4

RESPONDING TO SOCIETAL FORCES

The subject of ethics forms a central element in managerial responses to societal forces. In many situations, an individual must reach a personal decision in regard to what is the right thing to do. This component of the course encourages students to focus on principles that may help them when confronted by ethical dilemmas. In this process, the individual may look to philosophy or religious beliefs concerning what is right and wrong or may turn to history and laws for guidance. Some situations may require the student to consider resigning from the corporation or becoming a "whistle-blower" by going to law enforcement authorities. Alternatively, the student may decide that it would be best to attempt to change corporate decisions over time by working from within the organization.

The case of "John McCulloch—United Beef Packers" introduces this subject with a clear personal challenge in which McCulloch believes strongly that many corporate policies are wrong in an ethical or societal sense. The objective of profit maximization has led to exploitation of particularly vulnerable immigrant workers, whereas lax enforcement of product safety regulations has put consumers' health at risk. "NES China: Business Ethics" extends this discussion of ethics to national differences in generally accepted norms and values—in this case, concerning bribery. In the "Textron" case, management recognizes that to shift manufacturing facilities to China would reduce costs substantially, but that cost reduction would involve working conditions and labor standards grossly inferior to those in the United States. In considering these issues, students will find many helpful articles in the *Journal of Business Ethics* and the *Business Ethics Quarterly.* Thomas Donaldson (1996), in a *Harvard Business Review* article, has focused on culture relativism and the search for guiding principles when making decisions in countries whose norms and values differ from those in one's home country.

Recent years have seen a proliferation of academic articles and media commentary concerning "corporate social responsibility," with the search for consistent corporate positions on these issues. Many firms have sought to develop guidelines and formal statements that can assist employees when they confront ethical dilemmas. Management may look to

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such pronouncements rather than having to focus solely on personal evaluations of each issue. However, it is not easy for an organization to develop clear and useful pronouncements. Values, cultural behaviors, and even ethical standards differ significantly among countries. For some issues, such as those relating to social interaction, there may be a general acceptance of local norms. For certain issues, such as prohibitions against bribery of government officials, some firms attempt to enforce their home-country code of conduct globally while realizing that this could handicap their financial success; other firms adapt to local practices. In each country, managers need to understand such cross-cultural differences and consider what adjustments in corporate practices would be appropriate.

Recent years have also witnessed a proliferation of stakeholder groups who believe that their views should be incorporated into the decision-making process of the firm. Stakeholders may use a variety of mechanisms to influence corporate decisions. Laws and regulations, lobbying, media relationships, and boycotts all differ substantially among countries, and so the nature and power of stakeholders also differ. Confronted with this reality, students may find it helpful to develop a decision-making framework in which they delineate the stakeholders in a particular decision, seeking to understand their interests and power in the context of social norms. Students may discuss appropriate mechanisms for consultation with relevant stakeholders, in which they can better understand the objectives of each. Such an approach can be used to generate alternative courses of action that students can then compare, recognizing that they must differentiate between the short term and the long term in reaching their decisions. Short-term gains may well lead to expensive long-term costs. With many issues, stakeholder interests and strength will vary over time, requiring continual revisitation of corporate decisions.

Several subject areas have become particularly important as the focus for corporate social responsibility and stakeholder actions. Concerns about environmental pollution now cover a host of corporate activities. Investments in new technologies to reduce pollution may be expensive, and so investment decisions can also be affected by differences in environmental regulations and labor standards, as firms locate in countries with lower standards and/or lax enforcement. Alternatively, a firm's subsidiary in a country with low standards could decide to adhere to the higher levels required in economically advanced nations. Here the subject of ethics again enters the cross-country analysis of comparative costs. Examining such societal differences and their impacts on business draws students into ethical perspectives that might not be raised in a traditional course with a domestic focus. There is a concern that corporations may tend to invest in less developed countries because they have lower environmental standards. At the same time, air and water cross national boundaries, and so corporate pollution has increasingly become an international concern, with new international agreements creating new environmental regulations. From this perspective, corporate decisions may have to be based on expectations concerning future stakeholder and government actions rather than solely the current situation.

Government programs and policies are affected by societal pressures, and societal pressures may also affect a firm directly. Societal forces differ significantly among countries, and they change significantly over time. Corruption and human rights violations have become international concerns rather than just domestic issues and have led to new international agreements that seek to create common standards. For businesses, trade sanctions in response to human rights violations pose a recurring dilemma. The repressive violation of human rights has led people throughout the world to urge their governments to place embargoes on certain countries, placing a halt to trade and investment with them.

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The current "anti-globalization debate" deserves consideration because many express the view that poverty and inequality have been exacerbated by the reduction of trade and investment barriers (Held & McGrew, 2002; Oestreich, 2002). Anti-globalization protestors blame corporations for exploiting less developed countries in their trade and investment decisions, and the "Planet Starbucks" case provides the context for a discussion concerning the validity and implications of this movement. This debate extends to the obligations that rich nations should accept in assisting poor nations in the development process, including criteria for foreign aid and debt forgiveness (Dragsbaek Schmidt & Hersh, 2000; Torres, 2001). This debate also extends to the appropriate role for international institutions, especially the International Monetary Fund (IMF) and World Bank (Stiglitz, 2002). Students have to make specific managerial decisions in the context of these societal forces.

Both shareholders and stakeholders look to boards of directors for leadership and corporate decision making in many of these societal issues. Consequently, the role and responsibilities of boards of directors have tended to increase in many countries. Meanwhile, with the extension of business activities internationally, board members face an increasingly complex array of information that they must understand and evaluate.

The recent proliferation of literature on corporate social responsibility and the role of boards of directors attracts considerable interest in the context of recent corporate scandals, as well as debates about appropriate corporate reporting (Bulik, 2002; Hartman, 2002; Hatcher, 2002; "Special Report," 2002). In examining the implications of these societal forces for management decisions, a key question is, "Whose decision is it?" For firms with branches in many countries, this question raises the allocation of responsibilities between local management and the head office. In many countries, governance practices have been changing significantly in recent years. For some societal issues, employees may have the right to participate in the decision process. The board of directors may feel that it should be the final decision maker with regard to certain societal issues, and the law may in fact require the board to bear responsibility (Grundfest, 1997; "Special Report," 2003; Stiles, 2001).

John McCulloch—United Beef Packers

John McCulloch took a job as assistant general manager at a meat packing plant with a large number of immigrant workers. After a short time in the job, he discovered it was nothing like he expected; worker safety was constantly compromised, the safety of the public from consuming tainted food was compromised, and everything was subordinated to the production line's constant movement. He had to decide whether he would stay with the company.

NES China: Business Ethics (A) & (B)

NES was one of Germany's largest industrial manufacturing groups. The company wanted to set up a holding company to facilitate its manufacturing activities in China. It authorized representatives in its Beijing office to draw up the holding company application and to negotiate with the Chinese government for terms of this agreement. To maximize their

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chances of having their application accepted, the NES team in Beijing hired a government affairs coordinator who was a native Chinese and whose professional background had familiarized her with Chinese ways of doing business. NES's government affairs coordinator found herself in a difficult position when she proposed that gifts should be given to government officials to establish a working relationship that would improve NES's chance of having its application approved. This method of doing business was quite common in China. The other members of the NES team were shocked at what would be considered bribery and a criminal offence in their country. The complementary (B) case (9B01C030) gives a brief summary of the eventual solution to this problem.

Textron Ltd.

Textron Ltd. was a family-owned manufacturer of cotton and sponge fabricated items. The company wanted to expand its business with an offshore manufacturing enterprise that would fit with the company's policy of caring for its employees and providing quality products. The company was looking at two options: a guaranteed outsourcing purchase agreement or a joint venture. After several meetings with offshore alliance candidates, the vice president of the company had to analyze the cross-cultural differences to established corporate guidelines of global ethics and social responsibility that the company could use in its negotiations with a foreign manufacturing firm.

Note on the Pollution Problem in the Mexico-U.S. Border Region

Many argue that the global expansion of capitalism threatens to create an environmental nightmare as countries compete to attract investment and generate growth, even at the cost of acting as "pollution havens" for foreign multinationals. Others point to the rising tide of environmental consciousness, along with more stringent regulations at the national and international levels, as heralding a new era of "sustainable development." Managers need to understand the various aspects of the issue to formulate and implement effective environmental strategies.

Planet Starbucks

The case details the history and development of the company, highlighting the evolution of the corporate concept of a "third place," and the key individuals in the organization in this development. The second part of the case details the international expansion activities of the firm, highlighting the potential cultural and economic challenges that it may increasingly face as it expands to more traditional coffee-drinking markets and low-income emerging markets. The third and final section of the case details the increasing pressure placed on Starbucks by the anti-globalization movement. Although Starbucks has actively pursued a number of socially responsible operating policies, such as the purchase of Fair-Trade coffee, the subsidization of health care facilities in Central America, and the introduction of a number of socially responsible coffee products in its stores, it continued to be the target of anti-globalization activities. Ultimately, the case is useful for debating

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whether a firm can be successful internationally employing a different strategy and structure than it employed in the construction of its already successful domestic business.

Siam Canadian Foods Co., Ltd.

Although relatively undeveloped compared to the rest of Southeast Asia, Myanmar (Burma) had been experiencing increasing levels of foreign investment activity in recent years. Siam Canadian Foods, which had considered entering Myanmar (Burma) in the past but declined, needed to determine if the time was now appropriate to enter the market. This case introduces the issue of human rights violations and the imposition of trade sanctions in response to these.

Royal Trustco

This case examines the role of the board of directors with regard to decisions that might jeopardize the future of the company. How should the board ensure that it is made aware of all necessary information, how should it analyze this information, how should it focus this analysis on the concrete issues facing the company, and how should it relate with management, shareholders, and other stakeholders? These questions were complicated by the firm's expansion to other countries.

John McCulloch—United Beef Packers

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In August 2003, three months after John McCulloch had started working as assistant general manager at the United Beef Packers Blue River processing plant in Nebraska, he already felt trapped. He reread the latest memo from his boss ordering him to terminate the employment of a line worker. McCulloch was not sure he could go through with it. McCulloch began wondering why he had taken this job in the first place and how he was going to get out of this mess.

The Meat Packing Industry[1]

By the turn of the 21st century, the American meat packing industry had gone through many changes since the early 1900s. First dominated by independent ranchers, corporations took control and created the Beef Trust, a council whereby the major beef packers could control prices, wages and supplies and therefore maximize profits. Inspired by Upton Sinclair's book

The Jungle, an exposé of the industry from the point of view of a laborer, President Teddy Roosevelt ordered the Beef Trust dismantled and anti-competitive actions ended.

Regional competition and small players kept competition in the industry active until the 1970s, when large food processors began consolidating the industry again. In 1980, the top four meat packers processed 20 per cent of the beef in the United States; by the year 2000, the top four companies processed 82 per cent of the beef available for sale in the United States.

A trade association, the American Meat Institute (AMI), represented meat packing companies. According to the AMI, major meat packing companies were at the cutting edge on technology, worker safety, hygiene, and environmental responsibility. Recent attacks on the industry were explained by jealousy of the success of these companies. The AMI pointed to advances in ergonomic tool design (to reduce repetitive stress disorders) as an example of the companies putting the well-being of the employees first. Furthermore, complaints of tainted meat and food poisoning (by salmonella, E. coli, or other pathogens) were deemed frivolous and inappropriate by AMI. According to the AMI, the highest standards of cleanliness were being observed and if there were cases of food poisoning, they were the fault of improper preparation of the meat (by the restaurant or the chef) and not the meat itself.

United Beef Packers

United Beef Packers (UBP) was one of the "big four" meat producers in the United States, and was owned by Wholly Pure Foods, Inc. UBP operated several plants across the Great Plains, primarily in states such as Nebraska, Texas, Iowa, Colorado and Kansas. Founded in the late 1960s, UBP represented the pinnacle of what could be achieved when management and employees worked together with common goals and ideals. The founder of the company, Ken Hill, was a great believer in communication and teamwork, and he treated his employees well. The workers at Hill's Blue River plant enjoyed high wages, a clean work environment, and a general sense that the company was looking out for them. The relationship between the union and the company was amicable, and each tried to help the other out when necessary.

Then towards the end of the 1970s and in the early 1980s, the recession hit, and it hit the meat packing industry hard. Consolidation of the industry began. Hill found he could no longer enjoy profits and still treat his employees well, so he opted for the former and cut wages. Conditions in the various plants deteriorated. Hill bought a new slaughterhouse a few miles down the highway and fired the unionized workers there upon purchase of the plant. He reopened it shortly thereafter without a union, staffing it primarily with recent immigrants and poorly educated locals. The union at the Blue River plant decided to hold a strike in protest. Hill hired "scabs" as retaliation, and soon received numerous death threats. Unionized workers who were let back into the plant posing as scabs committed acts of sabotage. In frustration, Hill closed the Blue River plant and fired the entire unionized workforce. After six months, he reopened the plant with immigrants and new employees. The days of cordial relationships were gone.

In the mid-80s, amidst the consolidation boom, Wholly Pure Foods, Inc. (WPF) bought UBP in a friendly takeover. Hill retired from active duty and accepted a seat on WPF's board. Consultants, industry experts and top managers from other divisions of WPF were brought in to study and direct UBP. By 1994, no upper management from the early days of the company remained.

Plant Operations

Despite technological advances, cattle slaughter and processing in 2000 was done in much the same way it had been done 100 years before. Because cows were not grown to uniform size

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(unlike chickens), automation of meat processing was not possible. It was still a very labor-intensive process. Cattle were led into the plant and struck on the head with a mallet, rendering them unconscious. After this "knocking," a worker wrapped a chain around the hind legs of the cow and the live cow was hoisted far up into the air. There the cow encounters the "sticker," an employee whose job it was to kill the cow with one lance of a long, thin blade, severing the animal's carotid artery and causing death as quickly as possible. From there the carcass had its hide removed, was decapitated, disemboweled and the body split in two by a worker with a large chainsaw. After this, workers began their individual tasks of removing meat and organs from the cattle, grinding the bones (for fertilizer and animal feed), and disposing of the useless and possibly infectious parts of the animal, such as the brain, spine and lower intestines.

In the 20 years leading up to 2000, line speeds in cattle plants increased from approximately 175 cattle an hour to 400 cattle per hour. Because of this, safety and sanitation in the plants had declined. For example, there was a team of workers whose job it was to remove the bowel of the carcass. This was a job that must be done carefully, because if the intestine or bowel was pierced, manure would spray the area and raise the chance of infecting the meat. Even the most competent people on this job still pierced the intestines of one out of every 200 cattle. This meant that, at best, pathogens were released into the plant twice an hour. There were cleaning techniques for the meat, but these were typically reserved for whole cuts of meat (steaks, roasts, etc.). For ground beef, there was no way to ensure that meat sold was clean. Because some plants could produce 400,000 pounds of ground beef per eight-hour shift, one or two accidents could have serious health consequences.

Per-capita beef consumption in the United States had remained flat with little growth in the 12 years leading up to 2000 (see Exhibit 1). The high line speeds, according to the AMI, were necessary to meet demand for beef. New techniques of ensuring safety were under review, such as irradiation of meat (or, as the meat producers prefer to call it, "cold pasteurization"). The concern of the United States Department of Agriculture (USDA), which regulates beef, was that better end-of-line safety mechanisms would cause health standards throughout the line to decline because of the fail-safe at the end. As one journalist, commenting on irradiation, put it, "Irradiation is fine; I just don't want irradiated [manure] with my meat."

Plant Employees

By 2000, most meat processing plant employees were immigrants, legal and otherwise. The big four companies used Mexican radio to advertise job openings. Many workers who had earned $7 a day in Mexico jumped at the chance to earn more than that per hour at the U.S. meat plants. The migrant immigrant worker had changed from going from farm to farm to pick seasonal fruits and vegetables into an individual who went from meat plant to meat plant to work until they were injured, fired or otherwise forced off the job. Annual industry turnover was extremely high. On average, an employee remained at a meat packing plant for six months.

Until the industry consolidated, meat processing plant employees were some of the most highly paid workers in the country. In 1983, however, the national average hourly wage for someone working in industry passed the average meat packer's wage. Since then, the industry average wage was typically 25 per cent to 40 per cent higher than the meat industry's average wage (see Exhibit 2), which was due to a number of factors, not least of which was the lack of unions in the sector. Today, less than one-third of all meat packers are unionized. Because of high industry turnover, it was difficult to maintain a union; twice a year, a whole new group of employees must be sold on the idea.

The area where the meat companies had really taken power was in the field of employee safety. All the major meat companies were self-insured, which meant that every dime paid out in

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Year	*Turkey Pounds*	*Beef Pounds*	*Pork Pounds*	*Chicken Pounds*	*Total Red Meat & Poultry*
1990	13.9	64.1	46.7	42.7	169.3
1991	14.2	63.3	47.3	44.4	171.2
1992	14.2	63.0	49.9	46.4	175.3
1993	14.1	61.6	49.2	46.6	174.5
1994	14.1	63.7	49.8	47.1	177.5
1995	14.1	64.2	49.2	46.7	177.1
1996	14.6	64.4	46.1	48.1	175.5
1997	13.9	63.6	45.7	49.2	174.4
1998	14.0	64.8	51.0	51.2	182.7
1999	14.1	65.8	51.1	53.2	186.0
2000	14.1	66.1	50.5	55.8	188.0
2001	14.1	63.4	50.8	57.1	187.8

Exhibit 1 U.S. Per Capita Meat Consumption

Source: Research Education Advocacy People (REAP) 2001 Annual Report.

worker's compensation claims came from the company's bottom line. As a result, the meat producers did everything they could to avoid paying for employees' medical costs. The powerful AMI lobby had rendered the U.S. government's regulatory body, the Occupational Health and Safety Administration (OSHA), virtually powerless. OSHA had to announce all plant visits at least 48 hours prior to the inspection. It was even legal for plant managers to keep two sets of worker accident records; one log for OSHA, and one that listed all the accidents.

Worker injuries remained very common in this industry. On-the-job injuries such as lacerations, repetitive stress disorder, infections, amputations and chemical burns occur frequently (see Exhibit 3). The level of repetitive stress disorders in meat packing plants was 75 times the national average. Despite all this, the AMI and the meat producing companies claimed they met all necessary standards for worker safety.

John McCulloch

John McCulloch was born in Chicago, Illinois, in 1972. Because both of his parents were Canadian (his father was studying at university), McCulloch was given dual citizenship so, when the time came, he could decide where he wished to live and work. With his undergraduate degree in engineering, McCulloch found a job in an auto parts plant in Albuquerque, New Mexico. He truly enjoyed working there; the people were friendly, the management/union relations were cordial and he enjoyed living in a culture and community so different from his Welland, Ontario, upbringing. McCulloch even learned Spanish from some of the employees he supervised. He married a local Albuquerque girl, Selena, and they had a son, Theodore.

A reduction in the workload at the plant gave McCulloch the opportunity to continue his education. Using his "golden parachute" from the

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Year	Meat Packing Processing	Meat Packing Slaughter	U.S. Manufacturing
1975	$5.36	$5.67	$4.83
1976	$5.87	$6.06	$5.22
1977	$6.28	$6.57	$5.68
1978	$6.73	$7.09	$6.17
1979	$7.40	$7.73	$6.70
1980	$8.06	$8.49	$7.27
1981	$8.73	$8.97	$7.99
1982	$9.08	$9.00	$8.49
1983	$8.83	$8.58	$8.83
1984	$8.89	$8.17	$9.19
1985	$8.74	$8.10	$9.54
1986	$8.76	$8.24	$9.73
1987	$8.85	$8.41	$9.91
1988	$9.04	$8.48	$10.19
1989	$9.22	$8.64	$10.48
1990	$9.37	$8.74	$10.83
1991	$9.43	$8.92	$11.18
1992	$9.62	$9.16	$11.46
1993	$9.89	$9.26	$11.74
1994	$10.06	$9.44	$12.07
1995	$10.41	$9.61	$12.37
1996	$10.47	$9.82	$12.77
1997	$10.74	$10.03	$13.17
1998	$11.03	$10.34	$13.49
1999	$11.17	$10.81	$13.91
2000	$11.80	$10.94	$14.38
2001	$12.27	$11.38	$14.84

Exhibit 2 Average Hourly Wage Comparison: Meat Packing Compared to U.S. Manufacturing According to the U.S. Bureau of Labor Statistics

Source: REAP 2001 Annual Report.

Year	Poultry	Slaughter	Processing	All Private Industry
1996	17.8	30.3	16.3	7.4
1997	16.6	32.1	16.7	7.1
1998	16.8	29.3	13.4	6.7
1999	14.3	26.7	13.5	6.3
2000	14.2	24.7	14.7	6.1

Exhibit 3 Occupational Injuries and Illness Per 100 Full-Time Workers U.S. Bureau of Labor Statistics

Source: REAP 2001 Annual Report.

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plant as funding, he enrolled in an MBA program. Though it was nice to be close to his family again, McCulloch was anxious to get out into the workforce. He loved working in operations, and he made that the focus of his studies and job search. McCulloch found UBP through an independent job search on the Web. The pictures on the site and the description of the job sounded great: he would supervise a large number of employees, work for a large multinational with lots of room for advancement, receive good pay (especially relative to the cost of living where the plants were located), and there were many process/control challenges to tackle.

Through e-mail, McCulloch applied for the position of assistant general plant manager and he followed up with a phone call. He met with a contingent from UBP's human resource department following a successful phone interview, and he had the opportunity to ask about the plants, the employees and the day-to-day mechanics of the job. A few weeks later, McCulloch was flown to UBP headquarters in Omaha, Nebraska, where he met with the vice-president of plant operations. Following a short conversation, McCulloch was presented with an offer sheet. After discussing the matter with Selena, he accepted the position.

The First Day

When McCulloch reported to the plant for his first day of work and orientation, he did not know how he would possibly be able to work there. The place stank of blood and meat. It was hot and humid. There were hundreds of workers, mostly Mexican, walking around in bloody aprons that looked like chain-mail armor, and carrying knives, lots of knives; long, short, thin, it seemed like everyone had at least one. The plant general manager, Greg Kramer, was waiting for him. Kramer was the only one dressed normally. He had been with UBP for four years, having taken the job after earning his business degree.

The two retired to Kramer's office to discuss McCulloch's role at the plant. Even in Kramer's clean office, McCulloch could still smell the plant and hear the shouting, the grinding of the machinery and general sounds of a slaughterhouse. According to Kramer, the Blue River plant was the best-functioning beef plant in the state. The processing line moved at an average of 350 cattle per hour, and that average was maintained no matter what. Any shutdowns would be made up for by speeding up the line later. The line, however, was Kramer's responsibility; as he put it, he got paid to ensure that the right amount of meat came out of the plant every day.

McCulloch's responsibility was to be much more operational. He was to work closely with the floor supervisors to make sure that all worker issues were taken care of quickly. He would report directly to Kramer. The message was received loud and clear: no problems that could shut down the line would be allowed. Kramer then showed McCulloch to his office and suggested they tour the plant.

Both men suited up in what looked like spacesuits. They ventured out into the plant. The floor was covered in blood, inches deep in some places. The line, or chain as it was called, moved above, carrying beef carcasses in various stages of dismemberment. And everywhere, the workers cut and hacked at the pieces of meat in front of them, in a constant, repetitive motion. McCulloch noticed that he and Kramer were the only people wearing protective garb. Other than the aprons, the workers had only metal gloves and chest-plates to protect them from the many knives in motion.

The First Three Months

Over the next four weeks, McCulloch met with the floor supervisors and tried to learn from them. These meetings, unfortunately, made him depressed. It seemed that his direct reports would feel more at home as slave drivers than as a plant supervisors. They had no respect for the workers and were trained to care only about keeping the line moving and keeping workers working. McCulloch decided to try to get a different view by talking to others in the plant.

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Concerned with the high incidence of workplace accidents, McCulloch went to see the plant nurse. She was a friendly woman who responded to McCulloch's naïveté by letting him know that this was just how the industry worked. They were interrupted by a pair of workers coming in with deep lacerations. The nurse said "I guess they're making up for lost time today. I can always tell how fast the chain is moving by how many injuries there are."

