing Odwalla to remain true to its vision of optimal nourishment. Importantly, we will continue to aggressively pursue the research and development of alternative methods to bring our customers safe, unpasteurized apple juice.

The following day, all apple juice and blended juice products were reintroduced to the market with flash pasteurized juice. The label had been redesigned to indicate that the product had been flash pasteurized, and Odwalla coolers prominently displayed signs so advising customers.

At the same time, the company moved forward with its expert panel to develop a comprehensive Hazard Analysis Critical Control Points (HACCP) (pronounced hassip) plan for fresh juice production. HACCP was not a single step, but a comprehensive safety plan that involved pathogen control at multiple points in the juice production process, including sanitation of the fruit, testing for bacteria, and quality audits at several points in the process. The company also continued to monitor new, alternative technologies for controlling bacterial contamination.

Regulating the Fresh Fruit Juice Industry

In the wake of the E. coli outbreak, public concern about food safety mounted, and federal and state regulators began considering stricter regulation of the fresh fruit juice industry. On December 16, the FDA sponsored a public advisory hearing in Washington, D.C., to review current science and to consider strategies for improving the safety of fresh juice. Debate at the two-day hearings was wide-ranging.

Steltenpohl and Williamson represented Odwalla at the hearing. In their testimony, the Odwalla executives reported that they had decided to adopt flash pasteurization but argued *against* government rules requiring all juice to be heat-treated. "Mandatory pasteurization would be a premature and unnecessary step in light of the vast new technologies emerging," Steltenpohl told the hearing. He warned the panel that mandates could "lead to widespread public fears about fresh food and beverages."

Steltenpohl and Williamson called on the FDA to continue to explore different methods for producing fresh juice safely. In addition, they called for industry self-regulation aimed at adoption of voluntary standards for safe manufacturing practices and hazard control programs. The Odwalla executives reported that they viewed flash pasteurization as the last line of defense in a comprehensive program to eliminate pathogens.

Some other juice makers and scientists supported Odwalla's position. Several small growers vigorously opposed mandatory pasteurization, saying they could not afford the expensive equipment required. A representative of Orchid Island Juice Company of Florida asked, "What level of safety are you trying to achieve? We don't ban raw oysters and steak tartare, although the risks are much higher. Nor do we mandate that they be cooked, because it changes the flavor." A number of food

safety experts testified about emerging technologies able to kill pathogens without heat treatment.

Some scientists and industry representatives, however, were on the other side. Two major firms, Cargill and Nestlé, both major producers of heat-treated juice products, argued vigorously for a government mandate, saying that “other technologies just won’t do the job.” Dr. Patricia Griffin of the Centers for Disease Control and Prevention noted that “current production practices do not guarantee the safety of apple cider, apple juice, and orange juice.” She called for pasteurization of apple juice and cider, as well as product labels warning customers of potential risk. A representative of the Center for Science in the Public Interest called for a label warning the elderly, infants, and persons with suppressed immune systems to avoid fresh, unpasteurized juice.

Several days after the hearing, the advisory panel recommended against mandatory pasteurization, for the moment at least, calling instead for “good hazard control” at juice manufacturing plants and in the orchards that supplied them. However, an FDA spokesman added, “We can never say that forced pasteurization is completely off the boards.” The agency indicated that it would continue to study a number of alternative approaches to improving juice safety, including mandatory pasteurization.

Looking to the Future

In May 1997, Steltenpohl reflected on the challenges facing Odwalla:

Our task now is to rebuild a brand and a name. How you rebuild these are important decisions. You can make what might be good short-term business decisions, but they wouldn’t be the right thing. The decisions we make now become building blocks for the [company’s] culture. We have to look at what’s right and wrong. We need a clear moral direction.

Discussion Questions

1. What factors contributed to the outbreak of E. coli poisoning described in this case? Do you believe that Odwalla was responsible, wholly or in part, for the outbreak? Why or why not?
2. What do you believe Odwalla should have done as of October 30, 1996? As of November 11, 1996? In each instance, please list at least three options and state the arguments for and against each.
3. What steps, if any, should Odwalla take as of the point when the case ends?
4. Do you consider Odwalla’s voluntary recall decision to be an act of corporate social responsibility? Why or why not?
5. What is the appropriate role for public policy in the area of food safety? Assess the role of government authorities in this case. In your view, did they act properly?

By Anne T. Lawrence. Copyright © 2003 by the author. All rights reserved. Sources for this case include articles appearing in *The Wall Street Journal*, *The New York Times*, *BusinessWeek*, *Fortune*, *Houston Chronicle*, *Newsweek*, *Time*, and *USA Today*. The data included in this report are from the Special Investigative Committee of the Board of Directors of Enron Corp., February 1, 2002 (the Powers Committee Report); William S. Lerach and Milberg Weiss Bershad Hynes & Lerach LLP, “In Re: Enron Corporation Securities Litigation” (consolidated complaint for violation of the securities laws), 2002; and transcripts of hearings before the U.S. House of Representatives Committee on Financial Services and Committee on Energy and Commerce and the U.S. Senate Committee on Governmental Affairs and Committee on Commerce, Science, and Transportation. Secondary sources consulted include Peter C. Fusaro and Ross M. Miller, *What Went Wrong at Enron* (Hoboken, NJ: John Wiley & Sons, 2002); Robert Bryce, *Pipe Dreams: Greed, Ego, and the Death of Enron* (New York:

PublicAffairs/Perseus Books, 2002); Malcolm S. Salter, Lynne C. Levesque, and Maria Ciampa, "The Rise and Fall of Enron," unpublished paper, Harvard Business School, April 10, 2002; and Mark Jickling, "The Enron Collapse: An Overview of Financial Issues," Congressional Research Service, February 4, 2002.

¹ "Enron's Last Year: Web of Details Did Enron In As Warnings Went Unheeded," *The New York Times*, February 10, 2002. Revenue data are from Enron's 2000 Annual Report.

² "Enron's Collapse: Audacious Climb to Success Ended in Dizzying Plunge," *The New York Times*, January 13, 2002.

³ Fusaro and Miller, *What Went Wrong*, p. 9.

⁴ Enron's early history is described in two cases, "Enron: Entrepreneurial Energy," Harvard Business School case 700-079, and "Enron's Transformation: From Gas Pipelines to New Economy Powerhouse," Harvard Business School case 9-301-064.

⁵ Darden School of Business videotape, May 25, 2001, cited in Joseph Bower and David Garvin, "Enron's Business and Strategy," unpublished paper, Harvard Business School, April 10, 2002.

⁶ Salter, Levesque, and Ciampa, "The Rise and Fall," pp. 12-13.

⁷ "Enron's Many Strands: The Company Unravels; Enron Buffed Image Even As It Rotted from Within," *The New York Times*, February 10, 2002.

⁸ "The Rise and Fall of Enron" [Editorial], *The New York Times*, November 2, 2001.

⁹ Fusaro and Miller, *What Went Wrong*, p. 70.

¹⁰ 1999 Enron Annual Report.

¹¹ Fusaro and Miller, *What Went Wrong*, p. 52. Enron's "rank and yank" system is described in Malcolm Gladwell, "The Talent Myth," *The New Yorker*, September 16, 2002.

	Base Bonus	Other	Options	Stock Total	as % of Total	Stock Options	Salary
Lay	1.3	7.0	.4	123.4	132.1	93	
Skilling	.9	5.6	—	62.5	69.0	91	

Note: All figures are in millions of dollars, rounded to the nearest \$100,000. "Stock options" represents stock options exercised and sold in 2000, not granted in 2000. These figures do not include the value of perquisites, such as personal use of company aircraft.

Sources: Enron, SEC Schedule 14A (proxy statement), March 27, 2001, p. 18; and Dan Ackman, "Executive Compensation: Did Enron Execs Dump Shares?" *Forbes.com*, March 22, 2002.

¹² Enron, SEC Schedule 14A (proxy statement), March 27, 2001, p. 15.

¹³ "Enron Compensation Raised Questions," Dow Jones Newswires, March 26, 2002.

¹⁴ <http://www.enron.com>

¹⁵ "The Fall of the Giant: Enron's Campaign Contributions and Lobbying," Center for Responsive Politics; available online at www.opensecrets.org.

	Contributions from PACs	Contributions from Individuals	Contributions from Democrats	Contributions from Republicans	Election Cycle	Total Contributions	Soft Money Contributions
1990	\$163,250	N/A	\$130,250	\$33,000	42	58	
1992	\$281,009	\$75,109	\$130,550	\$75,350	42	58	
1994	\$520,996	\$136,292	\$189,565	\$195,139	42	58	
1996	\$1,141,016	\$687,445	\$171,671	\$281,900	18	81	
1998	\$1,049,942	\$691,950	\$212,643	\$145,349	21	79	
2000	\$2,441,398	\$1,671,555	\$280,043	\$489,800	28	72	
2002	\$353,959	\$304,909	\$32,000	\$17,050	6	94	
TOTAL	\$5,951,570	\$3,567,260	\$1,146,722	\$1,237,588	26	74	

Note: Soft money contributions were not publicly disclosed until the 1991-92 election cycle. Soft money contributions were banned in 2002.

Source: Center for Responsive Politics, based on Federal Election Commission data; available online at www.opensecrets.org/news/enron/enron_totals.asp.

- ¹⁶ *Blind Faith: How Deregulation and Enron's Influence over Government Looted Billions from Americans* (Washington, DC: Public Citizen, December 2001).
- ¹⁷ "Exemption Won in 1997 Set Stage for Enron Woes," *The New York Times*, January 23, 2002.
- ¹⁸ *Blind Faith*.
- ¹⁹ "Enron's Collapse: Audacious Climb to Success Ended in Dizzying Plunge," *The New York Times*, January 13, 2002.
- ²⁰ A. Christine David, "When to Consolidate a Special Purpose Entity," *California CPA*, June 2002.
- ²¹ "Andrew S. Fastow: Enron Corp.," *CFO Magazine*, October 1, 1999.
- ²² Powers Committee Report, p. 8.
- ²³ *Ibid.*, p. 4.
- ²⁴ "Show Business: A Blockbuster Deal Shows How Enron Overplayed Its Hand—Company Booked Big Profit from Pilot Video Project That Soon Fizzled Out," *The Wall Street Journal*, January 17, 2002; and Bryce, *Pipe Dreams*, pp. 281–83.
- ²⁵ "Question Mark to Market: Energy Accounting Scrutinized," *CFO.com*, December 4, 2001.
- ²⁶ Testimony of Professor Frank Partnoy, Senate Committee on Governmental Affairs, January 24, 2002, online at www.senate.gov/~gov_affairs/012402partnoy.htm.
- ²⁷ Jay W. Lorsch, "The Board at Enron," unpublished paper, Harvard Business School, April 10, 2002, p. 1.
- ²⁸ Pearl Meyer and Partners, *2001 Director Compensation: Boards in the Spotlight: Study of the Top 200 Corporations*, 2002. Data are rounded to the nearest thousand dollars.
- ²⁹ Other members of the audit committee were: John Mendelsohn, president of the M.D. Anderson Cancer Clinic; Paolo V. Ferraz Pereira, former president of the State Bank of Rio de Janeiro; John Wakeham, former British Secretary of State for Energy; and Ronnie Chan, chairman of a large property development group in Hong Kong.
- ³⁰ Earlier, the board had provided a cursory review of Chewco, but had apparently been unaware of Kopper's role.
- ³¹ "Enron's Many Strands."
- ³² Powers Committee Report, p. 24.
- ³³ "Court Documents Show Andersen's Ties with Enron Were Growing in Early '90s," *The Wall Street Journal*, February 26, 2002.
- ³⁴ "Were Enron, Andersen Too Close to Allow Auditor to Do Its Job?" *The Wall Street Journal*, January 21, 2002.
- ³⁵ "Out of Control at Andersen," *BusinessWeek*, April 8, 2002.
- ³⁶ "Enron's Doomed 'Triumph of Accounting,'" *The New York Times*, February 4, 2002.
- ³⁷ "Is Enron Overpriced?" *Fortune*, March 5, 2001.
- ³⁸ Powers Committee Report, pp. 131–32.
- ³⁹ The full text of Lay's memo appears in Fusaro and Miller, *What Went Wrong*, p. 201.
- ⁴⁰ The full text of Watkins's memo appears in Fusaro and Miller, *What Went Wrong*, pp. 185–91.
- ⁴¹ Based on data reported in the Powers Committee Report, p. 6.

EXHIBIT 3

Enron Stock Price and Trading Volume, 1998–2002

Source: bigcharts.com.

- ⁴² "Enron Lessons: Big Political Giving Wins Firms a Hearing, Doesn't Assure Aid," *The Wall Street Journal*, January 15, 2002.

Odwalla, Inc., and the ☐ E. Coli Outbreak

By Anne T. Lawrence. This is an abridged version of a full-length case, "Odwalla, Inc., and the E. Coli Outbreak (A), (B), (C)," *Case Research Journal* 19, no. 1 (Winter 1999). Abridged and reprinted by permission of the *Case Research Journal*. This case was written with the cooperation of management, solely for the purpose of stimulating student discussion. Sources include articles appearing in the *Natural Foods Merchandiser*, *Nation's Business*, *San Jose Mercury News*, *Rocky Mountain News*, *San*

Francisco Chronicle, Seattle Times, Fresno Bee, The New York Times, The Wall Street Journal, and Squeeze (Odwalla's in-house newsletter); press releases issued by Odwalla and by the American Fresh Juice Council; and Odwalla's annual reports and prospectus. Odwalla's Web site may be found at www.odwalla.com. Copyright © Anne T. Lawrence and the North American Case Research Association. All rights reserved.

In 2006, the pharmaceutical giant Merck faced major challenges. Vioxx, the company's once best-selling prescription painkiller, had been pulled off the market in September 2004 after Merck learned it increased the risk of heart attacks and strokes. When news of the recall broke, the company's stock price had plunged 30 percent to \$33 a share, its lowest point in eight years, where it had hovered since. Standard & Poor's had downgraded the company's outlook from "stable" to "negative." In late 2004, the Justice Department had opened a criminal investigation into whether the company had "caused federal health programs to pay for the prescription drug when its use was not warranted."¹ The Securities and Exchange Commission was inquiring into whether Merck had misled investors. By late 2005, more than 6,000 lawsuits had been filed, alleging that Vioxx had caused death or disability. From many quarters, the company faced troubling questions about the development and marketing of Vioxx, new calls for regulatory reform, and concerns about its political influence on Capitol Hill. In the words of Senator Charles Grassley, chairman of a Congressional committee investigating the Vioxx case, "a blockbuster drug [had become] a blockbuster disaster."²

Merck, Inc.

Merck, the company in the eye of this storm, was one of the world's leading pharmaceutical firms.³ As shown in Exhibit 1, in 2005 the company ranked fourth in sales, after Pfizer, Johnson & Johnson, and GlaxoSmithKline. In assets and market value, it ranked fifth. However, Merck ranked first in profits, earning \$7.33 billion on \$30.78 billion in sales (24 percent).

Merck had long enjoyed a reputation as one of the most ethical and socially responsible of the major drug companies. For an unprecedented seven consecutive years (1987 to 1993), *Fortune* magazine had named Merck its "most admired" company. In 1987, Merck appeared on the cover of *Time* under the headline, "The Miracle Company." It had consistently appeared on lists of best companies to work for and in the portfolios of social investment funds. The company's philanthropy was legendary. In the 1940s, Merck had given its patent for streptomycin, a powerful antibiotic, to a university foundation. Merck was especially admired for its donation of Mectizan. Merck's scientists had originally developed this drug for veterinary use, but later discovered that it was an effective cure for river blindness, a debilitating parasitic disease afflicting some of the world's poorest people. When the company realized that the victims of river blindness could not afford the drug, it decided to give it away for free, in perpetuity.⁴

In 1950, George W. Merck, the company's longtime CEO, stated in a speech: "We try never to forget that medicine is for the people. It is not for the profits. The profits follow, and if we have remembered that, they never fail to appear. The better we have remembered that, the larger they have been."⁵ This statement was often repeated in subsequent years as a touchstone of the company's core values.

Merck was renowned for its research labs, which had a decades-long record of achievement, turning out one innovation after another, including drugs for tuberculosis, cholesterol, hypertension, and AIDS. In the early 2000s, Merck spent around \$3 billion annually on research. Some felt that the company's culture had been shaped by its research agenda. Commented the author of a history of Merck, the company was "intense, driven, loyal, scientifically brilliant, collegial, and arrogant."⁶ In 2006, although Merck had several medicines in the pipeline—

including vaccines for rotavirus and cervical cancer, and drugs for insomnia, lymphoma, and the effects of stroke—some analysts worried that the pace of research had slowed significantly.

Estimating the company's financial liability from the Vioxx lawsuits was difficult. Some 84 million people had taken the drug worldwide over a five-year period from 1999 to 2004. In testimony before Congress, Dr. David Graham, a staff scientist at the Food and Drug Administration, estimated that as many as 139,000 people in the United States had had heart attacks or strokes as a result of taking Vioxx, and about 55,000 of these had died.⁷ Merrill Lynch estimated the company's liability for compensatory damages alone in the range of \$4 to \$18 billion.⁸ However, heart attacks and strokes were common, and they had multiple causes, including genetic predisposition, smoking, obesity, and a sedentary lifestyle. Determining the specific contribution of Vioxx to a particular cardiovascular event would be very difficult. The company vigorously maintained that it had done nothing wrong and vowed to defend every single case in court. By early 2006, only three cases had gone to trial, and the results had been a virtual draw—one decision for the plaintiff, one for Merck, and one hung jury.

Government Regulation of Prescription Drugs

In the United States, prescription medicines—like Vioxx—were regulated by the Food and Drug Administration (FDA).⁹ Before a new drug could be sold to the public, its manufacturer had to carry out clinical trials to demonstrate both safety and effectiveness. Advisory panels of outside medical experts reviewed the results of these trials and recommended to the FDA's Office of Drug Safety whether or not to approve a new drug.¹⁰ After a drug was on the market, the agency's Office of New Drugs continued to monitor it for safety, in a process known as post-market surveillance. These two offices both reported to the same boss, the FDA's director of the Center for Drug Evaluation and Research.

Once the FDA had approved a drug, physicians could prescribe it for any purpose, but the manufacturer could market it only for uses for which it had been approved. Therefore, companies had an incentive to continue to study approved drugs to provide data that they were safe and effective for the treatment of other conditions.

In the 1980s, the drug industry and some patient advocates had criticized the FDA for being too slow to approve new medicines. Patients were concerned that they were not getting new medicines fast enough, and drug companies were concerned that they were losing sales revenue. Each month an average drug spent under review represented \$41.7 million in lost revenue, according to one study.¹¹

In 1992, Congress passed the Prescription Drug User Fee Act (PDUFA). This law, which was supported by the industry, required pharmaceutical companies to pay "user fees" to the FDA to review proposed new medicines. Between 1993 and 2001, the FDA received around \$825 million in such fees from drug makers seeking approval. (During this period, it also received \$1.3 billion appropriated by Congress.) This infusion of new revenue enabled the agency to hire 1,000 new employees and to shorten the approval time for new drugs from 27 months in 1993 to 14 months in 2001.¹²

Despite the benefits of PDUFA, some felt that industry-paid fees were a bad idea. In an editorial published in December 2004, the *Journal of the American Medical Association (JAMA)* concluded: "It is unreasonable to expect that the same agency that was responsible for approval of drug licensing and labeling would also be committed to actively seek evidence to prove itself wrong (i.e., that the decision to approve the product was subsequently shown to be incorrect)." *JAMA* went on to

recommend establishment of a separate agency to monitor drug safety.¹³ Dr. David Kessler, a former FDA commissioner, rejected this idea, responding that “strengthening post-marketing surveillance is certainly in order, but you don’t want competing agencies.”¹⁴

Some evidence suggested that the morale of FDA staff charged with evaluating the safety of new medicines had been hurt by relentless pressure to bring drugs to market quickly. In 2002, a survey of agency scientists found that only 13 percent were “completely confident” that the FDA’s “final decisions adequately assess the safety of a drug.” Thirty-one percent were “somewhat confident” and 5 percent lacked “any confidence.” Two-thirds of those surveyed lacked confidence that the agency “adequately monitors the safety of prescription jobs once they are on the market.” And nearly one in five said they had “been pressured to approve or recommend approval” for a drug “despite reservations about [its] safety, efficacy or quality.”¹⁵

After the FDA shortened the approval time, the percentage of drugs recalled following approval increased from 1.56% for 1993–1996 to 5.35% for 1997–2001.¹⁶ Vioxx was the ninth drug taken off the market in seven years.

Influence at the Top

~~The following text is a placeholder for content that has been removed or is otherwise obscured. It appears to be a list of names or entities, possibly related to the industry or regulatory bodies mentioned in the text.~~

Following the Congressional ban on soft money contributions in 2003, the industry shifted much of its contributions to so-called stealth PACs, nonprofit organizations which were permitted by law to take unlimited donations without revealing their source. These organizations could, in turn, make “substantial” political expenditures, providing political activity was not their primary purpose.¹⁷

In addition, the industry maintained a large corps of lobbyists active in the nation’s capital. In 2003, for example, drug companies and their trade association spent \$108 million on lobbying and hired 824 individual lobbyists, according to a report by Public Citizen.¹⁸ Merck spent \$40.7 million on lobbying between 1998 and 2004.¹⁹ One of the industry’s most effective techniques was to hire former elected officials or members of their staffs. For example, Billy Tauzin, formerly a Republican member of Congress from Louisiana and head of the powerful Committee on Energy and Commerce, which oversaw the drug industry, became president of PhRMA at a reported annual salary of \$2 million in 2004.²⁰

Over the years, the industry’s representatives in Washington had established a highly successful record of promoting its political agenda on a range of issues. In addition to faster drug approvals, these had more recently included a Medicare prescription drug benefit, patent protections, and restrictions on drug imports from Canada.

The Blockbuster Model

In the 1990s, 80 percent of growth for the big pharmaceutical firms came from so-called “blockbuster” drugs.²¹ Blockbusters have been defined by *Fortune* magazine as “medicines that serve vast swaths of the population and garner billions of dollars in annual revenue.”²² The ideal blockbuster, from the companies’ view, was a medicine that could control chronic but usually nonfatal conditions that afflicted large numbers of people with health insurance. These might include, for example, daily maintenance drugs for high blood pressure or cholesterol, allergies, arthritis pain, or heartburn. Drugs that could actually cure a condition—and thus would not need to be taken for long periods—or were intended to treat diseases, like malaria or tuberculosis, that affected mainly the world’s poor, were often less profitable.