Just then, one of the supervisors came in. He shoved a piece of paper in front of one of the injured workers and ordered him, in Spanish, to sign it. When McCulloch asked what it was, the supervisor explained in English that all injured workers had to sign a waiver that allowed UBP to administer medical treatment and disallowed the worker from getting an outside medical opinion, seeing a non-company doctor, or suing the company. Signing waivers was standard operating procedure, according to the supervisor. The supervisor then demanded that the other worker sign a copy of the waiver. Because this worker's lacerations were to his hands, he had to sign it by writing with a pen in his mouth.

McCulloch then went to see Kramer and asked about the waiver procedure. Kramer told him that because the company was self-insured, it had a right to insist that all medical treatment come from company personnel. When McCulloch asked what happened when a worker did not sign the waiver, he was told that the worker was then fired. Because an employee could not collect benefits if fired, almost everyone signed the waiver. Kramer assured McCulloch that everything was legal and that he had better get on board with the policy if he was going to last at the plant. Although McCulloch had tried to talk to individual workers on the line, no one would give him the kind of low-down, nitty-gritty information he wanted. McCulloch felt it was all well and good to know how the plant was supposed to operate and how it was suppose to look to the outside world, but if he was going to be an effective manager, he had to know what really went on.

On his way into his office one day, McCulloch saw a large, muscular man in a wheelchair sorting files. He had never seen this man before. After introducing himself, McCulloch asked this man (Bobby Vasquez) if he would be willing to tell McCulloch what went on in the plant. Vasquez seemed more than happy to oblige.

Vasquez started working at the plant in the late 1970s at the age of 24. In 1994, he heard someone yell "watch out!" and, looking up from his work, saw a 100-pound box of meat falling towards him. He reached out and caught it with one arm, but the force of the box caused him to fall backwards hitting his back on a metal table. The company doctor told him it was a pulled muscle, but after months of excruciating pain he got a second opinion and found out he had two herniated discs. A month after surgery, Vasquez was back doing heavy labor in the plant. Taking on an extra shift, one night he was ordered to clean the gigantic blood tanks with liquid chlorine. Because no protection was given to him, he ended up in the hospital with severe chemical burns to his lungs. He still returned to work. Subsequent accidents included a shattered ankle and a broken leg, the reason for his being in a wheelchair and restricted to "light duty" work.

McCulloch could not believe the litany of horrors that had befallen Vasquez. But what the man said next chilled McCulloch even more:

> John, you should get out as soon as you can. You really don't want to know what goes on in the plant. Your supervisors are loyal only to the company, because they know they'd never get a job managing others anywhere else. They sell drugs to the workers so that they can work faster and longer. They harass and abuse female employees in exchange for easier work. They let tainted meat go out for sale. Trust me, the less you know the better.

A few days later, Vasquez was back on the line, cutting meat.

The Meat Recall and the Loading Dock

Around two months after McCulloch had begun working at UBP, head office sent a task force to

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Date: August 12, 2003

To: John McCulloch, Assistant General Manager

From: Greg Kramer, General Manager

Re: Bobby Vasquez

John:

If you haven't already heard from the floor supervisors, plant employee Bobby Vasquez is seriously incapacitated and unable to work at the plant for the next several months due to a heart attack.

Vasquez has never been that valuable an employee and is quite accident-prone. He was recently confined to a wheelchair because of a broken leg, and he has had problems with his back in the past as well. He has also displayed contempt for the company and is not considered loyal.

Head office and I agree that we would benefit from no longer having this individual on our payroll and enrolled in our benefits plan. Please ensure his employment is terminated as soon as possible. Do not wait until Vasquez contacts the plant; track him down and serve him with his termination papers. I understand he is recuperating at Blue River General Hospital, room 1115.

Greg

Exhibit 4 Memorandum

the Blue River plant. UBP had gotten some bad press after several E. coli infections were traced back to some ground beef produced at Blue River. UBP upper management wanted to hold a press conference at the plant to announce a recall and show that they had nothing to hide. The company was recalling 250,000 pounds of ground beef, though by now, McCulloch knew that there was no way the company could be certain of how much meat had been infected. It mattered little; the USDA could only ask for a recall of tainted meat; it did not have the power to force the company to pull the meat from the shelves.

Greg Kramer was furious because this episode meant that the line had to be shut down for extensive cleaning. Shifts were added for the sanitation effort, and others were cancelled so the line did not look as frenetic when the reporters arrived. "We'll be running at 400 an hour for a month to make up for this," Kramer complained.

The task force assigned McCulloch the duty of inspecting the non-core areas of the plant, such as the offices and loading dock, for anything that would look out of the ordinary. Upon arrival at the loading dock, McCulloch saw several boxes of beef sitting on the dock with no truck to pick them up. The time stamp on the box was six hours old, and the meat was sitting in 30-degree Celsius temperatures. When he asked the dock foreman why this meat was there, the man looked at McCulloch quizzically. McCulloch repeated his question, and the foreman explained that this meat was "seconds," not of high quality, and would be sold under a brand name other than UBP's, so it was okay that it sat outside for a while until the truck came to get it.

Breaking Point

After three months of lost sleep, no appetite, depression and the stench of cattle constantly around him, McCulloch wondered how much more he could take. He was in constant fear: of public exposure, of legal liability, of his wife and son's health and of the loss of his own sanity. He knew he had made a mistake coming to work for

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UBP, but there seemed to be little he could do about it now, short of uprooting his life and those of his family.

Looking through his in-box tray, McCulloch found a memo from Kramer (see Exhibit 4). It seemed that Vasquez suffered a heart attack the previous week and was in the hospital. The doctors said he would no longer be able to work in the plant, and his recovery would be long and expensive. Kramer was ordering McCulloch to fire Vasquez, as the company did not want to pay for his medical bills any longer. McCulloch sat down, put his head in his hands and wished he were someplace else.

NOTE

1. Based on information from Fast Food Nation, by Eric Schlosser. Published by the Houghton Mifflin Company, 2001.

NES CHINA: BUSINESS ETHICS (A)

Prepared by Xin Zhang under the supervision of Professor Joerg Dietz

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By April 1998, it had been almost a year since the Germany-headquartered multinational company NES AG had first submitted its application to the Chinese government for establishing a holding company in Beijing to co-ordinate its investments in China. The application documentation had already been revised three times, but the approval by the government was still outstanding. Lin Chen, government affairs co-ordinator at NES AG Beijing Representative Office, came under pressure from the German headquarters and had to find a way to obtain approval within a month.

During the past year, Chen had almost exclusively worked on the holding company application. In order to facilitate the approval process, she had suggested giving gifts to government officials. But her European colleagues, Steinmann and Dr. Perrin, disagreed because they thought such conduct would be bribery and would violate business ethics. Confronted with the cross-cultural ethical conflict, Chen had to consider possible strategies that would satisfy everybody.

COMPANY BACKGROUND

NES and NES AG

NES was founded in Germany in 1881. Over the following 100 years, by pursuing diversification strategies, NES had grown from a pure tube manufacturer into one of the largest industrial groups in Germany, with sales of US$14 billion in 1997. NES built plants and heavy machinery, made automotive systems and components, manufactured hydraulic, pneumatic and electrical drives and controls, offered telecommunications services and produced steel tubes and pipes.

NES was managed by a holding company—NES AG—that implemented value-oriented portfolio management and directed its financial resources to the areas with the greatest profit potentials. In 1997, NES AG owned NES's 11 companies in four business segments: engineering, automotive, telecommunications and tubes. These companies generally operated independently and largely at their own discretion, as

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NES AG was interested in their profitability and not their day-to-day operations.

NES had always been committed to move along the road of globalization and internationalization. Headquartered in Germany, NES had businesses in more than 100 countries with over 120,000 employees. In the process of globalization and internationalization, NES established a business principle that demonstrated its responsibilities not only to shareholders, employees and customers, but also to society and to the countries where it operated. As an essential part of the company's corporate culture, this principle pervaded the decentralized subsidiaries worldwide and guided the decision-making and conduct of both the company and its employees.

NES China Operations

NES's business in China dated back to 1889, when it built the flood barrages for the Canton River. In 1908, NES supplied seamless steel tubes for the construction of a waterworks in Beijing. Through the century, NES continued to broaden its presence. From the mid-1950s to 1997, NES supplied China with an enormous 5.2 million metric tons of steel tube and 1.6 million tons of rolled steel.

Since China opened up to foreign trade and investment in the late 1970s, NES's presence had grown dramatically. From 1977 to 1997, NES had completed more than 40 technology transfer and infrastructure projects. It had also set up 20 representative offices, six equity joint ventures and three wholly owned enterprises.

In developing business links with China, NES adhered to its business principle. Most NES enterprises in China had highlighted this principle in their codes of conduct in employment handbooks (see Exhibit 1). These codes required employees to pursue the highest standards of business and personal ethics in dealing with government officials and business customers, and to avoid any activities that would lead to the involvement of the company in unlawful practices. Instead of tendering immediate favors or rewards to individual Chinese officials and customers, NES relied on advanced technology, management know-how and top quality products and service as a source of its competitive advantage. NES emphasized long-term mutual benefits and corporate social responsibility. Since 1979, NES had trained more than 2,000 Chinese engineers, master craftsmen, technicians and skilled workers in Germany. It had also offered extensive training programs in China. Moreover, NES was the first German company to adopt the suggestion of the German federal government to initiate a scholarship program for young Chinese academics to study in Germany. As a result, NES had built a strong reputation in China for being a fair business partner and a good guest company.

NES Beijing Representative Office

In 1977, NES was the first German company to open its representative office in Beijing. Along with NES's business growth, the Beijing Representative Office continued to expand. In 1997, it had 10 German expatriates and more than 40 local staff in nine business units. One unit represented NES AG. This unit was responsible for administrative co-ordination and office expense allocation. The other eight units worked for the German head offices of their respective NES companies in the engineering, automotive and tube segments.

Chinese legal restrictions severely limited the activities of the Beijing Representative Office. It was allowed only to engage in administrative activities, such as conducting marketing research for the German head offices, passing on price and technical information to Chinese customers, and arranging for meetings and trade visits. Moreover, it could not directly enter into employment contracts with its Chinese employees. Instead, it had to go through a local labor service agency designated by the Chinese government and consult with the agency on almost all personnel issues including recruitment, compensation and dismissal. As a result, the German managers of the Beijing Representative Office found it difficult to effectively manage their Chinese employees. In the absence of direct

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Article 3 Employment and Duties

3.1 The Company employs the Employee and the Employee accepts such employment in accordance with the terms and conditions of the Employment Contract and this Employment Handbook.

3.6 The Company expects each Employee to observe the highest standards of business and personal ethics, and to be honest and sincere in his/her dealings with government officials, the public, firms, or other corporations, entities, or organizations with whom the Company transacts, or is likely to transact.

3.7 The Company does business without favoritism. Purchases of materials or services will be competitively priced whenever possible. An Employee's personal interest or relationship is not to influence any transaction with a business organization that furnishes property, rights or services to the Company.

3.8 Employees are not to solicit, accept, or agree to accept, at any time of the year, any gift of value which directly or indirectly benefits them from a supplier or prospective supplier or his employees or agents, or any person with whom the Company does business in any aspect.

3.9 The Company observes and complies with all laws, rules, and regulations of the People's Republic of China which affect the Company and its Employees. Employees are required to avoid any activities which involve or would lead to the involvement of the Company in any unlawful practices and to disclose to the proper Company authorities any conduct that comes to their attention which violates these rules and principles. Accordingly, each Employee should understand the legal standards and restrictions that apply to his/her duties.

3.10 All Employees are the Company's representatives. This is true whether the Employee is on duty or off duty. All Employees are encouraged to observe the highest standards of professional and personal conduct at all times.

Article 13 Discipline

13.1 The Company insists on utmost discipline. The Employee's misconduct or unsatisfactory performance will be brought to the attention of the responsible Head of Department or Member of the Management when it occurs and will be documented in the Employee's file.

13.2 Some offences are grounds for immediate dismissal and disciplinary procedures will apply to other offences.

13.3 Offences which are grounds for immediate dismissal include:
- (i) Breach of the Company's rules of conduct.
- (j) Neglect of duties, favoritisms or other irregularities.

Exhibit 1 Excerpt from the Employment Handbook of one of the Nes's Enterprises in China

Source: Company files.

employment contracts, the managers had to rely on an internal reporting and control system.

Current Situation

Establishing China Holding Company

In early 1997, NES AG had decided to establish a holding company in Beijing as soon as possible after carefully weighing the advantages and disadvantages of this decision. Establishing a China holding company was advantageous because, unlike a representative office, a holding company had its own business licence and could therefore engage in direct business activities. In addition to holding shares, a holding company could co-ordinate many important functions for its enterprises, such as marketing, managing government relations, and providing financial

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support. As a "country headquarters," a holding company could also unite the NES profile in China and strengthen the good name of NES as a reliable business partner in the world's most populous country. Moreover, it could hire staff directly and thus retain full control over its own workforce. In light of these advantages, NES AG expected substantial time and cost efficiencies from the China holding company.

Several disadvantages, however, potentially outweighed the advantages of a China holding company. First, Chinese legal regulations still constrained some business activities. For example, a Chinese holding company could not balance foreign exchange accounts freely and consolidate the taxation of NES's Chinese enterprises, although this might be permitted in the future. Second, the setup efforts and costs were high. To establish a holding company, NES had to submit a project proposal, a feasibility study, articles of association and other application documents to the local (the Local Department) and then to the central trade and economic co-operation departments (the Central Department) for examination and approval. Third, there was only a limited window of opportunity for NES AG. Once the China holding company had received its business licence, within two years, NES AG would have to contribute a minimum of US$30 million fresh capital to it. The Chinese regulations prescribed that this capital could be invested only in new projects, but otherwise would have to remain unused in a bank account. NES currently was in a position to invest the capital in its new projects, but the company was not certain how much longer it would be in this position.

Working Team

NES AG authorized the following three individuals in the Beijing Representative Office to take up the China holding company application issue:

> Kai Mueller, 58 years old, had worked for NES in its China operations since the 1970s and had experience in several big co-operative projects in the steel and metallurgical industries. He would be the president of the holding company.
>
> Jochen Steinmann, 30 years old, was assigned to Beijing from Germany in 1996. He would be the financial controller of the holding company.
>
> Dr. Jean Perrin was a 37-year-old lawyer from France who had an in-depth understanding of Chinese business laws. He would work as the legal counsel. His previous working experience included a professorship at the Beijing International Business and Economics University in the 1980s.

The trio had advocated the idea of a China holding company to NES AG for quite some time and were most happy about NES AG's decision, because the future holding company would give them considerably more responsibilities and authority than did the Beijing Representative Office.

Considering the complexity and difficulty in coping with the Chinese bureaucratic hurdles, Mueller decided in March 1997 to hire Lin Chen as a government affairs co-ordinator for the working team. Chen, a native Chinese, was a 28-year-old politics and public administration graduate who had worked four years for a Chinese state-owned company and was familiar with the Chinese way of doing business. Mueller expected that Chen would play an instrumental role in obtaining the holding company approval from the Chinese government. He also promised that Chen would be responsible for the public affairs function at the holding company once it was set up.

Chen's View of Doing Business in China

Chen officially joined the Beijing Representative Office in June 1997. She commented on doing business in China:

> China's economy is far from rules-based; basically, it is still an economy based on relationships. In the absence of an explicit and transparent legal framework, directives and policies are open to interpretation by government officials who occupy positions of authority and power. In such

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circumstances, businesspeople cultivate personal *guanxi* (interpersonal connections based implicitly on mutual interest and benefit) with officials to substitute for an established code of law that businesspeople in the Western society take for granted.

In building and nurturing *guanxi* with officials, gifts and personal favors have a special place, not only because they are associated with respect and friendship, but also because in today's China, people place so much emphasis on utilitarian gains. In return for accepting gifts, officials provide businesspeople with access to information about policy thinking and the potentially advantageous interpretation of the policy, and facilitate administrative procedures. Co-operation leads to mutual benefits.

Although an existing regulation forbids government officials to accept gifts of any kind,1 it remains pervasive for businesspeople to provide officials with major household appliances, electric equipment, "red envelopes" stuffed with cash, and overseas trips. There is a common saying: "The bureaucrats would never punish a gift giver." Forbidding what the West calls bribery in a *guanxi*-based society where gift giving is the expected behavior can only drive such under-the-table transactions further behind the curtain.

While sharing benefits with officials is normal business conduct in China, it is interpreted as unethical and abnormal in the West. Faced with their home country's ethical values and business rules, Western companies in China cannot handle government relationships as their Asian counterparts do. They often find themselves at a disadvantage. This dilemma raises a question for a multinational company: Should it impose the home country's moral principles wherever it operates or should it do what the Chinese do when in China, and, if so, to what extent?

Different Opinions on Bribery

When Chen started working in June 1997, Mueller was sick and had returned to Germany for treatment. Steinmann and Dr. Perrin told Chen that NES had submitted the holding company application to the Local Department in April 1997 and that the Local Department had transferred the documents to the Central Department at the end of that month. But nothing had happened since then. Chen felt that she had to fall back to her former colleague, Mr. Zhu, who had close personal *guanxi* with the Central Department, to find out first who had the authority in the Central Department to push the processing and what their general attitudes towards the application were.

In July, Chen reported her findings to Steinmann and Dr. Perrin:

> The approval process at the Central Department is difficult. Because holding companies are a relatively new form of foreign investment in China, the officials are unsure whether they are a good idea for China. They have been very prudent to grant approval. Hence, we don't have much negotiating leverage, although we are a big company and have products and technologies that China needs. The officials say that they will consider a holding company's application within 90 days of its submission. They issue approval however, only when the application is deemed "complete and perfect" (in that all issues have been resolved to the Central Department's satisfaction). The Central Department is under no real obligation to approve any holding company application. They can always find some minor issues. So the approval procedure may be lengthy. The legal basis for establishing holding companies is provided by the Holding Company Tentative Provisions, Supplementary Rules and some unpublished internal policies. This provisional and vague status allows the officials to be flexible in authorizing a holding company. In such circumstances, maintaining close connections with the responsible officials is absolutely critical.

Chen suggested:

> The quickest and most effective way to build such connections is to invite the responsible officials to dinner and give gifts. It won't cost the company too much. But what the company will gain in return—efficiency in obtaining approval and flexibility in the interpretation of the wording within the scope permitted by law—is worth much more.

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Upon hearing Chen's report and suggestion, Steinmann was shocked:

> That would be bribery. In Germany bribing an official is a criminal offence for which both the briber and the bribed are punished. NES is a publicly traded company with a board of directors that reports to shareholders and monitoring authorities in Germany.
>
> We have met the criteria for setting up the holding company. What we should do now is organize a formal meeting with the officials and negotiate with them. This is the way we have done it in the past, and it has always worked. I am not aware that we ever had to use bribery. NES does not have a history of wrongdoing.

Knowing how critical it was to follow China's customary business practices in tackling such issues, Chen argued:

> Yes, it is correct. NES did not have to give gifts of this kind in the past. But don't forget: virtually all of NES's projects or joint ventures in the past were approved by agencies responsible for specific industries or local governments that were very keen on having access to NES's technology. As a result, NES always has had considerable bargaining power. It is different this time: we need to found a holding company, and we have to deal with the Central Department that we have never contacted before. Even Mueller does not have relations in this department. Moreover, our contacts at the industrial and local levels won't help much because they have very limited influence on the Central Department and, hence, the holding company application issue.
>
> Moreover, you can't equate gifts with bribes. The approval letter doesn't have predetermined "prices" and no one forces us to pay. We give gifts just to establish relationships with officials. We develop good relationships, and favorable consideration of these officials comes naturally. According to Chinese law,2 to give gifts to government officials and expect them to take advantage of their position and power to conduct *illegal* actions is bribery. Our intent is to motivate officials to handle our application legally but without delay. I see no serious ethical problem.
>
> In some ways it's also hard to blame officials for feathering their nest because they are poorly paid. Whether they process our application quickly or slowly has absolutely no impact on their US$200 monthly income. Then, how can we expect them to give our case the green light? They are not morally wrong if they accept our gifts and don't create obstacles for us in return.
>
> Negotiation doesn't help much. Unless we have close relationships with them, they will always find some minor flaws in our documents. After all, they have the authority for interpreting the regulations. Therefore, we have to be open-minded and get accustomed to the Chinese way of doing business.

Chen hoped that Dr. Perrin would support her, as she had a feeling that the French were more flexible and less ethically sensitive than the Germans. Dr. Perrin, however, shared Steinmann's view. Perrin said:

> We should not give officials anything that has some value, with the exception of very small objects (pens, key holders, calendars and the like) given mainly for marketing and advertisement purposes. I also think that these officials should not accept any gifts. It's unethical and illegal. If we think it is unethical, we should combat it and refrain from it.

Nonetheless, Dr. Perrin understood the importance of *guanxi* as an informal solution to Chinese bureaucracies. So he agreed that Chen could invite one of the two responsible officials to dinner through Mr. Zhu and present a CD player to this official as an expression of respect and goodwill, although he thought it went too far and was approaching bribery.

On a Saturday evening in July, Chen met the official at one of the most expensive restaurants in Beijing. At the dinner, the official promised to work overtime the next day on NES's documents and give feedback as soon as possible.

The following Monday, Chen got the government's official preliminary opinion demanding a revision of 16 clauses of the application documents. Steinmann and Dr. Perrin found it difficult to understand this. NES had drafted the documents with reference to those of another

company, whose application had been approved by the Central Department a few months ago. Why didn't the Central Department accept the similar wording this time? Chen again contacted her former colleague Zhu, who told her:

> You should never expect to get things done so quickly and easily. It takes time to strengthen your relationships. I can ask them to speed up the procedure without changing too much of the wording. But you'd better offer them something generous to express your gratitude since they would consider it a great favor. RMB3,000 (US$360) for each of the two will be OK. Don't make me lose face anyway.

Steinmann and Dr. Perrin thought it was straightforward bribery even if gifts were given through a third party. If they agreed to do so, they would run high personal risks by violating the corporate business principle and professional ethics. As controller and lawyer, they were expected to play an important role in implementing strict control mechanisms in the company and keeping the corporate conscience. Moreover, they were worried that the potential wrongdoing might damage the strong ethical culture of the Beijing Representative Office and the good corporate image among the Chinese employees of the office, although it likely would not affect the whole company because NES was so decentralized.

However, Chen thought that *renqing* (social or humanized obligation) and *mianzi* (the notion of face) were more important and that NES's business ethics and social responsibility could be somewhat compromised. In Chen's eyes, Steinmann and Dr. Perrin were inflexible and lacked knowledge of the Chinese business culture. Steinmann and Dr. Perrin told Chen that she needed to learn Western business rules and values in order to survive in a multinational company.

Recent Developments

In August 1997, the vice-president of NES AG led a delegation to visit China. Chen arranged a meeting for the delegation with a senior official of the Central Department. It turned out just to be a courtesy meeting and did not touch upon the details of the holding company approval issue.

In November, Steinmann and Dr. Perrin met the two responsible officials in hopes of negotiating with them such that the officials would allow NES to leave some clauses unchanged. But the officials insisted on their original opinion without giving a detailed explanation of the relevant legal basis. The negotiation lasted only half an hour, and Steinmann and Dr. Perrin felt that it accomplished nothing.

Because of the limited window of opportunity (that is, new investment projects required an immediate capital injection), they felt that they had no choice but to modify the documents according to the officials' requirements. Modifying the documents was an administrative struggle with NES AG, because due to company-internal policies, the German headquarters had to approve these modifications. The application was resubmitted at the end of November. When Chen inquired about the application's status in December, the officials, however, said that the case needed more consideration and then raised some new questions that they said they failed to mention last time. This happened once again three months later in February 1998.

What Next?

In April 1998, Steinmann, Dr. Perrin and Chen submitted the newest revision of the application. As NES AG could not defer funding the new projects, it demanded that the Beijing working team obtained approval within a month so that NES AG could use the China holding company's registered capital of US$30 million. Otherwise, NES AG would have to re-evaluate the China holding company and might abandon it all together. In that case, Mueller, Steinmann and Dr. Perrin would miss opportunities for career advancement. As for Chen, she was concerned about her job because the Beijing Representative Office would no longer need her position.