Historically, drug companies focused most of their marketing efforts on prescribing physicians. The industry hired tens of thousands of sales representatives—often, attractive young men and women—who sold the products and give out free samples.²³ Drug companies also offered doctors gifts—from free meals to tickets to sporting events—to cultivate their good will. They also routinely sponsored continuing education events for physicians, often featuring reports on their own medicines, and supported doctors financially with opportunities to consult and to conduct clinical trials.²⁴ In 2003 Merck spent \$422 million to market Vioxx to doctors and hospitals.²⁵

During the early 2000s, when Vioxx and Pfizer's Celebrex were competing head-to-head, sales representatives for the two firms were hard at work promoting their brand to doctors. Commented one rheumatologist of the competition between Merck and Pfizer at the time: "We were all aware that there was a great deal of marketing. Like a Coke-Pepsi war."²⁶ An internal Merck training manual for sales representatives, reported in the *The Wall Street Journal*, was titled "Dodge Ball Vioxx." It explained how to "dodge" doctors' questions, such as "I am concerned about the cardiovascular effects of Vioxx." Merck later said that this document had been taken out of context and that sales representatives "were not trained to avoid physician's questions."²⁷

Direct-to-Consumer Advertising

Although marketing to doctors and hospitals continued to be important, in the late 1990s the focus shifted somewhat. In 1997, the FDA for the first time allowed drug companies to advertise directly to consumers. The industry immediately seized this opportunity, placing numerous ads for drugs—from Viagra to Nexium—on television and in magazines and newspapers. In 2004, the industry spent over \$4 billion on such direct-to-consumer, or DTC, advertising. For example, in one ad for Vioxx, Olympic figure skating champion Dorothy Hamill glided gracefully across an outdoor ice rink to the tune of "It's a Beautiful Morning" by the sixties pop group The Rascals, telling viewers that she would "not let arthritis stop me." In all, Merck spent more than \$500 million advertising Vioxx.²⁸

The industry's media blitz for Vioxx and other drugs was highly effective. According to research by the Harvard School of Public Health, each dollar spent on DTC advertising yielded \$4.25 in sales.

The drug companies defended DTC ads, saying they informed consumers of newly available therapies and encouraged people to seek medical treatment. In the age of the Internet, commented David Jones, an advertising executive whose firm included several major drug companies, "consumers are becoming much more empowered to make their own health care decisions."²⁹

However, others criticized DTC advertising, saying that it put pressure on doctors to prescribe drugs that might not be best for the patient. "When a patient comes in and wants something, there is a desire to serve them," said David Wofsy, president of the American College of Rheumatology. "There is a desire on the part of physicians, as there is on anyone else who provides service, to keep the customer happy."³⁰ Even some industry executives expressed reservations. Said Hank McKinnell, CEO of Pfizer, "I'm beginning to think that direct-to-consumer ads are part of the problem. By having them on television without a very strong message that the doctor needs to determine safety, we've left this impression that all drugs are safe. In fact, no drug is safe."³¹

The Rise of Vioxx

Vioxx, the drug at the center of Merck's legal woes, was known as a selective COX-2 inhibitor. Scientists had long understood that an enzyme called cyclo-oxygenase, or COX for short, was associated with pain and inflammation. In the early 1990s, researchers learned that there were really two kinds of COX enzyme. COX-1, it was found, performed several beneficial functions, including protecting the stomach lining. COX-2, on the other hand, contributed to pain and inflammation. Existing anti-inflammatory drugs suppressed both forms of the enzyme, which is why drugs like ibuprofen (Advil) relieved pain, but also caused stomach irritation in some users.

A number of drug companies, including Merck, were intrigued by the possibility of developing a medicine that would block just the COX-2, leaving the stomach-protective COX-1 intact. Such a drug would offer distinctive benefits to some patients, such as arthritis sufferers who were at risk for ulcers (bleeding sores in the intestinal tract).³² As many as 16,500 people died each year in the United States from this condition.³³

In May 1999, after several years of research and testing by Merck scientists, the FDA approved Vioxx for the treatment of osteoarthritis, acute pain in adults, and menstrual symptoms. The drug was later approved for rheumatoid arthritis. Although Merck, like other drug companies, never revealed what it spent to develop specific new medicines, estimates of the cost to develop a major new drug ran as high as \$800 million.³⁴

Vioxx quickly became exactly what Merck had hoped: a blockbuster. At its peak in 2001, Vioxx generated \$2.1 billion in sales in the United States alone, contributing almost 10 percent of Merck's total sales revenue worldwide, as shown in Exhibit 3.

The price of Vioxx was around \$300 per pill, and when it was first approved, it was sold for about \$100 per pill. The price of Vioxx was around \$300 per pill, and when it was first approved, it was sold for about \$100 per pill. The price of Vioxx was around \$300 per pill, and when it was first approved, it was sold for about \$100 per pill.

Safety Warnings

Even before the drug was approved, some evidence cast doubt on the safety of Vioxx. These clues were later confirmed in other studies.

Merck Research: Internal company e-mails suggested that Merck scientists might have been worried about the cardiovascular risks of Vioxx as early as its development phase. In a 1997 e-mail, reported in the *The Wall Street Journal*, Dr. Alise Reicin, a Merck scientist, stated that “the possibility of CV (cardiovascular) events is of great concern.” She added, apparently sarcastically, “I just can’t wait to be the one to present those results to senior management!” A lawyer representing Merck said this e-mail had been taken out of context.³⁵

VIGOR: A study code-named VIGOR, completed in 2000 after the drug was already on the market, compared rheumatoid arthritis patients taking Vioxx with another group taking naproxen (Aleve). Merck financed the research, which was designed to study gastrointestinal side effects. The study found—as the company had expected—that Vioxx was easier on the stomach than naproxen. But it also found that the Vioxx group had nearly five times as many heart attacks (7.3 per thousand person-years) as the naproxen group (1.7 per thousand person-years).³⁶ Publicly, Merck hypothesized that these findings were due to the heart-protective effect of naproxen, rather than to any defect inherent in Vioxx. Privately, however, the company seemed worried. In an internal e-mail dated March 9, 2000, under the subject line “Vigor,” the company’s research director, Dr. Edward Scolnick, said that cardiovascular events were “clearly there” and called them “a shame.” But, he added, “there is always a hazard.”³⁷ At that time, the company considered

reformulating Vioxx by adding an agent to prevent blood clots (and reduce CV risk), but then dropped the project.

The FDA was sufficiently concerned by the VIGOR results that it required Merck to add additional warning language to its label. These changes appeared in April 2002, after lengthy negotiations between the agency and the company over their wording.³⁸

Kaiser/Permanente: In August 2004, Dr. David Graham, a scientist at the FDA, reported the results of a study of the records of 1.4 million patients enrolled in the Kaiser health maintenance organization in California. He found that patients on high doses of Vioxx had three times the rate of heart attacks as patients on Celebrex, a competing COX-2 inhibitor made by Pfizer. Merck discounted this finding, saying that studies of patient records were less reliable than double blind clinical studies.³⁹ Dr. Graham later charged that his superiors at the FDA had “ostracized” him and subjected him to “veiled threats” if he did not qualify his criticism of Vioxx. The FDA called these charges “baloney.”⁴⁰

APPROVe: In order to examine the possibility that Vioxx posed a cardiovascular risk, Merck decided to monitor patients enrolled in a clinical trial called APPROVe to see if they those taking Vioxx had more heart attacks and strokes than those who were taking a placebo (sugar pill). This study had been designed to determine if Vioxx reduced the risk of recurrent colon polyps (a precursor to colon cancer); Merck hoped it would lead to FDA approval of the drug for this condition. The APPROVe study was planned before the VIGOR results were known.

Merck Recalls the Drug

On the evening of Thursday, September 23, 2004, Dr. Peter S. Kim, president of Merck Research Labs, received a phone call from scientists monitoring the colon polyp study. Researchers had found, the scientists told him, that after 18 months of continuous use individuals taking Vioxx were more than twice as likely to have a heart attack or stroke than those taking a placebo. The scientists recommended that the study be halted because of “unacceptable” risk.⁴¹

Dr. Kim later described to a reporter for *The New York Times* the urgent decision-making process that unfolded over the next hours and days as the company responded to this news.

On Friday, I looked at the data with my team. The first thing you do is review the data. We did that. Second is you double-check the data, go through it and make sure that everything is O.K. [At that point] I knew that barring some big mistake in the analysis, we had an issue here. Around noon, I called [CEO] Ray Gilmartin and told him what was up. He said, “Figure out what was the best thing for patient safety.” We then spent Friday and the rest of the weekend going over the data and analyzing it in different ways and calling up medical experts to set up meetings where we would discuss the data and their interpretations and what to do.⁴²

According to later interviews with some of the doctors consulted that weekend by Merck, the group was of mixed opinion. Some experts argued that Vioxx should stay on the market, with a strong warning label so that doctors and patients could judge the risk for themselves. But others thought the drug should be withdrawn because no one knew why the drug was apparently causing heart attacks. One expert commented that “Merck prides itself on its ethical approach. I couldn’t see Merck saying we’re going to market a drug with a safety problem.”⁴³

On Monday, Dr. Kim recommended to Gilmartin that Vioxx be withdrawn from the market. The CEO agreed. The following day, Gilmartin notified the board, and

the company contacted the FDA. On Thursday, September 30, Merck issued a press release, which stated in part:

Merck & Co., Inc., announced today a voluntary withdrawal of VIOXX®. This decision is based on new data from a three-year clinical study. In this study, there was an increased risk for cardiovascular (CV) events, such as heart attack and stroke, in patients taking VIOXX 25 mg compared to those taking placebo (sugar pill). While the incidence of CV events was low, there was an increased risk beginning after 18 months of treatment. The cause of the clinical study result is uncertain, but our commitment to our patients is clear. . . . Merck is notifying physicians and pharmacists and has informed the Food and Drug Administration of this decision. We are taking this action because we believe it best serves the interests of patients. That is why we undertook this clinical trial to better understand the safety profile of VIOXX. And it's why we instituted this voluntary withdrawal upon learning about these data. Be assured that Merck will continue to do everything we can to maintain the safety of our medicines.

Discussion Questions

1. Do you believe Merck acted in a socially responsible manner when it decided to voluntarily withdraw Vioxx? Why or why not? In your view, what is the company's duty to patients, stockholders, and the general public when it comes to drug safety? How should the company handle such situations?
2. What should Merck have done differently?
3. What is the way forward for the production of prescription drugs? Specifically, what are the responsibilities of pharmaceutical companies, government regulators, physicians, and the courts in ensuring the safety and effectiveness of prescription drugs?
4. How should the system be changed to protect patients?

By Anne T. Lawrence. Copyright © 2006 by the author. All rights reserved. An earlier version of this case was presented at the Western Casewriters Association Annual Meeting, Long Beach, California, March 30, 2006. This case was prepared from publicly available materials.

¹ "Justice Dept. and SEC Investigating Merck Drug," *The New York Times*, November 9, 2004.

² Opening Statement of U.S. Senator Chuck Grassley of Iowa, U.S. Senate Committee on Finance, Hearing, "FDA, Merck, and Vioxx: Putting Patient Safety First?" November 18, 2004, <http://finance.senate.gov>.

³ A history of Merck may be found in Fran Hawthorne, *The Merck Druggernaut: The Inside Story of a Pharmaceutical Giant* (Hoboken, NJ: John Wiley & Sons, 2003).

Company	Sales (\$bil)	Profits (\$bil)	Assets (\$bil)	Market Value (\$bil)
Pfizer	40.36	6.20	120.06	285.27
Johnson & Johnson	40.01	6.74	46.66	160.96
GlaxoSmithKline	34.16	6.34	29.19	124.79
Merck	30.78	7.33	42.59	108.76
Novartis	26.77	5.40	46.92	116.43
Roche Group	25.18	2.48	45.77	95.38
Aventis	21.66	2.29	31.06	62.98
AstraZeneca	20.46	3.29	23.57	83.03
Bristol-Myers Squibb	19.89	2.90	26.53	56.05
Abbott Labs	18.99	2.44	26.15	69.27

Source: Forbes 2000, available online at www.forbes.com. Listed in order of overall ranking in the Forbes 2000.

⁴ Merck received the 1991 Business Enterprise Trust Award for this action. See Stephanie Weiss and Kirk O. Hanson, "Merck and Co., Inc.: Addressing Third World Needs" (Business Enterprise Trust, 1991).

⁵ Hawthorne, *The Merck Druggernaut*, pp. 17–18.

⁶ *Ibid.*, p. 38.

⁷ “FDA Failing in Drug Safety, Official Asserts,” *The New York Times*, November 19, 2004. The full transcript of the hearing of the U.S. Senate Committee on Finance, “FDA, Merck, and Vioxx: Putting Patient Safety First?” is available online at <http://finance.senate.gov>.

⁸ “Despite Warnings, Drug Giant Took Long Path to Vioxx Recall,” *The New York Times*, November 14, 2004.

⁹ A history of the FDA and of its relationship to business may be found in Philip J. Hilts, *Protecting America’s Health: The FDA, Business, and One Hundred Years of Regulation* (New York: Alfred A. Knopf, 2003).

¹⁰ Marcia Angell, *The Trust about the Drug Companies* (New York: Random House, 2004), Ch. 2.

¹¹ Merrill Lynch data reported in “A World of Hurt,” *Fortune*, January 10, 2005, p. 18.

¹² U.S. General Accounting Office, *Food and Drug Administration: Effect of User Fees on Drug Approval Times, Withdrawals, and Other Agency Activities*, September 2002.

¹³ “Postmarketing Surveillance—Lack of Vigilance, Lack of Trust,” *Journal of the American Medical Association* 92, no. 21 (December 1, 2004), p. 2649.

¹⁴ “FDA Lax in Drug Safety, Journal Warns,” www.sfgate.com, November 23, 2004.

¹⁵ 2002 Survey of 846 FDA scientists conducted by the Office of the Inspector General of the Department of Health and Human Services, www.peer.org/FDAscientistsurvey.

¹⁶ “Postmarketing Surveillance.”

¹⁷ “Big PhRMA’s Stealth PACs: How the Drug Industry Uses 501(c) Non-Profit Groups to Influence Elections,” *Congress Watch*, September 2004.

¹⁸ “Drug Industry and HMOs Deployed an Army of Nearly 1,000 Lobbyists to Push Medicare Bill, Report Finds,” June 23, 2004, www.citizen.org.

¹⁹ Data available at www.publicintegrity.org.

Election	Total Contributions	Contributions from Individuals	Contributions from PACs	Soft Money Contributions	Percentage to Republicans
2006	\$5,187,393	\$1,753,159	\$3,434,234	N/A	70%
2004	\$18,181,045	\$8,445,485	\$9,735,560	N/A	66%
2002	\$29,441,951	\$3,332,040	\$6,957,382	\$19,152,529	74%
2000	\$26,688,292	\$5,660,457	\$5,649,913	\$15,377,922	69%
1998	\$13,169,694	\$2,673,845	\$4,107,068	\$6,388,781	64%
1996	\$13,754,796	\$3,413,516	\$3,584,217	\$6,757,063	66%
1994	\$7,706,303	\$1,935,150	\$3,477,146	\$2,294,007	56%
1992	\$7,924,262	\$2,389,370	\$3,205,014	\$2,329,878	56%
1990	\$3,237,592	\$771,621	\$2,465,971	N/A	54%
Total	\$125,291,328	\$30,374,643	\$42,616,505	\$52,300,180	67%

Source: Center for Responsive Politics, www.opensecrets.org.

²⁰ “Rep. Billy Tauzin Demonstrates that Washington’s Revolving Door is Spinning Out of Control,” *Public Citizen*, December 15, 2004, press release.

²¹ “The Waning of the Blockbuster,” *BusinessWeek*, October 18, 2004.

²² “A World of Hurt,” *Fortune*, January 10, 2005, p. 20.

²³ In 2005, 90,000 sales representatives were employed by the pharmaceutical industry, about one for every eight doctors. *The New York Times* revealed in an investigative article (“Give Me an Rx! Cheerleaders Pep Up Drug Sales,” November 28, 2005) that many companies made a point of hiring former college cheerleaders for this role.

²⁴ The influence of the drug industry on the medical professional is documented in Katharine Greider, *The Big Fix: How the Pharmaceutical Industry Rips Off American Consumers* (New York: Public Affairs, 2003).

²⁵ “Drug Pullout,” *Modern Healthcare*, October 18, 2004.

²⁶ “Marketing of Vioxx: How Merck Played Game of Catch-Up,” *The New York Times*, February 11, 2005.

²⁷ “E-Mails Suggest Merck Knew Vioxx’s Dangers at Early Stage,” *The Wall Street Journal*, November 1, 2004.

²⁸ IMS Health estimate reported in: “Will Merck Survive Vioxx?” *Fortune*, November 1, 2004.

²⁹ “With or Without Vioxx, Drug Ads Proliferate,” *The New York Times*, December 6, 2004.

³⁰ “A ‘Smart’ Drug Fails the Safety Test,” *The Washington Post*, October 3, 2004.

³¹ “A World of Hurt,” *Fortune*, January 10, 2005, p. 18.

³² “Medicine Fueled by Marketing Intensified Troubles for Pain Pills,” *The New York Times*, December 19, 2004.

³³ “New Scrutiny of Drugs in Vioxx’s Family,” *The New York Times*, October 4, 2004.

³⁴ This estimate was hotly debated. See, for example, “How Much Does the Pharmaceutical Industry Really Spend on R&D?” Ch. 3 in Angell, *The Trust*; and Merrill Goozner, *The \$800 Million Pill: The Truth Behind the Cost of New Drugs* (Berkeley: University of California Press, 2004).

	U.S. Prescriptions Dispensed	U.S. Sales	U.S. Sales of Vioxx as % □ of Total Merck Sales
1999	4,845,000	\$372,697,000	2.2%
2000	20,630,000	\$1,526,382,000	7.6%
2001	25,406,000	\$2,084,736,000	9.8%
2002	22,044,000	\$1,837,680,000	8.6%
2003	19,959,000	\$1,813,391,000	8.1%
2004*	13,994,000	\$1,342,236,000	5.9%

(i) *Withdrawn from the market in September 2004.

Sources: Columns 1 and 2: IMS Health (www.imshealth.com); Column 3: Merck Annual Reports (www.merck.com).

³⁵ “E-Mails Suggest Merck Knew Vioxx’s Dangers at Early Stage,” *The Wall Street Journal*, November 1, 2004.

³⁶ “Comparison of Upper Gastrointestinal Toxicity of Rofecoxib and Naproxen in Patients with Rheumatoid Arthritis,” *New England Journal of Medicine*, 2000, p. 323.

³⁷ “E-Mails Suggest Merck Knew Vioxx’s Dangers at Early Stage.”

³⁸ At one of the early Vioxx trials, the plaintiff introduced a Merck internal memo that calculated that the company would make \$229 million more in profits if it delayed changes to warning language on the label by four months □ (*New York Times*, August 20, 2005). The FDA did not have the authority to dictate label language; any changes had to be negotiated with the manufacturer.

³⁹ “Study of Painkiller Suggests Heart Risk,” *The New York Times*, August 26, 2004.

⁴⁰ “FDA Official Alleges Pressure to Suppress Vioxx Findings,” *The Washington Post*, October 8, 2004.

⁴¹ “Painful Withdrawal for Makers of Vioxx,” *The Washington Post*, October 18, 2004. Detailed data reported the following day in *The New York Times* showed that 30 of the 1,287 patients taking Vioxx had suffered a heart attack, compared with 11 of 1,299 taking a placebo; 15 on Vioxx had had a stroke or transient ischemic attack (minor stroke), compared with 7 taking a placebo.

⁴² “A Widely Used Arthritis Drug Is Withdrawn,” *The New York Times*, October 1, 2004.

⁴³ “Painful Withdrawal for Makers of Vioxx,” *The Washington Post*, October 18, 2004.

Michael Pace faced a dilemma. He was Kimpton Hotels’ West Coast Director of Operations and Environmental Programs, General Manager of its Villa Florence Hotel in San Francisco, and the main catalyst for implementing its EarthCare program nationally. He was determined to help the boutique hotel chain “walk the talk” regarding its commitment to environmental responsibility, but he also had agreed not to introduce any new products or processes that would be more expensive than those they replaced. They were already successful in introducing nontoxic cleaning products, promotional materials printed on recycled paper, towel and linen reuse programs, and complimentary organic coffee and had made substantial progress in recycling bottles, cans, paper and cardboard. Now that the initial phase of the program was being implemented nationwide, he and the company’s team of eco-champions were facing some difficult challenges with the rollout of the second, more ambitious, phase.

For example, the team had to decide whether to recommend the purchase of linens made of organic cotton, which vendors insisted would cost at least 50 percent more than standard linens. It would cost an average of \$100,000 to \$150,000 to switch out all the sheets, pillowcases, and towels in each hotel. If they couldn’t negotiate the price down, was there some way they could introduce organic cotton in a limited but meaningful way? All linens were commingled in the

laundry, so they couldn't be introduced one floor at a time. Maybe they could start with pillowcases—although the sheets wouldn't be organic, guests would be resting their heads on organic cotton. Would it even be worth spending so much on linens? The team would face similar issues when deciding whether to recommend environmentally friendly carpeting or furniture.

There were also issues with their recycling initiatives. The program had been field-tested at Kimpton Hotels in San Francisco, a singular city in one of the most environmentally aware states in the United States. Now the eco-champions team had to figure out how to make it work in cities like Chicago, which didn't even have a municipal recycling program in place. In Denver, recycling actually cost more than waste disposal to a landfill, due to the low cost of land in eastern Colorado. Pace knew that the environmental initiatives most likely to succeed would be those that could be seamlessly implemented by the general managers and employees of the 39 unique Kimpton hotels around the country. The last thing he wanted to do was to make their jobs more difficult by imposing cookie-cutter standards. At the same time, he knew that recycling just 50 percent of Kimpton Hotels' waste stream would save over \$250,000 per year in waste disposal costs.

Kimpton had recently embarked on a national campaign to build brand awareness by associating its name with each unique property. Pace knew that the success of Kimpton's strategy would rest heavily on its ability to maintain the care, integrity, and uniqueness that customers had come to associate with its chain of boutique hotels. Other hotel companies had begun investing heavily in the niche that Kimpton had pioneered. To differentiate itself, the company had to continue to find innovative ways to offer services that addressed the needs and values of its customers, and EarthCare was a crucial part of its plans. But could Pace find a way to make it happen within Kimpton's budget, and without adversely affecting the customer experience? Would Kimpton be able to keep the promises made by its new corporate brand?

The Greening of the U.S. Hotel Industry

The U.S. hotel industry—with its 4.5 million rooms, common areas and lobbies, conventions, restaurants, laundry facilities, and back offices—had a significant environmental impact. According to the American Hotel and Lodging Association, the average hotel toilet was flushed 7 times per day per guest, an average shower was 7.5 minutes long, and 40 percent of bathroom lights were left on at night. A typical hotel used 218 gallons of water per day per occupied room. Energy use was pervasive, including lighting in guestrooms and common areas, heating and air-conditioning, and washing and drying towels and linens. The hotel industry spent \$3.7 billion per year on electricity.¹

Hotels had other environmental impacts, as well. Guestrooms generated surprisingly large amounts of waste, ranging from one-half pound to 28 pounds per day, and averaging 2 pounds per day per guest. Nonrefillable bottles of amenities, such as shampoo and lotion, generated large amounts of plastic waste, and products used to clean bathrooms and furniture contained harmful chemicals. Paints contained high levels of volatile organic compounds. Back office and front desk activities generated large amounts of waste paper. And furniture, office equipment, kitchen and laundry appliances were rarely selected for their environmental advantages.

Options for reducing the environmental footprint were plentiful, and many could be implemented at a low cost. Reducing the amount of waste generated by hotels was a high priority. Many hotels had already begun to use low-flow showerheads, which could reduce the amount of water used by 50 percent. A 1.3-gallon per flush toilet could be replaced with a 1.0-gallon per flush toilet, which could reduce the amount of water used by 25 percent. Many hotels had already begun to use energy-efficient light bulbs, which could reduce the amount of energy used by 75 percent. Many hotels had already begun to use energy-efficient light bulbs, which could reduce the amount of energy used by 75 percent.

percent energy. Water could be significantly reduced. For many hotels, 50-80 percent of the solid waste was composted, and significant portions of the remaining waste was made up of cardboard and aluminum cans.

In addition to increasing environmental programs, the potential for greater business Government and NGO cooperation and certification programs was being explored. In 1998, the Green Lodging Program in California, which had an annual travel budget of \$70 million, had launched a Green Lodging Program and encouraged state employees to select hotels it certified. The criteria for certification include recycling, composting, energy and water efficient fixtures and lighting, and nontoxic or less toxic alternatives for cleaning supplies. State governments in Pennsylvania, Florida, Vermont, and Virginia also had developed green lodging programs.

CERES, a well-respected environmental nonprofit, had developed the Green Hotel Initiative, designed to demonstrate and increase demand for environmentally responsible hotel services. Some major corporations had endorsed the initiative, including Ford Motor Company, General Motors, Nike, American Airlines, and Coca-Cola. CERES, the Center for Environmental Responsibility, and the Green Meetings Industry Council were encouraging the industry to "get" there by encouraging hoteliers to use environmentally friendly hotels for lodging and meeting sites.

Despite all this potential, environmental progress in the U.S. hotel industry had been very limited. With a few exceptions, most hotels were doing very little beyond easy-to-implement cost-saving initiatives. These hotels had reduced their environmental footprint as a consequence of their cost-cutting efforts, but they were not necessarily committed to a comprehensive environmental program. During a 1998 effort by Cornell University's School of Hotel Administration to identify hotels employing environmental best practices, researchers were "surprised by the dearth of nominations."² In contrast to their U.S. counterparts, hotels in Canada and Europe seemed to be embracing the hotel greening process.

Kimpton Hotels

Kimpton Hotels was founded in 1981 by the late Bill Kimpton, who once said, "No matter how much money people have to spend on big, fancy hotels, they're still intimidated and unsettled when they arrive. So the psychology of how you build hotels and restaurants is very important. You put a fireplace in the lobby and create a warm, friendly restaurant, and the guest will feel at home."

Credited with inventing the boutique hotel segment, Kimpton Hotels had built a portfolio of unique properties in the upscale segment of the industry.³ By 2005, Kimpton had grown to include 39 hotels throughout North America and Canada, each one designed to create a unique and exceptional guest experience. Every hotel lobby had a cozy fireplace and plush sitting area, where complimentary coffee was served every morning, and wine every evening. Guestrooms were stylishly decorated and comfortably furnished, offering amenities such as specialty suites that included Tall Rooms and Yoga Rooms. Every room offered high-speed wireless Internet access and desks with ample lighting. Rather than rewarding customer loyalty with a point program, Kimpton offered customization and personalization. "We record the preferences of our loyal guests," said Mike Depatie, Kimpton's CEO of real estate. "Someone may want a jogging magazine and a Diet Coke when they arrive. We can get that done."

Business travel (group and individual) accounted for approximately 65 percent of Kimpton's revenues, and leisure travel (tour group and individual) the other 35 percent. The selection of hotels for business meetings and conferences was through meeting and conference organizers. Around 35 percent of all rooms were booked through Kimpton's call center, 25 percent through travel agents, 25 percent through their Web site, and the remainder "came in off the street." The Internet

portion of their business continued to grow, but they didn't cater to buyers looking for the "steal of the century." Rather, they were increasingly being discovered by the 25 percent of customers that market researchers called *unchained seekers*, many of whom used the Internet to search for unique accommodations that matched their particular needs or values.

Historically, Kimpton had prospered by purchasing and renovating buildings at a discount in strategic nationwide locations that were appropriate for their niche segment. The hotel industry in general had been slow to enter the boutique niche, and Kimpton enjoyed a substantial edge in experience in developing value-added services for guests. "All hotels are starting to look alike and act alike, and we are the counterpoint, the contrarians," explained Tom LaTour, Kimpton president and CEO. "We don't look like the brands, we don't act like the brands, and as the baby boomers move through the age wave, they will seek differentiated, experience-oriented products."

Kimpton executives initially recognized the potential to develop a unique Kimpton brand manager of employees from large brands who had the cultural and leadership skills to create a hotel culture, but only the constraints of time, resources, and capital budgets.

This sense of autonomy and personal responsibility was conveyed down through the ranks to all 5,000 Kimpton employees. Kimpton's flexible corporate structure avoided hierarchy, preferring a circular structure where executives and employees were in constant communication.⁴ Steve Pinetti, Senior Vice President for Sales and Marketing, liked to tell the story of a new parking attendant who had to figure out how to deal with a guest who felt that he had not been adequately informed of extra charges for parking his car at the hotel. The attendant decided on the spot to reduce the charges, and asked the front desk to make the necessary adjustments. He had heard his general manager tell everyone that they should feel empowered to take responsibility for making guests happy, but he fully expected to be grilled by his GM, at the very least, about his actions. A sense of dread took hold as he was called to the front of the room at a staff meeting the very next day, but it dissipated quickly when his general manager handed him a special award for his initiative.

Commitment to Social and Environmental Responsibility

An important part of Kimpton's history was its long-standing commitment to social and environmental responsibility. Staff at each hotel had always been encouraged to engage with local community nonprofits that benefit the arts, education, the underprivileged and other charitable causes. Kimpton maintained these local programs even in periods of falling occupancy rates and industry downturns. These local efforts evolved into the companywide Kimpton Cares program in 2004, as part of the company's corporate branding effort. At the national level, Kimpton supported the National AIDS Fund (in support of its Red Ribbon Campaign) and Dress for Success (which assisted economically disadvantaged women struggling to enter the workforce) by allotting a share of a guest's room fee to the charity. At the global level, Kimpton embarked on a partnership with Trust for Public Land (TPL), a nonprofit dedicated to the preservation of land for public use. In 2005, Kimpton committed to raising \$15,000 from its total room revenues to introduce the TPL Parks for People program, and created eco-related fundraising events in each of its cities to further support the campaign.

Kimpton also introduced EarthCare, a comprehensive program of environmental initiatives intended for rollout to all the chain's hotels. "As business leaders, we believe we have a responsibility to positively impact the communities we live in, to be conscious about our environment and to make a difference where we can," said Niki Leondakis, Kimpton's Chief Operating Officer. Kimpton's top executives

considered the Kimpton Cares program, and its EarthCare component, essential parts of the company's branding effort. Steve Pinetti noted, "What drove it was our belief that our brand needs to stand for something. What do we want to stand for in the community? We want to draw attention to our efforts and we want to impact the world positively through our good deeds, we'll be able to influence other companies."

Anecdotal evidence suggested that Kimpton's early efforts had already had financial payoffs. Kimpton was receiving significant coverage of its EarthCare program in local newspapers and travel publications. "We've booked almost half a million dollars in meetings from a couple of corporations in Chicago because of our ecological reputation," said Pinetti. "Their reps basically told us, 'Your values align with our values, and we want to spend money on hotels that think the way we do.'" Kimpton believed that companies that identified with being socially responsible would look for partners like Kimpton that shared those values; and that certifications like the California Green Lodging Program would attract both individuals and corporate clientele.

However, Pinetti noted, "The cost-effectiveness wasn't clear when we started. I thought we might get some business out of this, but that's not why we did it. We think it's the right thing to do, and it generates a lot of enthusiasm among our employees."

Kimpton's Real Estate CEO Mike Depatie believed that incorporating care for communities and the environment into the company's brand had been a boon to hiring. "We attract and keep employees because they feel that from a values standpoint, we have a corporate culture and value system that's consistent with theirs," he commented. "They feel passionate about working here." While the hotel industry was plagued with high turnover, Kimpton's turnover rates were lower than the national averages.

Rolling Out the EarthCare Program

Pratt and Pace led the way to build the program and operational details of the initiative. Steve Slye, Director of Business Development, was a process management consultant who worked with small and medium-sized businesses to figure out how to "cut" their companies. He had led the Kimpton waste reduction program and integrated it into the brand's efforts. In October 2004, Pratt and Pace and Slye 10-page document that high-level objectives and a plan for rolling out the program. Kimpton's program was based on the following consistent

Lead the hospitality industry in supporting a sustainable world by continuing to deliver a premium guest experience through nonintrusive, high quality, eco-friendly products and services.

On-site energy conservation and reduction of energy usage through efficient lighting and polystyrene-free food service. Reduce and eliminate the use of single-use plastics and paper products.

Slye worked with Pinetti and Pace to fill various gaps in their plan and develop an ecostandards program, a concise report outlining a strategy for greening the products and processes that Kimpton used. In December 2004, Pratt and Pace presented the report to Kimpton's COO, Nick Landis. Landis got the proposal enthusiastically, but he had to add an additional component to the strategy for communicating the program both internally (to management and staff) and externally (to guests, investors, and the press). As important as the external audiences were, Slye knew that the internal communications strategy would be particularly crucial, given the autonomy afforded each Kimpton Hotel, each with its own set of local initiatives. Getting everyone on board would require a strategy that respected that aspect of Kimpton's culture.

Slye, Pace, and Pinetti decided to create an ad hoc network of eco-champions - throughout the company. The national lead (Pace) and co-lead (Pinetti) would head up the communications effort and be accountable for its success. Each of five

geographic regions (Pacific Northwest, San Francisco Bay Area, Central U.S., Washington D.C., and Northeast/Southeast), covering six or seven hotel properties, would also have a lead and co-lead who would help communicate the program to employees, and be the local point-persons in the chain of command. One of their key roles would be to solicit employee suggestions regarding ways to make products and processes greener.

In addition to eco-products, the network of eco-champions would be responsible for identifying and evaluating green products and services. Products would be selected on the basis of environmental benefits, cost, quality, and ease of use. Product specialists would be assigned to specific product categories, such as cleaning supplies, energy management, and food and beverage. Product specialists would also be responsible for identifying and evaluating green products and services. Product specialists would be assigned to specific product categories, such as cleaning supplies, energy management, and food and beverage. Product specialists would also be responsible for identifying and evaluating green products and services.

By February 2005, the network of eco-champions was in place, and everyone had agreed on the basic ground rules for the transition. No new product or service could cost more than the product or service it replaced, nor could it adversely affect customer perceptions or satisfaction. All leads, co-leads, and product specialists began meeting via conference call every Friday morning to discuss the greening initiative and share accounts of employee suggestions, progress achieved, and barriers encountered.

To help communicate the program's goals and achievements, and help motivate employees seeking recognition, the team began to post regular updates and success stories in Kimpton's internal weekly newsletter, *The Word*, which was distributed throughout the organization and read by all GMs. They also ran an EarthCare contest to further galvanize interest, which generated over 70 entries for categories such as Best Eco-Practice Suggestion, Most EarthCare Best Practices Adopted, and Best Art and Humor Depicting EarthCare. The team also communicated the environmental benefits of their activities to the staff. For example, printing on 35 percent post-consumer recycled paper would save 24,000 pounds of wood and recycling 100 glass bottles per month would save the energy equivalent of powering one hundred 100-watt light bulbs for 60 days.

The team of eco-champions also quickly learned that the national rollout effort would have its share of potential operational risks and challenges, which would need to be addressed. Among them:

- *Potential resistance by general managers (GMs) to a centralized initiative.* A green management program mandated by corporate headquarters might threaten Kimpton's culture of uniqueness and autonomy. GMs might chafe at what they saw as corporate intrusion upon their autonomy and would want the flexibility to adapt the program to local requirements.
- *Potential resistance by hotel staff to new products and procedures.* Kimpton's relatively low turnover meant that some employees had been working there for many years and had become accustomed to familiar ways of doing things. Informal queries by management, for example, revealed that many cleaning staff equated strong chemical odors with cleanliness. Also, many of the service staff did not speak English fluently, and might have difficulty understanding management's reasons for switching to new procedures or greener cleaning products.
- *A slower payback period or a lower rate of return for green investments, relative to others.* The gains in operating costs achieved by installing longer-life and more energy-efficient fluorescent lighting could take years to pay off, while higher acquisition costs could inflate short-term expenses. The same logic applied to water conservation investments. Would corporate executives and

investors be patient? What if consumer tastes or Kimpton's branding strategies changed before investments had paid off?

- *Benefits intangible to customers.* Unless informed, guests would not be aware that their rooms have been painted with low-VOC paints. Likewise, organic cottons would likely not feel or look superior to traditional materials.
- *For some products, required investments might exceed existing budgets or fail to meet ~~their~~ ~~investor~~ ~~in~~ ~~the~~ ~~space~~ ~~and~~ ~~the~~ ~~of~~ ~~Kimpton~~ ~~is~~ ~~the~~ ~~General~~ ~~of~~ ~~the~~ ~~product~~ ~~is~~ ~~selling~~ ~~at~~ ~~a~~ ~~10–15~~ ~~percent~~ ~~premium~~ ~~over~~ ~~standard~~ ~~products.~~ ~~They~~ ~~discovered~~ ~~that~~ ~~virtually~~ ~~every~~ ~~product~~ ~~they~~ ~~were~~ ~~interested~~ ~~in~~ ~~was~~ ~~more~~ ~~expensive~~ ~~than~~ ~~those~~ ~~currently~~ ~~used.~~ ~~At~~ ~~the~~ ~~extreme,~~ ~~eco-friendly~~ ~~paper~~ ~~products~~ ~~were~~ ~~priced~~ ~~50~~ ~~percent~~ ~~above~~ ~~standard~~ ~~products.~~ ~~Would~~ ~~additional~~ ~~budget~~ ~~be~~ ~~provided?~~ ~~Would~~ ~~savings~~ ~~in~~ ~~other~~ ~~areas~~ ~~be~~ ~~allowed~~ ~~to~~ ~~pay~~ ~~for~~ ~~it?~~*
- *Marketing the program could prove challenging.* How should the EarthCare program be promoted, given customer concerns regarding the impact of some environmental initiatives on the quality of their guest experience? Guests might be concerned, for example, whether low-flow shower heads or fluorescent lighting would meet their expectations. According to the American Automobile Association's Diamond Rating Guidelines, some water saving showerheads and energy-saving light bulbs could lower a hotel's diamond rating.⁵
- *Regional variations in customer values.* Environmental awareness and concern varied considerably by geographic region, from very high on the West Coast and in the Northeast, to considerably lower in the South and Midwest.
- *Regional differences in recycling infrastructure and regulatory environment.* California had a mandated recycling program requiring 70 percent recycling of solid waste by 2007, so San Francisco's disposal service provided free recycling containers. Other localities might not be so generous.

Even in the face of these challenges, Kimpton executives believed that the EarthCare program was the smart, as well as the "right," thing to do. According to Tom LaTour, Chairman and CEO:

It's good business. It's not just because we're altruistic, it's good for business. Otherwise the investors would say, what are you guys doing? A lot of people think it's going to cost more. It's actually [more] advantageous to be eco-friendly than not.

Niki Leondakis, COO, saw the program's impact on marketing and employee retention:

Many people say we're heading toward a tipping point: If you're not environmentally conscious, your company will be blackballed from people's choices. Also, employees today want to come to work every day not just for the paycheck but to feel good about what they're doing. . . . It's very important to them to be aligned with the values of the people they work for, so from the employee retention standpoint, this helps us retain and attract them so we can select from the best and the brightest.⁶

Discussion Questions

1. What are the benefits of Kimpton's environmental initiatives? What are the costs?
2. How would you justify the EarthCare program to Kimpton's board of directors and stockholders? This is what the business case for the program is.
3. What challenges face the EarthCare program and how might Kimpton overcome them?
4. What further steps should Kimpton take to institutionalize its environmental commitments?

5. How do you measure the success of the Fair Campaign and how should the results be used?

By Murray Silverman and Tom Thomas, San Francisco State University. Copyright © 2006 by the authors. Used by permission. All rights reserved. This is an abridged and edited version of a longer case, "Kimpton Hotels: Balancing Strategy and Environmental Sustainability."

¹ California Green Lodging Program, www.Ciwmb.ca.gov/epp/

² Cathy A. Enz and Judy A. Siguaw, "Best Hotel Environmental Practices," *Cornell Hotel and Restaurant Administration Quarterly*, October, 1999.

³ Sloan, Gene, "Let the Pillowfights Begin", *USA Today*, 8/27/2004

⁴ Liz French, *Americanexecutive.com*, December, 2004.

⁵ *AAA Lodging Requirements & Diamond Rating Guidelines*, AAA Publishing, Heathrow, FL, June 2001.

⁶ Carlo Wolff, "Environmental Evangelism: Kimpton Walks the Eco-Walk," *Lodging Hospitality*, March 1, 2005.

James McCafferty, a second-year MBA student at Western Washington University, came home from class one day in early 2006 to find a pile of mail waiting for him. In it was material from Johnson & Johnson, the health care products and services company, including the firm's 2005 annual report and proxy statement. McCafferty owned several hundred shares of Johnson & Johnson as part of his investment portfolio, and he took his responsibilities as a shareholder very seriously. "I make an attempt to be aware of the company's news stories, review the annual report, and at least take a quick look through the reported financials," he explained.

As he looked through the proxy statement, McCafferty noticed a shareholder proposal. Entitled "Shareholder Proposal on Charitable Contributions," it brought to mind discussions in his MBA course work on corporate social responsibility. Intrigued, he read further. The proposal had been put forward by a Virginia-based organization called Human Life International. The proposal read, in its main part: "Resolved: The shareholders request the Board of Directors to implement a policy listing all charitable contributions on the company Web site."

As McCafferty continued to read, he saw that behind this relatively straightforward and narrow proposal was a more complex issue. As part of its charitable giving, Johnson & Johnson had contributed to Planned Parenthood Federation of America Inc., an organization that provided reproductive health care and sexual health information to women, men, and teens. Among other services, Planned Parenthood provided abortions and abortion referrals. As a result, several pro-life organizations (groups opposed to abortion) had boycotted Johnson & Johnson products, and several mutual funds had decided against investing in the company's stock or to sell stock they already owned. The resolution implied that Johnson & Johnson's contributions had the potential to hurt shareholder value and therefore should be fully disclosed. (See Exhibit 1 for the full text of the shareholder proposal.) "At first I had several reactions," McCafferty explained later. "On one hand, we had a company that had not disclosed all its philanthropic efforts. On the other hand, I had to wonder if specific philanthropic efforts really influenced the share price."

Reading further, McCafferty saw that the board of directors had issued a rejoinder, urging that shareholders vote against the proposal. Johnson & Johnson's response was twofold. First, it argued that its corporate contributions program was essential to its mission and values, regardless of its effect on shareholder wealth. Second, those contributions were already sufficiently disclosed in the company's annual report on its corporate contributions program. (See Exhibit 2 for the full text of management's response.)

James McCafferty

In 2006 James McCafferty was 36 years old. Growing up in Seattle, Washington, he had ~~an impressive legal~~ ~~employment~~. "It has always seemed to me that if I must work, I might as well do work that does more than add to someone's bottom line," he explained. McCafferty graduated from the University of Oregon in 1993 with a major in journalism, with an emphasis in public relations (PR), and went to work for the Seattle Community College District as a foundations and PR specialist. After five years, he became the program director and summer camp director for the Snohomish County Council of Camp Fire USA. During this time he also consulted with many nonprofit and educational groups in the areas of development and overall marketing, and he fulfilled his commitment to volunteerism through working with the University of Oregon Alumni Association and the American Camp Association.

By 2004, McCafferty had decided that to have a truly positive impact on society he needed to go back to school to earn his Master of Business Administration (MBA) degree. He entered Western Washington University's MBA program in September 2004 and was scheduled to graduate in June 2006.

McCafferty had long been an active investor in equity markets. Beyond his personal investments—which included stock from nearly 25 firms, bonds, and mutual funds from several companies—he managed several trust funds for others. "Being somewhat knowledgeable about investing and business can be both a blessing and a curse," McCafferty observed. "People I am close to have come to me for guidance, and I have taken on their portfolios as a personal challenge to see if I can get them where they want to be." McCafferty selected investments on the basis of their potential for growth, dividend yield, and the market appeal of a firm's products or services. He also considered whether a firm acknowledged and took action to mitigate any negative social impacts. "I look for the personality behind the company when evaluating potential investments," he explained. "If I don't agree with the business model or the company's overall behavior I'll keep looking even if the ratios look great. As an investor I demand both profitability and long-term societal sustainability. It makes no sense to me to seek large short-term gains when the net benefit to all of us is a long-term loss." McCafferty understood proxy voting. He realized that as an individual shareholder with a modest number of shares, his votes were, as he put it, "drops in a bucket," but he still took them seriously. He equated voting his proxies with voting in political elections.

Johnson & Johnson

Founded in 1886 by three brothers, Johnson & Johnson's first product was a medicinal plaster to be used as a surgical dressing to reduce infections. From this beginning, the firm had grown to employ more than 115,000 people in 57 countries through more than 230 operating units. In 2005, sales totaled more than \$50 billion, with net earnings for the same period of \$10.5 billion. The company had recorded year-to-year increases in sales for 71 straight years, with 19 straight years of double-digit earnings increases.

Johnson & Johnson made many well-known consumer products, including Johnson's Baby Powder, Band-Aid brand adhesive bandages, Tylenol, Motrin, St. Joseph aspirin, and Neutrogena skin care products. The company operated three main business segments: consumer health and beauty products, medical devices and diagnostics, and pharmaceuticals.

Johnson & Johnson was famous for paying a dividend to its shareholders (see Exhibit 3). When Robert Wood Johnson, the son of the founder, died in 1931, the CEO was widely viewed as a custodian of the stock and view of the firm. The statement that he held showed how the firm was representing its business and its shareholders. The CEO of the company's view of its position was important to the shareholders.

The company's Credo had met a defining test in 1982, when Extra-Strength Tylenol capsules laced with cyanide caused seven deaths in the Chicago area.

(Tampering, not a production error, ultimately was determined as the source of the cyanide.) Johnson & Johnson had immediately pulled capsules from shelves nationwide and issued press releases advising all consumers not to take any Tylenol product until the cause of the poisoning could be determined. Confounding many experts, Tylenol not only recovered as a brand but even increased its market share. The case was often cited as evidence that good ethics could be good business practice as well.

Johnson & Johnson had a long history of philanthropic contributions. Robert Wood Johnson had established a foundation that identified itself as the largest charity devoted exclusively to health issues.¹ Johnson & Johnson also contributed to various charitable organizations directly. The firm's philanthropy focused in 2004 on women's and children's health, community responsibility, access to care, global public health, and advancing health care knowledge. Johnson & Johnson gave nearly \$600 million in cash and product contributions during 2005.

Human Life International

Human Life International (HLI) was founded in 1981 by the Reverend Paul Marx, a Benedictine monk. Thomas Euteneuer became president in 2000. The organization billed itself as "the largest international, pro-life, pro-family, pro-woman organization in the world."² Its published mission was "to train, organize and equip pro-life leaders around the world to defend the sanctity of human life and the family. We fulfill this mission through prayer, service and education, in accordance with the teachings of the Roman Catholic Church."³ HLI worked with people of all faiths, not just Catholics, to attempt to fulfill this mission.