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Being very anxious about the current situation, Mueller decided to come back to Beijing immediately. Chen wanted to be able to suggest a practical approach that would gain the co-operation of the bureaucrats while conforming to the German moral standards. Chen also contemplated some challenging questions. For example, what constituted bribery? When ethical values conflicted, which values should people follow? How could these differences be resolved? To what extent should a multinational company like NES adapt to local business practices? Should the future China holding company develop special ethical codes to recognize the Chinese business culture? The answers to these questions were very important to Chen, because she expected to face similar ethically sensitive issues in the future.

Notes

1. The China State Council Order No. 20 promulgated on 1988.12.01. Article 2 Any State administrative organization and its functionary shall not give and accept gifts in activities of domestic public service. The China State Council Order No. 133 promulgated on 1993.12.05. Article 7 Gifts accepted in activities of foreign public service shall be handled properly. Gifts above the equivalent of RMB200 (about US$24) according to the Chinese market price shall be . . . handed over to the gift administrative department or acceptor's work unit. Gifts of less than RMB200 belong to the acceptor or to the acceptor's work unit. P. R. China Criminal Law (revised edition) promulgated on 1997.03.14. Article 394 Any State functionary who, in his activities of domestic public service or in his contacts with foreigners, accepts gifts and does not hand them over to the State as is required by State regulations, if the amount involved is relatively large, shall be convicted and punished in accordance with the provisions of Article 382 and 383 of this law. (Article 382 and 383 regulate the crime of embezzlement.)

2. The China State Council Order No. 20 promulgated on 1988.12.01. Article 8 Any State administrative organization and its functionary who give, accept or extort gifts for the purpose of securing illegitimate benefits shall be punished in accordance with relevant state law and regulations on suppression of bribery. The P. R. China Criminal Law (revised edition) promulgated on 1997.03.14. Article 385 Any State functionary who, by taking advantage of his position, extorts money or property from another person, or illegally accepts another person's money or property in return for securing benefits for the person shall be guilty of acceptance of bribes. Article 389 Whoever, for the purpose of securing illegitimate benefits, gives money or property to a State functionary shall be guilty of offering bribes.

NES China: Business Ethics (B)

Prepared by Xin Zhang under the supervision of Professor Joerg Dietz

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Mueller was coming back to the office the next day. His secretary was sorting out the mail and faxes on his desk, when Chen came in and accidentally found a letter sent from a Chinese law firm a few month's earlier. The firm had learned from the Central Department that NES was applying for a holding company and would like to provide consulting service. Chen thought that using this firm would be a solution to the ethical conflict that her working team was facing.

The next day, Chen talked to Mueller about the letter. Mueller liked the idea because it could

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solve the problem in a legal way. That same afternoon, Mueller met a partner of the firm who promised to help NES get approval within a month. The partner also said that his firm had good relationships with the Central Department and was experienced in handling holding company applications. Mueller decided to have this law firm involved.

Ten days later, the Central Department issued approval for NES China holding company and the NES Beijing Representative Office paid the law firm US$10,000.

TEXTRON LTD.

Prepared by Lawrence A. Beer

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INTRODUCTION

Gary Case, executive vice-president of Textron Ltd., sat at his desk and slowly drew a circle around the words *ethics* and *social responsibility.* Above the circle he wrote in bold letters the phrase "public opinion," and sat back to ponder his symbolic illustration of a potential problem that only he seemed to envision.

Case was thinking ahead and letting his mind focus on an issue that seemed out of the realm of the tenants of basic managerial principles that his undergraduate and MBA studies had prepared him for during his scholastic years. While he well appreciated the strategic decision-making concepts of running a transnational business, he felt himself personally wondering how to approach the complex subject of applying global ethics and social responsibility to an international venture that was being pushed on his company.

BACKGROUND

Textron Ltd. was a 65-year-old, family-held business based in Youngstown, Ohio. As a producer of cotton and sponge fabricated items for the beauty trade, selling to intermediate users as components in their make-up compact cases as well as direct to the retail trade for onward sale to consumers, the company was under constant attack from Far Eastern manufacturers. The need to enter into some type of offshore manufacturing enterprise was now evident in order to maintain a cost competitive position for the firm to continue to prosper and grow.

As a maker of cotton puffs for the application of make-up cosmetics, the company had grown from a loft in Brooklyn, New York back, in the mid-1930s to a medium-sized enterprise with sales of $25 million and pre-tax earnings of $1 million plus. In the category of cosmetic applicators, Textron's fine reputation had been built on years of excellent service to the trade with attention to detail. Using, at first the hand sewing abilities of seamstresses from the garment centres of lower Manhattan, the company had been a pioneer in developing customized machinery to produce quality cotton puffs to the precise custom requirements of modern cosmetic manufacturers. Today, 100 per cent virgin cotton rolls would enter Textron's factory at one end and exit as soft velour pads in numerous shapes, contoured sizes and colors at the other end of the process.

These puffs would be either sewn or glued with ribbon bands and satin coverings bearing the well-known brand names of the major franchised cosmetics companies of the world from Revlon, Estee Lauder, Maybelline and Max Factor as well as numerous others. They might

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also contain the names of retail store house brands or the internationally recognized trademarks of their own company. Currently, a new collection had been created through a licensing arrangement bearing the name of a highly respected fashion beauty magazine, whose instant recognition with the teenage trade was propelling the company to new sales levels. While historically Textron Ltd. primarily had produced components, supplying cosmetic companies with custom applicators tailored to their cosmetic ingredient requirements, the growth of its retail business in this sub-category was developing at a rapid pace. Major drug store chains, supermarkets and specialty shops featured Textron brands and their lines were becoming synonymous with the best in cosmetic applicators and assorted beauty accessories. With the launch of an additional range under the guise of a high fashion authority, featuring highly stylized "cool shapes" and "hot colors" designed to entice younger adolescent buyers, their reputation was achieving enhanced public notice. Such products using uniquely descriptive trendy phrases evoked an image of "hip to use applicators" and a whole new generation of teenage users was being developed.

The firm also was a key purveyor to the entertainment industry directly servicing the Hollywood movie and TV production companies, Broadway and the theatrical community, along with indirect sales to professional make-up artists and modeling studios thanks to the quickly developing beauty store trade. All in all, the future for Textron Ltd. was most promising.

Gary Case, a college friend of the company's president and principal owner, was brought into the business because of his experience at the retail sales and marketing level. The chief executive officer, who possessed an engineering background was more than capable of overseeing the manufacturing side of the business; however, the strong movement of the organization into direct consumer goods, coupled with the overall expansion of the company, necessitated Case's hiring.

As the company began to prosper in the early 1970s, other stateside competitors emerged, but none could match the quality and inherent reputation of Textron Ltd. Their attention to detail and expertise of their original equipment manufacturer (OEM) sales staff servicing the franchise cosmetic companies gave Textron a competitive edge. They were called upon to work closely with their industrial customers to develop cotton puffs that matched the trends in new cosmetic ingredients and application methods at the research and development (R&D) stage of such developments. Such progressive fashion-oriented but facially skin-sensitive cosmetic formulas required applicators that matched the demanding specifications of these new advances in the cosmetic field. Cotton materials were needed to sustain the look on the skin and provide the user with the same result that the cosmetic cream, lotion or powder promised. While women, the prime purchasers of such products, wanted to obtain the dramatic results the franchise cosmetic companies advertised, professional make-up artists had long known that the choice of applicators to transfer the pressed powder in the compact, the lotion in the bottle or the cream in the jar, was the key to the process. The right puff was therefore needed to compliment the make-up process.

In the late 1980s, Far Eastern manufactures of cosmetic applicators began to emerge, offering cheaper versions of such items. While the detailed processing of the raw cotton material used in such production was inferior to the quality and exacting details of those manufactured by Textron Ltd., the cost considerations necessitated a strong consideration of their offerings by the company's clients. As textile manufacturing began to develop in the Indochina region and more and more American firms brought their expertise to the area, the overall quality of goods as well as the base materials used began to improve. As an outgrowth of improvements in the generic textile business emerged, better methods of production, selection of raw materials and attention to quality filtered down into the cosmetic cotton applicator category.

Case, along with the president of the company, David Grange, and the head of product

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development group, Nancy Adams, had made periodic trips to the Hong Kong Beauty Exhibition to constantly gauge Far Eastern competitors. For many years, they observed a display of poor offerings and found themselves returning from such trips visits confident that the threat of offshore competition was not yet emerging as a viable alternative for their clients. Their regular customers, both beauty companies and retailing organizations, were rarely evident at such conventions and hence their positive feelings were continuously strengthened.

Current Issues

Over the last few years, however, it became evident that startup companies, beginning as derivative plants of the large textile manufacturers throughout China, Taiwan, Korea and Thailand, could become a real danger to their ever-growing global business. While many of these enterprises still produced inferior merchandise, Textron noticed that a number of their American competitors were now forming alliances with such organizations. These associations brought with them the knowledge of how to deal with the beauty industry both in America and Europe, instilling in them a deep appreciation for quality and endurance of raw materials to work with the new cosmetic preparations. Once such considerations took a foothold and a reputation for delivering such competitively detailed quality merchandise with vastly lower costs was discovered by Textron's clients, the company could be in for some rough times ahead. During the last visit to the Hong Kong show, Grange had bumped into a number of his key franchise cosmetic component buyers as well as a few of his retail chain merchandise managers. They had all acknowledged the quality advances made by these emerging new players. It was felt however that the distance of such suppliers from their own factories and key decision-making staffs and the fact that the shapes and designs were still not up to the innovative expertise of the Textron company created a hesitation among clients wanting to deal with them. Grange knew full well however that with advanced global communication technology and the alliances with American-based representative organizations, the gap would be closed shortly. If such alterations were made and a fully competitive quality product could be offered with the inherent deep labor and overhead cost advantages that Far Eastern firms possessed, Textron was due for some major sales competition in the future.

After their last trip to the Asian convention in September of 1999, Grange and Case spent the hours on the return trip discussing strategic alternatives for the company in the years ahead. This wasn't the first time such matters were approached and, in fact, two years earlier, the company entered into an alliance with a United Kingdom manufacturer for the production on a joint basis of cosmetic sponges. Grange had always been reluctant to place his production facilities out of his geographical everyday domain. He was a "hands on" entrepreneur who felt strongly that all facets of one's business should be at arm's reach. Grange was deeply committed to his people and his door was always open to everyone in his organization. He was involved in every area of the business and it was not until Case joined Textron that Grange began to relinquish control over selective daily operations. This desire to closely preside over and monitor his people was born out of a heritage of family involvement as exemplified by his father. His dad had instilled in Grange a great empathy for workers and staff, and even today the company's culture still carried such roots of benevolent carrying.

When the firm had moved from the greater New York area to Youngstown, key personnel were given liberal incentives to move to the new location, and great care was given to those who could not make the journey. Still today, the company showed great pride in its relationship with employees. Textron's human resources department was not merely a conduit for processing applications for employment and overseeing payroll but a large fully functional multitalented group that ran off-site improvement seminars and cross training exercises. Besides offering a

full array of benefit packages, the company had a well-supervised child-care facility on the premises at no charge to employees. The human resources director attended all managerial meetings, thereby maintaining a strong presence in all company decision-making and the position was considered on par with senior management executives. The commitment to maintaining hands-on control of his organization and the strong, caring relationship with his people made for a close-knit family and a kind of patriarchal role for Grange. He prided himself on the fact that union attempts to organize his factory labor force never got off the ground, as his employees felt that they were best represented by Grange himself.

Years ago, a satellite retail packaging assembly plant and distribution facility in San Antonio, Texas, which had been part of the purchase of a small professional beauty applicator business, was dissolved in favor of consolidating all operations in Youngstown. All personnel at this redundant factory were given an opportunity to relocate in Youngstown or they received good termination benefits.

The United Kingdom alliance was finalized due to Grange's long and valued friendship with the principal of that company. The two also shared similar feelings about managing people and a common cultural background. Both parties had spent many years working together and enjoyed a special relationship, which had been fostered by the fact that the U.K. managing director's family resided in Ohio, thereby bringing the two executives together on a monthly basis as the Englishman came home often. Grange also visited the British facility every two months and the two executives spoke weekly on the phone. Both men viewed the alliance as more of a partnership than an arm's length sourcing arrangement.

Grange always felt that one of his prime differentiated product marketing characteristics was that up until the U.K. association for sponge material applicators, all his products were made in the United States. He believed that such designation symbolized quality of material and manufacturing excellence as well as innovative styling and technologically advanced, state-of-the-art compliance. Even with the English sponge production unit, all the cotton puff applicators were still made in the States. To drive home this important selling issue, all packages of retail cotton finished goods bore the American flag proudly stamped on them next to the words "Made in the U.S.A." Grange had recently seen consumer products bearing the slogan "Designed in America" as well as "Product Imported From China and Packaged in the U.S.A." but felt that the global customer still valued the U.S.A. slogan indicating the country of origin on his retail line. But in Grange's recent discussions with component buyers in the cosmetic and fragrance industry, such designation did not seem so important, given the fact that both the sponges and cotton puffs were slightly undistinguishable or hidden parts in the total presentation of the makeup compact, the accent being on the brand name, ingredients and plastic case; imported items could be utilized if quality was maintained. The recent acceptance of the sponges made in England by Textron's clients gave credence to the fact that quality, price and service were the prime criteria for the industry, rather than the country of origin.

Decision-Making Time

Following the conference on the plane ride home from the Orient, Grange and Case had assembled their managerial staff and charged them with putting together a preliminary plan to form an association with a Far Eastern manufacturer of cotton puffs. At the initial briefing meeting, samples of cotton puff merchandise collected from a variety of Far Eastern producers were evaluated by the manufacturing quality control people as well as by representatives of the marketing and sales groups from the retail and OEM divisions. The immediate consensus was that with a little direction in fashion styling composition and adjustment in fixative dyes to sustain color in the cotton velour, a quality comparative range to supplement their domestic manufacturing output could be produced abroad. When Case presented

the factory cost quotations for the samples being reviewed, the vice-president of finance exclaimed, "Such values were way below our own manufacturing standard costs before administrative overhead." He further added that "even with anticipated duty and freight via containerized shipments, the projected landed price at our door would eclipse our costs by a good 20 per cent or more reduction." When Case noted that, "These foreign price quotations were based on minimum quantities and could be subject to economies of scale discounting," all participants quickly realized that their projected stock keeping unit (SKU) sales for 2000 would easily allow for even greater margins.

When the meeting broke up, Chris Jenkins, the vice-president of finance, cornered Grange and Case in the hallway.

> Guys, if these numbers can be confirmed, and if future production of these Chinese puffs can be modified to accommodate our quality stability color standards and slightly altered for design modification, we need to jump on this as soon as possible. Better still, if we can manufacture over there ourselves via our own factory or through a joint venture, our profit potential would be magnified at least three times.

Alternative Proposals

It was now six months since that initial meeting. In the interim, Case had been back and forth a number of times, holding substantial discussions with what was now a short list of two potential alliance candidates, both of which were co-operative ventures, with local Chinese governmental bodies holding a share in them. While these companies' abilities to alter their production to accommodate changes in the color additive process and make design modifications were verified, and the exchange of cost quotations were proceeding well, Case had not yet proposed the final type of alliance he wanted.

In the back of his mind, Case wanted to form his own subsidiary but felt that such initial market entry strategy was both costly and risky, given the large investment required. Besides Case and Grange, the company did not have any other executives familiar with managing abroad. Given such considerations, Case's discussions to date with his Chinese associates had produced only two feasible alternatives to begin the relationship:

1. An initial three-year guaranteed outsourcing purchase agreement wherein, following the detailed specifications of Textron Ltd., supplies of cotton powder puffs would be produced at base prices. Such quotations would be subject to preset quantity discounting but offset slightly by an inflationary yearly adjustment. The right to pre-approve the samples of each and every shipment before departure would also be included in the arrangement. In essence a simplistic arm's-length purchasing association was contemplated.
2. The creation of a joint venture wherein Textron Ltd. would own 48 per cent of the company and the alliance partner would own the rest. Textron would be primarily responsible for sales and marketing worldwide along with periodic on-site technical assistance as to product design, quality assurances and engineering considerations by their technical staff. The plant facility, the manufacturing process itself and everyday operations would be under the direct control of the Chinese partner. Textron Ltd. would contribute a yet-to-be-finalized small dollar investment to help upgrade machinery and in general modernize the physical facilities. The partners would share the revenue generated by the sales efforts of Textron for the items produced in the plant.

Although exacting details of either proposed strategy needed to be worked out, with the former option requiring more legal and regulatory considerations, Case was confident that both situations could be accomplished. With the additional help of some local Chinese alliance specialists whom Case had utilized during the days when he had actually lived and worked in Hong Kong for a former employer, all seemed to be progressing nicely. Case knew he had to give additional thought to many other operational and

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administrative issues, and he wanted to obtain some sound advice form his internal teams before deciding which alternative to pursue. Questions as to the capital investment and how such funds would be utilized would require more discussions with the potential partners if the joint-venture route was chosen, but such issues would be addressed during Case's next trip to the Far East.

China as the Prime Choice of Supply

The focus on China was due mainly to Case's familiarity with the people and business environment. He felt very comfortable, given his prior experiences in the region and his knowledgeable appreciation of the culture and the way relationships were constructed. Beyond Case's personal considerations, the Chinese manufacturers he had encountered already had the necessary machinery and were well versed in the production of cotton puffs. Many already supplied the worldwide beauty trade, but did not possess the sophisticated marketing and sales competencies practised by Textron, nor had they gained the reputation Textron historically enjoyed with the franchise cosmetic industry. An alliance with Textron would enhance the Chinese manufacturers' technical abilities and provide them with a wider entrée to the trade. The annual beauty show in Hong Kong attracted a global following, which would allow Textron to even create an offshore sales office and showroom close to the prime production facility to entertain prospective clients. Besides the Chinese connection, Case had opened initial discussion with makers of sponge applicators and other beauty accessories in Japan and Korea so that his trips to the China could be combined with other business opportunities he wanted to pursue in the Far East.

Case had entertained pursuing a Mexican manufacturer, as he had had prior dealings with companies producing a variety of cotton products in Mexico. Given the background of many of them in the cotton and aligned textile trade, this seemed a natural consideration, especially given the NAFTA accords and geographical proximity to Textron's major market, the United States. All potential companies Case visited, however, were located in central part of the country, none near the border where the *Maquiladores* were available. Case's Mexican contacts were not familiar with the specific production of cotton puff applicators as their cotton experience was in the manufacturing of surgical dressings, bandages, feminine hygiene pads and simple cotton balls. They would need to buy machinery and train a staff in such manufacturing operations. If Textron would fund such investment and provide technical assistance, a number of them agreed to manage such a facility on the U.S.-Mexican border through a joint venture. Case was hesitant to provide the funding, and he was worried that starting up a new plant would not let Textron achieve the inherent historical benefits that the more mature existing production in China would instantly allow.

Besides the economic considerations, Case found the Mexican manager's attitude a bit troublesome. Textron had once used a Mexican plant to supply, in final packaged form, cotton pads for the removal of facial cosmetic make-up. While his dealings with the principles of this family owned and operated business was most cordial and personally gratifying, Case had found that their attention to manufacturing details left much to be desired. The quality inspection of the raw cotton coming into their plants had given Case cause for concern. Many openly told him they mixed first quality fibres with "seconds" and remnants from the textile manufacturers in their local areas to achieve cost efficient production. As Textron always claimed its materials for cotton puff applicators were of "100 per cent virgin cotton," such an assertion using might be difficult to enforce and supervise, given the pronouncements by his prior supplier. When discussions as to the importance of schedules to insure timely supply arose, the Mexican sources seemed to give the impression that they would do their best to comply. This slight hesitation bothered Case, as his component buyers demanded

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on-time delivery and were always changing specifications at the last minute.

Case had deep reservations on the business competencies exhibited by such Mexican firms, as his communications with them in the past, wherein days would go by before he heard from them, had left a poor impression on him. Many times, when he had repetitively inquired by e-mail, fax and telephone as to shipping dates for packaged finished products, he was eventually told that third-party suppliers of the packaging materials for the cotton pads caused the assembly delay. Inquiring further, during a visit with his Mexican supplier, Case learned that when local Mexican firms contract with each other, time promises are flexible and it seemed that an attitude of "when they are available, we get them" took precedence over definite schedules. During the year the company utilized the Mexican supplier, not one shipment was dispatched within the required period, and Case had given up contacting them, even paraphrasing the Mexican explanation when queried by his own inventory/warehouse manager.

The decision to go with a Chinese partner in some format seemed to be the best solution.

Case's Personal Reflections

As Case pondered what other matters needed to be resolved, his mind began to focus on his three-year posting, back in the early 1990s in Hong Kong, with an electronics manufacturer to oversee their Chinese network of suppliers. When Case and his family had first arrived in the then-British colony, the excitement of this new foreign land and it's unique culture had made a lasting impression on him. He had marveled at the sights, sounds, smells and overall ambience of the city state that mixed East and West. Coming from a middle class American lifestyle, the treatment the family received was like being transformed into a rich conclave of the elite. His children went to a specialized English-type boarding school and rarely mixed with local natives of their own age. In fact, such young Chinese children were lucky to get a basic elementary school education before being forced out into the real world and into the working community. The outskirts of the city, and even sections within, contained deep pockets that were below some extreme poverty levels Case had seen in other depressed regions of the world. Within a severely overpopulated area that was strained every day with new immigrants from the mainland, the concept of work, any job, took on a new meaning. People would work for what seemed like slave wages to Case, and he wondered how they survived, just attaining a mere sustenance level. His wife could afford household maids and cooks that were more like indentured servants than domestic employees. They worked long hours at meagre wages and never complained.

During Case's visits to plants in mainland China, both during his expatriate posting years and subsequent trips back in the mid-1990s, the conditions at such facilities had initially deeply disturbed him. The environments he witnessed were nothing like he had ever seen in the United States. Factories were like prison compounds. The laborers seemed to toil at their job stations never looking up, never smiling and always looked like they were staring out with blank facial expressions. Rarely had Case seen them take a break, with many workers eating lunch at their desks and at their worktables or machinery. He seldom witnessed the laborers even taking bathroom breaks. The air in the facilities was always stale with no ventilation except for a few fans, and it was always very hot or very cold, depending on the outside temperature. He witnessed children, younger it seemed that his two adolescent kids, toiling in the plants alongside the elderly. He watched infants placed alongside their mothers on the floor of the factories being rocked by feet as the mothers' hands moved on the table above them. As these visits become more frequent, Case's disdain for such initially horrific working conditions began to lessen and he began to accept what he saw.

Many times, in social conversations with other executives and managers, Case had voiced

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his concerns about the treatment of the workers. He listened as they tried to get him to understand and appreciate that while the conditions were terrible, the alternative might be even worse. With the expanded population, growing at a massive rate, the supply of people outstripped employment opportunities. In order to survive, people would take any job and children as well as the elderly all had to work. Public governmental assistance was not only inadequate but almost impossible to administer, even if the resources could be found. The old communist philosophy of all society working for the good of the common proletariat, and hence the state, had been indoctrinated with the birth of the Mao regime; people saw it as their duty and obligation to endure hard times.

Case's Chinese friends had often remarked that if China were to catch up to the Western capitalistic nations and be a participant in the world's expanded trading economies, its people were its greatest competitive asset. In order to be a member in the world community and to provide enrichment for future generations, sacrifices had to be made. Capital for the improvement of factory environmental conditions was secondary to the need to update basic machinery and gain technology. The government had to build a sound internal infrastructure of roadways, rail and port facilities to ship its goods before the physical welfare of its people could be considered. With power still a scarce commodity, any electricity flowing into a factory needed to be first used to run the machinery and not for hot or cool air to be produced. The only way to achieve the goal of making mainland China competitive with the rest of the world was through the exportation route which was founded in the country's ability to produce cheaper goods than the rest of the globe. This simple fact necessitated low labor and overhead operating costs that contributed to poor working conditions in the factories.