Although headquartered in the United States, HLI was active around the world, with affiliates in 51 countries. It organized conferences and missionary trips, distributed pro-life literature, and engaged in public relations activities. HLI grants, totaling nearly \$600,000 in fiscal year 2004, supported scholarships (principally to Catholic clergy and leaders studying bio-ethics) and the activities of affiliates. These activities were wide-ranging, including grassroots activism, operation of crisis pregnancy centers, education of clergy and counselors, and radio and television programming. In the United States, HLI issued press releases on many politically charged issues such as the Terri Schiavo case, which involved a dispute over whether or not to remove the feeding tube of a severely brain-damaged woman. HLI also took positions on various issues involving patient and family rights and Supreme Court appointments.

Annual contributions to HLI in fiscal year 2004 totaled more than \$2.3 million. Support from the general public in the five years ending September 30, 2003 accounted for more than 92 percent of HLI's revenue, an uncommonly large percentage for a not-for-profit organization and well above the 33.3 percent requirement to attain 501(c)3 (tax-exempt, not-for-profit) status. The organization's assets at the end of 2004 were slightly more than \$3 million, including nearly \$1.1 million of common stocks and bonds.

Socially Responsible and Morally Responsible Investing

Socially responsible investing (SRI) as a method of shareholder activism began with the first socially responsible mutual fund in 1971. It gained momentum in the late 1970s, as both religious and secular groups urged the divestment (sale) of stock of firms operating in South Africa, then under the grip of racist apartheid policies. Later, some of these groups expanded their activism to include firms that engaged in anti-union activities, used child labor, harmed the environment, or produced undesirable products such as armaments or cigarettes, among others. Social investors created mutual funds that excluded the stock of companies

engaged in activities deemed inappropriate and included the stock of companies deemed to be socially or environmentally responsible.

Social investors also turned to another tool: the social responsibility shareholder resolution. A 1971 resolution brought by the Episcopal Church to General Motors' shareholders concerning investment in South Africa began the modern era of the shareholder resolution, but institutional investors and a 1992 Securities and Exchange Commission rule change prompted growth in the tactic in the 1990s.⁴ One prominent organization in this movement was the Interfaith Center on Corporate Responsibility, a coalition of 275 groups whose members annually sponsored more than 200 resolutions in the 2000s.⁵

In the early 1990s, social conservatives began to use similar tactics, primarily targeting firms that had connections with industries such as pornography, alcohol, tobacco, or gambling, or that supported organizations perceived to favor abortion, gay marriage, or other practices they opposed. Called morally responsible investing (MRI), this movement sometimes worked with SRI activists and sometimes against them. One of the MRI movement's main targets was Planned Parenthood, which at some clinics performed abortions. Life Decisions International, an anti-abortion group based in Virginia, published semiannual lists of firms that supported Planned Parenthood to help those interested in boycotting such firms. Johnson & Johnson frequently appeared on these lists, and HLI was in the network of organizations supporting such boycotts.

Some conservative activists opposed using shareholder resolutions as a tactic. To file a shareholder resolution one actually had to be a shareholder, and these activists opposed owning stock in targeted organizations even for the sole purpose of being eligible to file such resolutions. Others encouraged the filing of shareholder resolutions.

HLI and Shareholder Resolutions

HLI had used shareholder resolutions before, working sometimes with Thomas Strohbar, the founder of Pro Vita Advisors (an organization founded to help conservative individuals and institutions invest according to their beliefs and to encourage shareholder activism). HLI and Strohbar had filed resolutions with Merck & Co. Inc., calling for a review of ways to link executive compensation with performance on ethical and social issues. Those resolutions were voted down in both 2003 and 2004. The organization also filed a resolution with Berkshire Hathaway in 2002, calling for the company to stop all corporate donations (Berkshire Hathaway had donated to Planned Parenthood, among other organizations). The proposal was defeated, but eventually Berkshire Hathaway did stop making corporate donations to all groups.

Johnson & Johnson was the only firm targeted by HLI in 2006. Other firms targeted by HLI in 2006 included Nike, Inc., Citigroup, and Nike, Inc. HLI also filed resolutions with Johnson & Johnson in 2007 and 2008.

Planned Parenthood

The roots of Planned Parenthood could be traced to 1916, when Margaret Sanger, her sister, and another woman, all nurses, opened a birth control clinic in Brooklyn, New York. All three were arrested and convicted of violating a law forbidding the dissemination of birth control information. More than two decades later, in 1939, the organization ~~that became the Planned Parenthood Federation of America, Inc. was formed~~, Planned Parenthood focused on safe and legal methods of contraception and family planning. By the mid-1960s, sexual education had also become an important focus. In the meantime, pro-choice advocates were pressing

for legalization of abortion. After the 1973 *Roe v. Wade* U.S. Supreme Court decision legalizing abortion, some Planned Parenthood clinics began offering abortions and abortion referrals. In 2006, the organization's clinics offered a wide range of services, mostly centered on family planning and fertility, sexual education, and some primary care services. Planned Parenthood received funds from governmental and private sources, including insurance reimbursement and individual, corporate, and foundation contributions.

The Decision

McCafferty wrote a memo to the board of directors in 2006 that asked, "In MBA courses, we are taught that the firm's primary responsibility is to its shareholders. The issue of whether the firm should fund Planned Parenthood is a difficult one, and it is not clear that the firm's shareholders have a right to know the firm's contributions to such organizations, some of which are in the same industry as the firm. The fact that the firm is viewed as a 'public good'—and that the firm's contributions to such organizations are viewed as 'public goods'—could be a significant factor in the firm's decision to fund such organizations and cause 'Future' to be a more attractive investment in the firm's future. The firm's primary responsibility is to its shareholders, and it is not clear that the firm's shareholders have a right to know the firm's contributions to such organizations, some of which are in the same industry as the firm." McCafferty also wrote, "Because of the firm's public good status, the firm's contributions to such organizations could be a significant factor in the firm's decision to fund such organizations and cause 'Future' to be a more attractive investment in the firm's future. The firm's primary responsibility is to its shareholders, and it is not clear that the firm's shareholders have a right to know the firm's contributions to such organizations, some of which are in the same industry as the firm."

Even if corporate donations were acceptable in general, McCafferty thought, were Johnson & Johnson's donations to Planned Parenthood and other possibly controversial organizations appropriate? The firm was largely a consumer products company. For that reason, it was vulnerable to boycotts by people who did not agree with its donations. Boycotts, if successful, could substantially hurt Johnson & Johnson's sales and profitability. However, the reverse could also be true. "Johnson & Johnson might stimulate sales by engaging in a social debate," McCafferty said, "but only if it could control the debate, a questionable proposition." Johnson & Johnson was well known for supporting organizations focusing on women's health issues and access to care, both of which were important to Planned Parenthood. Managers could be seen as making these contributions either to improve the firm's strategic position or to support a good cause. Even if the motivation was strictly philanthropic, however, strategic implications would ensue due to Planned Parenthood's controversial nature.

The issue immediately addressed by the resolution, McCafferty mused, was the company's disclosure of information about its donations. Curious, he accessed Johnson & Johnson's Web site and pulled up the relevant documents on his laptop. Johnson & Johnson had a separate page for contributions and a contributions annual report (the 2004 report was the latest posted). The contributions page had links to many other pages, but none of them had many details on specific contributions. The contributions annual report mentioned Planned Parenthood only once: the firm had helped Planned Parenthood's Korean affiliate and other organizations begin a program providing mammograms to women through a specially equipped bus. Most of the programs detailed in the report were from outside the United States. The report did not claim to list all Johnson & Johnson contributions, although it did describe the five areas in which the firm focused its giving: women's and children's health, community responsibility, access to care, advancing health care knowledge, and global public health.⁶

~~AMC Health Services, Inc. (AMC) is a leading provider of health care services, including hospital care, ambulatory care, and home care. AMC is committed to providing high-quality care and is a leader in innovation and technology. AMC is also committed to social responsibility and community engagement. AMC is a member of the United Way and is committed to supporting the community through various programs and initiatives. AMC is a leader in the health care industry and is committed to providing the best care possible to its patients.~~

Discussion Questions

1. What are arguments for and against Johnson & Johnson's corporate citizenship? In what ways do the company's relationships with the company and its shareholders and stakeholders?
2. Specifically, what are arguments for and against Johnson & Johnson's contributions to Planned Parenthood?
3. Do you think Johnson & Johnson has an obligation to disclose fully all information regarding its corporate citizenship? Why or why not?
4. Do you think that activists should be allowed to promote their views on social and ethical issues? If not, under what circumstances are such resolutions appropriate?
5. How do you think McCaffery should vote on this shareholder proposal and why do you think so?

By Brian Burton, Steven Globerman, and James McCafferty, Western Washington University. An earlier version of this case was presented at the 2006 annual meeting of the North American Case Research Association, San Diego, California, October 20–21, 2006. Copyright © 2006 by the authors; all rights reserved to the authors and NACRA. Used by permission.

The following shareholder proposal has been submitted to the Company for action at the meeting by Human Life International of Front Royal, Virginia, a holder of 100 shares of stock. The affirmative vote of a majority of the shares voted at the meeting is required for approval of the shareholder proposal. The text of the proposal follows:

“Whereas, Thomas Jefferson said in a Bill for Establishing Religious Freedom, ‘To compel a man to furnish contributions of money for the propagation of opinions, which he disbelieves is sinful and tyrannical.’

Whereas, charitable contributions should serve to enhance shareholder value.

Whereas, our company has given money to ‘charitable’ groups involved in abortion and other activities.

Whereas, our company respects diverse religious beliefs. It should try not to offend these beliefs wherever possible.

Whereas, our company is the subject of a boycott by Life Decisions International because of certain ‘charitable’ contributions.

Whereas, mutual funds like the Timothy Plan and the Ave Maria Catholic Values Fund will not invest in our company because of contributions to certain groups.

Whereas, some potential recipients of charitable funds promote same sex marriages.

Resolved: The shareholders request the Board of Directors to implement a policy listing all charitable contributions on the company Web site.

Supporting Statement: Full disclosure is integral to good corporate governance. Shareholder money is entrusted to the Board of Directors to be invested in a prudent manner for the benefit of the shareholders. People did not invest in this company so a portion of their investment could be given to someone else’s favorite charity. In fact, some money has gone to Planned Parenthood, a group responsible for more than 200,000 abortions per year. How such contributions contribute to shareholder value would be difficult to quantify. In contrast, the subsequent boycotts caused by these contributions could hardly be considered beneficial.”

The Board of Directors favors a vote AGAINST the adoption of this proposal for the following reasons:

The many contributions of Johnson & Johnson to a broad range of charitable organizations are a powerful reflection of our responsibility “to the communities in which we live and work and to the world community,” as articulated in the Johnson & Johnson Credo. Our efforts are based on partnerships with outstanding not-for-profit and community organizations, and our objective for these partnerships is improvement in the quality of life in our communities.

The Company already publishes on an annual basis a report on its Corporate Contributions Program that discloses the total contributions made by the Johnson & Johnson Family of Companies for each of the last five years, including a breakdown of contributions made in cash, in non-cash and total contributions as a percentage of the Company’s worldwide pre-tax income. This report, which is available on the Company’s Web site at www.jnj.com, also provides background and details concerning significant contributions programs that occurred in the prior year. We believe this report provides our shareholders and other stakeholders with meaningful and robust disclosure on the charitable contributions made by the Company.

We do not believe that the detailed disclosure sought by this proposal would provide any greater insight for shareholders or serve the Company, our shareholders or the communities we are trying to serve. Moreover, the proposal would require additional administrative efforts by the many operating companies of Johnson & Johnson, which would be burdensome, and not an effective use of the Company’s resources.

The Johnson & Johnson Corporate Contributions Program is fundamental to our values and to our mission to improve health care for people all over the world. This shareholder proposal would be detrimental to our Corporate Contributions Program. It is, therefore, recommended that the shareholders vote AGAINST this proposal.

Source: www.investor.jnj.com/downloads/2006_proxy.pdf.

¹ www.rwjf.org/.

² www.hli.org/what_is_hli.html.

We believe our first responsibility is to the doctors, nurses and patients, □to mothers and fathers and all others who use our products and services. □In meeting their needs everything we do must be of high quality. □We must constantly strive to reduce our costs □in order to maintain reasonable prices. □Customers' orders must be serviced promptly and accurately. □Our suppliers and distributors must have an opportunity □to make a fair profit.

We are responsible to our employees, □the men and women who work with us throughout the world. □Everyone must be considered as an individual. □We must respect their dignity and recognize their merit. □They must have a sense of security in their jobs. □Compensation must be fair and adequate, □and working conditions clean, orderly and safe. □We must be mindful of ways to help our employees fulfill □their family responsibilities. □Employees must feel free to make suggestions and complaints. □There must be equal opportunity for employment, development □and advancement for those qualified. □We must provide competent management, □and their actions must be just and ethical.

We are responsible to the communities in which we live and work □and to the world community as well. □We must be good citizens — support good works and charities □and bear our fair share of taxes. □We must encourage civic improvements and better health and education. □We must maintain in good order □the property we are privileged to use, □protecting the environment and natural resources.

Our final responsibility is to our stockholders. □Business must make a sound profit. □We must experiment with new ideas. □Research must be carried on, innovative programs developed □and mistakes paid for. □New equipment must be purchased, new facilities provided □and new products launched. □Reserves must be created to provide for adverse times. □When we operate according to these principles, □the stockholders should realize a fair return.

³ www.hli.org/what_is_hli.html.

⁴ www.corpwatch.org/article.php?id=13716.

⁵ www.iccr.org/.

⁶ www.jnj.com/community/contributions/publications/2004_contributions.pdf.

Jean-Pierre Garnier, chief executive officer of the global pharmaceutical company GlaxoSmithKline (GSK, or Glaxo), had been on the job for less than a year, and the annual shareholders' meeting, scheduled for May 21, 2001, was just a week away. Certainly, much of the news he had to report was good. Recently formed through a merger of Glaxo Wellcome and SmithKline Beecham, GSK had immediately become the leading drug manufacturer in the world, with a profit rate in 2000 close to 28 percent. In his first few months on the job, Garnier had moved quickly to buy scores of smaller firms, rounding out Glaxo's portfolio of medicines in the few areas where it was weak, and promising that new therapies were in the pipeline. Investors seemed enthusiastic about the potential synergy of the merger.

But the company was also facing a vexing issue, one that Garnier knew he would have to address at the shareholders' meeting. As the world's leading maker of medicines for the treatment of acquired immunodeficiency syndrome (AIDS), Glaxo had been strenuously criticized by public health, human rights, and shareholder activists for not doing enough to ensure access to these drugs, particularly in sub-Saharan Africa, the center of the world pandemic. The company had recently joined the United Nations' Accelerated Access initiative and, through it, had offered its drugs at discounted prices to several poor African countries.

However, Glaxo had also garnered much unfavorable publicity for pursuing legal action against the government of South Africa, which had tried to buy its citizens low-cost generic versions of drugs GSK had under patent. An Indian maker of generics had offered to sell deeply discounted copies of Glaxo drugs to a humanitarian organization, putting pressure on big pharmaceutical firms to follow suit. The company also faced damaging activist campaigns aimed at forcing Glaxo

to reduce its prices and quit aggressively enforcing its intellectual property rights, in the interest of alleviating suffering. Certainly Garnier could expect to face urgent questions on this issue at the annual meeting. He needed to find some answers.

GlaxoSmithKline

GlaxoSmithKline PLC (GSK) had been formed in December 2000 through a merger of the British firm Glaxo Wellcome and the American firm SmithKline Beecham. The merger created the largest pharmaceutical company in the world, with over \$25 billion in annual sales and a 7 percent global market share. With dominance in four of the five largest therapeutic areas, GSK immediately became the sales leader in pharmaceuticals in both Europe and the United States. The combined firm had an annual research budget of almost \$4 billion and over 16,000 scientists on staff. GlaxoSmithKline established its corporate headquarters in London and its operational headquarters in the United States. Jean-Pierre Garnier, a pharmacologist who had recently been chosen to become CEO of SmithKline, became the chief executive of the merged firm. Together, he said, the two corporate partners would become the “kings of science.”

Historically, Glaxo Wellcome (itself the product of a merger between Glaxo and Burroughs Wellcome) had been a leader in the development of drug therapies for AIDS. In 1986, the company had introduced Retrovir, the first antiretroviral medication designed to inhibit the replication of HIV, the retrovirus that caused AIDS. In 1995, it introduced Epivir and in 1997, Combivir, a drug that combined the ingredients of Retrovir and Epivir in a single tablet. In 1998, the company had introduced Ziagen and Agenerase, protease inhibitors, and in 1999, Trizvir, another combination drug. Glaxo also manufactured several antibiotics designed for use by AIDS patients to treat opportunistic infections. These drugs were big moneymakers. In 2000, the company sold \$1.74 billion of AIDS drugs, an increase of 14 percent over the prior year.¹ In the United States, for the year ending February 2000, the company earned revenues of \$478 million on the sale of Combivir alone.²

Glaxo’s sales of AIDS drugs were concentrated in developed countries. Of the company’s \$1.7 billion in sales of AIDS drugs in 2000, 60 percent were in the United States, 30 percent in Europe, and 10 percent in the rest of the world combined.³ The sale of AIDS drugs in affluent countries was projected to be a growth area for pharmaceutical companies. According to Decision Resources, Inc., a market research firm, overall spending on AIDS drugs in developed countries was expected to grow from \$3.4 billion in 1999 to \$7.1 billion by 2009.⁴

Garnier realized that the developing world represented a huge potential market for the company’s AIDS medicines, as well as other products. In a January 2001 speech via satellite to the newly merged company’s 100,000 employees, the CEO said:

The pharmaceutical industry today sells 80 percent of its products to 20 percent of the world’s population. I don’t want to be the CEO of the company that only caters to the rich.□.□.□. I want those medicines in the hands of many more people who need them.⁵

The AIDS Pandemic in Africa

One group of people who badly needed the company’s products was the estimated 25 million Africans who were infected with the virus that caused AIDS.

Acquired immunodeficiency syndrome, or AIDS—the disease for which Glaxo had led the search for drug treatment—was, in the words of the U.S. Surgeon General, the “worst epidemic the world has ever known.”⁶ In 2001, sub-Saharan Africa was the epicenter of the global pandemic, with some 70 percent of the cases worldwide. Nine percent of all adult Africans were believed to be HIV-positive. Although no reliable statistics existed in sub-Saharan Africa (where many people never even knew they had the disease, and death certificates typically did not record AIDS as the cause), the United Nations estimated that 25.3 million people were infected with HIV. Every year, 3.8 million people there were newly sickened, and 2.4 million died of the disease. In some southern African countries, the awful figures were even higher. According to the United Nations, 36 percent of adults in Botswana, 25 percent in Swaziland and Zimbabwe, and 20 percent in Zambia, South Africa, and Namibia were HIV-positive in 2000.⁷

Unlike the developed world, where AIDS had been largely confined to homosexuals and IV drug users, the disease in Africa was mainly transmitted through heterosexual contact, and affected both men and women equally—many in the prime of life. Large numbers of infants born to HIV-positive mothers were also infected. The results were predictably dire for the economies of southern Africa, where millions of adults were too sick to work—and, in an upending of traditional arrangements, children and the elderly were left to care for their middle-aged relatives. A study in South Africa’s *Journal of Economics* published in 2000 predicted that South Africa’s national income would be 17 percent lower in 2010 than it would have been without AIDS.

Very few Africans afflicted by the pandemic had access to the most recent medicines and treatments. In the early 2000s, the standard therapy for AIDS consisted of a combination of antiretroviral drugs that suppressed (although they did not eliminate) the HIV virus that caused the disease. Such a drug “cocktail” was very expensive—typically costing between \$10,000 and \$15,000 a year in the United States. Most individuals in sub-Saharan Africa did not carry public or private health insurance, and households paid two-thirds of the cost of medicines—a much higher burden than in the developed world. Needless to say, the cost of these drugs was way out of reach for most of the sick. In Zambia, for instance—a country hard-hit by AIDS—60 percent of the population lived on less than \$18 a month. Government budgets for health care, in most cases, were paltry.

The high incidence of AIDS and high death rates from the disease in Africa were only partially due to the high cost of medicine, however. Poor nutrition, lack of clean water and sanitation, and poverty meant that overall health levels were low, even before people became ill with AIDS; and secondary infections, such as measles or malaria, were more likely to be fatal. Most African countries, moreover, lacked the medical infrastructure to distribute or monitor demanding drug treatment regimens. The typical AIDS drug “cocktail” had potentially dangerous side effects. In the West, patients were carefully followed with frequent blood tests to check for possible organ damage. Doctors also checked for resistance to particular drugs and changed the combination as necessary. Such follow-up care was often unavailable in Africa.⁸

Cultural factors also contributed to the terrible toll of AIDS in Africa. In many areas, AIDS was deeply stigmatized, and discussion of sexually transmitted disease was taboo. Few people were ever tested, and most that were ill with AIDS did not know the reason. In Kenya, for example, the head of the centers for disease control estimated that 90 percent of those infected did not even know it.⁹ In South Africa in particular, efforts to treat AIDS were hampered by the curious position of President Thabo Mbeki. The president had publicly challenged the almost universally held belief of medical experts that AIDS was caused by the HIV virus, and he had rejected the idea that the government should distribute antiretroviral drugs.¹⁰

Global Intellectual Property Rights

The global rules governing intellectual property rights—such as the patents on AIDS drugs that Glaxo held in its portfolio—were drawn up by the World Trade Organization (WTO). An organization of member nations committed to free markets, the WTO met periodically to negotiate multilateral agreements on issues related to international trade. These rules had a profound impact on the distribution and pricing of AIDS drugs in Africa.

In 1997, the WTO adopted an agreement on trade-related aspects of intellectual property rights, known by the acronym TRIPS. Its main purpose was to extend patent protection to all member nations. Under this agreement, all WTO member nations would be required to adopt national legislation giving patent holders exclusive marketing rights for a period of 20 years. For example, Glaxo Wellcome had patented the drug Combivir in 1996. Under TRIPS, Glaxo would have sole rights to sell this vital AIDS medicine in all WTO-member countries until 2016. These rules were criticized by some in the public health community, who feared that they would restrict competition and lead to higher prices of essential medicines in poor countries.

Glaxo and other pharmaceutical companies had lobbied hard for national patent laws and for international agreements, like TRIPS, that extended intellectual property laws to trading partners around the world. The industry had argued that patent protection was necessary to compensate companies for the high cost of research and development for new drugs. In 2000, the pharmaceutical industry as a whole spent over \$26 billion on research. Typically, a company like Glaxo spent \$500 million or more to bring a major new drug to market—a process that involved extensive scientific research, testing, and clinical trials for safety and efficacy; in 2000, the company spent 14 percent of its revenue on research. Many prospective medicines failed and had to be abandoned. Without exclusive marketing rights, Glaxo argued, it would have no incentive to undertake the risky and costly process of pharmaceutical research and development.

The TRIPS agreement did permit some exceptions to protect public health. Developing countries were given an extension until 2006 before TRIPS would take effect. Moreover, all nations—not just the less developed—would be able to override patent protections in certain situations. In a national emergency, nations could engage in *compulsory licensing*. This meant that they could compel a patent holder, like Glaxo, to license another firm to make a low-cost copy of a drug (called a generic), provided that an appropriate royalty was paid. Nations could also engage in *parallel importing* in such emergencies. Sometimes called gray market importing, this referred to cross-border trade that was not sanctioned by the patent holder—for example, importing cheaper generics from another country.

In practice, Glaxo and other pharmaceutical companies had vigorously contested these public health safeguards in the few instances in which member nations had attempted to invoke them. For example, Pfizer moved to block the government of Kenya from importing a generic version of a drug used to treat opportunistic infections in AIDS patients, citing violation of its patent rights. Use of the generic would have decreased the annual cost of treatment from \$3,000 to \$104 a year. One-quarter of all adult Kenyans were believed to be HIV-positive.¹¹

Pressure on the Pharmaceutical Industry

In early 2001, several events combined to escalate pressure on Glaxo and other pharmaceutical companies to ease up on enforcing WTO rules, as well as to slash prices of their AIDS drugs in Africa.

Cipla's Offer

In February, a surprise offer by a generic drug maker in India to sell AIDS drugs at a deep discount focused media attention on pricing policies for patented medicines. The Chemical, Industrial and Pharmaceutical Laboratories, known as Cipla, Ltd., was the largest manufacturer of generic drugs in India. K. A. Hamied, an Indian Muslim, had founded the company. As a young man studying abroad in the 1930s, Hamied and his wife, a Lithuanian Jew, had fled Europe as the Nazis consolidated power. Hamied later became active in Ghandi's nonviolent movement for Indian independence and launched a small pharmaceutical company to bring medicines to his countrymen.

In 2001, Cipla, Ltd., was run by Hamied's son Yusuf, an organic chemist. Under the son's leadership, the company had developed an expertise in reverse engineering, a process in which chemists analyzed a medicine to learn how to manufacture it. Using this skill, Cipla had become one of the world's largest makers of generic drugs, with 3,500 employees and exports to 130 countries. Exploiting the provision in TRIPS that gave developing countries like India until 2006 to bring their national patent laws into compliance, Cipla was able to produce copies of drugs developed and patented in the West. Because it did not bear the research and development costs, Cipla was able to sell them at discounted prices.

In February 2001, Hamied shocked many pharmaceutical companies with a bold offer. Cipla announced that it would offer its drug Duovir—a copy of Glaxo's Combivir—to the humanitarian organization Doctors Without Borders at the ultracheap price of \$350 for a year's supply. It also offered the drug to African governments at the company's cost of production, which it reported to be around \$600 per year. Citing his own parents' experience with Nazism and calling AIDS the holocaust of the 21st century, Hamied said that his sole motivation was his "obligation to society."

Trial in South Africa

Just a month later, the issue of AIDS drugs for Africa was further highlighted by a well-publicized lawsuit brought by Glaxo and other pharmaceutical companies against the South African government.

In 1997, South Africa's new Medicines and Related Substances Act that was signed by the country's first African president, Nelson Mandela, to help combat the AIDS pandemic by allowing parallel importation and compulsory licensing. The South African Minister of Health, "We have a situation where we are suffering from a massive shortage of medicines. The only way to solve this problem is to import medicines from other countries."¹²

The pharmaceutical industry viewed both provisions of the Medicines Act as an assault on its intellectual property rights. In 1998, a group of 40 drug companies and trade associations sued in South African courts, arguing that the law violated South Africa's own patent laws. The case, however, proved to be a public relations nightmare for the pharmaceutical industry. A page one article in *The Wall Street Journal* began this way: "Can the pharmaceuticals industry inflict any more damage upon its ailing public image? Well, how about suing Nelson Mandela?"¹³ In mid-April 2001, drug companies, under heavy pressure from AIDS activists around the world, abandoned their lawsuit. The companies agreed not to challenge the South African law any further, provided that the government's implementation complied with TRIPS rules.¹⁴

Activist Campaigns

Against the backdrop of these events, a campaign by Oxfam demanding that pharmaceutical companies cut the cost of AIDS drugs for Africa moved forward. An international human rights group with branches in the United Kingdom, the United States, and other countries, Oxfam's mission was to create "lasting

solutions to poverty, hunger, and social injustice through long-term partnerships with poor communities around the world.”

In February 2001, Oxfam’s efforts got a boost when David Earnshaw, formerly director of European government affairs for SmithKline Beecham, took a position as head of the organization’s campaign on drug prices. Earnshaw told reporters that he had been “very frustrat[ed] seeing the industry failing to act.” In a series of reports, protests, and media actions, Oxfam demanded that the leading pharmaceutical companies cut the cost of AIDS drugs and forgo their patent rights on them. They also demanded that the companies donate a portion of their profits on blockbuster drugs to support the development of treatments for diseases, like tuberculosis and malaria, which afflicted mainly the poor.

In a briefing paper on GlaxoSmithKline, Oxfam wrote:

Pharmaceutical companies face a major reputation risk if they do not do more to promote access to lifesaving drugs in the developing world. This is particularly important at a time of unprecedented scrutiny of the industry’s record in this field. The withdrawal of public support could lead the industry to suffer the same problems of staff recruitment and retention suffered by companies charged with complicity in human rights abuses or environmental damage. Perhaps more significantly it carries with it the threat of more stringent government regulation.¹⁵

Oxfam also advanced an ethics argument:

It is both ethically correct and in the company’s self-interest to ensure that those who own and control medical knowledge use all means at their disposal to stop preventable diseases from killing millions of people every year, particularly if they are using their exclusive marketing position to prevent others from developing the same knowledge.¹⁶

In an interview, Earnshaw explained what he thought was required of Glaxo’s leadership:

It means talking to governments without money, people without money, working with healthcare providers. These are people most of the managers have never talked to. Garnier is a man of vision. The problem is the corporate clones around him.¹⁷

Formulating a Response

GlaxoSmithKline’s predecessors had not been inactive on the issue of providing AIDS drugs to Africa. In May 2000, Glaxo Wellcome had joined the Accelerated Access program of the United Nations Program on AIDS (UNAids). As part of this effort, Glaxo—along with several other pharmaceutical companies—had offered significant price discounts on AIDS drugs to poor nations, to be negotiated on a country-by-country basis. To date, agreements had been concluded with three countries—Rwanda, Senegal, and Uganda. But, partly because of deficiencies in those nations’ ability to pay for drugs and to distribute them effectively, only a few hundred people had received medication. In February 2001, Glaxo had offered similar discounts to nongovernmental organizations, United Nations agencies, and to employers that operated their own clinics. These steps had not helped many patients, however, and had done little to appease public health and humanitarian activists.

In GSK’s 2000 annual report, released in March 2001, Garnier and Chairman Richard Sykes commented on the company’s continuing role:

As the world leader in the discovery and development of medicines that effectively treat HIV/AIDS, GlaxoSmithKline is determined to play its full part in dealings with this desperate humanitarian crisis which is blighting and destroying the lives of so many millions of people. Yet it disappoints our employees and our other stakeholders that much of the public comment has so far failed to convey the immense complexity of the issue or give due credit for the substantial contribution our company is already making. Real progress in increasing the number of patients treated will only come through concerted action whereby companies such as GlaxoSmithKline work actively in partnership with governments that have the political will to develop real solutions; donor funders who can help buy medicines; and organizations on the ground working to provide medical facilities, establish reliable drug distribution systems, and provide patients with proper care and treatment.¹⁸

Now, Garnier had to consider what further steps, if any, Glaxo should take to promote the “real progress” he had called for. Certainly, the company could cut prices further, or even give the drugs away altogether in some markets. Doing so might appease humanitarian activists like Oxfam. It could prolong the lives of some AIDS sufferers, and improve the quality of life for others. A price cut could also get Glaxo’s AIDS medicines—rather than its competitors’—into what was potentially the biggest market for them in the world.

But Garnier’s decision was far from straightforward. In an interview in April 2001, the chief executive had observed that even after other companies had slashed prices, few African nations had stepped forward to buy their products. “That’s the ultimate proof,” Garnier had observed, “[that] the issue of pricing is irrelevant in the grand scheme of things.”¹⁹ Many poor African countries simply did not have the funds to purchase drugs even at greatly reduced prices or the medical infrastructure to deliver them to the needy.

There were other problems, as well. Making large quantities of cheap drugs available in Africa practically invited the development of black market exports back to rich nations. The executive could easily envision scores of rich AIDS patients paying for safaris to Kenya, with money left over, with the savings from dirt cheap medications purchased during their visits. Direct assistance might be diverted by corrupt governments or programs. He was also concerned about the emergence of drug-resistant strains of AIDS if medications were dispensed in poorly controlled settings. What would happen then to the company’s investment in their existing generation of medicines? And slashing prices for AIDS drugs could set a dangerous precedent. If the company discounted these medicines, it ran the risk of escalating demands from governments, insurers, and patients in the developed world to reduce the prices of Glaxo medicines for all kinds of other conditions. This was, indeed, a problem of “immense complexity.”

Discussion Questions

1. What is GlaxoSmithKline’s business?
2. What price should the company have when pricing products in the poor and rich worlds?
3. What grade would you recommend GSK’s managers and why?

On April 24, 2000, Philip H. Knight, CEO of athletic shoe and apparel maker Nike, Inc., publicly announced that he would no longer donate money to the University of Oregon (UO). It was a dramatic and unexpected move for the high-profile

executive. A former UO track and field star, Knight had founded Nike's predecessor in 1963 with his former coach and mentor, Bill Bowerman. Over the years, Knight had maintained close ties with his alma mater, giving more than \$50 million of his personal fortune to the school over a quarter century. In 2000, he was in active discussion with school officials about his biggest donation yet—millions for renovating the football stadium. But suddenly it was all called off. Said Knight in his statement: “[F]or me personally, there will be no further donations of any kind to the University of Oregon. At this time, this is not a situation that can be resolved. The bonds of trust, which allowed me to give at a high level, have been shredded.”

At issue was the University of Oregon's intention, announced April 14, 2000, to join the Worker Rights Consortium (WRC). Like many universities, UO was engaged in an internal debate over the ethical responsibilities associated with its role as a purchaser of goods manufactured overseas. Over a period of several months, UO administrators, faculty, and students had been discussing what steps they could take to ensure that products sold in the campus store, especially university-logo apparel, were not manufactured under sweatshop conditions. The university had considered joining two organizations, both of which purported to certify goods as “no sweat.” The first, the Fair Labor Association (FLA), had grown out of President Clinton's Apparel Industry Partnership (AIP) initiative and was vigorously backed by Nike, as well as several other leading apparel makers. The second, the Worker Rights Consortium, was supported by student activists and several U.S.-based labor unions that had broken from the AIP after charging it did not go far enough to protect workers. Knight clearly felt that his alma mater had made the wrong choice. “[The] University [has] inserted itself into the new global economy where I make my living,” he charged. “And inserted itself on the wrong side, fumbling a teachable moment.”

The dispute between Phil Knight and the University of Oregon captured much of the furor swirling about the issue of the role of multinational corporations in the global economy and the effects of their far-flung operations on their many thousands of workers, communities, and other stakeholders. In part because of its high-profile brand name, Nike had become a lightning rod for activists concerned about worker rights abroad. Like many U.S.-based shoe and apparel makers, Nike had located its manufacturing operations overseas, mainly in Southeast Asia, in search of low wages. Almost all production was carried out by subcontractors rather than by Nike directly. Nike's employees in the United States, by contrast, directed their efforts to the high-end work of research and development, marketing, and retailing. In the context of this global division of labor, what responsibility, if any, did Nike have to ensure adequate working conditions and living standards for the hundreds of thousands of workers, mostly young Asian women, who made its shoes and apparel? If this was not Nike's responsibility, then whose was it? Did organizations like the University of Oregon have any business pressuring companies through their purchasing practices? If so, how should they best do so? In short, what were the lessons of this “teachable moment”?

Nike, Inc.

In 2000, Nike, Inc., was the leading designer and marketer of athletic footwear, apparel, and equipment in the world. Based in Beaverton, Oregon, the company's “swoosh” logo, its “Just Do It!” slogan, and its spokespersons Michael Jordan, Mia Hamm, and Tiger Woods were universally recognized. Nike employed around 20,000 people directly, and *half a million* indirectly in 565 contract factories in 46 countries around the world. Wholly owned subsidiaries included Bauer Nike

Hockey Inc. (hockey equipment), Cole Haan (dress and casual shoes), and Nike Team Sports (licensed team products). Revenues for the 12 months ending November 1999 were almost \$9 billion, and the company enjoyed a 45 percent global market share. Knight owned 34 percent of the company's stock and was believed to be the sixth-richest individual in the United States.

~~Knight had a high school diploma from a high school in the 1960s. During his first knowledge of a field, he decided to put two pairs of shoes from a partnership with his former coach. Bowman would provide signposts for his company, and he set shoes with the coach. Knight would handle all financial and day-to-day operations of the business. Nike had a minimum investment of \$500,000 and had the company (then called Blue Ribbon Sports) was officially founded in 1963. The company took the name Nike in 1978, two years after the company had \$29 million and 270 employees. Nike became a public traded company.~~

From the beginning, marketing had been a critical part of Knight's vision. The founder defined Nike as a "marketing-oriented company." During the 1980s and early 1990s, Nike aggressively sought out endorsements by celebrity athletes to increase brand awareness and foster consumer loyalty. Early Nike endorsers included Olympic gold medalist Carl Lewis, Wimbledon champion Andre Agassi, and six members of the 1992 Olympic basketball "Dream Team." Later endorsers included tennis aces Pete Sampras and Monica Seles, basketball great Michael Jordan, and golf superstar Tiger Woods.

An important element in Nike's success was its ability to develop cutting-edge products that met the needs of serious athletes, as well as set fashion trends. Research specialists in Nike's Sports Research Labs conducted extensive research and testing to develop new technologies to improve the performance of Nike shoes in a variety of sports. For example, research specialists studied the causes of ankle injuries in basketball players to develop shoes that would physically prevent injuries, as well as signal information to the user to help him or her resist turning the ankle while in the air. Other specialists developed new polymer materials that would make the shoes lighter, more aerodynamic, or more resistant to the abrasions incurred during normal athletic use. Findings from the Sports Research Labs were then passed on to design teams that developed the look and styling of the shoes.

Although it was the leading athletic footwear company in the world, Nike never manufactured shoes in any significant number. Rather, from its inception, the company had outsourced production to subcontractors in Asia, with the company shifting production locations within the region when prevailing wage rates became too high. In the early years, it had imported shoes from Japan. It later shifted production to South Korea and Taiwan, then to Indonesia and Thailand, and later yet to Vietnam and China.

~~The first factory in Asia was the first plant in the Philippines, which had a production capacity of 1 million pairs of shoes per month. The first factory in Asia was the first plant in the Philippines, which had a production capacity of 1 million pairs of shoes per month. The first factory in Asia was the first plant in the Philippines, which had a production capacity of 1 million pairs of shoes per month. The first factory in Asia was the first plant in the Philippines, which had a production capacity of 1 million pairs of shoes per month.~~

Along with lower labor costs, Asia provided the additional advantage of access to raw materials suppliers. Very few rubber firms in the United States, for example, produced the sophisticated composite soles demanded in modern athletic shoe designs. Satellite industries necessary for modern shoe production, plentiful in Asia, included tanneries, textiles, and plastic and ironwork moldings. A final factor in determining where to locate production was differential tariff rates. In general, canvas sneakers were assessed higher tariffs than leather molded footwear, such as basketball or running shoes. As a result, shoe companies had an incentive to outsource high-tech athletic shoes overseas, because tariffs on them were relatively low.

Many of Nike's factories in Asia were operated by a small number of Taiwanese and South Korean firms that specialized in shoe manufacturing, many owned by some of the wealthiest families in the region. When Nike moved from one location

to another, often these companies followed, bringing their managerial expertise with them.

Nike's Subcontractor Factories

In 2000, Nike contracted with over 500 different footwear and apparel factories around the world to produce its shoes and apparel. Although there was no such thing as a typical Nike plant, a factory operated by the South Korean subcontractor Tae Kwang Vina (TKV) in the Bien Hoa City industrial zone near Ho Chi Minh City in Vietnam provided a glimpse into the setting in which many Nike shoes were made.

TKV employed approximately 10,000 workers in the Bien Hoa City factory. The workforce consisted of 200 clerical workers, 355 supervisors, and 9,465 production workers, all making athletic shoes for Nike. Ninety percent of the workers were women between the ages of 18 to 24. Production workers were employed in one of three major areas within the factory: the chemical, stitching, and assembly sections. Production levels at the Bien Hoa City factory reached 400,000 pairs of shoes per month; Nike shoes made at this and other factories made up fully 5 percent of Vietnam's total exports.

Workers in the chemical division were responsible for producing the high-technology outsoles. Production steps involved stretching and flattening huge blobs of raw rubber on heavy-duty rollers and baking chemical compounds in steel molds to form the innovative three-dimensional outsoles. The chemical composition of the soles changed constantly in response to the cutting-edge formulations developed by the U.S. design teams, requiring frequent changes in the production process. The smell of complex polymers, the hot ovens, and the clanging of the steel molds resulted in a working environment that was loud and hot and had high concentrations of chemical fumes. Chemicals used in the section were known to cause eye, skin, and throat irritations; damage to liver and kidneys; nausea; anorexia; and reproductive health hazards through inhalation or in some cases through absorption through the skin. Workers in the chemical section were thought to have high rates of respiratory illnesses, although records kept at the TKV operations did not permit the tracking of illnesses by factory section. Workers in the chemical section were issued gloves and surgical-style masks. However, they often discarded the protective gear, complaining that it was too hot and humid to wear them in the plant.

In the stitching section, row after row of sewing machines operated by young women hummed and clattered in a space the size of three football fields. One thousand stitchers worked on a single floor of the TKV factory, sewing together nylon, leather, and other fabrics to make the uppers. Other floors of the factory were filled with thousands of additional sewing machines producing different shoe models. The stitching job required precision and speed. Workers who did not meet the aggressive production goals did not receive a bonus. Failing to meet production goals three times resulted in the worker's dismissal. Workers were sometimes permitted to work additional hours without pay to meet production quotas. Supervisors were strict, chastising workers for excessive talking or spending too

much time in the restrooms. Korean supervisors, often hampered by language and cultural barriers, sometimes resorted to hard-nosed management tactics, hitting or slapping slower workers. Other workers in need of discipline were forced to stand outside the factory for long periods in the tropical sun. The Vietnamese term for this practice was *phoi nang*, or sun-drying.

In the assembly section, women worked side by side along a moving line to join the uppers to the outsoles through the rapid manipulation of sharp knives, skivers, routers, and glue-coated brushes. Women were thought to be better suited for the assembly jobs because their hands were smaller and more capable of the manual dexterity needed to fit the shoe components together precisely. During the assembly process, some 120 pairs of hands touched a single shoe. A strong, sweet solvent smell was prominent in the assembly area. Ceiling-mounted ventilation fans were ineffective since the heavy fumes settled to the floor. Assembly workers wore cotton surgical masks to protect themselves from the fumes; however, many workers pulled the masks below their noses, saying they were more comfortable that way. Rows and rows of shoes passed along a conveyor before the sharp eyes of the quality control inspectors. The inspectors examined each of the thousands of shoes produced daily for poor stitching or crooked connections between soles. Defective shoes were discarded. Approved shoes continued on the conveyor to stations where they were laced by assembly workers and finally put into Nike shoeboxes for shipment to the United States.

Despite the dirty, dangerous, and difficult nature of the work inside the Bien Hoa factory, there was no shortage of applicants for positions. Although entry-level wages averaged only \$1.50 per day (the lowest of all countries where Nike manufactured), many workers viewed factory jobs as better than their other options, such as working in the rice paddies or pedaling a pedicab along the streets of Ho Chi Minh City (formerly Saigon). With overtime pay at one and a half times the regular rate, workers could double their salaries—generating enough income to purchase a motorscooter or to send money home to impoverished rural relatives. These wages were well above national norms. An independent study by researchers from Dartmouth University showed that the average annual income for workers at two Nike subcontractor factories in Vietnam was between \$545 and \$566, compared to the national average of between \$250 and \$300. Additionally, workers were provided free room and board and access to on-site health care facilities. Many Vietnamese workers viewed positions in the shoe factory as transitional jobs, a way to earn money for a dowry or to experience living in a larger city. Many returned to their homes after working for Nike for two or three years to marry and begin the next phase of their lives.

The Campaigns against Nike

In the early 1990s, criticism of Nike's global labor practices began to gather steam. *Harper's* magazine, for example, published the pay stub of an Indonesian worker, showing that the Nike subcontractor had paid the woman just under 14 cents per hour, and contrasted this with the high retail price of the shoes and the high salaries paid to the company's celebrity endorsers. The Made in the U.S.A. Foundation, a group backed by American unions, used a million-dollar ad budget to urge consumers to send their "old, dirty, smelly, worn-out Nikes" to Phil Knight in protest of Nike's Asian manufacturing practices. Human rights groups and Christian organizations joined the labor unions in targeting the labor practices of the athletic shoes firm. Many felt that Nike's antiauthority corporate image ("Just Do It") and message of social betterment through fitness were incompatible with

press photos of slight Asian women hunched over sewing machines 70 hours a week, earning just pennies an hour.

By mid-1993, Nike was being regularly pilloried in the press as an imperialist profiteer. A CBS news segment airing on July 2, 1993, opened with images of Michael Jordan and Andre Agassi, two athletes who had multimillion-dollar promotion contracts with Nike. Viewers were told to contrast the athletes' pay checks with those of the Chinese and Indonesian workers who made "pennies" so that Nike could "Just Do It."

In 1995, *The Washington Post* reported that a pair of Nike Air Pegasus shoes that retailed for \$70 cost Nike only \$2.75 in labor costs, or 4 percent of the price paid by consumers. Nike's operating profit on the same pair of shoes was \$6.25, while the retailer pocketed \$9.00 in operating profits. Also that year, shareholder activists organized by the Interfaith Center on Corporate Responsibility submitted a shareholder proposal at Nike's annual meeting, calling on the company to review labor practices by its subcontractors; the proposal garnered 3 percent of the shareholder vote.

A story in *Life* magazine documented the use of child labor in Pakistan to produce soccer balls for Nike, Adidas, and other companies. The publicity fallout was intense. The public could not ignore the photographs of small children sitting in the dirt, carefully stitching together the panels of a soccer ball that would become the plaything of some American child the same age. Nike moved quickly to work with its Pakistani subcontractor to eliminate the use of child labor, but damage to Nike's image had been done.

In October 1996, CBS News' "48 Hours" broadcast a scathing report on Nike's factories in Vietnam. CBS reporter Roberta Baskin focused on low wage rates, extensive overtime, and physical abuse of workers. Several young workers told Baskin how a Korean supervisor had beaten them with a part of a shoe because of problems with production. A journalist in Vietnam told the reporter that the phrase "to Nike someone" was part of the Vietnamese vernacular. It meant to "take out one's frustration on a fellow worker." Vietnamese plant managers refused to be interviewed, covering their faces as they ran inside the factory. CBS news anchor Dan Rather concluded the damaging report by saying, "Nike now says it plans to hire outside observers to talk to employees and examine working conditions in its Vietnam factories, but the company just won't say when that might happen."

The negative publicity was having an effect. In 1996, a marketing research study authorized by Nike reported the perceptions of young people ages 13 to 25 of Nike as a company. The top three perceptions, in the order of their response frequency, were (1) athletics, (2) cool, and (3) bad labor practices. Although Nike maintained that its sales were never affected, company executives were clearly concerned about the effect of criticism of its global labor practices on the reputation of the brand they had worked so hard to build.

The Evolution of Nike's Global Labor Practices

In its early years, Nike had maintained that the labor practices of its foreign subcontractors, like TKV, were simply not its responsibility. "When we started Nike," Knight later commented, "it never occurred to us that we should dictate what their factor[ies] should look like." The subcontractors, not Nike, were responsible for wages and working conditions. Dave Taylor, Nike's vice president of production, explained the company's position: "We don't pay anybody at the factories and we don't set policy within the factories; it is their business to run."