Obviously, Case understood this economic argument was the main reason his company—and therefore he himself—had come to the region. In order for his own organization to remain competitive in the cotton puff business both at home and abroad, it would have no choice but to locate a portion of its operations in China or some other emerging nation.

Case had seen the TV footage of the protesters at the 2000 WTO conference in Seattle who had destroyed that meeting and in latter months had done the same in Washington, D.C., and Ottawa, Canada. He heard them voicing and physically demonstrating their deep concerns against governments and transnational companies as to worker rights and environmental conditions in emerging and developing nations. Case was well aware of the attention the press gave to large multinational companies like Levi Strauss, Reebok and others over their treatment of employees accusing them of almost slavelike practices in their foreign factories. Even personalities that lent their names to the labels of garments, like Kathy Lee Gifford, had come under strong pressure for allowing their third party licensees in the United States to operate sweat shops and mistreat workers. Companies that did not even have a direct relationship wherein they exercised straight control over employee conditions were still questioned about the suppliers they used abroad as the social conscience of the world seem to be focused on these issues.

Although Case himself deplored the hiring of adolescent children, he understood the economic and social context that existed in China for their use. China wasn't America. Young kids grew up much faster and much more was expected of them as contributors to the family unit. Even with the government mandate, made within the framework of the message of a collective good of the nation for families to have only one child, did not alleviate the problem. In fact, in many families it just made the burden deeper. Most Chinese families were made up of extended relatives who grouped together to pool their resources for their common survival. In these family units, all members had to work. The simple luxury of going to a public school, playing games and watching TV, as American children enjoyed, was not part of their world. In numerous families, children, mostly young girls, were sent away from their rural villages to emerging urban

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industrial centres to look for work. After paying large portions of their meagre weekly salaries back to their employees for dormitory housing and food within the confines of the factory compound, any amount left over was sent to the family.

Even the elderly felt such pressure to work, as retirement after years of service and a reasonable pension was almost a non-existent consideration. No true governmental program like social security existed, and the family had to care for the elderly in their homes, putting a great burden on the whole extended unit. Political dissidents and even criminals were conscripted into the labor force to help offset the cost of the State having to provide for them. Plant conditions, treatment of workers and even caring about the environment were not primary issues for an emerging country trying to first find work for it's population during the transformation process into a competitive world economic nation.

Case pondered if it was time for the company to prepare a written corporate moral compass. Should it publish a code of ethics, as many transnational firms had been doing? What should it consist of, what specific criteria defining norms of behavior should be stated? and should it be incorporated as an obligation in the arm's length purchasing agreement being considered with the Chinese supplier? If the announced provisions were violated, should this be viewed as an automatic right for Textron to terminate the agreement, or should there be a time frame in which to cure such conditions? Case also wondered how his firm could monitor such matters to ensure compliance. If the alternative joint venture were chosen, how should such values be incorporated into the partnership agreement and how should Case process such matters during the negotiation?

Case was comfortable with discussions on costs, quality and delivery specifications as they had a finite measurable logic to them. Social responsibility and ethics touched upon many emotional areas that were harder to define. He had seen firsthand how different cultures approached them from divergent viewpoints, and he had gained a respect for the saying "when in Rome do as the Romans do." He also, however, maintained the feeling that there were core human values that at times transcended such local traditions and social context.

Moral Dilemmas—Unanswered Questions

What worried Case was even if the business decision were the right one, could the company be entering a relationship that might some day backfire? If a factory that Textron brought merchandise from or, because of the joint venture, was more deeply involved in was alleged to be mistreating employees, would public opinion injure the company's reputation? Was the focus of the world now on China and its historic practices of human rights abuse? Would someone be watching companies more closely that associated themselves with Chinese partners in any form?

What if Textron's buyers of components, the franchised cosmetic houses, were themselves chastised for using slave-type labor in the supplies used in their own manufacturing of their brand named products? Would they in turn cease to buy from Textron Ltd.? What if consumers of the retail packaged lines decided to boycott the products for similar reasons? What if the licensor of the new collection felt that such foreign sourcing of items bearing their trademark was injurious to their image and reputation, and they objected?

Given his company's strong traditional organizational culture of placing employees first, Case also wondered what effect any such ethical and socially responsibility issues stemming from a Chinese association could have on his own domestic operational employees.

He wondered about such matters again as he thought to himself that going global was more than just an exercise in financial, legal and operational logistical decision making; it involved taking a moral position in Textron's commercial relationships with overseas entities.

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NOTE ON THE POLLUTION PROBLEM IN THE MEXICO-U.S. BORDER REGION

Prepared by Dan Campbell, David Eaton, and Tony Frost

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> *History has shown that pollution increases in the first part of the country's major growth and this is certainly where Mexico is right now.*
>
> —Adolfo Gonzalez Calvillo, Director of Baja California's Department of Ecology

> *You don't solve problems in underdeveloped areas just by passing out money; 90 per cent of the problem is human attitude.*
>
> —Victor Miramontes, Managing director of the North American Development Bank

The Chilpancinco settlement in Tijuana sits in the shadow of Otay Mesa, on top of which sprawl dozens of the city's maquiladora factories, on the California-Mexico border. Many of them are owned by U.S. corporations, including a now closed battery recycling plant. A white chemical crust rims the clods of dirt in the field outside the plant, and pools of strange, yellow water dot the barren landscape. Lead and heavy metal deposits have been measured in the soil on the mesa at concentrations 40,000 times over safe levels. In this unincorporated settlement, or colonia, six babies were reported born without brains in 1993, and 13 in 1994, just one of several clusters of this rare birth defect, called anencephaly, on the border.[1]

In the wake of the passage of the North American Free Trade Agreement (NAFTA) in 1994, numerous national and binational organizations were created to study and attempt to alleviate the environmental crisis in the Mexican-U.S. border region. This crisis, precipitated by 30 years of exponential growth in manufacturing activity along the Mexican side of the border, had a direct impact on the 11 million people that inhabited the region and the natural environment that struggled to sustain them.

Contrary to what was often portrayed in the public press, solutions to the pollution problem in the border region were neither obvious nor easy to implement. Many economists argued that it was misplaced for a developing country like Mexico to implement U.S. and Canadian-level environment standards. In fact, the chief economist for the World Bank, Lawrence Summers, had written an internal memo (subsequently leaked to the press) stating that "the economic logic behind dumping a load of toxic waste in the lowest wage country is impeccable." According to this view, environmental consciousness, along with greater enforcement of environment laws should—and surely would—follow Mexico's long march out of poverty toward economic prosperity. To environmental groups, such arguments were misconceived, and ignored both the very real costs of the pollution hazards for those living in the region, as well as the long-term costs of a badly degraded natural environment.

In the political sphere, the environmental problems in the border region were just one more in a litany of economic, social and political problems that had plagued the U.S-Mexico relationship in the post-NAFTA era. Between the 1994 peso crisis, Mexico's growing political

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instability, the drug problem, the continued influx of illegal immigrants into the U.S. and the rapidly escalating trade deficit with Mexico, the voice of free trade in U.S. politics had grown increasingly dim. Although in 1997, President Clinton was again asking the U.S. Congress for "fast track" authority to further the free trade agenda, stories of massive environmental degradation and lax and/or corrupt enforcement of pollution regulations did little to further that agenda.

One thing was clear: stakeholders, activists and policymakers were operating in an "information vacuum" with respect to the environmental situation in the border region. Arguments on both sides of the issue were plagued by the paucity of data and scientific evidence. Had the environmental situation along the border improved under NAFTA, as some claimed? Had it gotten worse? Who exactly was responsible for the "white chemical crust" and "pools of strange, yellow water"? And, most importantly, what should be done?

The Mexico-U.S. Border Region

In 1965, new Mexican legislation permitted the creation of a new form of manufacturing operation in the Northern border region, called a *maquiladora.* Under a set of rules outlined in the Mexican Border Industrialization Program (BIP), a maquiladora factory could temporarily import supplies into Mexico duty-free. After the manufacturing process, the goods could be returned to the U.S., again duty-free. Only the value added in Mexico was taxed by the Mexican government as the goods left the country.

With few exceptions, the next 30 years in the border region were characterized by rapid and sustained industrial growth. In the early years, development was limited to low capital factories that relied heavily on cheap manual labor. Without the commitment of fixed capital, investors were quick to move or close facilities if they became dissatisfied with local conditions. As a result, the Mexican government offered exceptions from its stringent labor laws to continue to attract U.S. investment. Under a program called EL PACTO, the Mexican government, working with co-opted union officials, guaranteed preferential wage rates in order to attract direct foreign investment and curb inflation.[2] In later years, under pressure from external sources such as the International Monetary Fund (IMF) to encourage more permanent industry, Mexico began to support capital intensive activities that, although requiring fewer laborers, were hoped to provide a more stable economic base.

By 1997, the border region, 3,200 kilometres long and just 200 kilometres wide, was one of North America's fastest growing regions.[3] It was also the only geographical boundary in the world in which a free trade zone existed between an advanced industrial country and a developing country neighbor. Exhibit 1 shows a map of the region.

With output estimated at US$150 billion, the economy of the border region was larger than Poland's and nearly the size Thailand's. Growth was not projected to slow in the years ahead, despite the fact that NAFTA would eliminate most of the tariff advantages accruing to maquila operations. Proximity to the U.S. market and the further decline of real wage rates in Mexico following the peso crisis ensured that foreign companies—and not just U.S. companies—would continue to invest heavily in the border region. Indeed, the rapid influx into the region of major Asian companies such as Sony, Samsung and Daewoo had led the mayor of Tijuana to declare: "This is going to be the Hong Kong of North America's Pacific coast."[4]

The Border Environment

The rapid growth rates of the past 30 years had not come without cost. Infrastructure development was largely unable to keep up with the expansion.

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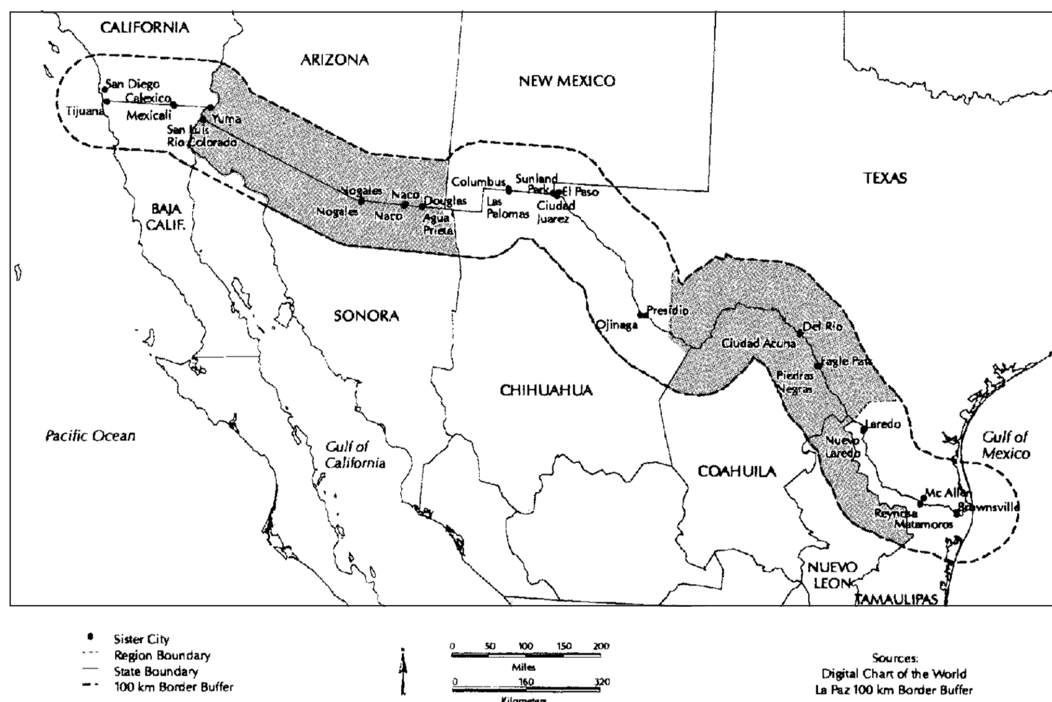

Exhibit 1 U.S.-Mexico Border Region

Standards of living were extremely low: maquiladora workers earned between US$5 and US$7 per day. The daily struggle for survival left precious little for "luxuries" such as running water and proper sewage disposal that might contribute to a cleaner environment. Economists estimated that the entire border region required additional infrastructure investment of $8 billion to bring drinking water, sewage treatment and garbage collection to all residents. Others put the price tag at closer to $20 billion.

Infrastructure and Lax of Tax Base

Environmental activists argued that low wages were not all that foreign multinationals were taking advantage of in the maquiladoras. Andrea Durbin, policy analyst with Friends of the Earth made the following comments before the House Ways and Means Subcommittee on Trade:

> Annex III of the La Paz Agreement and the 1988 Mexico Law of General Equilibrium require maquiladora industries to export their hazardous waste to the country of origin for treatment and disposal. The thinking behind the agreement is that Mexico lacks facilities to treat these wastes in a manner equivalent to the treatment they would receive in the U.S.
>
> The U.S.-owned maquiladoras widely flaunt this law. The Environmental Protection Agency estimates that only about one-third of the hazardous waste generated in the maquiladoras is returned to

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the U.S., leaving somewhere around 20,000 tons in Mexico.

This situation is not in the Mexican or the U.S. interest. The improperly dumped toxic wastes can lead to public health problems and huge long-term clean-up costs for Mexico. Industries may relocate to Mexico to take advantage of the situation and avoid the costs of proper disposal in the U.S. The problem is not isolated to Mexico, since the toxics [sic] can cross back into the U.S. through the air, water, or groundwater.[5]

Although Durbin was not alone in predicting that NAFTA would precipitate the migration of dirty industries from Canada and the U.S. to Mexico, others disagreed. The U.S. Environmental Protection Agency (EPA), for one, dismissed this prediction as unlikely:

NAFTA will not encourage U.S. firms to relocate to Mexico for environmental reasons because pollution abatement costs represent a small share of total production costs in most industries.

Mexican Environmental Laws and Enforcement

Based on U.S. legislation, Mexican environmental laws and regulations were relatively strict. Where Mexico and the U.S. diverged in terms of environmental legislation was mostly in areas that were only secondarily related to the environment, such as so-called "right to know laws" and provisions for civil liability. For example, companies in Mexico were not required to make public the nature of their manufacturing activities to interest groups or the general public. Even when individuals or groups were able to collect evidence of damages caused to them by a polluting company, the Mexican legal system did not provide an adequate opportunity to seek restitution. Multi-million dollar class-action settlements were non-existent in Mexico.

Most of the criticism surrounding Mexico's environmental record was aimed at the country's ability to enforce the legislation already in place. Fears of lax enforcement were, in fact, central to the so-called "pollution haven hypothesis"—the notion that free trade would precipitate a race to the bottom in environmental standards as countries competed for foreign investment. Carlos De OrduZa, former president of the National Council of Macquiladoras, commented that:

On the environment, Mexico has more difficult rules to comply with than the United States. Now, how well they can enforce the law is another story.

Under Mexican law, authorities had four enforcement mechanisms at their disposal:

Plant Closings: Ordered by an inspector while visiting a facility, plant closings were reserved for situations in which there is an imminent risk of "ecological disequilibrium" or if contamination exists that has "dangerous repercussions" for the environment.

Fines: Fines could be imposed on companies found to be violating environmental regulations ranging from 20 to 20,000 times the daily minimum wage.[6] A fine could only be issued after an administrative resolution, not at the time of the inspection.

Criminal Penalties: Depending on the severity of the crime, penalties could be issued against officers of offending companies ranging from one month to six years in prison, as well as fines of up to 20,000 times the daily minimum wage. If the environmental crime was carried out in a populated area, an additional three years of imprisonment could be imposed.[7]

Administrative Arrest: In extreme cases, corporate officers could be held for up to 36 hours by Profepa, Mexico's attorney general for the protection of the environment.

Until 1991, Mexico had only 109 environmental inspectors for the entire country. Many lacked basic training and tools, such as laboratories to test soil, water and waste. Moreover, the

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environmental bureaucracy in Mexico was widely viewed as an inept, if not openly corrupt, agency. As a result, orders were often routinely ignored. Inspections were thought to be rare and were targeted mainly at highly visible companies. One Mexican manager of a major multinational firm commented:

> Unless a small company is being visible about its environmental contamination, environmental authorities don't bother them. They go to the big companies. That's where the money is.

Not surprisingly perhaps, the level of enforcement of environmental regulations appeared to improve as talks about the NAFTA intensified. In the two years leading up to the signing of the NAFTA, the number of inspectors tripled, while inspections and enforcement actions increased dramatically. However, in 1994, a presidential election year, inspections dropped off substantially. Many argued that the ruling party did not want to risk potential backlash from plant closures and lost jobs. The severe economic crisis in 1995 made enforcement initiatives that could lead to job losses even less politically appealing.

NAFTA AND THE ENVIRONMENT

The controversey over the environmental impact of NAFTA led the Clinton administration to negotiate a parallel side agreement pertaining to the environment. The agreement established several bodies designed to deal with environmental issues and to investigate "persistent patterns of failure to effectively enforce (a country's) environmental law."[8]

Under NAFTA, the United States, Mexico and Canada were also expressly forbidden to lower environmental standards to attract investment. The agreement also supported harmonizing environmental standards and allowed the three nations, as well as states and cities to adopt more rigorous standards. Under NAFTA, the United States and Canada maintained the right to block the importation of goods that failed to comply with its health or environmental standards.

Despite claims that NAFTA was the "greenest trade agreement in history," its environmental provisions had been criticized on several accounts. First, environmentalists complained that the dispute resolution process was secretive, exclusive and lacked provisions for enforcement. No apparent means existed for public comment on environmental matters presented before NAFTA panels. A second complaint was with the burden of proof provisions, which required the challenging party to establish that the sanitary (health) or phytosanitary (plant health) measure in question is inconsistent with or in violation of NAFTA. In addition, no specific trade sanctions were provided as a means to combat noncompliance with the provisions of either NAFTA or the side agreement on the environment. Moreover, the sanctions specified under NAFTA were considered to be unenforceable and too complex to be of much use.

The signing of NAFTA had also established the Border Environmental Co-operation Commission (BECC) and the North American Development Bank (NADBank), which were created to complement existing funding to improve the border region's environmental infrastructure and to strengthen co-operation on addressing the region's environmental problems. The BECC's purpose was to certify environmental infrastructure projects—primarily for drinking water, wastewater treatment and municipal solid waste—for subsequent financing by the NADBank in the form of loans and loan guarantees at market interest rates with flexible repayment terms. The agreement was intended to encourage private sector investment in projects funded through user fees paid by polluters and the border communities benefiting from these projects.

The remainder of this note describes two companies operating in the border region: Sanyo North America Corporation, a subsidiary of the Japanese electronics giant Sanyo Electric; and Guillermo Jiron Y Asociados, a Mexican company, which provided hazardous waste disposal

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services to Sanyo and other maquiladoras in the border region.

Sanyo North America Corporation

The border operations of Sanyo North America Corporation (Sanyo) consisted of nine plants in Tijuana, Mexico, which bordered San Diego in the U.S. Although Sanyo had a long history of sales and manufacturing operations in the U.S., it had decided in 1996 to relocate its North American headquarters from New York to San Diego—closer to its manufacturing operations in Tijuana.

The Tijuana plants consisted mainly of low-cost assembly operations that manufactured products for the U.S., Canadian and other export markets: two refrigerator plants, two video cassette recorder plants, two plants manufacturing rechargeable batteries, and three others making televisions, appliances and laptop computers respectively. Most of the raw materials for these factories arrived as goods in process from factories in Japan. Materials entered the United States at the port of Long Beach in Southern California.

Sanyo's environmental policies were established by headquarters in Japan. In 1995, the company had launched a worldwide initiative to establish an environmental management system based around ISO 14000, an international standard of environmental management similar to the well known ISO 9000 quality standard. Sanyo had set the ambitious target of having each of its domestic and overseas factory sites as well as business headquarters, regional management centres, and research and development laboratories receive ISO 14000 certification by the end of the 1997 fiscal year.[9]

In part, to show its commitment to the border region, Sanyo had presented its corporate environmental policies to the North American organization at a conference in July at the company's North America headquarters in Tijuana. The conference brought together company management, environmental consultants, academics, and representatives from the EPA. Speaking at the conference, Mr. Yasuo Ohira, managing director of Sanyo Electric outlined the fundamental premise behind the company's environmental philosophy:

> Sanyo cannot overcome competitors without superior, environmentally-conscious products.

Mr. Ohira went on to explain what this meant for Sanyo in terms of its corporate environmental policies. He stated that Sanyo needed to:

- Define the environment as one of our major management issues.
- Strictly observe environmental laws, regulations and international accords.
- Achieve compatibility between sustainable development and environmental preservation, and promote business activities that harmonize the environment.
- Determine voluntary regulations and standards, and implement ongoing programs for continuously improving the environment.
- Develop products that harmonize with the environment, including: introduction of life cycle assessment (LCA); improved recycling and energy-conserving qualities of products; and reduced use of environmentally hazardous chemical substances.

As part of its environmental management effort, the company had laid out a broad set of internal environmental targets to be reached by the year 2000. These targets were known as the "Second Voluntary Plan" and are summarized in Exhibit 2.

Sanyo Energy Corporation—Battery Division

Sanyo's North American battery division was created in 1986 with the construction of a cell assembly plant.[10] In 1990, the division was expanded with the addition of a battery assembly plant that linked multiple cells together to form rechargeable power packs for a variety of applications. The most common were wireless hand tools such as drills and radio controlled model vehicles.

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Action objectives of the second voluntary Plan

SANYO Electric Co., Ltd.

Items		*Target for 2000*
Measures against global warming	Development of energy-saving products	Power usage levels compared with level in 1990 Air conditioner (main models) 35% (Cooling mode) reduction 20% (Heating mode) reduction Refrigerator (main models) 30% reduction Compared with level in 1995 TV (main models) 5-20% reduction
	Reduction of energy consumption per unit sales value	Compared with level in 1990 25% or more
Product assessment	Increase of recyclability Reduction of disassembling time Reduction of packaging use foam styrene	70% or more (main products) 55% or more (main products, compared to 1992) 50% or more (main products, compared to 1990)
Measures against industrial waste	Improvement in total volume of waste per unit sales value	70% or more (compared to 1990)
Promotion of environmental management system	Reduction of global environmental load	Fulfillment in accordance with guideline
Environmentally relevant substances (ERS)	Reduction of ERS use	(1) Selection of ERS concerned, establishment of investigation system for content in products until end of 1997 (2) Completion of content investigation, construction of data base, adoption of risk assessment guidelines and reduction targets until end of 1998 (3) Establishment of ERS management system in production stage covering whole SANYO company until end of the year 2000
Promotion of LCA	Reduction of global environmental load caused by products	Beginning of trial in 1996 for main products

Exhibit 2 Sanyo Electric Co., Ltd. Action Objectives

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Assembly

The cell assembly plant, using goods-in-process from Japan, manufactured single nickel-cadmium (NICAD) rechargeable cells. Manufacturing involved the winding together of nickel and cadmium plates into a cylinder approximately four centimetres long and two centimetres in diameter. The windings were then placed in a metal cylinder casing and filled with a chemical electrolyte before being sealed at either end with another metal plate.

During the winding of the plates, nickel and cadmium dust were created. Although the nickel dust was relatively harmless, the cadmium particles, while invisible to the naked eye, were extremely hazardous if ingested. To protect Mexican employees working within the plant, a ventilation system had been installed, with vacuum openings at each work station. Employees also wore masks and followed other procedures as dictated by the Materials Safety Data Sheet (MSDS) for cadmium dust that was published under the Workplace Hazardous Materials Information System (WHMIS).

Ultimately, the air from the ventilation system was vented into the external atmosphere, but not before being cleaned thoroughly. Plant management frequently tested the air leaving the ventilation system. Plant management admitted that they were unaware of any Mexican standard for these types of emissions, but levels were held below guidelines set out by the parent company for similar plants in Japan. As one plant manager noted:

> There is no way that a company like Sanyo is polluting. We are checking, watching everything. We test water going out into sewage, even though all we use it for is our restrooms. Our factories are practically brand new, newer than what we have in the United States.