When negative articles first began appearing in the early 1990s, however, Nike managers realized that they needed to take some action to avoid further bad

publicity. In 1992, the company drafted its first Code of Conduct, which required every subcontractor and supplier in the Nike network to honor all applicable local government labor and environmental regulations, or Nike would terminate the relationship. The subcontractors were also required to allow plant inspections and complete all necessary paperwork. Despite the compliance reports the factories filed every six months, Nike insiders acknowledged that the code of conduct system might not catch all violations. Tony Nava, Nike's country coordinator for Indonesia, told a *Chicago Tribune* reporter, "We can't know if they're actually complying with what they put down on paper."

In 1994, Nike tried to address this problem by hiring Ernst & Young, the accounting firm, to independently monitor worker abuse allegations in Nike's Indonesian factories. Later, Ernst & Young also audited Nike's factories in Thailand and Vietnam. A copy of the Vietnam audit leaked to the press showed that workers were often unaware of the toxicity of the compounds they were using and ignorant of the need for safety precautions. In 1998, Nike implemented important changes in its Vietnamese plants to reduce exposure to toxics, substituting less harmful chemicals, installing ventilation systems, and training personnel in occupational health and safety issues.

In 1996, Nike established a new Labor Practices Department, headed by Dusty Kidd, formerly a public relations executive for the company. Later that year, Nike hired GoodWorks International, headed by former U.S. ambassador to the United Nations Andrew Young, to investigate conditions in its overseas factories. In January 1997, GoodWorks issued a glossy report, stating that "Nike is doing a good job in the application of its Code of Conduct. But Nike can and should do better." The report was criticized by activists for its failure to look at the issue of wages. Young demurred, saying he did not have expertise in conducting wage surveys. Said one critic, "This was a public relations problem, and the world's largest sneaker company did what it does best: it purchased a celebrity endorsement."

Over the next few years, Nike continued to work to improve labor practices in its overseas subcontractor factories, as well as the public perception of them. In January 1998, Nike formed a Corporate Responsibility Division under the leadership of former Microsoft executive Maria S. Eitel. Nike subsequently doubled the staff of this division. In May of that year, Knight gave a speech at the National Press Club, at which he announced several new initiatives. At that time, he committed Nike to raise the minimum age for employment in its shoe factories to 18 and in its apparel factories to 16. He also promised to achieve OSHA standards for indoor air quality in all its factories by the end of the year, mainly by eliminating the use of the solvent toluene; to expand educational programs for workers and its microenterprise loan program; and to fund university research on responsible business practices. Nike also continued its use of external monitors, hiring PricewaterhouseCoopers to join Ernst & Young in a comprehensive program of factory audits, checking them against Nike's code.

Apparel Industry Partnership

One of Nike's most ambitious social responsibility initiatives was its participation in the Apparel Industry Partnership. It was this involvement that would lead, eventually, to Knight's break with the University of Oregon.

In August 1996, President Clinton launched the White House Apparel Industry Partnership on Workplace Standards (AIP). The initial group was composed of 18 organizations. Participants included several leading manufacturers, such as Nike, Reebok, and Liz Claiborne. Also in the group were several labor unions, including

the Union of Needletrades, Industrial, and Textile Employees (UNITE) and the Retail, Wholesale and Department Store Union; and several human rights, consumer, and shareholder organizations, including Business for Social Responsibility, the Interfaith Center on Corporate Responsibility, and the National Consumers League. The goal of the AIP was to develop a set of standards to ensure that apparel and footwear were not made under sweatshop conditions. For companies, it held out the promise of certifying to their customers that their products were “no sweat.” For labor and human rights groups, it held out the promise of improving working conditions in overseas factories.

In April 1997, after months of often-fractionious meetings, the AIP announced that it had agreed on a Workplace Code of Conduct that sought to define decent and humane working conditions. Companies agreeing to the code would have to pledge not to use forced labor, that is, prisoners or bonded or indentured workers. They could not require more than 60 hours of work a week, including overtime. They could not employ children younger than 15 years old, or the age for completing compulsory schooling, whichever was older—except they could hire 14-year-olds if local law allowed. The code also called on signatory companies to treat all workers with respect and dignity; to refrain from discrimination on the basis of gender, race, religion, age, disability, sexual orientation, nationality, political opinion, or social or ethnic origin; and to provide a safe and healthy workplace. Employees’ rights to organize and bargain collectively would be respected. In a key provision, the code also required companies to pay at least the local legal minimum wage, and to provide benefits, such as health care, to their employees.

Knight, who prominently joined President Clinton and others at a White House ceremony announcing the code, issued the following statement:

Nike agreed to participate in this Partnership because it was the first credible attempt, by a diverse group of interests, to address the important issue of improving factories worldwide. It was worth the effort and hard work. The agreement will prove important for several reasons. Not only is our industry stepping up to the plate and taking a giant swing at improving factory conditions, but equally important, we are finally providing consumers some guidance to counter all of the misinformation that has surrounded this issue for far too long.

The Fair Labor Association

But this was not the end of the AIP’s work; it also had to agree on a process for monitoring compliance with the code. Although the group hoped to complete its work in six months, over a year later it was still deeply divided on several key matters. Internal documents leaked to *The New York Times* in July 1998 showed that industry representatives had opposed proposals, circulated by labor and human rights members, calling for the monitoring of 30 percent of plants annually by independent auditors. The companies also opposed proposals that would require them to support workers’ rights to organize independent unions and to bargain collectively, even in countries like China where workers did not have such rights by law. Said one nonindustry member, “We’re teetering on the edge of collapse.”

Finally, a subgroup of nine centrist participants, including Nike, began meeting separately in an attempt to move forward. In November 1998, this subgroup announced that it had come to agreement on a monitoring system for overseas factories of U.S.-based companies. The AIP would establish a new organization, the Fair Labor Association (FLA), to oversee compliance with its Workplace Code of Conduct. Companies would be required to monitor their own factories, and those of their subcontractors, for compliance; all would have to be checked within

the first two years. In addition, the FLA would select and certify independent external monitors, who would inspect 10 percent of each firm's factories each year. Most of these monitors were expected to be accounting firms, which had expertise in conducting audits. The monitors' reports would be kept private. If a company were found to be out of compliance, it would be given a chance to correct the problem. Eventually, if it did not, the company would be dropped from the FLA and its termination announced to the public. Companies would pay for most of their own monitoring. The Clinton administration quickly endorsed the plan.

Both manufacturers and institutional buyers stood to benefit from participation in the Fair Labor Association. Companies, once certified for three years, could place an FLA service mark on their brands, signaling both to individual consumers and institutional buyers that their products were "sweatshop-free." It was expected that the FLA would also serve the needs of institutional buyers, particularly universities. By joining the FLA and agreeing to contract only with certified companies, universities could warrant to their students and others that their logo apparel and athletic gear were manufactured under conditions conforming with an established code of fair labor standards. Both parties would pay for these benefits. The FLA was to be funded by dues from participating companies (\$5,000 to \$100,000 annually, depending on revenue) and by payments from affiliated colleges and universities (based on 1 percent of their licensing income from logo products, up to a \$50,000 annual cap).

Although many welcomed the agreement—and some new companies signed on with the FLA soon after it was announced—others did not. Warnaco, a leading apparel maker that had participated in the Partnership, quit, saying that the monitoring process would require it to turn over competitive information to outsiders. The American Apparel Manufacturing Association (AAMA), an industry group representing 350 companies, scoffed at the whole idea of monitoring. "Who is going to do the monitoring?" asked a spokesperson for the AAMA, apparently sarcastically, "Accountants or Jesuit priests?" Others argued that companies simply could not be relied upon to monitor themselves. ~~did. It might not be controlled by the companies." A visit from an external monitor once every 10 years would not prevent abuses. And in any case, external monitors would be drawn from auditing firms that did business with the companies they were monitoring and were therefore unlikely to seek out lapses. Companies would not be required to publish a list of their factories, and any problems uncovered by the monitoring process could be kept from the public under the rules governing nondisclosure of proprietary information.~~

One of the issues most troubling to critics was the code's position on wages. The code called on companies to pay the minimum wage or prevailing wage, whichever was higher. But in many of the countries of Southeast Asia, these wages fell well below the minimum considered necessary for a decent standard of living for an individual or family. For example, the *Economist* reported that Indonesia's average minimum wage, paid by Nike subcontractors, was only two-thirds of what a person needed for basic subsistence. An alternative view was that a code of conduct should require that companies pay a *living wage*, that is, compensation for a normal workweek adequate to provide for the basic needs of an average family, adjusted for the average number of adult wage earners per family. One problem with this approach, however, was that many countries did not systematically study the cost of living, relative to wages, so defining a living wage was difficult. The Partnership asked the U.S. Department of Labor to conduct a preliminary study of these issues; the results were published in 2000.

The code also called on companies to respect workers' rights to organize and bargain collectively. Yet a number of FLA companies outsourced production to nondemocratic countries, such as China and Vietnam, where workers had no such rights. Finally, some criticized the agreement on the grounds it provided companies, as one put it, "a piece of paper to use as a fig leaf." Commented a representative of the needle trades unions, "The problem with the partnership plan

is that it tinkers at the margins of the sweatshop system but creates the impression that it is doing much more. This is potentially helpful to companies stung by public condemnation of their labor practices, but it hurts millions of workers and undermines the growing antisweatshop movement.”

The Worker Rights Consortium

Some activists in the antisweatshop movement decided to chart their own course, independent of the FLA. On October 20, 1999, students from more than 100 colleges held a press conference to announce formation of the Worker Rights Consortium (WRC) and called on their schools to withdraw from, or not to join, the FLA. The organization would be formally launched at a founding convention in April 2000.

The Worker Rights Consortium differed radically in its approach to eliminating sweatshops. First, the WRC did not permit corporations to join; it was composed exclusively of universities and colleges, with unions and human rights organizations playing an advisory role. In joining the WRC, universities would agree to “require decent working conditions in factories producing their licensed products.” Unlike the FLA, the WCA did not endorse a single, comprehensive set of fair labor standards. Rather, it called on its affiliated universities to develop their own codes. However, it did establish minimum standards that such codes should meet—ones that were, in some respects, stricter than the FLA’s. Perhaps most significantly, companies would have to pay a living wage. Companies were also required to publish the names and addresses of all of their manufacturing facilities, in contrast to FLA rules. Universities could refuse to license goods made in countries where compliance with fair labor standards was “deemed impossible,” whatever efforts companies had made to enforce their own codes in factories there.

By contrast with the FLA, monitoring would be carried out by “a network of local organizations in regions where licensed goods are produced,” generally nongovernmental organizations, independent human rights groups, and unions. These organizations would conduct unannounced “spot investigations,” usually in response to worker complaints; WRC organizers called this the “fire alarm” method of uncovering code violations. Systematic monitoring would not be attempted. The consortium’s governance structure reflected its mission of being an organization by and for colleges and universities; its 12-person board was composed of students, university administrators, and human rights experts, with no seats for industry representatives. The group would be financed by 1 percent of licensing revenue from participating universities, as well as foundation grants.

Over the course of the spring semester 2000, student protests were held on a number of campuses, including the University of Oregon, to demand that their schools join the WRC. By April, around 45 schools had done so. At UO, the administration encouraged an open debate on the issue so that all sides could be heard on how to ensure that UO products were made under humane conditions. Over a period of several months, the Academic Senate, the student body, and a committee of faculty, students, administrators, and alumni appointed by the president all voted to join the consortium. Finally, after concluding that all

constituents had had an opportunity to be heard, on April 12, 2000, University of Oregon president David Frohnmayer announced that UO would join the WRC for one year. Its membership would be conditional, he said, on the consortium's agreement to give companies a voice in its operations and universities more power in governance. Shortly after the university's decision was announced in the press, Phil Knight withdrew his philanthropic contribution. In his public announcement, he stated his main disagreements with the Worker Rights Consortium:

Frankly, we are frustrated that factory monitoring is badly misconstrued. For us one of the great hurdles and real handicaps in the dialogue has been the complexity of the issue. For real progress to be made, all key participants have to be at the table. That's why the FLA has taken so long to get going. The WRC is supported by the AFL-CIO and its affiliated apparel workers' union, UNITE. Their main aim, logically and understandably, however misguided, is to bring apparel jobs back to the U.S. Among WRC rules, no company can participate in setting standards, or monitoring. It has an unrealistic living wage provision. And its "gotcha" approach to monitoring doesn't do what monitoring should—measure conditions and make improvements.

Discussion Questions

1. Who do you think has the most responsibility for wages and working conditions of the employees who produce Nike shoes and apparel? Why do you think so?
2. The Fair Labor Association and the Worker Rights Consortium differ on how to establish fair labor standards. Which approach do you favor, and why? Consider how you would answer this question if you were representing the following: Nike, the U.S. labor union, the original U.S. laboring government, and a Nigerian.
3. If you were the CEO of Nike, what would you do next in this situation? If you were the president of the University of Oregon, what would you do next?

On November 10, 1995, world-renowned Nigerian novelist and environmental activist Ken Saro-Wiwa was executed by hanging in a prison courtyard. Just 10 days earlier, he had been convicted by a military tribunal on charges that he had ordered the murder of political opponents. Throughout his trial, Saro-Wiwa had vigorously maintained his innocence. Despite protests by many world leaders and human rights organizations, the Nigerian military regime quickly carried out the death sentence.

Saro-Wiwa's execution provoked a profound crisis for the Royal Dutch/Shell Group of Companies. In its wake, some environmentalists and political leaders called for an international boycott of Shell's gasoline and other products. The World Bank canceled a promised \$160 million combined loan and investment in Shell's liquefied natural gas project in Nigeria. In Canada, the Toronto city government refused a large gasoline contract to Shell Canada, despite its low bid—an event that received wide press coverage. Some even called for the oil company to pull out of Nigeria altogether.

Alan Detheridge, Shell's coordinator for West Africa, told a reporter in February 1996, "Saro-Wiwa's execution was a disaster for us."

Just what was the connection between Saro-Wiwa's execution and Shell? Why did the company find itself suddenly, in the words of *The New York Times*, "on trial in the court of public opinion"? Had the company done anything wrong in Nigeria? What, if anything, could or should it do in the face of an escalating chorus of international criticism?

The Royal Dutch/Shell Group

The Royal Dutch/Shell Group was the world's largest fully integrated petroleum company. "Upstream," the conglomerate controlled oil and gas exploration and production; "midstream," the pipelines and tankers that carried oil and gas; and "downstream," the refining, marketing, and distribution of the final product. The company also had interests in coal mining, forestry, chemicals, and renewable energy. In all, the Anglo-Dutch conglomerate comprised over 2,000 separate entities, with exploration and production operations, refineries, and marketing in scores of countries. Royal Dutch/Shell was, in both its ownership and scope, perhaps the world's most truly transnational corporation.

In 1994, Royal Dutch/Shell made more money than any other company in the world, reporting annual profits of \$6.3 billion. The same year, the company reported revenues of \$94.9 billion, placing it 10th on *Fortune's* Global 500 list. Assets were reported at \$108.3 billion, and stockholders' equity at \$56.4 billion. With 106,000 employees worldwide, it had the largest workforce of any oil company in the world.

This highly successful global corporation traced its history back over more than a century and a half. In the 1830s, British entrepreneur Marcus Samuel founded a trading company to export manufactured goods from England and to import products, including polished seashells (hence, the name "Shell"), from the Orient. In the early 1890s, Samuel's sons steered the company into the kerosene business, assembling a fleet of tankers to ply the fuel through the Suez Canal to Far Eastern ports. At about the same time, a group of Dutch businessmen launched the Royal Dutch Company to drill for oil in the Dutch East Indies. In 1907, Royal Dutch and Shell merged, with Royal Dutch retaining a 60 percent interest and Shell, 40 percent. The resulting organization came to be known as the Royal Dutch/Shell Group of Companies, or simply the Group.

Over the years, Royal Dutch/Shell developed a highly decentralized management style, with its far-flung subsidiaries exercising considerable autonomy. The company believed that vesting authority in nationally based, integrated operating companies—each with its own distinctive identity—gave it the strategic flexibility to respond swiftly to local opportunities and conditions. The corporation was governed by a six-person committee of managing directors. Reflecting its dual parentage, the Group maintained headquarters in both London and The Hague. The chairmanship rotated periodically between the chairman of Shell and the president of Royal Dutch. Decision making was by consensus, with no dominant personality.

Shell Nigeria

The Shell Petroleum Development Company of Nigeria (SPDC), usually called Shell Nigeria, was a wholly owned subsidiary of Royal Dutch/Shell. The company stated its corporate objective simply. It was "to find, produce, and deliver hydrocarbons safely, responsibly, and economically for the benefit of our stakeholders."

The Royal Dutch/Shell Group began exploring for oil in West Africa in the 1930s, but it was not until 1956 that oil was discovered in the Niger Delta in southeastern Nigeria. In 1958, two years before Nigeria's independence, Shell was the first major oil company to commence oil production there. Nigerian oil was of very high quality by world standards; in the industry, it was referred to as "light, sweet crude," meaning that it had a low sulfur content and produced a higher proportion of gasoline after refining than heavier crude oil. Of all the multinational oil companies in Nigeria, Shell had by far the most visibility, because of the extent

of its land-based operations. Other major players in the Nigerian oil industry, including Mobil and Chevron, mainly operated offshore.

Shell Nigeria was a participant in a joint venture with the Nigerian government and two other private firms. In 1995, the Nigerian National Petroleum Corporation (NNPC), the state-owned oil company, owned a 55 percent stake in the joint venture. Royal Dutch/Shell owned a 30 percent stake; Elf and Agip, both European oil companies, owned the remaining 15 percent. Shell was the joint venture operator; that is, it built and ran the oil operations on the ground. The other owners, although not involved in day-to-day management, had a say in the development of budgets and new projects. Investments in the business were made by the joint venture partners in proportion to their holdings. As operator, Shell issued “cash calls” to its partners to provide monthly payments. Shell executives were often frustrated by the NNPC’s failure to pay their share on time. In 1995, the government was \$300 million behind in its payments.

Shell Nigeria’s operations were huge, not only by Nigerian standards, but even by those of its parent firm. In 1995, Shell Nigeria produced an average of almost one million barrels of crude oil a day, about half of Nigeria’s total output, from 94 separate fields spread over 31,000 square kilometers. It operated 6,200 kilometers of pipelines and flow lines, much of it running through swamps and flood zones in the Niger Delta. In addition, the company operated two coastal export terminals. The company reported that the Nigerian operation provided about 12 percent of Royal Dutch/Shell’s total world oil production and 7 percent of its profits.

Shell Nigeria employed about 5,000 people. Ninety-five percent of all employees, and about half of executive directors, were Nigerian. Fifty-seven percent of its staff was drawn from the oil-producing states.

The company’s financial arrangements with its host country were highly beneficial to the Nigerian government. For every barrel of oil sold at between \$12.50 and \$23.00 a barrel, 70 cents went to Shell, 30 cents went to Elf and Agip, and \$4.50 went to cover costs. The Nigerian government received the rest. At a per-barrel price of \$15, for example, the government would receive \$9.50, or about 90 percent of net revenue after expenses. The Nigerian government’s take, at the time, was the highest of any government in the world with which Shell did business.

Nigeria: The Giant of West Africa

Nigeria, the Group’s sometimes-troublesome partner, has been called the “giant of West Africa.” Located on the Gulf of Guinea between the republics of Benin and Cameroon, Nigeria was slightly more than twice the size of California and, with over 100 million people, the most populous country on the continent. Nigeria’s gross domestic product of \$95 billion placed its economy second, smaller only than South Africa’s. The economy was heavily dependent on petroleum; oil and natural gas sales produced 80 percent of the federal government’s revenue, and more than 90 percent of the country’s foreign exchange. Forty-one percent of oil exports went to the United States, more than to any other single country.

Nigeria was a land of stark socioeconomic contrasts. The nation’s military and business elites had grown wealthy from oil revenues. Yet most Nigerians lived in poverty. The annual per capita income was \$250, less than that of Haiti or China, and in the mid-1990s economic distress in many parts of Nigeria was deepening.

A legacy of colonialism, in Nigeria as elsewhere in Africa, was the formation of countries that had little historical basis other than common colonial governance. In the Nigerian case, the modern nation was formed from what had been no less than 250 disparate ethnic groups, many with few cultural or linguistic ties. The nation

comprised three main ethnic groups: the Hausa-Fulani, the Yoruba, and the Ibo. Together, these three groups made up 65 percent of the population; the remaining 35 percent was made up of hundreds of smaller ethnic groups, including Saro-Wiwa's people, the Ogoni.

Since its independence from Britain in 1960, Nigeria had been ruled by military governments for all but nine years. Several efforts, all eventually unsuccessful, had been made to effect a transition to permanent civilian rule. In June 1993, then-military dictator Ibrahim Babangida annulled the presidential election, suspended the newly created national assembly, and installed an unelected civilian as president. Just five months later, yet another military man, General Sani Abacha, took power in a coup. The Abacha regime quickly developed a reputation as "indisputably the cruelest and most corrupt" government in Nigeria since independence. A specialist in African politics summarized the situation in Nigeria before the United States Senate Foreign Relations Committee in 1995:

[The] current government appears indifferent to international standards of conduct, while dragging the country into a downward spiral of disarray, economic stagnation, and ethnic animosity.... [It] has curtailed political and civil rights to an unprecedented degree in Nigerian history, magnified corruption and malfeasance in an endemically corrupt system, and substantially abandoned responsible economic management.

In 1993, inflation was running around 50 percent annually, foreign debt was growing, and the country's balance of payments was worsening. A succession of governments had arguably wasted vast amounts of money on unnecessary projects such as the construction of a massive steel mill and a new capital city, Abuja. Agriculture was in decline, and a proliferation of states had produced a complex and inefficient bureaucracy. Corruption was so rampant in Nigeria, the *Economist* concluded in an editorial that "the parasite□.□.□. has almost eaten the host."

The Ogoni People

The Ogoni people, Saro-Wiwa's ethnic group, lived in the heart of the Nigerian oil fields. Numbering about half a million in the mid-1990s, the Ogoni spoke four related languages and shared common religious and cultural traditions. Prior to the arrival of the British in 1901, a stable Ogoni society based on fishing and farming had existed for centuries in a small area (a mere 12 by 32 miles) in the Delta region near the mouth of the Niger River.

Production of oil in Ogoniland began in 1958. The value of the oil that had been extracted from Ogoniland was a matter of dispute. According to Shell's figures, \$5.2 billion worth of oil had been pumped from the region's five major oil fields since 1958. Ogoni activists claimed the amount was much higher, \$30 billion.

Although Ogoniland was the site of great mineral wealth, the Ogoni people had received little benefit from its development. Under revenue-sharing arrangements between the Nigerian federal government and the states prior to 1992, only 1.5 percent of the government's revenues from oil was returned to the Delta communities for economic development, and much of this went to line the pockets of officials.

Ogoniland, like much of the Delta area, was very poor and very densely populated. No modern sanitation

systems were in place; raw sewage was simply buried or discharged into rivers or lakes. Drinking water was often contaminated, and water-related diseases such as cholera, malaria, and gastroenteritis were common. Housing was typically constructed with corrugated tin roofs and cement or, more commonly, dirt floors. A British engineer who later returned to the Delta village near Ogoniland where oil was first discovered commented, "I have explored for oil in Venezuela, I have explored for oil in Kuwait, [but] I have never seen an oil-rich town as completely impoverished as Oloibiri."

In 1992, in response to pressure from the Ogoni and other Delta peoples, the Nigerian government established a commission, funded with 3 percent of the government's oil revenues, to promote infrastructure development in the oil-producing regions. In 1993, the group spent \$94 million, with about 40 percent going to the Rivers State, in which Ogoniland was situated. Shell Nigeria also gave direct assistance to the oil-producing regions. In 1995, for example, the company's community development program in Nigeria spent about \$20 million. Projects included building classrooms and community hospitals, paying teacher salaries, funding scholarships for Nigerian youth, operating agricultural stations, and building roads. However, Shell was criticized for making little effort to involve local residents in determining how its community development funds would be spent.

Ken Saro-Wiwa

Ken Saro-Wiwa, who became a leader of the Ogoni movement, was in many respects an unlikely activist. A businessman who later became a highly successful writer and television producer, he had a taste for gourmet food, sophisticated humor, and international travel. Yet in the final years of his life he emerged as a world-famous advocate for sustainable development and for the rights of indigenous peoples who was honored by receipt of the Goldman Environmental Prize.

Saro-Wiwa was born in 1941 in an Ogoni village. A brilliant student, he was educated first at government-run schools and later, with the aid of a scholarship, at the University of Ibadan, where he studied literature. After a brief stint as a government administrator, Saro-Wiwa left public service to launch his own business. After four years as a successful grocer and trader, he took the proceeds and began investing in real estate, buying office buildings, shops, and homes. In 1983, with sufficient property to live comfortably, Saro-Wiwa turned to what he called his first love, writing and publishing. He proved to be a gifted and prolific writer, producing in short order a critically acclaimed novel, a volume of poetry, and a collection of short stories.

In 1985, Saro-Wiwa was approached by a university friend who had become program director for the state-run Nigerian television authority. The friend asked him to develop a comedy series. The result, "Basi & Co.," ran for five years and became the most widely watched television show in Africa. Reflecting Saro-Wiwa's political views, the program satirized Nigerians' desire to get rich with little effort. The show's comic protagonist was Basi, "a witty rogue [who] hustled on the streets of Lagos and was willing to do anything to make money, short of working for it."

By the late 1980s, Saro-Wiwa had become a wealthy and internationally known novelist and television scriptwriter. His wife and four children moved to London, where his children enrolled in British private schools. Saro-Wiwa joined his family often, making many friends in the London literary community who would later work doggedly, although unsuccessfully, for his release.

In 1988, Saro-Wiwa undertook a nonfiction study of Nigerian history, later published under the title *On a Darkling Plain*. This work reawakened his interest in politics and in the plight of his own Ogoni people. In a speech in March 1990, marking the study's publication, Saro-Wiwa laid out a theme from the book that was to become central to the rest of his life's work:

The notion that the oil-bearing areas can provide the revenue of the country and yet be denied a proper share of that revenue because it is perceived that the inhabitants of the area are few in number is unjust, immoral, unnatural, and ungodly.

On a Darkling Plain, not surprisingly, ignited a storm of controversy in Nigeria, and "Basi & Co." was canceled shortly after its publication, as was a column Saro-Wiwa had been writing for the government-owned weekly *Sunday Times*.

Movement for the Survival of the Ogoni People

The cancellation of his TV series and newspaper column seemed to propel Saro-Wiwa further into political activism. In August 1990, he met with a group of Ogoni tribal chiefs and intellectuals to draft an Ogoni Bill of Rights. This document called for political autonomy; cultural, religious, and linguistic freedom; the right to control a "fair proportion" of the region's economic resources; and higher standards of environmental protection for the Ogoni people.

Only a few days after the bill's draft, an organization to push the demand for the Ogoni Bill of Rights was formed. The group, called the Movement for the Survival of the Ogoni People (MOSOP), was formed in a meeting of 100 Ogoni people in the town of Forcados. The group's initial focus was on education and health care, but it soon turned to the Ogoni Bill of Rights and organized a strike of the region's oil workers. Saro-Wiwa traveled abroad—to the United States, Switzerland, the United Kingdom, the Netherlands, and Russia—where he met with human rights and environmental groups and government officials to build support for the Ogoni cause. MOSOP also adopted a "demand note" calling on Shell to pay "damages" of \$4 billion for "destroying the environment" and \$6 billion "understandably" to the Ogoni people.

Environmental Issues

Another MOSOP demand was that Shell stop its operations in the Niger Delta. In 1992, the United Nations Development Program (UNDP) and MOSOP

Oil exploration has turned Ogoni into a wasteland: lands, streams, and creeks are totally and continually polluted; the atmosphere has been poisoned, charged as it is with hydrocarbon vapors, methane, carbon monoxide, carbon dioxide and soot. Acid rain, oil spillages and oil blowouts have devastated Ogoni territory. High-pressure oil pipelines crisscross the surface of Ogoni farmlands and villages dangerously. The results of such unchecked environmental pollution and degradation include the complete destruction of the ecosystem.

Shell disputed these charges, saying that they had been "dramatized out of all proportion." Shell argued that the land it had acquired for operations comprised only 0.3 percent of the Niger Delta. Three-quarters of Shell's operations were constructed before 1973 and were in full compliance at the time they were built. The company maintained a regular program of upgrading and replacing its

pipelines and other infrastructure, including a program to bury above-ground flow lines. The company asserted that it was in compliance with all relevant laws and regulations and that it attempted to remediate all oil spills. Moreover, Shell charged, many of the oil spills in the area had been caused by sabotage, for which it could not be held responsible.

One of the most hotly contested oil spills in the area had occurred in Ebubu (near Ogoniland), around a quarter century earlier. By all accounts, this was a major spill, with severe ecological and economic consequences. Crude oil had spread over 10 hectares (about 25 acres), penetrated deeply into the soil, and contaminated nearby waterways. The oil had burned and crusted over, leaving the land useless. Ogoni activists blamed Shell for the spill and vigorously criticized the company for failing to clean it up adequately. Shell, however, maintained that the Ebubu spill had been caused by retreating Biafran troops, during a period when the company had temporarily withdrawn from the area because of the civil war.

The relationship between human population and oil development in the region was complex. Ogoni activists claimed that Shell had insensitively located its pipelines and other infrastructure too close to human settlements. Shell pointed out, however, that the population of the Niger Delta had more than doubled during the 40 or so years that the company had operated there. In many cases, people had been drawn to the oil facilities in search of jobs, settling near pipelines and flow stations.

The Niger Delta was one of the world's largest wetlands, a vast floodplain built up by sedimentary deposits at the mouths of the Niger and Benue Rivers. In a comprehensive study of environmental conditions in the Niger Delta completed in 1995, the World Bank found evidence of significant environmental problems, including land degradation, overfishing, deforestation, loss of biodiversity, and water contamination. The study did find evidence of air pollution from refineries and petrochemical facilities and of oil spills and poor waste management practices at and around pipelines, terminals, and offshore platforms. Most of the Delta's environmental problems, however, the World Bank concluded, were the result not of oil pollution but rather of overpopulation coupled with poverty and weak, poorly enforced environmental regulations.

~~Over the past decade, Shell has been accused of causing environmental damage in the Niger Delta region of Nigeria. The company has been accused of causing oil spills, deforestation, and other environmental damage. Shell has denied these accusations and has stated that it is committed to environmental protection and sustainable development. Shell has also stated that it is working to improve its environmental performance and to address the concerns of the Niger Delta region.~~

During the early 1990s, Shell Nigeria became involved in a joint venture known as the Nigeria Liquefied Natural Gas (LNG) project. The aim of this project, in which Shell was a 26 percent shareholder, was to pipe natural gas to a liquefaction plant and from there to ship it abroad in special ships at supercooled temperatures. In late 1995, plans were under way for construction of an LNG processing facility that would be fully operational by 1999; all flaring was scheduled to cease by 2008.

Contrary to charges made by some of Shell's critics, Nigeria did have some environmental regulations in place, dating from 1992. These laws, which were enforced by the federal Department of Petroleum Resources, set emissions standards, restricted toxic discharges, required permits for handling toxic wastes, and mandated environmental impact studies for major industrial developments. Regulatory institutions were poorly developed, however, and government authorities had little incentive to vigorously enforce the country's environmental rules.

Civil Disturbances in the Niger Delta

During the early 1990s, civil disturbances in Ogoniland and other Delta communities, many directed at Shell, escalated. In one typical incident, as reported by Shell,

A gang of youths stormed a drilling rig in the Ahia oil field looting and vandalizing the facility and rig camp. Rig workers were held hostage for most of the first day while property worth \$6 million was destroyed or stolen. The rig was shut down for 10 days and the Ahia flow station was also shut down. [A protest leader] raised the issue of [distribution] of oil revenues to the oil-producing communities by the government, the need for a new road, and rumors of bribery by Shell of a [local] chief.

Most of the civil disturbances followed a similar pattern. A group of young men, armed with whatever weapons were readily available, would attack one of Shell's many far-flung oil installations in the Delta. Employees would be attacked, equipment would be sabotaged, and the group would make demands.

Shell's own data on patterns of community disturbances in the Niger Delta revealed a pattern of escalating violence throughout the early 1990s, peaking in 1993. Shell estimated that the company sustained \$42 million in damage to its installations in Ogoniland between 1993 and the end of 1995, as a direct result of sabotage.

One of the most highly publicized of these incidents occurred at Umeuechem, about 30 miles from Ogoniland. Shell later posted on the Internet a description of this event:

[This] incident happened when armed youths invaded and occupied a rig location and nearby flow station, chasing off staff who were not given the opportunity to make the location safe. The youths demanded N100 million naira, the Nigerian currency, at that time worth about \$12.5 million, a new road, and a water scheme. Attempts to talk with the youths, who were armed with guns and machetes, failed.

In response, Shell staff called the Nigerian authorities, who sent in a Mobile Police unit. The Mobile Police were widely known in Nigeria as the "Kill-and-Go Mob" because of their undisciplined behavior. In the ensuing riot, at least one policeman and seven civilians in the local village were killed. Shell concluded its posting, "The Shell response to the threatening situation was made with the best intentions and what happened was a shock to staff, many of whom had friends [in the village]."

The relationship between these community disturbances and MOSOP was complex. Saro-Wiwa's group explicitly rejected violence and repeatedly disavowed vigilante attacks on Shell or other companies, and Saro-Wiwa himself frequently toured Ogoniland to restore calm. Yet publication of the Ogoni Bill of Rights and MOSOP campaigns focusing attention on injustices suffered by the Ogoni clearly had the effect of boosting expectations within Ogoni society. In this context, many young unemployed Ogoni men simply took matters into their own hands.

The escalation of violence against the company posed a difficult dilemma for SPDC executives. Shell Nigeria officials stated that the company did not want military protection, preferring dialogue with local communities. When it was impossible to operate safely, the company's practice was simply to withdraw its personnel. (The one exception was the two coastal terminals; considered strategic areas by the government, the harbors' oil-loading areas were protected by military troops.) The company's own personnel were not armed. However, Nigerian police

officers known as *supernumerary police* were routinely assigned to protect oil facilities, including Shell's. The company paid these officers directly and was responsible for supervising, training, and equipping them. In one instance in 1982, Shell purchased 107 handguns for use by supernumeraries protecting its facilities. Shell defended these practices, saying it was normal in Nigeria to retain police protection in areas where violent crime was a daily occurrence.

Several human rights organizations and the civil unrest in Ogoniland, Shell began to work more directly with the military to coordinate security. The Nigerian Civil Liberties Organization reported that Shell-owned cash businesses and shops were regularly used to store police and military personnel and their families. Human Rights Watch reported that Shell regularly withheld payments to the Rivers State police and security operations. Shell denied existing allegations that the company paid the company police, but the company also stated that the United Nations had been a source of daily messages dealing with the Mobile Police.

On January 3, 1993, MOSOP held a massive rally to mark the start of the Year of the Indigenous Peoples. Hundreds of thousands of Ogoni and other people attended by as many as 300,000 people. The rally was held in Port Harcourt, a major Nigerian port city. Two weeks after the rally, Shell abruptly announced that it would withdraw from Ogoniland. It laid off all employees and shut down its operations. Company officials gave an explanation: "The crisis of our staff working in areas where it is a life or death situation."

Taking a Hard Line

After General Abacha took power in November 1993, he apparently decided to take a hard line with the Ogoni. Whether this was an effort to crush the Ogoni movement, to keep other ethnic groups from following their example, or to make the area safe for the resumption of commercial oil operations, or all three, was not clear. One of his first acts as a head of state was to dispatch a special paramilitary force, composed of selected personnel from the army, navy, air force, and police, to restore order in Ogoniland and elsewhere in the Rivers State. Paul Okuntimo, a notorious military officer who publicly boasted of his proficiency in killing people, headed the special force.

According to an alleged government memo, dated May 12, 1994, the purpose of Okuntimo's force was to ensure that those "carrying out business ventures in Ogoniland are not molested." The memo also noted, "Shell operations still impossible unless ruthless military operations are undertaken for smooth economic activities to commence." It advised the governor of Rivers State to put "pressure on oil companies for prompt regular inputs as discussed." Shell challenged the authenticity of this document and adamantly denied making any direct payments to the military authorities for this purpose.

In May and June 1994, there was violence erupted in Ogoniland. Amnesty International, which collected eyewitness accounts, reported that the government's paramilitary force in Ogoniland, which "included a large number of technical staff who have previously participated in being groups. The United States and the United Kingdom have been reported to have provided arms and training to the military. In May and June, the force of 300 men and 100 vehicles, which members of the army and navy, destroyed homes, killed and injured people, and looted property. The force also destroyed and looted property, including homes, schools, and churches. Amnesty International put a number of 2000 lives may have been killed.

In 1995, despite Okuntimo's efforts, Shell had still not returned to Ogoniland. Claude Ake, a well-known Nigerian political economist, described the situation in the Delta in December 1995: "The flow stations, that is the operational bases of the oil industry, operated under armed presence. This is a process," he added, in a chilling phrase, "of the militarization of commerce."

The Arrest, Trial and Execution of Saro-Wiwa

On May 21, 1994, just over a week after the "smooth economic activities" memo, Saro-Wiwa was en route to a MOSOP rally where he was scheduled to speak. On the way, his car was stopped at a military roadblock, and he was ordered to return home. He never attended the rally. Later that same day, a group of Ogoni chiefs, founders of MOSOP who had resigned in 1993 and become political opponents of Saro-Wiwa, held a meeting. Their gathering was interrupted by a crowd of several hundred youths, who denounced the men as "vultures" who had collaborated with

the military government. Four of the chiefs were assaulted and bludgeoned to death.

Later that day, Saro-Wiwa and several other leaders of MOSOP were arrested. In a televised press conference, the governor of Rivers State blamed the MOSOP leaders for the murders. Saro-Wiwa and his colleagues were detained in a secret military camp, where they were chained in leg irons and denied access to medical care. It would be eight months before they were formally charged.

During Saro-Wiwa's imprisonment, his brother, Owens Wiwa, met on at least two occasions with Shell Nigeria's managing director, Brian Anderson, to seek his help in securing Ken's release. Wiwa's and Anderson's later accounts of these conversations differed sharply. Wiwa said that Anderson had told him that it would be "difficult but not impossible" to get his brother out of prison. Anderson allegedly said that if MOSOP stopped the international campaign against Shell, he might be able to intervene. Wiwa refused, he said. For his part, Anderson acknowledged that he had met with Wiwa as part of an effort at "quiet diplomacy," but he denied his specific allegations as "false and reprehensible." Anderson reported that Wiwa had offered to stop the campaign against Shell if the company intervened to help his brother. Anderson said that he was not willing to make that kind of deal and that Shell could not have stopped the executions in any case, because the company had very little influence with the military government.

In November, General Abacha appointed a Civil Disturbances Special Tribunal to try the case of the MOSOP leaders. Established by special decree, this tribunal was empowered to impose the death penalty in cases involving civil disturbances. The decision of the court could be confirmed or disallowed by the military government, but defendants had no right of judicial appeal. Amnesty International and many other human rights organizations denounced the tribunal for violating standards of due process guaranteed by Nigeria's own constitution and by international treaties.

Saro-Wiwa's trial for murder began in February 1995. Prosecution witnesses testified that Saro-Wiwa had relayed a message to his youthful supporters, after the roadblock incident, to "deal with" his opponents. Saro-Wiwa's defense attorneys countered that Saro-Wiwa had been at home at the time and had had nothing to do with the killings.

On October 31, the tribunal found Saro-Wiwa and eight other MOSOP leaders guilty of murder and sentenced them to death. Six defendants were acquitted. On November 2, Royal Dutch/Shell chairman Cor Herkströter sent a letter to General Abacha, appealing for mercy for Saro-Wiwa and his codefendants. In Nigeria, Brian Anderson spoke out publicly for clemency on humanitarian grounds. Around the world, many political leaders and human rights organizations also called on the Nigerian government to spare Saro-Wiwa.

The military authorities, however, moved swiftly to carry out the sentence. On November 10, Saro-Wiwa and eight MOSOP associates were hanged in prison. His last words on the gallows were: "Lord, take my soul, but the struggle continues."

With Deep Regret

Shell issued a statement on the executions that read, in part, "It is with deep regret that we hear this news. From the violence that led to the murder of the four Ogoni leaders in May last year through to the death penalty having been carried out, the human cost has been too high." Earlier, Shell had told reporters that it would have been inappropriate to have intervened in the criminal trial. "A commercial organization like Shell cannot and must never interfere with the legal processes of

any sovereign state. Any government, be it in Europe, North America, or elsewhere, would not tolerate this type of interference by business.”

The company also defended its actions in the months leading up to Saro-Wiwa’s arrest and trial. Shell representatives stated that it would have been wrong to have tried to influence government policy on Ogoni autonomy or other political issues of concern to MOSOP. An executive told the news media, “Our responsibility is very clear. We pay taxes and [abide by] regulation. We don’t run the government.” Shell also vigorously resisted demands by some human rights activists and environmentalists that the company withdraw from Nigeria. If the company withdrew its 250 or so expatriate managers, the government or another oil company could easily take over the operation and continue to run it, very possibly with lower environmental, safety, and human rights standards.

Shell’s public disclaimers did little to slow down the controversy swirling around the company. By mid-1996, the company was facing calls for an international gasoline boycott, external pressure to abandon plans for its liquefied natural gas project, and persistent demands that it withdraw from Nigeria altogether. The crisis threatened the company’s reputation and relations with stakeholders, not only in Nigeria, but throughout the world.

Discussion Questions

1. What are the arguments for and against Shell in Nigeria? How would Shell’s courts of appeal? Do you believe Shell could have done anything differently in Nigeria?
2. What are the arguments for and against Shell’s withdrawal from Nigeria?
3. Evaluate Shell’s actions in Nigeria. How do you think Shell should have handled the situation? Do you believe Shell was in compliance with the law? Do you believe Shell was doing what was appropriate and just?
4. How do you think Shell should have handled the situation?
5. What do you think Shell should do?

In the late 1990s, Shell International underwent a remarkable transformation. Various terms by observers a “sea change,” a “mid-life crisis,” and a “dramatic overhaul,” the company undertook a deep and systematic effort to remake itself. In the process, Shell radically changed its organizational structure, its culture, its relationship with stakeholders (including its most vocal critics), its reporting practices, and, indeed, even its very business principles. In the end, it set out to become an organization in which financial, social, and environmental performance were equally valued and fully integrated.

A cover story in *Fortune* in 1997 was pointedly titled “Why Is the World’s Most Profitable Company Turning Itself Inside Out?” To some, this transformation represented wrongheaded New Age tampering with a proven management formula. To some, it was nothing more than a sophisticated public relations offensive to repair a reputation badly tarnished by human rights abuses in Nigeria, the controversy over the disposal of the oil rig Brent Spar, and struggles with shareholder activists over corporate governance. To others, though, it represented more. To them, Shell’s multilevel struggle to transform itself was the most ambitious effort ever by a major multinational corporation to define a new relationship between business and society in a world of rapidly changing public expectations.

The Campaigns against Shell

The early to mid-1990s were a period when international environmentalist, human rights, and shareholder campaigns directed against Shell gathered intensity. Three

separate but related campaigns—opposing at-sea disposal of old offshore oil facilities, alleging human rights abuses in Nigeria, and backing shareholder resolutions for reforms in corporate governance—focused a spotlight of often negative publicity on the world’s most profitable multinational corporation.

The Brent Spar Incident

A watershed event in Shell’s transformation was what came to be known as the Brent Spar incident. The Brent Spar was an oil storage and loading buoy in the North Sea, about 100 miles off the coast of Scotland. Although a unique structure, it was one of several hundred North Sea installations, many nearing the end of their useful lives.

In 1991, Shell took the Brent Spar out of service and began looking at options for disposing of it. According to international and British law, operators were required to determine the best practical environmental option for disposal. This could involve either sinking the platform in the deep sea or removing and dismantling it on land. Government approval was required. In April 1995, after extensive consultations with outside experts about possible options, Shell announced its intention to dispose of the Brent Spar at sea, and British authorities agreed.

The plan quickly ran into resistance from Greenpeace, however. At the time, Greenpeace was the largest environmental organization in the world, with a full-time staff of 120, a budget of about \$50 million, and a penchant for confrontational tactics. Greenpeace believed that toxic residue in the Brent Spar’s tanks would harm the marine environment and that its disposal at sea would set a precedent for other, soon-to-be decommissioned oil installations.

On April 30, 1995, Greenpeace activists boarded and occupied the abandoned buoy. After a three-week standoff, Shell personnel, aided by local law officers, evicted the protesters nonviolently. The company defended its decision to sink the Brent Spar in full-page newspaper advertisements and began towing the rig toward the open sea. However, the Greenpeace occupation and resulting media coverage had galvanized public opinion, especially on the Continent. By mid-June, government officials of Belgium, Denmark, Sweden, the Netherlands, and Germany had asked Shell to postpone sinking the Brent Spar. Meanwhile, a consumer boycott had gathered steam. In Germany, Shell franchise owners reported a 50 percent decline in sales over a two-week period. Several Shell gas stations, also in Germany, were anonymously firebombed. The British prime minister continued to support Shell, however; and the boycott was less successful in Britain.

On June 20, Shell abruptly changed course, announcing that it had decided to abandon its plan to dispose of the Brent Spar at sea and to seek a permit for onshore disposal. In a statement, the company said, “The European Companies of the Royal Dutch/Shell Group find themselves in an untenable position and feel that it is not possible to continue without wider support.” The company moved the buoy to a Norwegian fjord, while it considered further actions. Greenpeace later acknowledged that it had seriously erred in its estimate of the amount of toxic residue in the Brent Spar’s tanks and apologized.

Human Rights in Nigeria

Just a few months later, the execution of Ken Saro-Wiwa and his colleagues in Nigeria on November 10, 1995 (described in the preceding case, “Shell Oil in Nigeria”), led to what *Fortune* referred to as a “global uproar.” Much of it was directed at the government of Nigeria, which was summarily suspended from the

Commonwealth of Nations at the urging of President Nelson Mandela of South Africa. Other countries called for an arms embargo, sports boycott, and freezing the foreign bank accounts of the pariah nation's military leaders.