In fact, the majority of the production process had been designed and implemented in Japan. Sanyo had several almost identical factories in other parts of the world, and the Tijuana operation was a copy of the Japanese factory. Most of the equipment came to the Tijuana plant second-hand as it was replaced in a Japanese manufacturing operation. This included a waste water treatment facility. Philipe Rujana, the Mexican plant manager, recalled the installation of the facility:

> I wasn't even consulted about the installation of the water treatment facility. Management in Japan decided it was necessary for the operations in Japan, so they installed it here too. Where Sanyo and the environment are concerned, money has not been an issue. Even without local pressures, we would still have the same high level of environmental protections. They are willing to do "whatever it takes."

Guillermo Jiron y Asociados

Located in Tijuana, Guillermo Jiron y Asociados (GJyA) was a waste management company that offered a complete range of services required to dispose of hazardous wastes generated in maquiladora manufacturing operations. Sanyo was the company's largest client and provided it with 15 per cent to 20 per cent of total revenues.

Maquiladoras contracted companies like GJyA to classify and remove hazardous wastes directly from their manufacturing operations and to ensure that they were properly transported back into the U.S. To legally transport and dispose of hazardous waste materials was a multi-step process that included waste characterization, brokering and transportation.

Waste Characterization

Before waste materials could leave the manufacturing facility where they were created, the nature of the waste had to be determined and classified under a complicated set of guidelines outlined by the Mexican and U.S. governments. Because classifications were so narrow, a single manufacturing operation could generate waste materials that fell under numerous categories,

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each with their own handling and documentation requirements. The situation was further complicated by poorly defined requirements that were modified so frequently that even government and custom officials had a limited understanding of regulations and jurisdictions. The problem was exacerbated by confusion as to jurisdictional responsibilities in Mexico. For example, the management and movement of hazardous waste was considered federal jurisdiction whereas waste water treatment fell under state and local jurisdictions.[11]

Brokering

Due to the complexity of regulation, the services of a broker were required to work together with customs and other regulatory officials. The capacity and condition of customs facilities, as well as the training and staffing of officials at points-of-entry into the U.S. were insufficient to handle the large volume of traffic in the border region. The broker also negotiated with hazardous waste storage and disposal facilities in the U.S. to place or destroy the numerous categories of hazardous materials.

Transportation

GJyA had almost no transportation equipment of its own. Instead, the company contracted the transportation of the materials to several independent transport companies. Two different companies needed to be contracted to return goods to the U.S. because Mexican trucks were not permitted to cross the U.S. border. GJyA included the use of transportation contractors in their overall service package to end users. Often, clients of GJyA did not know which carrier was actually transporting their waste products.

Industry Conduct

Because maquiladoras were legally required to return their wastes to the U.S., Mexico had never developed a large hazardous waste storage or disposal capacity in the border region. The transportation industry, however, had developed rapidly and competition to provide hazardous waste trucking and disposal services was intense.

Guillermo Jiron, president of GJyA explained:

> This is a cost driven business. You'd be amazed at some of the operations we compete with. It doesn't take much to get into the industry . . . just a truck really.

Less stringent safety requirements for trucks and low levels of enforcement, reduced barriers to entry, allowing numerous carriers with substandard capital equipment to offer hazardous waste transportation services to the region's manufacturers. Another factor affecting competition in the industry was the nature of the liability affecting producers and handlers of hazardous waste. Jiron explained:

> In the U.S. and Canada, manufacturers are still liable for hazardous wastes produced in their facilities when the wastes are being transported by a third-party contractor. This is not the case in Mexico. Liability for hazardous waste infractions by transportation companies can only be placed on the carrier itself. As a result, manufacturing operations are generally less concerned with the level of safety in the transportation companies they contract with . . . price is one of the few means of differentiation . . . carriers are forced to reduce costs whenever possible.

Costs were often reduced by cutting corners on measures taken to comply with regulations. Such activities included: not purchasing emergency response equipment, failing to train drivers to deal with emergencies and carrying noncompatible wastes in one trailer or container, which laws state should be kept separate. Perhaps the easiest way to cut costs was simply to dump the waste in one of the many illegal sites in the country's northern deserts, where thousands of barrels of toxic waste dotted the countryside.

The incentive to cut corners was intensified by several other factors:

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Minimal Enforcement: Generally, transporters of hazardous waste did not fear a punitive reaction from government officials.

Lack of a Civil Liability: The absence of civil liability mechanisms, similar to those in the U.S., eliminated the risk of civil suits in the event of damage to individuals or the natural environment.

Limited Use of Insurance: Because the risk of civil liability was not present, few companies felt the need to carry insurance. In the U.S. and Canada, where insurance companies were responsible for damages, they either demanded that responsible risk management procedures be followed, or charge higher premiums. Mexican companies, lacking the need for insurance, also lacked the incentive toward responsible behavior that was imposed on their U.S. and Canadian counterparts.

Jiron also pointed to upcoming provisions, stipulated under NAFTA, as providing a potentially important change in the structures and incentives governing the handling of hazardous waste in Mexico:

> In the year 2001, goods entering Mexico from the U.S. will no longer require a temporary importation permit to cross the border duty free. Instead, they'll fall under the NAFTA and move freely from one country to another.
>
> Basically, what that means is that hazardous wastes produced in Mexico will be able to remain in Mexico. My guess is that many companies will start to look for domestic options for hazardous waste storage and disposal. Hey, I would, too: why expose myself to U.S. civil law by bringing waste back into the U.S.? Trucking waste across borders is also a real administrative headache: not only are Mexican regulations different than U.S. regulations, but California's are different than Arizona's, which are different than Texas's.

In 1997, some estimates suggested that only one-sixth of Mexico's domestic demand for disposal facilities was being met. Attempts to create new facilities had met with strong opposition from interest groups such as Greenpeace Mexico. David W. Eaton of the Center for Inter-american Trade and Commerce at the Monterrey Institute of Technological and Superior Studies commented:

> We don't know exactly what is going to happen to the hazardous wastes generated in the maquilas after the year 2001. The whole hazardous waste relationship that exists currently must be changed.

The Post-NAFTA Experience

In the two plus years following NAFTA's passage, numerous claims had been advanced about the environmental impact of the agreement. Several assumptions that had underpinned the green aspects of the agreement appeared not to have been correct.

The first was that NAFTA would fuel investment into Mexico's interior, thus relieving the pressure on the border ecosystem. However, the number of maquiladora workers had increased by more than 25 per cent from 546,000 in 1993, to 689,000 in September 1996. Nearly 400 new factories had opened along the frontier in 1996 alone. If anything, foreign investment in Mexico had become even more concentrated in the border region following NAFTA.

A second assumption was that rising income in the region—an outcome of greater trade and investment—would allow for greater investment in infrastructure to clean up the environment. However, the collapse of the peso in 1994, which reduced Mexican incomes by about half, caused federal and local governments in Mexico to cut environmental spending dramatically. According to some estimates, over 50 million gallons of untreated waste were still being dumped daily into the Rio Grande River in the town of Juarez, which lacked a waste treatment facility, threatening exposure to cholera, hepatitis and dysentery. Hepatitis rates on the border were two to five times the U.S. national average. In 1997, 40 per cent of the population on the Mexican side of the

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border were still thought to lack sewers, potable water or both.

A third assumption was that NAFTA institutions such as the BECC and NADBank would create a pool of funds for environmental projects. However, by mid-1997 BECC had certified only 16 projects for financing. Moreover, the NADBank, which was to fund these projects, was not expected to be fully capitalized until 1998. To date, it had only approved funding for four projects.

Supporters of the agreement, including the Clinton administration, countered with arguments and evidence of their own. A report issued by the U.S. government noted that while environmental problems along the US-Mexico border "were decades in the making and cannot realistically be corrected overnight . . . progress is evident." Since NAFTA's passage, enforcement of Mexican environmental law appeared to have improved. The number of Mexican environmental inspectors had increased, and an environmental crimes unit had been created. From 1993 to 1996, Mexico reported a 72 per cent reduction in serious violations from maquiladora facilities. This view was echoed by Jeanette Moorhouse of the Border Environmental Technology Resource Center:

> With (Mexican President) Zedillo and his predecessor, there has been a lot less corruption, and that means better enforcement of environmental laws. Today, businesses in Mexico can't just pay off a fine and keep continuing to illegally pollute like they could a few years ago.

In this atmosphere of uncertainty and incomplete information, the environmental situation on the U.S.-Mexican border was unlikely to disappear either from the public conscience or from the impending debates on the expansion of trade in the Americas.

Epilogue

More than 3,200 kilometres to the east of Tijuana, in Brownsville, Texas, a rash of birth defects, similar to those that occurred in Chilpancinco, saw 25 children born with spina bifida and another 30 babies born with anencephaly. Families of the dead and deformed babies subsequently filed a suit, claiming that contamination from factories, located across the Rio Grande, but owned by U.S. corporations, caused the defects.

In 1995, the defendants, comprised of multiple U.S. corporations including General Motors, agreed to an out-of-court settlement of US$17 million. General Motors, in a letter to the Cable News Network (CNN), commented that "the primary cause of these types of birth defects is lack of sufficient folic acid in the diet" of the expectant mother. In 1997, Time Magazine reported that "many companies cleaned up their worst environmental excesses after the outbreak of fetal deformities, [and the outbreak] ended as suddenly as it began."[12]

Notes

1. Environmental Action Magazine, "After NAFTA," September 22, 1995.
2. Maquiladora development history taken from Kopinak, Desert Capitalism: Maquiladoras in North America's Western Industrial Corridor, 1996.
3. The width of the border region was defined by the La Paz Agreement in 1983. The La Paz Agreement was signed by Mexico and the United States for the Protection and Improvement of the Environment in the Border Area.
4. Ibid.
5. Testimony of Andrea Durbin, policy analyst, Friends of the Earth before the House Ways and Means Subcommittee on Trade, September 21, 1993.
6. In 1997, the daily minimum wage was roughly US$3.25.
7. Economist Intelligence Unit, Managing Mexico's Environmental Challenge.
8. Business and Society Review, September 22, 1994.
9. Similar to ISO 9000 quality certification, ISO 14000 required that the environmental policies and practices be evaluated by recognized ISO 14000 auditors. Unlike ISO 9000 where objectives were measured

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by an absolute set of quality standards, ISO 14000 was based on the identification of, and progression toward, goals determined by each company on an individual bases. Within Sanyo, there were 34 sites in Japan and 48 overseas applying for certification.

10. Single units, often referred to as a battery by the general public, are actually a single cell. A battery is created when multiple cells are linked together.

11. The majority of wastes which were dumped illegally were liquid poured into the municipal drainage system.

12. Information about the Brownsville birth defects and ensuing legal action taken from, "The Border Babies; Did Toxic Waste from U.S. Factories Across the Border Damage the Environment of a Texas Town?," Time Magazine, May 26, 1997.

THUNDERBIRD
THE GARVIN SCHOOL OF INTERNATIONAL MANAGEMENT

Planet Starbucks (A)

Prepared by Professors Michael H. Moffett and Kannan Ramaswamy

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> *You get more than the finest coffee when you visit Starbucks. You get great people, first-rate music, a comfortable and upbeat meeting place, and sound advice on brewing excellent coffee at home. At home you're part of a family. At work you're part of a company. And somewhere in between there's a place where you can sit back and be yourself. That's what a Starbucks store is to many of its customers—a kind of "third place" where they can escape, reflect, read, chat or listen."*
>
> —1995 Annual Report, Starbucks Corporation

> *During the World Trade Organization talks in November 1999, protesters flooded Seattle's streets; and among their targets was Starbucks, a symbol, to them, of free-market capitalism run amok, another multinational out to blanket the earth. Amid the crowds of protesters and riot police were black-masked anarchists who trashed the store, leaving its windows smashed and its tasteful green-and-white decor smelling of tear gas instead of espresso. Says an angry Schultz: "It's hurtful. I think people are ill-informed. It's very difficult to protest against a can of Coke, a bottle of Pepsi, or a can of Folgers. Starbucks is both this ubiquitous brand and a place where you can go and break a window."*
>
> —"Planet Starbucks," *BusinessWeek*, September 9, 2002, p. 100.

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Ubiquitous—that was the term often applied to Starbucks. It had indeed become omnipresent within the United States and Canada throughout the 1990s. Now the company—and its founder, Howard Shultz—had set its sights on the global marketplace. Howard Schultz had stepped down as Chief Executive Officer and President in 2000 and taken on the title with associated duties of Chief Global Strategist (he remained Chairman of the Board). Between 1999 and 2002, the company averaged sales growth of over 25% per annum, and despite the recession wracking the global economy, 2003 was expected to show the same rapid growth. But the North American coffee markets were quickly reaching saturation. Howard Schultz and Starbucks knew that if Starbucks was to continue to meet the market's expectations for growth, the global marketplace would have to support it. By 2003, Starbucks had become the growing target of the anti-globalist movement, and many questioned its ability to successfully expand the U.S.-based business model to the global marketplace.

Starbucks History and Origins

Starbucks was founded in Seattle by Gerald Baldwin, Gordon Bowker, and Ziev Siegl in 1971 as a gourmet coffee bean roaster and distributor. The Starbucks name was a combination of Seattle's past, the *Starbo* mining camp of the nineteenth century and the first mate's name in *Moby Dick,* the classic American novel of whaling on the open seas. In 1982, Howard Schultz joined the company as a member of their marketing team. After a visit to Italy, Schultz urged the partners to consider opening Espresso bars in conjunction with their coffee sales. In 1984, Starbucks opened its first Espresso bar, a small corner of the company's downtown Seattle Starbucks store, to rave reviews. Although Schultz urged the company to expand the Espresso bar line, the controlling partners, now Baldwin and Bowker, were unwilling to enter what they considered the fast-food business, wishing to focus on the coffee-roasting niche market. The company had recently purchased Peet's Coffee and Tea, a Berkeley, California, coffee roaster and distributor, straining the company's management and financial capabilities. The partners wished to focus on these two main businesses.

Howard Schultz then left Starbucks and, actually with the financial backing of his former partners, opened *Il Giornale* in 1985, an espresso bar that sold coffee and assorted coffee beverages made exclusively with Starbucks' beans. Two years later, Schultz bought the former Seattle Starbucks company, six stores and roasting plant, for $3.8 million from Baldwin (who wished to focus on managing Peet's) and Bowker (who wished to cash out of the business). Schultz now was in control of Starbucks and with new investors, began building a global business which reached sales of $3.3 billion in 2002 and was acclaimed one of the top 100 growing global brands.

The Starbucks Concept

Howard Schultz's dream was to take the concept of the Italian—specifically Milan—espresso bar to every corner of every city block in the world. By the fall of 2002, the Starbucks business was a complex three-legged stool for global development: (1) retail coffee and assorted specialty items; (2) specialty sales; and (3) Frappuccino coffee drinks and specialty coffee ice creams sold through other retailers globally.

> **What We Are About.** Starbucks purchases and roasts high-quality whole bean coffees and sells them along with fresh, rich-brewed, Italian-style espresso beverages, a variety of pastries and confections, and coffee-related accessories and equipment—primarily through its company-operated retail stores. In addition to sales through its company-operated retail stores, Starbucks sells primarily whole bean coffees through a specialty sales group, a direct response business, supermarkets, and online at Starbucks.com. Additionally, Starbucks produces and sells bottled Frappuccino® coffee drink and a line of premium ice creams through its joint venture partnerships and offers a line of

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> innovative premium teas produced by its wholly owned subsidiary, Tazo Tea Company. The Company's objective is to establish Starbucks as the most recognized and respected brand in the world.
>
> To achieve this goal, the Company plans to continue to rapidly expand its retail operations, grow its specialty sales and other operations, and selectively pursue opportunities to leverage the Starbucks brand through the introduction of new products and the development of new distribution channels. (starbucks.com)

Starbucks' initial public offering was in 1992 (NASDAQ: SBUX). The company had, however, broken new ground the previous year when it became the first privately held company in the United States to offer its employees a stock ownership plan. The plan, termed *Bean Stock,* offered shares to both full-time and part-time employees.

The company had seemingly re-energized the entire coffee industry. Although Starbucks itself made up a relatively minuscule percentage of the entire North American coffee industry, it had sparked the expansion of coffee cafes like itself, rejuvenated the traditional mass market coffee sellers, and expanded all facets of the industry as distributed through the traditional supermarket distribution system. This *Starbucks Effect* as it was termed, was based on the *perceived* premium product's cachet extending to all of the collateral products, both complements and substitutes. In the case of Starbucks itself, the perceived premium was both in the product's quality and in the method of its delivery.

> First, every company must stand for something. Starbucks stood not only for good coffee, but specifically for the dark-roasted flavor profile that the founders were passionate about. That's what differentiated it and made it authentic.
>
> Second, you don't just give the customers what they ask for. If you offer them something they're not accustomed to, something so far superior that it takes a while to develop their palates, you can create a sense of discovery and excitement and loyalty that will bond them to you. (Howard Schultz, *Pour Your Heart Into It,* Hyperion Press, 1997, p. 35.)

The Starbucks Experience

The concept of Starbucks went far beyond being a coffeehouse or coffee brand. Emerging from Howard Schultz's original idea of an Italian Espresso coffee bar, it had evolved into its own Americanized version of a specialty coffee provider of coffee shop services. As described in the introductory quote from Howard Schultz, Starbucks based its customer's retail experience on high quality coffee, *arabica* bean-based coffee, but then surrounded the delivery of the coffee with specialty services and atmosphere.[1] Special pastries and selected music provided an atmosphere of both warmth and comfort.[2] Employees were trained to not only provide a wide array of advice on coffee selection and appropriateness to potential customer needs, but to engage the customer. The customer was to feel they were not at home, not at work, but "a third place."

The People

The maintenance and development of this quality experience required a strong organizational commitment. The decade of the 1990s saw Starbucks expand its talent pool on the most influential senior levels, with key additions contributing greatly to the evolution of the company's business lines. Howard Schultz began assembling an experienced team of professionals to drive Starbucks' growth.

In 1989, Howard Behar, with more than 20 years in retail, joined the company as the director of store operations. Behar refocused much of the Starbucks development away from the pure product itself—coffee, to the consumer's experience in a Starbucks. Behar believed the core component of the experience was in quality of service. Starbucks' employees (termed *partners* by Starbucks) needed to be highly motivated to pay continuing attention to repeat customer needs. The company invested in extensive employee training, but this investment was lost if the company could not retain its people. One of the biggest barriers to retention was, in turn,

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compensation and benefits, in which the service industry was notoriously deficient.

Starbucks' solution was to offer health care benefits to all employees who worked more than 20 hours per week. Although an expensive benefit to provide by industry standards, Behar argued that if employee retention was improved and quality of service preserved, it would more than pay for itself. The company followed this first instrumental move with the introduction of the employee stock ownership plan in 1991 (Bean Stock), which was intended to increase the ownership culture of store management. Howard Behar would eventually become President of North American operations.[3]

In 1990, Orin Smith joined the company as Chief Financial Officer and quickly filled the role of the company's right-brain to Howard Behar's left-brain. Smith had extensive experience in a number of organizations and consulting, and was a strong believer in process development. Where Behar had focused on the people, Smith focused his development efforts within Starbucks on the organizational processes which would support effective execution of strategies. Smith believed in strict organizational discipline, including careful use of the Starbucks brand and insisted for many years on company-owned and operated stores, rather than the franchising common among most American retailers. Behar became the unofficial defender of the quality of the Starbucks brand. Orin Smith would eventually become President and Chief Executive Officer of Starbucks. As illustrated by Exhibit 1, the Starbucks experience was based on people.

The Supply Chain

The pursuit of premium quality also drove Starbucks back up the coffee supply chain. Coffee, although second only to petroleum in volume of global trading, was highly fragmented. It was estimated that a full one-third of the world's coffee farms were three acres or less in size. This typically resulted in a consolidation process which handed off coffee from farmer to collector, collector to miller, miller to exporter or broker, and finally to importer. In the past, the importer and brokers then sold coffee to the large mass-market coffee roasters and producers.

Starbucks wished to improve the quality and integrity of its coffee by working back up the supply chain to the actual growers. As a result, Starbucks refined its coffee quality while effectively bypassing much of the middle market. As Starbucks developed expertise and relationships with the coffee growers themselves, the company worked tirelessly to increase the quality of the *green coffee* (unroasted beans) purchased while taking cost out of its supply chain. This would eventually prove a point of exposure for Starbucks politically, but also position the firm for opportunities in sustainable economic initiatives with these growers.

> Establish Starbucks as the premier purveyor of the finest coffee in the world while maintaining our uncompromising principles as we grow.
>
> The following six principles will help us measure the appropriateness of our decisions:
>
> 1. Provide a great work environment and treat each other with respect and dignity.
> 2. Embrace diversity as an essential component in the way we do business.
> 3. Apply the highest standards of excellence to the purchasing, roasting, and fresh delivery of our coffee.
> 4. Develop enthusiastically satisfied customers all the time.
> 5. Contribute positively to our communities and our environment.
> 6. Recognize that profitability is essential to our future success.

Exhibit 1 Starbucks Mission Statement

Source: starbucks.com

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Howard Schultz continued to add key leaders in the business in the early 1990s—people who would continue to fill out the gaps in the organization and solidify a corporate culture which was a difficult balance between entrepreneurship and disciplined growth. These decisions proved critical, as Starbucks embarked upon a massive expansion which would test the organization's capabilities.

Expansion

> At McClintock Drive and Ray Road, you can walk out of a Starbucks, built into a grocery store lobby, and gaze across the parking lot–at a brand new Starbucks. With the retailer's rapid expansion, it isn't unusual to find multiple sites within a mile or two of each other. And although having two in the same parking lot certainly isn't the norm, it's something that does happen on occasion. ("2 Starbucks, 1 Lot," *Arizona Republic,* October 21, 2002, p. B5.)

As Starbucks moved into a market, it focused on location. Providing ready access to consumer foot traffic, such as commuting routes, allowed Starbucks to place its third place directly between the other two places. Stores were located in pivotal positions for consumer recognition and access. Corner locations, the hallmark of the early store growth, provided high visibility and maximum exposure. As stores expanded in North America to more and more of the automobile-based cities, plentiful parking became critical to any store's accessibility.

The company was also admired and criticized for its market-swarming expansion techniques. As stores proliferated, Starbucks broke with many retail distribution traditions by in-filling, introducing stores which could not help but cannibalize existing store sales. This also led to the characterization of Starbucks as *ubiquitous.* With stores appearing across the street from existing stores, the firm did often actually appear to be everywhere you looked. The strategy, although not acknowledged officially, prevented competitor entry in established Starbucks markets through store proliferation. It had, however, led to a disquieting downward trend in sales per store. Between 1995 and 1998, Starbucks had averaged $0.69 million per store per year. Beginning in 1999, this revenue per store value had continuously declined, falling to $0.559 million per store in 2002.

The company was widely considered ruthless in its real estate practices. Practices included paying premiums over existing rental prices to push square footage prices up, retaining closed properties to prevent competitor entry, and generally aggressive property negotiations. The refusal to franchise allowed the firm to pursue real estate and store proliferation strategies which did not conflict with corporate goals; all stores were Starbucks-owned and operated, and therefore "turf" was not an issue.

Through the later 1980s and early 1990s, Starbucks focused expansion in the Pacific Northwest and California markets. Howard Schultz's expansion strategy revolved around establishing regional beachheads which the company needed to provide logistical support for stores while maintaining quality. In 1993, the company entered the Washington D.C. market, followed soon after in 1994 by Boston.[4] The Boston entry was through acquisition, buying out the Coffee Connection chain in the region. Beginning in late 1994, the company expanded rapidly to the major metropolitan areas of Minneapolis, New York, Atlanta, Dallas, and Houston. By the mid-1990s, Starbucks had stores in more than 40 states and was starting to look to the limitations of market saturation.

There were no hard and fast rules for store growth or saturation. Starbucks itself believed that only Seattle, with one store per 9,400 people, was actually at the saturation point. The island of Manhattan, with one store per 12,000 people, was still considerably below that point.

International Expansion

> "We remain highly respectful of the culture and traditions of the countries in which we do business," says Howard Schultz, chairman and chief

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global strategist. "We recognize that our success is not an entitlement, and we must continue to earn the trust and respect of customers every day."

Although the first Starbucks store outside the United States was opened in Vancouver, British Columbia in 1988, this was essentially a regional expansion—from Seattle outwards and northward in the Pacific Northwest—rather than an intended international expansion. Beginning in the mid-1990s, the company aggressively pursued true international expansion. Starbucks used two basic structures for international expansion—company-owned and licensing agreements—to move first across Asia (1996), the Middle East (1998), and finally Europe (2001) and Latin America (Mexico, 2002).[5]

The company had defied many of its critics with the growth and success of its international stores. Market analysts and critics had argued that Starbucks' premium prices, paper cups, and smoke-free cafes would not fit within traditional cultural practices in places like Tokyo and Vienna. Once again the chain proved the naysayers wrong by seemingly creating their own market and their own third place experience in some of the largest coffee-consuming cultures in the world.[6]

Japan

Starbucks' true international expansion had begun in Japan in October 1995 with the formation of a joint venture (JV) with Sazaby, a Japanese retailer and distributor with its own chain of Afternoon Tea stores. Sazaby proved to be an excellent partner, with expertise in both retail beverages and real estate.

The JV had opened its first store in Ginza in 1996 and had flourished. By 2002, it had more than 250 stores nationwide, and projected more than 500 stores by 2003. Although average Japanese store sizes were half that of the United States, they averaged nearly twice the sales. The JV had proven so successful that it undertook an initial public offering in October 2001, the only unit within Starbucks' international network to be listed independently of the parent.

Sazaby was also the prototype of the qualities Starbucks looked for in potential business partners. Starbucks officially listed the following characteristics as desired in its international partners:[7]

- Shared values and corporate culture
- Strong multi-unit retail/restaurant experience
- Dedicated human resources
- Commitment to customer service
- Quality image
- Creative ability, local knowledge, and brand-building skills
- Strong financial resources.

China

With the opening of its first store in January 1999 in the World Trade Centre in Beijing, Starbucks added the People's Republic of China to its growing list. In the next three-and-a-half years, its footprint had been expanded to 35 shops, focused in and about Beijing and Shanghai. The reception to Starbucks in a culture grounded in tea was remarkably successful. Although Starbucks was heavily criticized for opening an outlet in a souvenir shop in Beijing's Forbidden City in 2001, the shop flourished.

Europe

The company's entry into Continental Europe had been anticipated for years, but with much trepidation. Europe's longstanding traditions of coffee consumption and independently owned and operated coffeehouses constituted an established market which was not considered open to American entry. Starting in Switzerland and Austria in 2001, the company then expanded into Spain, Germany, and Greece in 2002. Although many critics argued—as they had in Japan before—that local customers would not be attracted to smoke-free, paper-cup coffee consumption, the lines had been long.

Each country of entry was evaluated in detail, including focus groups, quantitative market assessment, and detailed identification of appropriate

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business partners. As part of the expansion process, Starbucks brought all foreign managers to its Seattle offices for a rigorous 13-week training course in the Starbucks experience. By the end of 2002 Starbucks had 1,312 of its total 5,886 stores outside of the United States. The current plan was to open two international stores for every one new domestic store.

Corporate Social Responsibility

> Starbucks defines corporate social responsibility as conducting our business in ways that produce social, environmental, and economic benefits to the communities in which we operate. In the end, it means being responsible to our stakeholders.
>
> There is growing recognition of the need for corporate accountability. Consumers are demanding more than "product" from their favorite brands. Employees are choosing to work for companies with strong values. Shareholders are more inclined to invest in businesses with outstanding corporate reputations. Quite simply, being socially responsible is not only the right thing to do, it can distinguish a company from its industry peers. (Corporate Social Responsibility Annual Report Starbucks Coffee, Fiscal 2001, p. 3.)

Starbucks had found itself, somewhat to its surprise, an early target of the anti-globalist movement. Like McDonald's before it, it appeared to be yet another American cultural imperialist, bringing a chain-store sameness to all countries everywhere. Like McDonald's, Starbucks found that its uniquely defined brand and experience did not have to conform to local cultural norms, but could exist alongside traditional practices, creating its own market and successfully altering some consumer behaviors.

Unlike McDonald's, however, Starbucks was the purveyor of a commodity, coffee, which was priced and sold on global markets. Coffee was sourced from hundreds of thousands of small growers in Central and South America, many of which were severely impoverished by all global income and purchasing power standards. As coffee prices plummeted in the late 1990s, companies like Starbucks were criticized for both benefitting from lower-cost sourcing and for their unwillingness to help improve the economic conditions of the coffee growers themselves.

By 2001, Starbucks had implemented a multitude of programs to pursue its program for corporate social responsibility (CSR) and pursue sustainable economic development for the people in its supply chain. Although not wishing to own the supply chain, Starbucks' strategy was a complex combination of altered business practices in procurement, direct support to the coffee growers, and the formation of brands which would provide conduits for consumers wishing to support CSR initiatives. Exhibit 2 provides a brief overview of some of these programs.

Procurement

Coffee was traditionally bought and sold using *market pricing,* buying from wholesalers at a global market price—the so-called New York "C." Since Starbucks purchased only arabica bean premium grade green coffee, it always paid a premium above New York "C." Both New York "C" prices and the premium, however, moved up and down with global market conditions. Traditional robusta bean purchases by mass-market labels were made on the wholesale markets through brokers and buyers.

Starbucks, however, preferred to purchase using *outright pricing,* in which the price was negotiated directly with small and medium-sized farmers, cutting out the segment of the supply chain which the wholesalers usually occupied. In principle, a greater proportion of the price went directly to the producers, assuring a higher return to the small farmer. In addition to the pricing structure, Starbucks was also attempting to break from traditional market practices of always buying in the cash market. As illustrated in Exhibit 3, the company was moving aggressively to purchase more and more of its coffee under long-term contract (3 to 5 years, on average), guaranteeing prices to growers over multiple crop years.

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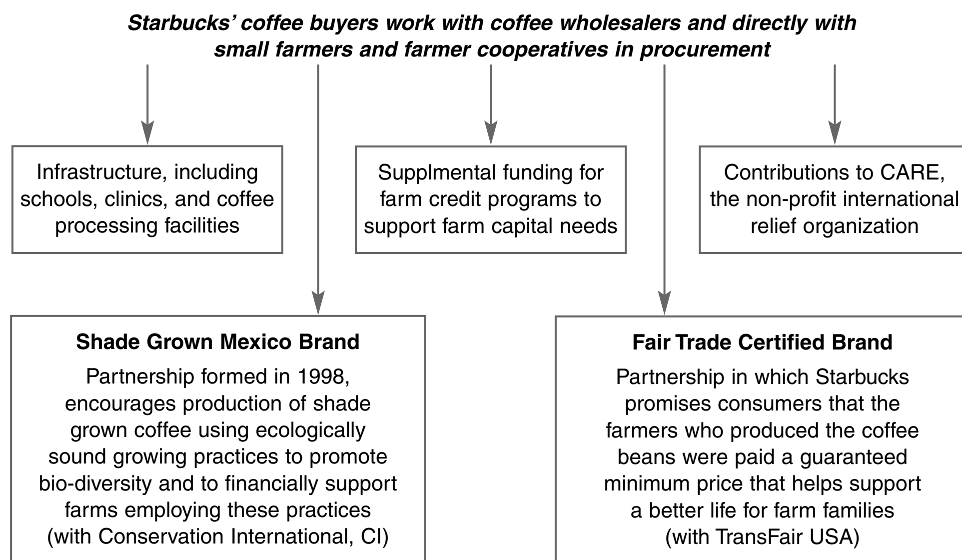

Exhibit 2 Starbucks' CSR Programs Focusing on Coffee Growers

	Percentage of Total Coffee Purchased	
	Fiscal 2001	*Fiscal 2002*
Price Basis		
Market pricing (New York C-basis)	88%	26%
Outright pricing (negotiated)	12%	74%
Relationships		
Direct relationships (from farms and co-ops)	9%	32%
Indirect relationships (through wholesalers)	91%	68%
Purchase Terms		
Purchased under long-term contract	3%	36%
Purchased in cash market	97%	64%

Exhibit 3 Starbucks Coffee Sourcing Practices, 2001–2002

Source: Corporate Social Responsibility Annual Report, Starbucks Coffee, Fiscal 2002, p. 6.

Amounts by category are not mutually exclusive.

A long-term dilemma of coffee farmers was the lack of access to affordable credit. Farmers without adequate working capital financing were often forced to accept low prices for coffee from buyers—so-called *coyotes* in Central and South America—in relative desperation. In an effort to stop this financial exploitation, Starbucks had initiated a number of loan guarantee programs in 2002 to provide pre-harvest and post-harvest financing for coffee farmers. As a result, Starbucks provided financing for more than 1.2 million pounds of coffee in 2002 (205 farmers received pre-harvest financing, 691 post-harvest financing).[8]

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	Pounds of Coffee Purchased		
	2000	*2001*	*2002*
Conduit Brand			
Fair Trade Certified Coffee	190,000	653,000	1,100,000
Certified Organic Coffee	570,000	874,000	1,700,000
Conservation (Shade Grown) Coffee	304,000	684,000	1,800,000

Exhibit 4 Conduit Brand Coffee Purchases by Starbucks, 2000–2002

Source: Corporate Social Responsibility Annual Report, Starbucks Coffee, Fiscal 2002, p. 8.

Volumes are by fiscal year. Certified Organic includes Organic Fair Trade and Organic Conservation (Shade Grown) coffee. Amounts by category are not mutually exclusive.

Direct Support

Starbucks was a regular and growing giver, supporting relief organizations such as CARE, the nonprofit international relief organization, as well as providing direct support to farmers and farm communities around the world.[9] For example, Starbucks had contributed $43,000 in 2001 to the construction of a health clinic and school in Guatemala and a health clinic in East Timor. The company was also providing aid in a variety of ways to the improvement of coffee processing facilities in a number of the countries of origin.

Conduit Brand Development

Much of the growing pressure on all multinational companies for sustainable development and social responsibility arose directly from consumer segments. In an effort to provide a direct conduit for these consumer demands, Starbucks had initiated a company program called *Commitment to Origins,* "dedicated to creating a sustainable growing environment in coffee originating countries." Under the program, Starbucks had introduced *Shade Grown Mexico* coffee, *Fair Trade Certified* coffee, and *Serena Organic Blend* coffee.

Shade Grown Mexico coffee was introduced in 1998 in partnership with Conservation International (CI), a nonprofit environmental organization. Coffee purchased by Starbucks from CI's Conservation Coffee Program was cultivated under the canopy of shade trees in origin countries. This practice was considered ecologically sound and helped support bio-diversity. Shade Grown Mexico coffee purchases had grown from 304,000 pounds in 2000 to 1.8 million pounds in 2002 (see Exhibit 4).[10] The Shade Grown Mexico coffee had been selectively introduced in Starbucks stores in North America and through online sales at starbucks.com.

Beginning in 2000, Starbucks began working with TransFair USA, a non-profit organization which provided independent certification for all *Fair Trade* coffee in the United States.[11]

> The concept of Fair Trade addressed the question of the just distribution of the burdens and benefits of trade. The Fair Trade movement argues that when most of the customers' purchasing dollar goes to the retailer, the marketer, the wholesaler, and the speculator and very little goes to the laborer or the farmer, something is wrong with the mutual benefits of the exchanges, particularly when those who provide the product have earnings that do not even cover subsistence costs.[12]

Although Starbucks had introduced *Fair Trade* coffee in North American stores, and promoted it through various brochures and promotions ("Coffee of the Day" monthly), it continued to be heavily criticized for not expanding the program faster. Fair Trade coffee purchases also expanded rapidly, rising from 190,000 pounds in 2002 to more than 1.1 million pounds in 2002.

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The third category of conduit brand development was Serena Organic Blend coffee. Organic coffee was grown without the use of synthetic pesticides, herbicides, or chemical fertilizers. Like Shade Grown coffee, Organic Blend was an environmental-sustainable development conduit. As illustrated in Exhibit 4, Starbucks' purchases of organic coffee had more than tripled between 2000 and 2002.

These product brand programs allowed consumers wishing to support these sustainable development initiatives to express their interest through purchasing—at a price.[13] All three coffees were roughly 20–25% more expensive compared to Starbucks' traditional blends (whole bean coffee sales).

Growing Pressures

By the spring of 2003, Starbucks was at what many thought the pinnacle of its prospects.

- It was operating nearly 5,700 stores in 28 countries.
- It had made more than $215 million in profit on $3.29 billion in sales in 2002, and sales and profits were both expected to grow 25% in 2003.
- It was named by *Interbrand* one of the most recognizable global brands, although the company still spent less than $20 million per year in advertising.
- The New York "C" coffee prices remained at near-record lows, decreasing sourcing costs and increasing gross operating margins.

Starbucks was one of the few companies to continue rapid sales and earnings growth through the 2001–2002 period and the company was continuing to expand international operations at a breakneck pace. But all was not aromatic in the Starbucks marketplace.

Service quality and employee motivation and retention were continuing issues. Although *barrista* (the coffee brewers in Starbucks lingo) pay was still superior to other low-end wage jobs, rapid expansion was confronting the firm with employee fatigue. Store managers and employees were overworked and underpaid. Required overtime for store managers had only been eliminated in 2000 as a result of the settlement of a class action suit brought in California by disgruntled store managers.[14]

The limits to remaining expansion opportunities in North America were now in sight. Seattle, with a Starbucks store for every 9,400 people, was

Participate in the Organic Consumers Association
"Global Week of Action Against Starbucks," September 21–28.

In October 2001, Starbucks made a commitment to buy 1 million more pounds of Fair Trade coffee and brew Fair Trade coffee once a month. Don't let Starbucks stop there—Send a Free Fax to demand that Starbucks brew Fair Trade Coffee of the Day EVERY WEEK!

The coffee industry is in crisis. Coffee prices are at an all time low, remaining below $.50 since August with no increase in sight. This means that farmers are becoming even more impoverished, going further into debt and losing their land. Meanwhile, coffee companies such as Starbucks have not lowered consumer prices but are pocketing the difference, even taking into account the quality premiums in the specialty industry.

The Fair Trade Labeling Organizations International recently released figures that show a total production by groups on the Fair Trade Coffee Register of 165,000,000 pounds in year 2000, whereas total sales were only 30,000,000 pounds. This leaves an additional 135,000,000 pounds of Fair Trade coffee produced by cooperatives that are not receiving a Fair Trade price.

Exhibit 5 The "Starbucks Campaign"

Source: Global Exchange, Global Economy, www.globalexchange.org/economy/coffee/starbucks accessed 10/6/02.

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considered by the company the limit.[15] Manhattan, with 124 stores or one store per 12,000 people, was considered still open to further development. But same store sales in the United States, Canada, and even Japan were now beginning to show declines which persisted; in the past, in-filling store entry had caused only temporary same-store sales declines for the most part.

Although very aggressive in the eyes of many, the anti-globalization movement continued to focus much of its efforts on Starbucks. Plummeting coffee prices on world markets in 2001 and 2002 had led to more and more pressure on Starbucks to increase the prices it paid to growers. Howard Shultz himself increasingly became the target of mail, fax, and e-mail campaigns to pressure Starbucks into more proactive policies for grower income support (see Exhibit 5). Although Starbucks had actively pursued a number of corporate social responsibility initiatives, it was accused of polishing its image more than truly working to improve the lives of those its existence depended upon: the coffee growers.

Rapid international expansion seemed to only magnify the growing pressures. As Starbucks moved into more and more countries, labor and real estate practices came under increasing scrutiny, as did its image as global imperialist. Wall Street looked on with a critical eye as the firm entered the global marketplace through joint ventures which assured the firm of less profits per store than in the domestic past. Earnings growth was sure to slow. The question grew as to how far and how fast the company could still go.

NOTES

1. The traditional coffee sold by U.S. mass market brands like Folgers and Maxwell House was the lower grade and cheaper robusta bean.

2. The experience itself had evolved. In his early attempts to reproduce the Italian coffee bar, Schultz had provided little seating with opera music. The seating was expanded and the music replaced, as American customers complained.

3. Behar had retired in 1999, but returned to the company on a full-time basis in 2001.

4. The choice of Washington, D.C. was a surprising choice to everyone but Starbucks' management team. The company had tracked closely the catalogue sales of Starbucks products in the early 1990s, identifying the Washington, D.C. area as an extremely strong market for Starbucks mail order products, and therefore a logical first step on the East Coast.

5. A third structure, company ownership, had been confined to the United Kingdom, Thailand, and Australia.

6. According to the Coffee Research Institute, the 10 largest coffee importing countries for the decade of the 1990s were the United States (25.6% of global imports), Germany (14.2%), Japan (7.7%), France (7.5%), Italy (6.3%), Spain (3.8%), Holland (3.4%), the United Kingdom (3.4%), Canada (2.8%), and Sweden (2.2%). Note that these are importation statistics, and not consumption. Source: www.coffeeresearch.org/ market/importations, accessed 10/6/02.

7. www.starbucks.com/aboutus/international.asp, accessed on 9/28/02.

8. Corporate Social Responsibility Annual Report, Starbucks Coffee, Fiscal 2002, p. 8.

9. Starbucks was one of CARE's largest North American corporate donors. Cumulative contributions to CARE by Starbucks over time totaled more than $2 million. Starbucks work with CARE had begun in 1991.

10. Starbucks also noted that growers of Shade Grown Mexico coffee received price premiums of 60% over local coffee prices in fiscal 2001.

11. TransFair USA is associated with Equal Exchange, a Fair Trade organization promoting socially responsible business practices with coffee growers in Central and Latin America.

12. John Kohls and Sandra L. Christensen, "The Business Responsibility for Wealth Distribution in a Globalized Political-Economy: Merging Moral Economics and Catholic Social Teaching," *Journal of Business Ethics,* February 2002, p. 12.

13. Starbucks reported that buyers paid $1.26/lb. for non-organic green and $1.41/lb. for organic green in 2001, when New York "C" prices were hovering at roughly $0.50/pound. Although production costs varied significantly across countries and regions, coffee growers associations estimated average production costs to be $0.80/pound.

14. In a highly publicized settlement, Starbucks had settled a class action suit in 2001 brought by store managers in California who complained the company refused to pay legally mandated overtime. Prior to the

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case, managers were required to sign affidavits upon hiring that they agreed to work 20 hours per week overtime without additional compensation.

15. "Planet Starbucks," *BusinessWeek,* September 9, 2002, p. 101.

Appendix 1: Starbucks Consolidated Statement of Earnings, 1998–2002 (millions of US$)

Income items	*1998*	*1999*	*2000*	*2001*	*2002*
Net revenues	$1,308.7	$1,686.8	$2,177.6	$2,649.0	$3,288.9
Retail	1,102.6	1,423.4	1,823.6	2,229.6	2,792.9
Specialty	206.1	263.4	354.0	419.4	496.0
Less cost of sales & occupancy costs	(578.5)	(747.6)	(961.9)	(1,112.8)	(1,350.0)
Gross operating income	730.2	939.2	1,215.7	1,536.2	1,938.9
Less store operating expenses	(418.5)	(543.6)	(704.9)	(875.5)	(1,121.1)
Less general & admin expenses	(77.6)	(89.7)	(110.2)	(151.4)	(202.2)
Less other operating expenses	(52.4)	(54.6)	(78.4)	(93.3)	(127.2)
Income from equity investees	—	3.2	20.3	28.6	35.8
EBITDA	181.8	254.5	342.5	444.6	524.3
EBITDA margin (%)	13.9%	15.1%	15.7%	16.8%	15.9%
Less depreciation & amortization	(72.5)	(97.8)	(130.2)	(163.5)	(205.6)
Operating income	109.2	156.7	212.3	281.1	318.7
Net interest income (expense)	7.1	7.3	7.1	10.8	9.3
Internet investment losses & other	—	—	(58.8)	(2.9)	13.4
Earnings before tax (EBT)	116.4	164.0	160.6	288.9	341.4
Less corporate income tax	(48.0)	(62.3)	(66.0)	(107.7)	(126.3)
Net income or earnings	68.4	101.7	94.6	181.2	215.1
Return on sales (%)	5.2%	6.0%	4.3%	6.8%	6.5%
Effective tax rate (%)	41.2%	38.0%	41.1%	37.3%	37.0%
Shares outstanding	358.5	363.7	376.3	380.0	385.6
Earnings per share (EPS)	$0.19	$0.28	$0.25	$0.48	$0.56
EPS growth rate	11.4%	46.6%	–10.1%	89.8%	17.0%

Source: Starbucks Coffee Company, Annual Report, 1999, 2000, 2001, 2002. EBITDA = Earnings before interest, taxes, depreciation and amortization.

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Appendix 2: Starbucks Consolidated Balance Sheet, 1998–2002 (millions of US$)

	1998	*1999*	*2000*	*2001*	*2002*
Assets					
Cash & cash equivalents	$123.5	$117.8	$132.2	$220.6	$402.2
Accounts receivable	51.0	47.6	76.4	90.4	97.6
Inventories	143.1	180.9	201.7	221.3	263.2
Prepaid expenses & other	19.7	40.2	48.0	61.7	84.6
Total current assets	$337.3	$386.5	$458.2	$593.9	$847.5
Investments in unconsolidated subsidiaries	38.9	68.1	55.8	63.1	106.0
Property, plant & equipment, net	600.8	760.3	930.8	1,135.8	1,265.8
Other assets	15.8	37.7	46.7	58.2	73.5
Total fixed assets	$655.5	$866.0	$1,033.3	$1,257.1	$1,445.2
Total Assets	$992.8	$1,252.5	$1,491.6	$1,851.0	$2,292.7
Liabilities & Equity					
Short-term debt	$33.6	$63.8	$56.3	$62.0	$74.9
Accounts payable	49.9	56.1	73.7	127.9	136.0
Accrued payroll	35.9	43.9	69.7	81.5	105.9
Accrued occupancy costs	17.5	23.0	29.1	35.8	51.2
Income taxes payable	18.3	30.8	35.8	70.3	54.2
Other current liabilities	24.2	33.6	47.0	67.7	115.3
Total current liabilities	$179.5	$251.2	$311.7	$445.3	$537.5
Long-term debt	—	7.0	6.5	5.8	6.1
Deferred taxes & other long-term liabilities	19.0	33.3	21.4	19.1	22.5
Common equity	794.3	961.0	1,152.0	1,380.9	1,726.6
Total liabilities & equity	$992.8	$1,252.5	$1,491.6	$1,851.0	$2,292.7

Source: Starbucks Coffee Company, Annual Report, 1999, 2000, 2001, 2002.