But much outrage was also directed at Shell, which was perceived by many as not acting forcefully to prevent Saro-Wiwa's execution. Environmentalist organizations, particularly, spoke out. The chairman of Greenpeace U.K. told the press, "There is blood on Shell's hands. Ken Saro-Wiwa was hanged for speaking out against Shell. He was trying to secure the most basic of human rights—the right to clean air, land, and water." The Sierra Club promoted a boycott of the company under the slogan "(S)hell no, corporate accountability yes," and urged its supporters to cut up their Shell credit cards, boycott Shell products, and participate in protest demonstrations.

One of the organizations most involved in the protests against Shell was The Body Shop International (BSI), the beauty products retailer chaired by social activist Anita Roddick. BSI initiated a major protest campaign against Shell, which included the perhaps unprecedented event of one corporation publicly accusing another of murder. Greenpeace, The Body Shop International, and Friends of the Earth ran a full-page advertisement with a photograph of a gas flare under the heading, "Dear Shell, This is the Truth. And it Stinks." Protest demonstrations featured hooded dummies dangling from nooses.

Shareholder Activism

Against the backdrop of the controversies over Brent Spar and Nigeria, a coordinated campaign by shareholder activists critical of Shell moved forward, placing into public debate issues that had previously been solely the prerogative of management.

Although developed in the United States, the movement to protect investors was gaining ground in the United Kingdom in the early 1990s. A similar movement was an organizational Persons and Investor Read Consultants (PIRC) PIRC's goal was to shed light on areas of corporate governance and to promote solely responsible management. What if 25% of organizations worked primarily with public employees in firms that worked with religious organizations who stockholders, some of which were members of the Financial Conduct Authority (FCA) and which claimed to own and with this of companies with the highest PIRC share of total assets, PIRC pushed the directors to put them in

In 1995, in response to the Nigeria and Brent Spar controversies, PIRC requested the first of what was to be a series of meetings with Shell officials. There, it made the first of several proposals to Shell reflecting its members' concerns with ethics, environmental policy, and corporate governance generally.

Initiating Organizational Change

In early 1994, more than a year before the Brent Spar, Nigeria, and shareholder campaigns erupted, Shell management had initiated a process of internal organizational change, aimed at improving the Group's financial performance relative to its competitors.

At the time, Shell's return on average capital employed (ROACE), a common measure of performance in the petroleum industry, showed that the company lagged behind many of its competitors. Although Shell remained very profitable (in fact, in 1994 it earned more profit than any other company in the world), other big oil companies, including rivals British Petroleum, Exxon, and Mobil, were enjoying significantly higher ROACE. Of particular concern to Shell executives were hypercompetition from discount retailers and weak sales of nonfuel products, such as food and convenience items, at the retail level. To help improve the company's profitability, the company engaged the services of management consultants McKinsey & Company to lead an

extensive internal review. McKinsey quickly focused its attention on the company's organizational structure.

Since the 1950s, Royal Dutch/Shell had used a matrix form of organization. Under this structure, the chief executive of the national operating companies reported simultaneously to two superiors: a regional manager and a product manager. For example, the managing director of Shell Nigeria would report both to a regional coordinator for Africa and to the coordinator for exploration and production. In addition, staff at Shell's headquarters in London and The Hague provided functional expertise in finance, legal matters, human resources management, and external affairs. (Shell U.S., the largest of the Group companies, maintained its own staff of functional specialists and operated for most purposes independently.) At the time, it was believed that this matrix organization benefited Shell by devolving power and balancing interests.

In March 1995, Shell concluded the first phase of its internal review by announcing a plan to reorganize into five worldwide business units. These were exploration and production, oil products, chemicals, gas and coal, and central staff functions. The five units would be overseen by committees of senior executives, who would report to the committee of managing directors (CMD). Under this plan, managers of the operating companies would report only to their business unit superiors, in a single line of command, thus eliminating the matrix, which was perceived as unnecessarily complicated. Excess staff at the center was also cut. The restructuring was intended to enable the company to focus more efficiently on the needs of its business and retail customers.

Talking about a "New Shell"

Even as Shell announced its intended organizational redesign, however, external pressures on the company, as well as internal debate, had the effect of shifting the focus of the transformation process to the softer issues of the company's reputation and relations with stakeholders. The key events took place in a series of retreats for top executives held in late 1995 and early 1996.

In 1995, Shell had engaged the services of a group of private management consultants to lead the next phase of the transformation process. In a series of exercises, conducted at retreats in 1995 and early 1996, these consultants asked directors and a selected group of top executives from the operating companies to "hold up a mirror" to reflect their own practice. Their objective was to develop a "diagnosis of current reality" that could serve as a starting point for further changes aimed at improving corporate profitability.

To the apparent surprise of both the consultants and Shell's top leaders, discussion began to shift, seemingly spontaneously, from strictly business matters to Shell's social and environmental performance. Many participants at the retreats wanted to talk not about profitability but about the fact that Shell was being pilloried in the press as a corporate murderer. At first, the top leaders present tended to dismiss the relevance of Brent Spar and Nigeria to the business problems the company faced. But as the discussion proceeded, the attitude of the leadership appeared to change. One of the consultants present, Philip H. Mirvis, later recalled:

The leadership stepped up □.□.□.□.□ Cor [Herkströter, chairman of the CMD] was essentially saying, "We own this problem. It is not a technical problem, if only we had had a better analysis with the Brent Spar. This is not a relationship problem, if only we had had a better relationship with the government, or if we had had a different government in Nigeria, this wouldn't have happened. We as leaders are responsible for this result." Quite frankly, Cor had a sense of shame over his own leadership and the leadership of the CMD. This sent a gasp through the organization. This was an

organization that was Teflon, bulletproof, apologized for nothing, admitted to nothing, and so on. To see the leadership taking on responsibility and expressing a deep sense of remorse over this opened the gates for a dialogue about what are we doing, what are we responsible for, what is the role of our company around the globe, and so on.

The willingness of Shell’s leaders to take responsibility for what had happened, Mirvis later wrote, “legitimated expressions of guilt and anger over past wrongs and, in effect, assigned some blame to the corporate culture.” The consultants used this opening to ask executives to write personal stories that expressed their vision of where they had been and where they wanted to go and to share them with each other and their staffs. This process was then repeated at lower levels of the organization.

Mark Moody-Stuart, a member of the CMD (and later Herkströter’s successor as chairman), framed Shell’s problem as the need for a new mind-set that paid greater attention to societal expectations. In Mirvis’s words:

Mark Moody-Stuart should be credited with the intellectual framing of this. Shell was an engineering-type company □.□.□.□ a very technical organization and essentially a very bureaucratic organization □.□.□.□ What Mark said was that the technical mind-set, our rational, logical approach, is blinding us to a world out there of human rights activists, of environmentalists, of governments with different wants and interests and changing customer tastes, expectations of the public, et cetera. We are so internally focused, so technical, that we are missing a whole set of opportunities and a whole new reality out there □.□.□.□ We are not talking any more about a structural change in the organization; we are not even talking about new leadership per se. We are talking about a new Shell.

Evaluating Society’s Changing Expectations

Once the CMD became convinced that it had failed to meet the “new reality” of changing expectations, the directors quickly undertook a series of interrelated initiatives to improve Shell’s social and environmental performance and the public’s perception of its corporate citizenship. These involved a study of society’s perceptions of the company, revision of the company’s business principles, and a new approach to reporting and verifying its social and environmental performance to stakeholders.

On Shell’s own terms, the study was a response to the need to address the public’s growing concerns about the company’s social and environmental performance. The study was conducted in 1976 and 1977. It was a public relations exercise designed to improve the company’s image and to address the public’s concerns about the company’s social and environmental performance.

As might be expected, the study was conducted in a number of ways. For example, Shell conducted a survey in Latin America, which was widely perceived as an effective provider of its products, and in Africa, which was the developing countries that depended on Shell for energy. The survey was conducted in the form of a questionnaire. Overall, however, the study was a success. It was a success because it led to a number of changes in the company’s social and environmental performance.

Revision of the Statement of General Business Principles

As a direct result of the Shell Study, the Statement of General Business Principles (SGBP) first developed in 1976, the SGBP sought to define the company’s core values. Now, the need to revise the SGBP had to be revisited in light of the changing environment in which the company operated. Accordingly, in 1996, the company conducted a major review of the SGBP. The process included a distribution of hundreds of questionnaires and scores of interviews with managers in 80 operating companies and a data mining exercise in the SGBP that added a new dimension to the principles. The principles were revised to reflect the changing environment.

In March 1997, Shell published a revised Statement of General Business Principles. Although similar in most respects to the earlier document, the revision included three significant changes recommended by Integrity Works. First, the company declared its support for “fundamental human rights in line with the legitimate role of business.” (Shell did not explicitly endorse the Universal Declaration of Human Rights in the revised business principles, although it did do so later in other documents.) Second, the company committed itself “to contribute to sustainable development.” Finally, the revisions clarified the company’s stand on political activity. The earlier formulation, which emphasized abstention from politics, was replaced with language stating the company’s intention to abstain from *party politics*, while emphasizing its right and responsibility to make its position known to governments on matters affecting the company or its stakeholders.

All operating companies were instructed to adopt the revised principles as their own policy. Beginning in 1998, these companies’ chief executives were required to confirm in writing annually to the CMD that they were in compliance with the revised principles or, if not, where they fell short. The compliance letter requirement focused the attention of operating managers on the changes and ways in which their actions were consistent, or inconsistent, with the company’s values.

With the assistance of Amnesty International, Shell also developed a primer, *Business and Human Rights*, explaining what the commitment to human rights meant in practical terms.

Resolution 10

In early 1997, the Pensions and Investment Research Consultants (PIRC) decided that Shell, despite its efforts, had still not addressed its concerns satisfactorily. The investor activists therefore decided to place a resolution before the shareholders at the May annual general meeting (AGM) of Shell Transport and Trading. Resolution 10, as it came to be known, was jointly sponsored by 18 institutional investors.

The resolution called on Shell to take three actions. These were to place a director (board member) in charge of environmental and corporate responsibility; to monitor, externally audit, and report to shareholders on its environmental and social policies; and to issue a report by the end of the year on the company’s operations in Nigeria. Resolution 10 generated intense media and shareholder interest.

The company recommended a vote against the resolution and issued a statement in response that stated, in part:

Your Directors, and all Royal Dutch/Shell Group of Companies, consider that environmental and corporate responsibility policies are an integral part in the proper conduct of the Group’s business activities. Your Directors reject the implication in this resolution that the Group does not have effective policies in place.

In spite of the company’s opposition, of the 46 percent of shares that were voted, 10.5 percent supported the resolution and 6.5 percent abstained. Although the resolution failed, support for it was much higher than support for virtually any other such social responsibility resolution introduced that year by shareholder activists in Europe or the United States.

Although Shell opposed Resolution 10, it moved quickly to institute some organizational changes requested by its shareholder critics. In late 1997, Shell established a social accountability team, consisting of six members of the

committee of managing directors and one representative each from Shell and Royal Dutch. Herkströter was given overall responsibility for environmental and corporate responsibility policies. A new position, manager for social accountability, was created.

Social and Environmental Reporting

Shell considered that an important element in its corporate responsibility initiative was to be publicly accountable not only to its shareholders but also to its other stakeholders and society at large. Accordingly, it began publishing a series of reports that went well beyond traditional annual financial reports.

In April 1998, the company published its first annual *Shell Report*, subtitled *Profits and Principles—Does There Have to Be a Choice?* This unusual document reported on Shell's commitment to human rights, environmental protection, and corporate citizenship. It also invited others to join with the company in a global debate on the responsibilities of multinational corporations. In its introduction, the report stated:

This Report is about values. It describes how we, the people, companies, and businesses that make up the Royal Dutch/Shell Group, are striving to live up to our responsibilities—financial, social, and environmental. It is also an invitation to you to tell us what you think of our performance.

The report also included a list of examples of how the company's self-interest was met by the actions of its employees and contractors. It also included a list of questions and answers. Many of the questions had been subject to extensive public debate in the United Kingdom. For example, a question was: "Under what circumstances should a company be allowed to operate in an area where the government has not granted a license?" The report also included a list of issues such as:

The report also included an essay by John Elkington, chairman of SustainAbility, a consultancy specializing in advising corporations on sustainable development. In this essay, Elkington presented his concept of the *triple bottom line*, arguing that companies had a duty to provide audited reports not only of their financial performance but of their social and environmental performance as well. The report concluded with a road map for the future. Shell followed up *Profits and Principles* with a *Health, Safety, and Environment Report* and *Shell's Investment in Society*, reporting specifically on its environmental and social performance. All three reports were intended to be annual publications.

Although Shell had opposed PIRC's 1997 shareholder resolution calling for external auditing of its environmental performance, it now undertook to provide independent verification of its social and environmental reports. This goal presented unique challenges. The scope of practices to be audited was worldwide and complex. Moreover, unlike financial reporting, where auditing practices were well established, meaningful measures of social and environmental performance were not generally accepted. The company set out to work with its auditors, KPMG and PriceWaterhouse, and others to develop social and environmental accounting and assurance standards. In *Profits and Principles*, the company set out a timetable leading to integrated, externally verified reporting for its financial, social, and environmental performance by 2002.

The company's July 1998 *Health, Safety, and Environment Report* was the first independently verified audited environmental report ever published by a multinational oil company. The auditors, KPMG and PriceWaterhouse, acknowledged that the job had "proved to be a considerable challenge" because of the "absence of established generally accepted international standards for the

verification of HSE data.” The initial cost to audit Shell’s health, safety, and environmental data in 30 entities worldwide in 1998 was around \$2 million.

To bring the message of these reports to a wider public, Shell in 1999 initiated a \$25 million “profits and principles” advertising campaign. Its purpose, in the words of Mark Moody-Stuart, was “to keep all of our stakeholders informed, both about the issues themselves and the work we at Shell are doing to address those issues.”

Dialogue with Stakeholder Organizations

During this period, Shell initiated a program to engage with stakeholders in some of its most volatile and high-profile areas. This was accomplished through a number of initiatives, such as the *Profits and Principles* website, which was developed to allow stakeholders to submit comments on Shell’s website, which primarily covers its commercial activities. Some of the comments were posted on the website, while others were posted on a separate website. The comments were posted on a separate website, which was accessible to the public. The comments were posted on a separate website, which was accessible to the public.

In addition to opening itself up for freewheeling public comment, Shell also engaged in written and face-to-face dialogue with stakeholders, including community activists and human rights, environmentalist, and corporate governance organizations. The engagement process was coordinated by Shell’s Department of External Affairs, but it involved managers at many levels throughout the Group.

The Human Rights Dialogue

One such dialogue occurred with two human rights organizations, Amnesty International and Pax Christi. In December 1995, in the wake of Ken Saro-Wiwa’s execution, Pax Christi—a Catholic lay organization devoted to promoting world peace, human rights, and economic justice—wrote Shell asking the company to speak out on the issue of human rights in Nigeria. Herkströter replied, responding to specific points in the letter and inviting Pax Christi to engage in further discussions.

Pax Christi asked Amnesty International, with which it shared many concerns, to join it in this process. At that time, Amnesty International was probably the best-known human rights organization in the world, with more than a million members worldwide. Over the following three years, these two organizations engaged in an ongoing dialogue with Shell, involving an exchange of position papers, public forums, and face-to-face meetings.

In these discussions, Pax Christi and Amnesty International focused on several issues. They agreed that it was imperative that the company incorporate explicit support for the United Nations Declaration of Human Rights in its Statement of General Business Principles. The two human rights organizations urged Shell to appoint a director of human rights and to include human rights in its staff policies and to appoint a director of human rights. They recommended independent auditing of the company’s human rights practices. One portion of the discussion focused specifically on the situation in Nigeria and Shell’s relationship with Saro-Wiwa and his relationship to the Nigerian military authorities.

In some cases, the company made specific changes in response to the NGOs’ recommendations. For example, the NGOs raised questions about the adequacy of the guidance provided to police assigned to protect Shell’s property and for failing to require accountability for possible police misconduct. In response, Shell reviewed its policies and made specific changes to bring them into compliance with United Nations standards. The company also updated the plastic wallet-sized cards distributed to police assigned to Shell facilities, summarizing the company’s revised human rights policies. In other situations, by contrast, Shell declined the NGOs’ recommendations. For example, the company declined to appoint a director of human rights, saying that its current corporate governance procedures were sufficient.

The Brent Spar Dialogue

After reversing its initial decision to seek deep-sea disposal of the Brent Spar, Shell initiated a two-year-long dialogue with its environmental critics, including Greenpeace. In October 1995, the company announced an international competition to solicit innovative solutions to the problem of what to do with the decommissioned rig. It also sponsored open meetings in the United Kingdom, Germany, Denmark, and the Netherlands to discuss various options. These gatherings were facilitated by an independent organization, the Environmental Council, which worked with groups to find common ground in environmental disputes. After winnowing the list of possible options, in 1997 Shell held yet another round of public meetings in all four countries, accompanied by a CD-ROM describing the short-listed options.

Finally, in January 1998 Shell announced its selection of a solution: to recycle the Brent Spar as a ferry quay near Stavanger, Norway. So-called Ro/Ro (roll-on, roll-off) ferries, which carried both cars and people, were widely used in Norway, with its mountainous terrain and miles of coastline. Under the plan, the Spar would be disassembled, and its flotation tanks and other parts reused to construct a Ro-Ro dock. The ferry quay solution appealed to environmentalists, who liked the idea of putting the old rig to good use. The British government quickly approved the plan, and construction began in late 1998.

Shell later commented that the Brent Spar experience “taught us the value of dialogue with our critics and other interested parties. . . . This unique consultation exercise has helped promote a different approach to decision making in the Group, and has shown new ways in which Shell companies can be more open and accountable.” In a speech, a Shell executive later described this new approach as a switch from DAD—decide, announce, and defend, to DDD—dialogue, decide, and deliver.

In addition to its dialogues with human rights organizations and environmentalists, Shell also continued to meet with shareholder activists, religious leaders, and other stakeholders during this period.

Continuing Challenges of Corporate Responsibility

Over a four-year period, Shell had undergone a major transformation. It had undertaken a revision of its business principles, an internal structural reorganization, a survey of its global reputation, and externally audited reports on its social and environmental performance. It had conducted hundreds of meetings with stakeholders, and changed its corporate policies in many areas.

What did the “new” Shell’s proclaimed environmental and social commitments mean in practice? What changes did managers and employees on the ground in the Group’s scores of operating companies do differently, if anything, as a result of the transformation of Shell? In its far-flung worldwide operations, the company continued to face daily challenges to act in a manner consistent with its support for human rights, sustainable development, and social responsibility. To some, the company was making marked progress toward meeting society’s changing expectations. To others, it continued to fall short, focusing more on changing the public’s perception than on changing its actual practice.

In an interview in July 1999, chairman Mark Moody-Stuart reflected on Shell’s transformation process:

I think that the main goals [of the transformation] were to make sure that we were internally effective, that we made best use of our resources, our assets, our people. . . . But, also, that we had this connection to society and to the customers. . . . [It] is the society that commercial organizations have to serve, no matter what you do. Even if you are a baker making bread, you had better know what the trends are on bread in the society. If people are

going to give up eating bread, you had better know about it. If they like chocolate bread, you had better know about that. . . . You can't divorce the two. People sometimes try to do that. They say, all this societal stuff is woolly, we should stick to commerce. The two are absolutely linked. . . . These soft issues are really business issues because we are part of society, and members of society are our customers. So, our impact on society really matters commercially.

Discussion Questions

1. In the 1990s, Shal was a transformation. What were the key changes that Shal made in its organization structure and relationships with its competitors and business partners? What findings, if any, do you believe Shal should have made?
2. In your opinion, what was the most important cause of Shal's transformation? Do you believe the company was motivated by external pressures or by internal pressures? Why do you think so?
3. Some people believe Shal was in the drug business and had decided that the company's transformation was mainly for to manipulate public opinion. What is your opinion? How would you best determine the answer to this question?

By Anne T. Lawrence. Copyright © 2002 by the author. All rights reserved. An earlier version of this case was presented at the Western Casewriters Association Annual Meeting, Palm Springs, California, March 21, 2002. The author is grateful to participants in that meeting and to Asbjorn Osland for their comments, and to Leon Levitt and Robbin Derry for their insights into the issues raised here. This case was prepared from publicly available materials, including news stories appearing in *The New York Times*, *The Wall Street Journal*, *San Francisco Chronicle*, *Scientific American*, *Dollars and Sense*, *Financial Times* (London), *Newsweek*, *Time*, and *BusinessWeek*. The case also draws on a series of reports by Oxfam. These include *Dare to Lead: Public Health and Company Wealth* (February 2001); *Formula for Fairness: Patient Rights before Patent Rights* (July 2001); *Patent Injustice: How World Trade Rules Threaten the Health of Poor People* (February 2001); and *Patent Rules and Access to Medicines: The Pressure Mounts* (June 2001). These reports are available online at www.oxfam.org.uk/cutthecost. GlaxoSmithKline's 2000 Annual Report is available online at www.gsk.com/financial/reports/ar/pdf_excel/report/report.pdf.

¹ Figures for 2000 represent the combined results for Glaxo Wellcome and SmithKline Beecham, as if they had operated as a merged entity for the entire year.

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¹⁴ "Drug Makers Agree to Drop South Africa Suit," *The Wall Street Journal*, April 19, 2001.

¹⁵ *Dare to Lead: Public Health and Company Wealth* (London: Oxfam UK).

¹⁶ *Ibid.*, p. 5.

¹⁷ "Paying for AIDS," p. 16.

¹⁸ "Joint Statement by the Chairman and the Chief Executive Officer," GlaxoSmithKline, Annual Report 2000, p. 4.

¹⁹ "South Africa Stuns AIDS Activists after Victory," *The Wall Street Journal*, April 19, 2001, p. A12.

By Rebecca J. Morris and Anne T. Lawrence. This is an abridged version of a full-length case, "Nike's Dispute with the University of Oregon," *Case Research Journal* 21, no. 3 (Summer 2001). Abridged and

reprinted by permission of the *Case Research Journal*. Sources include articles appearing in *The New York Times*, *The Oregonian*, *The Washington Post*, and other daily newspapers, and material provided by Nike at its Website, www.nikebiz.com. Book sources include J.B. Strasser and L. Becklund, *Swoosh: The Unauthorized Story of Nike and the Men Who Played There* (New York: HarperCollins, 1993); D. R. Katz, *Just Do It: The Nike Spirit in the Corporate World* (Holbrook, MA: Adams Media Corporation, 1995); and T. Vanderbilt, *The Sneaker Book* (New York: New Press, 1998). Web sites for the Fair Labor Association and the Worker Rights Consortium may be found, respectively, at www.fairlabor.org and www.workersrights.org. Ernst & Young's audit of Nike's subcontractor factories in Vietnam is available at www.corpwatch.org/trac/nike/ernst. Coverage of Nike and the WRC decision in the University of Oregon student newspaper is available at www.dailymerald.com. A U.S. Department of Labor study of wages and benefits in the footwear industry in selected countries is available at www.dol.gov/dol/ilab/public/media/reports/oiea/wagestudy. A full set of footnotes is available in the *Case Research Journal* version. Copyright © 2001 by the *Case Research Journal* and Rebecca J. Morris and Anne T. Lawrence. All rights reserved jointly to the authors and the North American Case Research Association (NACRA).

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