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Appendix 3: Starbucks Statements of Cash Flow, 1998–2002 (Millions of US$)

	1998	*1999*	*2000*	*2001*	*2002*
Operating Activities					
Net earnings	$68.4	$101.7	$94.6	$181.2	$215.1
Adjustments to reconcile to net cash:					
Depreciation and amortization	80.9	107.5	142.2	177.1	221.1
Gain on sale of investment	—	—	—	—	(13.4)
Internet-related investment losses	—	—	58.8	2.9	—
Provision for impairment and asset disposals	7.2	2.5	5.8	11.0	26.6
Deferred income taxes, net	2.1	0.8	(18.3)	(6.1)	(6.1)
Equity in income of investees	0.0	(2.3)	(15.1)	(15.7)	(22.0)
Tax benefit from exercise of stock options	10.5	18.6	31.1	30.9	44.1
Cash provided/used by changes in working capital:					
Net purchases of trading securities	—	—	(1.4)	(4.0)	(5.7)
Accounts receivable	(19.8)	3.8	(25.0)	(20.4)	(6.7)
Inventories	(23.5)	(36.4)	(19.5)	(19.7)	(41.4)
Prepaid expenses and other current assets	(2.5)	(7.6)	0.9	(10.9)	(12.5)
Accounts payable	4.6	4.7	15.6	54.1	5.5
Accrued compensation and related costs	9.9	7.6	25.4	12.1	24.1
Accrued occupancy costs	5.3	5.5	6.0	6.8	15.3
Accrued taxes	7.2	12.4	5.0	34.5	(16.2)
Deferred revenue	—	—	6.8	19.6	15.3
Other accured expenses	1.8	10.3	5.7	2.8	34.0
Net cash provided by operating activities	$152.2	$229.2	$318.6	$456.3	$477.3
Investing Activities					
Purchase of available for sale securities	$(51.4)	$(122.8)	$(118.5)	$(184.2)	$(340.0)
Maturity of available for sale securities	5.1	3.6	58.8	93.5	78.3
Sale of available for sale securities	112.1	85.1	49.2	46.9	144.8
Purchase of businesses, net of cash acquired	—	(15.7)	(13.5)	—	—
Additions to equity and other investments	(12.4)	(30.9)	(43.9)	(12.9)	(6.1)
Proceeds from sale of equity investment	—	—	—	—	14.8
Distributions from equity investees	2.8	9.0	14.3	16.9	22.8
Additions to property, plant and equipment	(201.9)	(257.9)	(316.5)	(384.2)	(375.5)
Additions to other assets	(3.2)	(6.9)	(3.1)	(4.6)	(24.5)
Net cash provided (used) by investing activities	$(148.8)	$(336.4)	$(373.2)	$(428.5)	$(485.3)
Financing Activities					
Increase (decrease) in short-term debt	$4.8	$29.9	$(7.5)	$5.7	$12.9
Proceeds from sale of common stock under esop*	4.6	9.4	10.3	13.0	16.2
Proceeds from exercise of stock options	20.8	33.8	58.5	46.7	91.3
Principal payments on long-term debt	(2.0)	(1.2)	(1.9)	(0.7)	(0.7)
Repurchase of common stock	—	—	—	(49.8)	(52.2)
Net cash provided by financing activities	$28.3	$71.9	$59.4	$14.8	$67.4

Source: Starbucks Coffee Company, Annual Report, 1999, 2000, 2001, 2002. esop = employee stop ownership plan

Appendix 4: Starbucks Corporation Store, Revenue and Profit Growth, 1992–2002 Average

United States & Canada	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*Average Annual Growth Rate*
Company-Owned	162	261	399	627	929	1,270	1,622	2,038	2,446	2,971	3,496	36%
Licensed	3	11	26	49	75	94	133	179	530	809	1,078	80%
International												
Company-Owned	—	—	—	1	9	31	66	104	173	295	384	
Licensed	—	—	—	—	2	17	65	177	352	634	928	
Total Stores												
Company-Owned	162	261	399	628	938	1,301	1,688	2,142	2,619	3,266	3,880	37%
Licensed	3	11	26	49	77	111	198	356	882	1,443	2,006	92%
Total Stores	165	272	425	677	1,015	1,412	1,886	2,498	3,501	4,709	5,886	43%
Percent of total licensed	*2%*	*4%*	*6%*	*7%*	*8%*	*8%*	*10%*	*14%*	*25%*	*31%*	*34%*	
Revenues & Profits												
Revenues (millions)	$93	$164	284.9	$465	$698	$ 975	$1,309	$1,680	$2,169	$2,649	$3,289	43%
Change (%)		*76%*	*74%*	*63%*	*50%*	*40%*	*34%*	*28%*	*29%*	*22%*	*24%*	
Net profit (millions)	$4	$ 9	10.2	$ 26	$42	$ 55	$ 68	$ 102	$ 95	$181	$215	49%
Change (%)		*107%*	*20%*	*155%*	*62%*	*31%*	*24%*	*50%*	*–7%*	*92%*	*19%*	
Revenue/store	$0.564	$0.601	$0.670	$0.687	$0.688	$ 0.691	$0.694	$0.673	$0.620	$0.563	$0.559	0%
Change (%)		*7%*	*12%*	*2%*	*0%*	*0%*	*1%*	*-3%*	*–8%*	*–9%*	*–1%*	
Net profit/store	$0.025	$0.031	$0.024	$0.038	$0.041	$ 0.039	$0.036	$0.041	$0.027	$0.038	$0.037	4%
Change (%)		*26%*	*–23%*	*60%*	*8%*	*–6%*	*–7%*	*13%*	*–34%*	*42%*	*–5%*	
Earnings per share (EPS)	$0.03	$0.04	$0.05	$0.09	$0.14	$ 0.17	$0.19	$0.27	$0.25	$0.46	$0.56	34%
Change (%)		*33%*	*25%*	*80%*	*56%*	*21%*	*12%*	*42%*	*-7%*	*84%*	*22%*	
Share Price (eoy)	$1.89	$ .42	$2.88	$4.73	$8.25	$ 10.45	$9.05	$12.39	$20.03	$14.84	$14.84	23%
Change (%)		*81%*	*–16%*	*64%*	*74%*	*27%*	*–13%*	*37%*	*62%*	*–26%*	*0%*	

Source: Company Reports and Thomas Weisel Partners LLC, "Starbucks Corporation," February 6, 2002, pp. 14–17.

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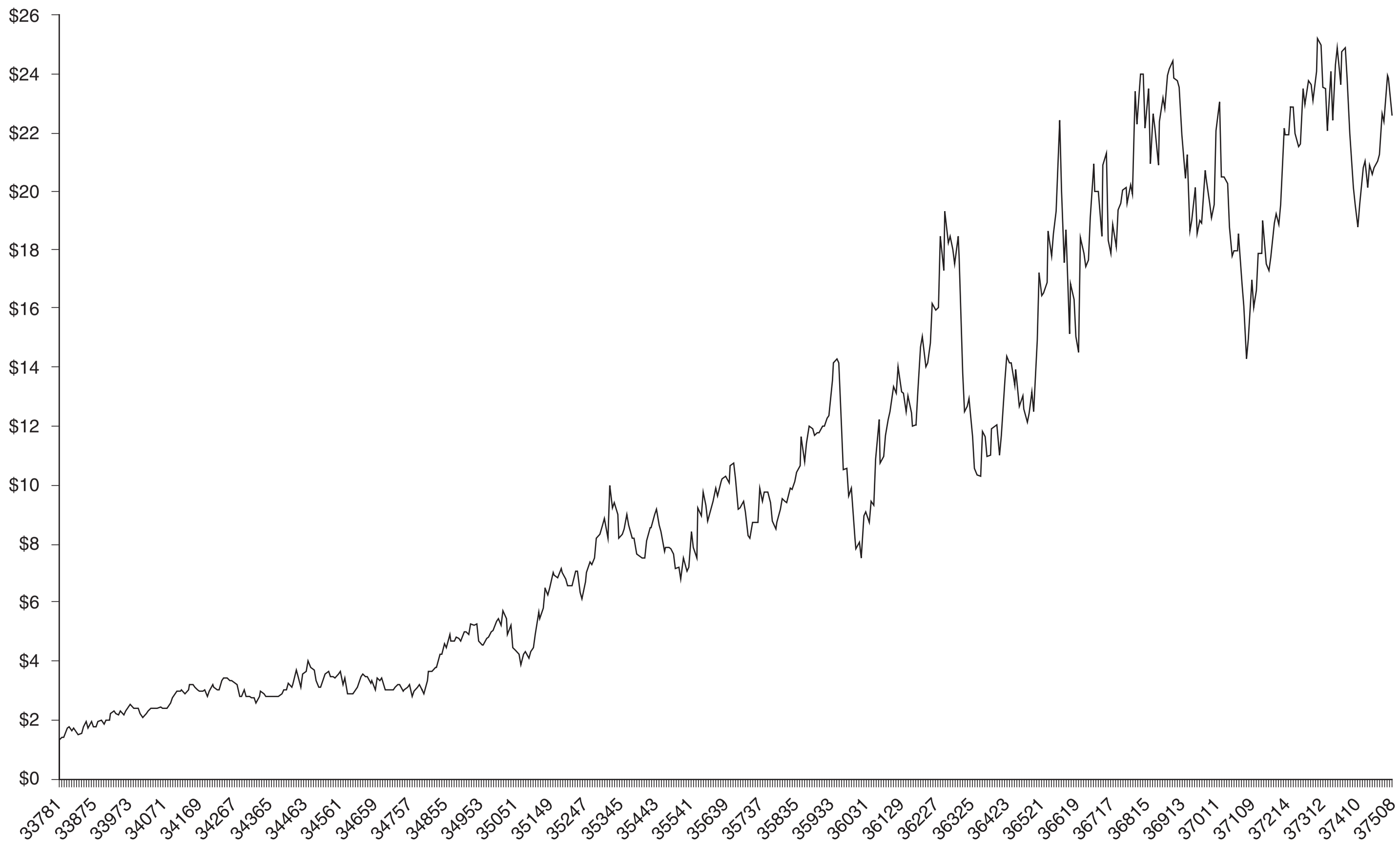
Appendix 5: Starbucks' International Operations

Asia-Pacific	***Middle East***	***Europe***
Australia	Bahrai	Austria
Guam	Israel	Germany
Hong Kong	Kuwait	Greece
Indonesia	Lebanon	Portugal
Japan	Oman	Spain
Malaysia	Qatar	Switzerland
New Zealand	Saudi Arabia	United Kingdom
P.R. of China	United Arab Emirates	
Philippines	***North America***	
Singapore	Canada	
South Korea	Mexico	
Taiwan	United States	
Thailand		

Source: Starbucks.com, 10/07/02.

Appendix 6: Starbucks Corporation, Closing Share Price (Weekly, Adjusted for Share Splits)



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Siam Canadian Foods Co., Ltd.

Prepared by Tom Gleave under the supervision of Professors John Kennedy and Tony Frost

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In July 1996, Jim Gulkin, Managing Director and founder of Bangkok-based Siam Canadian Foods Co., Ltd., was considering the emerging business opportunities in neighbouring Burma (also known as Myanmar). Although relatively undeveloped compared to the rest of Southeast Asia, Burma had been experiencing increasing levels of foreign investment activity in recent years. Gulkin, who had considered entering Burma in the past but declined, needed to determine if the time was now appropriate for him to enter the market.

Company Profile

Siam Canadian Foods Co., Ltd. (SC) was a brokerage business based in Bangkok, Thailand. It was started in April 1987 after Canadian Jim Gulkin quit his job in the oil industry and invested his life savings of Cdn$130,000 in the business. Gulkin was raised in Montreal where he remained until he graduated from grade 11 "with a stratospheric 51 per cent average." With school out of the way, he began travelling and working in various parts of the world and became enamoured with Thailand after holidaying there in 1979. SC's role as a food broker was to identify overseas customers, usually food importers, and negotiate sales with them on behalf of food processors in Thailand. SC's initial activity was limited to brokering canned pineapple and tuna; however, it gradually expanded its offerings to include a wide range of products such as frozen seafood, frozen poultry, canned and frozen fruit and vegetables as well as dehydrated fruit and juice concentrates. Over time, SC also began to source various products from both Burma and India on an ad hoc basis.

When first starting out, Gulkin was admittedly very inexperienced in the food brokering business. He commented:

> I didn't have a clue what I was doing . . . I didn't know what a letter of credit, invoice or cross-check was. I didn't even have a business plan or a marketing plan.

Adding to this inexperience, Gulkin found that local processors were reluctant to deal with him, despite the fact that he spoke fluent Thai. As a newcomer to an industry tightly controlled by Thailand's highly assimilated Overseas Chinese community, Gulkin struggled to develop comfortable levels of trust and confidence with the processors.

The food brokerage business generally operated on low margins, thus necessitating movements of large volumes of goods in order to achieve profitability. As the business evolved, SC began to focus mainly on brokering frozen seafood because the commissions were the most attractive. The company earned an average commission revenue of 1.25 per cent on sales contracts, usually denominated in U.S. dollars, that it negotiated on behalf of the food processors. During the late 1980s and early 1990s, the frozen seafood business was in a state of expansion in North America and Europe. At the same time, Thailand was quickly becoming a globally recognized source of frozen seafood, largely on the strength of overseas market acceptance of Black Tiger Shrimp. Gulkin estimated that

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Thailand harvested about 200,000 tons of Black Tiger shrimp in 1995, 90 per cent of which came from aquaculture facilities.

The following is an estimate of Thailand's recent fresh and frozen shrimp exports:

Year	**1990**	**1992**	**1994**
Baht (Billions)	20.5	31.7	49.2

25 Baht = US$1.00

In 1991, Gulkin opened up a representative office in Vietnam with the help of Philippe Vo. Vo was born in France to a French mother and Vietnamese father and, prior to moving to Vietnam, managed a seafood exporting business in California. The purpose of the representative office was to procure frozen seafood products for sale to overseas importers. Several months later, Gulkin, Vo and another local partner started a separate importing and distribution business, SC Food Services, in Ho Chi Minh City.

In 1992, Gulkin began to investigate the possibility of setting up a representative office in Burma but decided against it because he felt "very uncomfortable" with the local players in the seafood industry. This investigation made him realize that, apart from the necessary start-up capital which would be required, he also needed "connections" to people favoured by the ruling military junta, SLORC. He returned to Burma in 1994 when he discovered that new activity in the seafood industry was being generated by independent, non-politically connected business people. Discussions with the new players gave him a much higher level of comfort that business could be done in Burma without the need for buying favours. However, Gulkin also found that these new players were "sincere but incompetent" given that his attempt to export US$100,000 of frozen seafood collapsed due to insufficient raw material supplies of acceptable quality, resulting in a net loss to SC of about US$30,000. He later recalled that "it was a cheap lesson for the market knowledge we gained."

In 1994, SC secured one of the most significant contracts in the company's history on the strength of the relationship it had established with one of its key German importers. The contract called for SC to procure 600 tons of breaded shrimp to be shipped for ultimate sale to McDonald's Restaurants in Germany. A second contract for 450 tons was awarded to SC in 1995, with shipments this time going to McDonald's in Germany and Austria. The trading value of the 1995 shipment was US$7 million to US$8 million. Under the terms of the contracts, SC received a commission from the processor as well as a supervision fee paid by the importer. The latter was paid because SC dispatched quality control personnel to the processor's site to oversee the production and packaging of the breaded shrimp.

SC first achieved profitability in 1991 and had remained in the black ever since. In 1995, SC's trading volume was valued at about US$85 million, 90 per cent of which was attributable to frozen seafood. By 1996, SC employed 15 staff who were involved in sales, quality control and administration. The main destinations for the company's shipments were importers from the following countries, in descending order of sales value: United States, France, Germany and Canada.

The combination of increasing success in the food brokering business and the growing affluence in Bangkok in recent years, led Gulkin to form a separate sister company, Siam Canadian Gourmet Ltd., in early 1996. This importing and distribution business was initially focused on importing wines and coffees for sale to hotels, restaurants and specialty food retailers. It was later expected to expand its product range to include imported cheeses, sauces and other gourmet cuisine items. Initial results were considered "very promising."

SC's Vietnamese Experience

Gulkin's motivation for entering Vietnam in 1991 was largely based upon his assessment that, as an undeveloped country with a large, intelligent

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and hard-working population, many opportunities were becoming available to small firms with limited resources such as SC. As well, entering Vietnam was also consistent with Gulkin's view that in order to succeed in the food brokering business, firms had to adopt a diversification strategy in terms of both supply sources and product line offerings. Furthermore, the amount of foreign investment in Vietnam had been escalating, due largely to the implementation of the Vietnamese government's so-called "doi moi" or "renewal" policy, which was designed to attract foreign investment. This meant that there would be a limited window of opportunity for SC to enter the market before being shut out permanently by bigger players. Therefore, with the help of Vo, Gulkin opened up Siam Canadian Foods (Vietnam) in order to gain access to frozen seafood for shipment overseas. Apart from Vo, SC (Vietnam) employed four quality control staff and an administrative assistant. Gulkin held 100 per cent ownership of SC (Vietnam) while maintaining a 50 per cent profit-sharing arrangement with Vo. Later, Gulkin, Vo and a local Vietnamese partner opened up SC Food Services, a separate distributorship that imported meats and dairy products, and sourced local fruits and vegetables, for sale to hotels and restaurants in the Ho Chi Minh City area.

Gulkin's view on the performance of SC Foods (Vietnam) was mixed. The business had experienced modest profitability since its inception, something that he felt was "very good, all things considered." On the other hand, daily operations were frustrating, particularly with respect to the honoring of contracts by food processors. Gulkin offered the following as a simple, typical example of a Vietnamese contract gone bad:

> We enter into a contract with a Vietnamese processor to supply us with 30 metric tonnes (mt) of frozen cuttlefish tentacles per month for 12 months. We, in turn, contract to sell this quantity of product to a European buyer. One month into the contract the Japanese, all of a sudden, become interested in this particular commodity. The raw material price, therefore, goes up and out of 360 mt contracted, we might get to ship 15 or 30 mt. The Vietnamese processor has absolutely no intention of honouring our contract if it means that he loses money or even makes less than he originally hoped. The contract is meaningless to him. It is nothing more than a piece of paper. His word or his reputation are not tangible concepts to him. My company, however, has to find a way to pacify our buyers who are none too happy. Sometimes it costs some money but fortunately our relationships with our buyers are strong. We do tend to make it very clear to our buyers beforehand that a contract in Vietnam is basically worthless and we, therefore, give ourselves a very wide notwithstanding clause in any contract we involve ourselves in.

These frequent experiences left Gulkin with the impression that local processors only considered the short-term implications of their business, often leading him to ponder the question "why bother?"

BURMA

Burma, also known as The Union of Myanmar, was the largest mainland country in Southeast Asia and had a population of about 47 million. The country bordered on Bangladesh and India in the northwest, China in the northeast, Laos in the east and Thailand in the southeast. It was a diverse nation with over 135 distinct cultural groups, the predominant one being the Bamars, representing about 69 per cent of the population. The country was considered by the World Bank to be among the poorest in the world, with a per capita income of US$676, based on purchasing-power parity. The capital city of Rangoon (also known as Yangon) had a population of approximately six million and was the nation's main port through which over 90 per cent of all ocean going trade passed. The physical geography of the country was a mixture of tropical mountains, plains and delta lowlands. Burma had a coastline that totalled over 2,830 kilometres bordering along the Andaman Sea and the Bay of Bengal. The country was thought to have abundant natural resources, particularly in teak wood, oil and seafood. (See Exhibit 1 for a Regional

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Cambodia, Myanmar, Laos

Exhibit 1 Map of Southeast Asia

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	1991/1992	*1992/1993*	*1993/1994*
Nominal GDP (kyat—billions)	187	248	339
Real GDP* (kyat—billions)	50	55	58
Real Per Capita GDP (kyat—millions)	1,202	1,289	1,341
Real GDP Growth Rate (%)	−0.6	+9.3	+6.0
Consumer Price Index (1986 = 100)	349.30	460.49	541.51
Total Exports (kyat—millions)	2,932	3,655	4,071
Total Imports (kyat—millions)	5,337	5,365	7,218
GDP Area of Economic Activity (%)			
Agriculture	37.5	38.5	38.3
Trade	22.1	22.1	22.1
Processing/Manufacturing	8.9	8.8	9.2
Livestock/Fishing	7.6	7.3	7.2
Social Administration	7.2	6.7	6.7
Rental and Other Services	4.8	4.5	4.4
Transportation	4.0	4.0	3.9
Construction	2.9	3.0	3.0
Other	5.0	5.1	4.2

Exhibit 2 Recent Economic Indicators—Burma

*Real GDP figures given use 1985/1986 fiscal year as benchmark.

1994 exchange rates: US$1.00 = 5.08 kyat; Cdn$1.00 = 3.78 kyat

Source: Investing in Myanmar, Union of Myanmar Investment Commission, 1995

Map of Southeast Asia and Exhibit 2 for Recent Economic Indicators on Burma.)

Burma's seafood resources were plentiful given its exclusive economic fishing zone of 486,000 square kilometres along its coastline. Prior to 1994, the Myanmar Fisheries Enterprise, a state-run company controlling the nation's seafood harvesting and processing, was the dominant player in the Burmese fishing industry. This company was dissolved in 1994 in an effort to improve the industry through attracting private investment. The total marine harvest for Burma was estimated to be as follows:

Year	**1990**	**1992**	**1994**
Tonnes (Thousands)	645.7	650.7	689.0

Gulkin estimated that the total current annual harvest of all shrimp species in Burmese waters was about 20,000 tons. Given that the state of

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Firm	*Activity*	*Origin of Foreign Investor*
1. Myanmar Bangladesh Fisheries Ltd.	Shrimp farm management	Bangladesh
2. Myanmar American Fisheries Co., Ltd.	Fish and marine products	United States
3. General Fisheries Co., Ltd.	Fishing, breeding, processing of fresh and saltwater products	Thailand
4. Myanmar Niino Joint Venture Co., Ltd.	Culturing and marketing of high quality pearls	Japan
5. Hanswaddy Fisheries Co., Ltd.	Fishing, prawn farming, processing and marketing of fresh and saltwater products	Thailand
6. Myanmar P.L. International Ltd.	Prawn farming, processing and marketing	Singapore
7. Myanmar Garming Fisheries Ltd.	Shrimp cultivation, fish processing and marketing	Hong Kong
8. Myanmar Seafoods Ltd.	Procurement, processing, handling and marketing of fresh and saltwater products	Singapore

Exhibit 3 Recent Joint Venture Investments in the Burmese Fisheries Sector

development within the seafood industry was relatively low, he felt that the placement of modern fishing fleets and aquaculture facilities, spurred on by recent measures to liberalize the industry, would increase Burma's seafood output considerably over the next several years, but not to the extent that it would match Thailand's output.

In 1988, Burma passed the Foreign Investment Law which, much like Vietnam's "doi moi" policy, was designed to attract foreign capital to industries which would promote exports and provide for the acquisition of new technologies. This Law was seen by the Burmese government as a market oriented measure because it allowed 100 per cent foreign ownership of firms, repatriation of capital and an "unequivocal guarantee" against the nationalization or expropriation of businesses. Firms operating under the guidelines of the Law paid a flat tax of 30 per cent; however, there existed numerous provisions which could be used to lessen a firm's tax burden, including the following:

- a tax holiday period of three consecutive years inclusive of the year of start-up with a possible extension if the Myanmar Investment Commission deemed it appropriate
- exemption or relief of tax paid on profits which were held in reserve and re-invested into the firm within one year
- accelerated depreciation of capital assets
- exemption or relief from customs duties paid on various equipment and instruments imported during the start-up phase of the firm

By 1994, 113 enterprises involving foreign ownership were engaged in a variety of agricultural, seafood processing, manufacturing, mining, energy and transportation activities in accordance with the provisions of the Law, eight of which were directly related to the seafood industry. (See Exhibit 3.)

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Recent Political History

In April 1947, Burma took a significant step towards gaining independence from British colonization by having its first free elections after WWII. The winner of the election was Aung San, the leader of the Anti-Fascist People's Freedom League (AFPFL.) On July 19, 1947, Aung San, along with six of his senior cabinet colleagues, was assassinated. This became known as Martyr's Day. U Nu, the ranking AFPFL politician remaining, took over the leadership of the country and gained Burma's independence from Britain in early 1948. During these early years, U Nu attempted to establish his party's concept of Buddhist based socialism. However, in March 1962, General Ne Win led a left-wing military takeover of Burma in support of the Burmese Socialist Programme Party (BSPP) and subsequently imprisoned U Nu and his supporters. In July 1962, several students who protested this takeover were shot to death at Rangoon University. These killings were followed by the complete destruction of the student union building on the campus. In the ensuing years, Ne Win began to direct the country towards the "Burmese way to socialism" in accordance with the doctrine of the BSPP. As a consequence, virtually all businesses were nationalized and there was a gradual closure of trade with most of the outside world. This eventually led to the collapse of the Burmese economy.

In 1987 and 1988, many Burmese organized mass demonstrations protesting the legacy of incompetence of the Government and calling for the removal of Ne Win. In July 1988, Ne Win stepped down following six weeks of bloody confrontations between pro-democracy demonstrators and the military, in which an estimated 3,000 people were killed. The BSPP did not relinquish power, however. In September 1988, a BSPP-backed military coup was staged resulting in the establishment of the new State Law and Order Restoration Council (SLORC), under the leadership of General Saw Maung, Commander-in-Chief of the armed forces. Saw Maung immediately imposed a state of martial law while promising to hold a democratic election in the near future. This quickly led to the forming of the National League for Democracy (NLD), a coalition of parties opposed to the BSPP, under the leadership of Aung San's daughter, Aung San Suu Kyi. The NLD went on to win the election which was held in May 1989, despite allegations that SLORC had attempted to manipulate the outcome. After the election, SLORC refused to allow the NLD to assume the role of government and arrested the party's leadership and soon after placed Suu Kyi under house arrest.

On July 10, 1995, Suu Kyi was released from house arrest after six years of detainment, and four years after she had won the Nobel Peace Prize, in absentia, for her dedication to democratic reform in Burma. Despite SLORC's warning that Suu Kyi should abstain from political activism, she continued to hold press conferences and political rallies outside of her housing compound on University Avenue in Rangoon. Furthermore, she repeatedly called upon the United States and the European Community to impose economic sanctions against Burma as a means to force democratic reform in the country and was successful to some degree. During 1995, the four U.S. cities of Santa Monica and Berkeley, California, Ann Arbor, Michigan and Madison, Wisconsin passed "selective purchasing" legislation which barred these cities from buying goods and services from companies doing business in Burma. Similar legislation had also been tabled and was awaiting ratification by the cities of Oakland, San Francisco, New York and Colorado Springs.

By July 1996, several recent events had caused the issue of human and democratic rights in Burma to gain political attention and press coverage worldwide. Two months previously, in May, the Burmese government arrested 262 NLD members, thus preventing them from holding their first national congress since the 1990 election. This incident was followed by the mysterious death of James Nichols, a Burmese resident and former honorary consul in Burma for Denmark, Finland, Norway and Switzerland,

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who died in jail under vague circumstances. The 69-year-old Nichols, a close friend of Suu Kyi, had served two months of a three-year prison sentence for possessing an unlicensed fax machine.

These events led Suu Kyi to escalate her call to the Western powers for sanctions against Burma. At one point, she was able to have a video-taped speech smuggled out of the country. The message, which was played to members of the European Parliament, prompted the European Union to support Suu Kyi's position that economic sanctions were needed in Burma in order to move the democratic reform process forward. The culmination of these events led Heineken to announce on July 1 that it would divest itself of its interest in its Burmese joint venture. Soon after, Carlsberg announced that it had cancelled its plans to develop a brewery in the country. These announcements occurred about four months after Pepsi sold off its 40 per cent stake in a Burmese joint venture.

That same July (1996), leaders from the Association of Southeast Asian Nations (ASEAN), whose members included Thailand, Vietnam, Malaysia, the Philippines, Brunei, Singapore and Indonesia, met in Jakarta for their annual conference. ASEAN was a forum used to discuss issues that were of mutual interest to its members, including political, economic, security and environmental concerns. Burma had been invited to the conference as an observer for the first time, a move that was seen by many as the first step towards eventually granting it full membership status. Interestingly, by the time the conference concluded in late July, the United States Senate had passed a bill approving the use of sanctions against Burma if SLORC engaged in any acts which suppressed the pro-democracy movement of the NLD. The only hurdle which remained for full passage of the bill was the signature of President Clinton who, only several months previously, approved the Helms-Burton Bill, a measure designed to penalize firms and firm managers who continued to conduct business with Cuba.

The issue of democratic and human rights abuses in Burma was very prominent at the conference. However, while the United States and the European Union considered applying economic sanctions on Burma, ASEAN's policy position called for "constructive engagement" with SLORC. ASEAN's view was that the region's economic and security interests would be better served if Burma was not isolated. To this end, many ASEAN firms were encouraged by their governments to invest in Burma. In fact, Singapore-based Fraser and Neave immediately offered to take over Heineken's ownership stake in its Burmese joint venture. Similarly, discussions about building a new brewery between the Golden Star Group, Carlsberg's former Burmese partner, and Malaysia's Asia-Euro Brewery were already underway, less than three weeks after Carlsberg announced its pull-out.

Gulkin's Perspective on Burma's Politics

In considering his position on the question of democratic and human rights in Burma, Gulkin offered the following:

> Aung San Suu Kyi is a decent, intelligent, well-intended, brave and selfless person. I realize that the politically correct trend is to call for sanctions against Burma, but economic isolation simply does not work. Take a look a Cuba, Chile, North Korea and Iraq. All of those countries have experienced economic sanctions of varying degrees, but their leaders still remained. People will often use South Africa as an example that sanctions work, but their case was unusual. The new South Africans were an island of Europeans isolated both within their own country and from the rest of the world.
>
> Economic empowerment raises hope for democracy. Just take a look at Taiwan, South Korea and even here in Thailand. All of these countries went from dictatorships to democracies as their level of wealth increased. In 1992, when the Thai military tried to take over the government, the people said 'No!' and what happened? Democracy prevailed. Many Thais had started to enjoy the benefits of increased economic power and were not going to give them up. It is the economically deprived that

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> lack money and education. These people are easy to keep in place.
>
> On the question of human rights, Burma is no worse than Indonesia or China. The Indonesian government has brutally occupied East Timor for over 20 years. As for China, there are tens of thousands of executions happening there each year, some even for economic crimes. Amnesty International is constantly citing China as a major human rights offender but I don't see Pepsi or Carlsberg pulling out of there.

Reconsidering Burma in 1996

Gulkin recognized that time was of the essence if he was going to finally commit to Burma. On the positive side, Rangoon had seen the development of at least five new seafood processing plants in past two years financed by independent firms. Having had preliminary discussions with some of the independents, Gulkin's instincts led him to believe that corruption would not be a problem and that he would be able to quickly develop relationships of trust and confidence with them. As well, the lack of economic development within the country meant that smaller firms such as his own might be able to gain a sustainable foothold before many larger, well-financed firms entered the market. It was Gulkin's view that bigger multinational corporations could afford to be "politically correct," while smaller firms needed to take advantage of the windows of opportunity while they existed. A further incentive for establishing operations in Burma was his belief that, given the underdeveloped state of the Burmese seafood industry, he would be able to realize significantly larger commission margins than he was currently receiving in Thailand or Vietnam.

Investment in Burma was also consistent with Gulkin's business philosophy of developing and managing diverse supply sources and product ranges. This was particularly important when he considered that the Thai seafood market was simultaneously experiencing increased levels of competition as well as dwindling supplies of raw materials. He estimated that the seafood industry in Thailand had reached the saturation point in terms of the number of processors operating and that raw material supply levels would gradually deplete to the point where the industry would be in definite decline within ten years. At the same time, relations between Thailand and Burma had moved in a decidedly favourable direction in recent months. In March 1996, Banharn Silpa-archa became the first Thai Prime Minister in 16 years to visit Burma. The primary objectives of the trip were twofold: first, to re-establish border trade between the two countries, given that cease-fires between insurgent ethnic groups along the border had been sustained, and second, to give Thai business interests a chance at gaining a stronger foothold in the country given the recognition of increased interest that other nations in the region were showing in Burma.

Gulkin's view was that most of the other nations in the region did not offer the same potential for developing his seafood exporting business further. For instance, although neighbouring Cambodia had a sizeable coastline along the Gulf of Siam and thus strong potential as a seafood exporter, the country was still experiencing the devastating effects that years of brutal war and governance under the Khmer Rouge had brought to the country. A strong consensus among many business people living in Thailand was that Cambodia was not a secure place to travel, let alone conduct business. Evidence of this insecurity was shown by the recent kidnapping of a British landmine disposal expert, along with 20 Cambodian colleagues who were working on behalf of the Mines Advisory Group. Additionally, in a highly publicized incident in 1994, three foreign backpackers were kidnapped and subsequently murdered by the Khmer Rouge.

Gulkin had also dismissed the possibility of entering Malaysia because it had experienced very strong economic growth in recent years which, in turn, allowed the seafood exporting industry to become well-developed. Gulkin

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viewed Indonesia as having potential, given that it was a large, resource rich archipelago; however, he dismissed this option because of its considerable distance from Thailand. Furthermore, Indonesia was currently experiencing political turmoil of its own, brought on by the arrest of Megawati Sukarno, daughter of Indonesia's founding President Sukarno and the principal political foe of the current President, General Suharto.

Several factors existed which were working to dissuade Gulkin from making the leap to Burma, however. First, Gulkin was concerned about competing against PL Corporation, a local seafood exporting company controlled by General Ne Win's son-in-law, particularly since local companies were often shown preferential treatment by local suppliers and producers. Additionally, there was increased interest in the region from two of SC's key competitors, the Hong Kong-based Sun Wah Trading Company and a sourcing division for the Japanese trading giant, Mitsui. Sun Wah was a well-financed firm which maintained its own fleet of transport ships and had a well-established reputation in the seafood trading business. Its solid financial position allowed the firm to extend million dollar financing arrangements to processors, thus enabling them to remain open in times when cash flow was squeezed, something SC was not able to do for its customers. Mitsui's sourcing division was interested in Burma's raw material supply so that other members of the Mitsui keiretsu would be assured of having inputs for their value-added food processing operations. Gulkin viewed Mitsui, as well as the increasing interest of Japan's other big trading companies, as his largest threat in Burma. This was because the Japanese giants would be able to outbid many of the smaller players, and in turn, limit their ability to secure reliable supply sources. Additionally, the recent trend of the Japanese Yen was also cause for some concern because its rising value gave the Japanese greater purchasing power throughout the world.

The recent political attention given to Burma also worried Gulkin. While Gulkin viewed economic isolation as harmful, he also needed to consider the view of his overseas customers. He remained cautiously optimistic that his customers would not view his possible foray into Burma as unduly harmful. At the same time, however, he realized that if the economic sanctions movement gained momentum, some of SC's customers might "black list" Burma. Adding further confusion to this situation was the recognition that an increasing number of Asian firms were making inroads into Burma, despite the calls for sanctions elsewhere in the world. It was quite clear that Asia's view of Burma was considerably different from that of the Western powers.

The level of development of Burma's infrastructure was also cause for some concern. It would clearly be difficult to conduct business in a country which lacked an adequate system of roads or communication linkages. The port facility in Rangoon was especially problematic and was considered to be the biggest bottleneck in the country. It was not uncommon for vessels to wait for several days or even weeks before they could be loaded or unloaded. The matter was so grave that it prompted several foreign investors from Singapore and Hong Kong to begin the development of a new port across the river from Rangoon; however, it was expected to be about a year before the port became operational.

Decision

In considering his Burmese investment decision, Gulkin had to consider several trade-offs. Could he afford to take a "wait and see" approach to Burma while other Asian firms started to tap into the market? Similarly, could he afford to allow this opportunity to pass him by given that other seafood exporting opportunities in the region were quite limited? Alternatively, if Gulkin entered Burma, could he be assured that his investment was secure given the state of political governance in the country? At the same time, would he run the risk of losing some key clients who would discontinue doing business with him because of his involvement in Burma?

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Royal Trustco[1]

Prepared by Alan W. Andron under the supervision of Professor David Conklin

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You have a board of directors that has worked diligently, assiduously, in your interests. I never in my life have known a better group of people and I think you should recognize that they have saved this company.

—Hartland MacDougall, Royal Trustco Chairman, comments to a shareholders' meeting as quoted in "A question of governance," Globe & Mail, July 19, 1993, Pg B1.

You know, it's like in my game. Second guessing after something happened is much easier than when you have to make the decision.

—Jean Beliveau, Royal Trustco Director, as quoted in "A question of governance," Globe & Mail, July 19, 1993, Pg B1.

Company Background

Royal Trust[2] opened for business in Montreal on November 24, 1899. The company started with one employee and a desk located in the Bank of Montreal on Place D'Armes. The company's first president and board of directors were the same as the Bank's, although the Bank did not own Royal Trust.[3]

By the early 1980s, Royal Trustco had grown to have corporate assets of $11.1 billion, and assets under administration of $37.6 billion.[4] The company had diversified to include intermediary and real estate brokerage businesses. Royal Trustco classified business into three broad groups: 1) intermediary services, which consisted of deposit accounts, chequing accounts, personal loans and mortgages; 2) trustee services for both corporations and individuals, which included managing stock transfers and administering estates; and 3) managed assets, where Royal Trustco would manage a person's assets (not estates), provide financial advice, and other investment management services such as mutual funds on a fee for service basis.[5] Exhibit 1 provides a five-year income statement and balance sheet for Royal Trustco.

1980: The Campeau Corporation Takeover Bid

On August 28, 1980, Ottawa-based Campeau Corporation, a property developer headed by Robert Campeau, announced a take-over bid for Royal Trustco. Originally an Ottawa home builder, Campeau had moved into land development and built several large office complexes in downtown Ottawa and Hull. In recent years, Campeau had expanded into several major Canadian and United States markets. Campeau's bid for Royal Trustco surprised many investment analysts.[6]

Royal Trustco's management recommended to the board that the offer be opposed.[7] To help fight the take-over bid, Royal Trustco filed suit in both Canadian and U.S. courts,[8] as well as complaints with the Ontario Securities Commission

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CONSOLIDATED INCOME STATEMENT 1988 TO 1992
($ millions)

	1992	*1991*	*1990*	*1989*	*1988*
Net Investment Income	352	484	453	542	479
Provision for Loan Losses	(421)	(155)	(209)	(22)	(18)
Fees and Other Income	351	337	291	278	229
Net Revenues	282	666	535	798	690
Operating Expenses					
Salaries and Benefits	296	281	282	252	223
Premises, Computer & Equipment	160	154	149	131	115
Other Operating Expenses	179	167	186	186	150
Write-off of Good Will	93	—	—	—	—
Income Taxes	213	19	(85)	(35)	(10)
Income from Operations	(659)	45	3	264	212
Sale of Stock Transfer Business	—	21	—	—	—
International Restructuring	—	—	(30)	—	—
Write-down of investments	—	—	(84)	—	—
Income–Discount'd Operations	(193)	41	46	1	—
Net Income	(852)	107	(65)	265	212

CONSOLIDATED BALANCE SHEET 1988 TO 1992
($ millions)

	1992	*1991*	*1990*	*1989*	*1988*
Cash and Short Term Investments	3,131	3,227	4,810	5,265	5,310
Securities	2,905	4,581	4,526	4,605	3,920
Loans and Investments	17,790	20,320	22,649	21,457	18,803
Other Assets	417	698	688	510	444
Net Discontinued U.S. Assets	817	998	582	444	—
Total Assets	25,114	29,824	33,255	32,281	28,477
Demand Deposits	4,120	4,026	3,828	3,906	4,451
Term Deposits	16,928	20,038	23,572	22,516	19,361
Bonds, Debentures, Borrowings	1,436	2,253	2,510	2,789	2,243
Other Liabilities	234	209	179	203	235
Total Liabilities	22,718	26,526	30,089	29,414	26,290
Minority Interest	9	8	7	26	42
Subord. Notes; Capital Debent.	1,419	1,334	1,335	766	661
Shareholders' Equity	968	1,956	1,824	2,075	1,484
Total Equity	2,396	3,298	3,166	2,867	2,187
Total Liabilities and Equity	25,114	29,824	33,255	32,281	28,477

Exhibit 1

Source: Royal Trustco Annual Report 1992.

All values are quoted in Canadian funds.

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(OSC). Both the courts[9] and the OSC[10] ruled that the Campeau bid was valid.

During the take-over bid, a group of Canada's top corporations, including Toronto Dominion Bank (TD), Noranda, Olympia & York Developments (O&Y), actively purchased Royal Trustco stock.[11] Campeau eventually withdrew the offer because the desired number of shares were not tendered.

1982/83: The Brascan Revolution

Brascan, which was a part of the Edper Group (Exhibit 2 outlines the member companies of the Edper Group; Exhibit 3 lists directors of key Edper companies) controlled by Edward and Peter Bronfman, purchased its original interest (14.9 per cent) in Royal Trustco in early 1981.[12] In 1983, Trilon, a member of the Brascan family, purchased the Brascan interest in Royal Trust, as well as the large interest held by O&Y. Trilon indicated that it was interested in purchasing more shares in the future.[13] By 1983, Trilon had gained control of Royal Trustco[14] through a series of share purchases from other shareholders. Michael Cornelissen was appointed to the position of President and Chief Executive Officer of Royal Trustco and its operating subsidiaries.

1983–1992: The Cornelissen Era of Entrepreneurship

Michael Cornelissen was a chartered accountant by training. He had worked for Touche Ross in his native South Africa, and in Montreal, where he met Jack Cockwell, who in 1975 would hire Cornelissen to work for the Hees-Edper group. Following his time in Montreal, Cornelissen returned to South Africa to return to school, and later worked for a large public company in Johannesburg. In 1975, Cornelissen became one of the original group of employees to work on the building of the Hees-Edper businesses (Hees was one of the subsidiaries of Edper, and Jack Cockwell, Cornelissen's new boss, was one of the key personnel in the organization). Cornelissen rose to prominence in the early 1980s after managing a turnaround at the Edper-controlled Trizec Corp, a Calgary-based real estate developer.[15]

At the time Cornelissen was appointed president and CEO of Royal Trustco, the company was described with such terms as "ossified," "hierarchical," "inwardly oriented," and "unexceptional."[16] His assignment was to develop an entrepreneurial culture within Royal Trustco. The goal was to give the organization a sales and marketing orientation, and transform its culture from one that was risk averse.[17] Under Cornelissen, Royal Trustco set a target of annual growth in earnings per share of 15 per cent,[18] and formulated a strategic plan which outlined how the earnings growth would be achieved.[19]

To achieve these goals, Cornelissen followed the Hees philosophy[20] of how to run a firm. He reduced the levels of management and bureaucracy within Royal Trustco. Senior managers were required to start at 7 a.m., traditional long lunches were eliminated, and everyone was required to work flat-out; those who couldn't work in the new environment were replaced.[21] An extensive internal communications plan was implemented to deliver the customer service message to the employees in the branches.[22]

In order to motivate senior and middle level managers, Royal Trustco required enrolment in its stock purchase plan.[23] Royal Trustco provided 100 per cent financing of the stock purchases; stocks were kept in a trust account for a five-year period, managers repaid 20 per cent of the principal each year and took possession of the stock, or could wait five years, pay off the loan in one payment, and take possession of the stock.[24] Loan interest payments were set to equal the dividends available on the stock.[25] The assumptions behind the plan were that: a) an ownership position would ensure that managers acted in the best interests of the stockholders, and b) stock price was the best indicator of the performance of the company.[26] Management salaries were significantly lower (an estimated 30 to 50 per cent)

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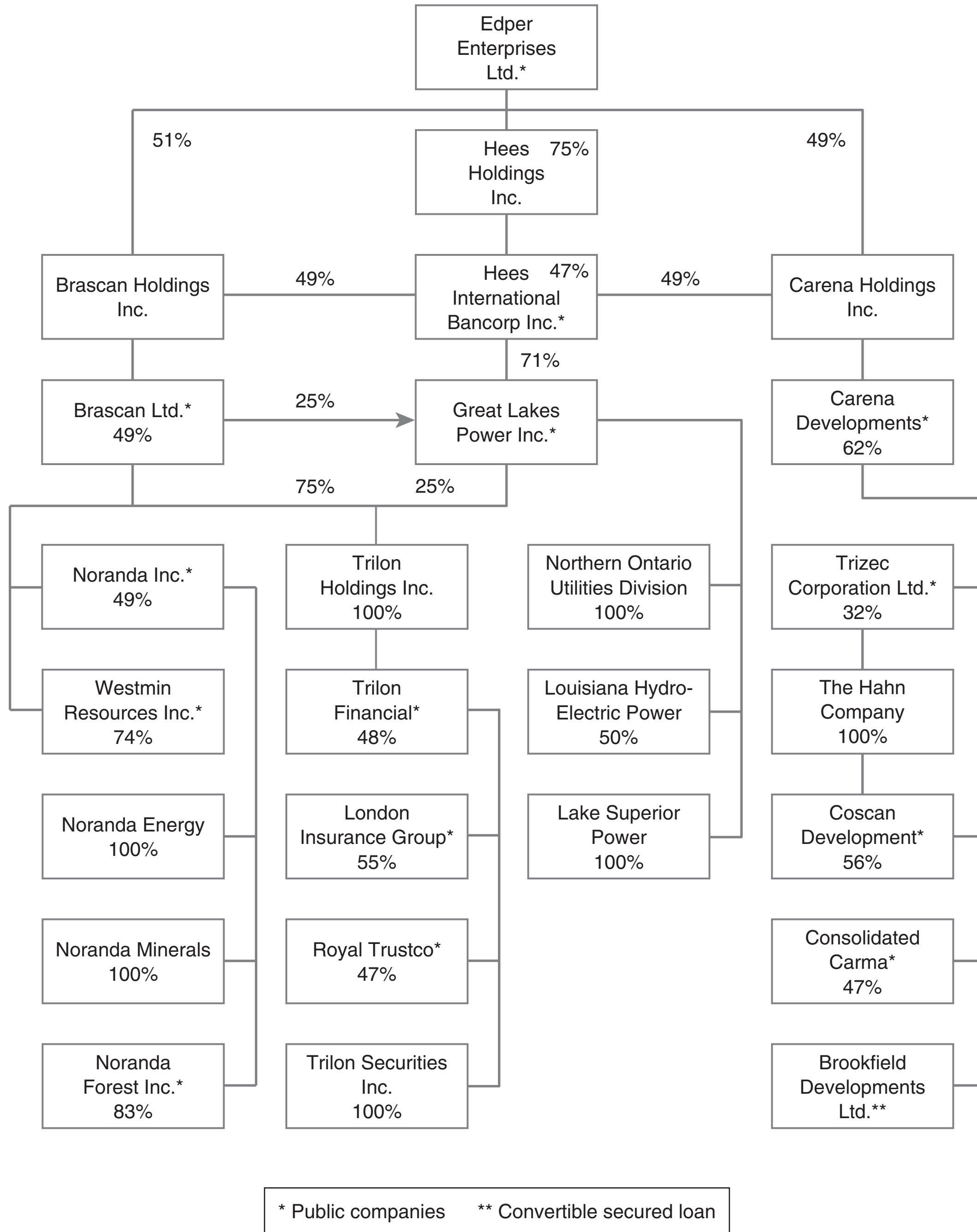

Exhibit 2 Edper Enterprises Ltd Corporate Organization

Source: Edper Enterprises Ltd Annual Report 1992.

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ROYAL TRUSTCO BOARD OF DIRECTORS

Hartland MacDougall C.V.O.; James Miller; Hon. James Balfour, Q.C.; Jean Beliveau O.C.; Thomas R. Bell; Brian Canfield; Kenneth R. Clarke; Adrienne Clarkson O.C.; Jack L. Cockwell; Gordon R. Cunningham; David L. Donne; Hon. J. Trevor Eyton Q.C.; Fraser Fell Q.C.; Paul Gobeil; Melvin Hawkrigg; Dr. Warren McFarlan; Neil McKelvey O.C., Q.C.; Earl Orser; Roger Phillips; Richard Pound, O.C., Q.C.; Hon. Maurice Riel P.C., Q.C.; Margaret Southern C.M., L.V.O.; James M. Tory Q.C.; Marshall Williams

Source: Royal Trustco Annual Report 1992.

TRILON FINANCIAL BOARD OF DIRECTORS

Hugh Aird; Peter F. Bronfman; Kenneth R. Clarke; Jack L. Cockwell; George Cormack; Gordon R. Cunningham; William Dimma; Gary Goodman; Melvin Hawkrigg; Alan Hockin; Joseph Jeffery OBE, CD, LLD; Allen Lambert O.C.; Frank Lochan; Donald Lowe; Hon. Edward Lumley; Hartland MacDougall; David McCamus; Ross McKenzie; George Myhal; Earl Orser

Source: Trilon Financial Annual Report 1992.

BRASCAN LTD BOARD OF DIRECTORS

Roberto P. Cezar De Andrade; Hon. Conrad M. Black P.C., O.C.; Bruce A. Bronfman; Edward M. Bronfman; Peter F. Bronfman; Jack L. Cockwell; Robert A. Dunford; Hon. J. Trevor Eyton O.C., Q.C.; Rhys T. Eyton; Hon. Edwin A. Goodman P.C., O.C., Q.C.; Lewis B. Harder; Patrick J. Keenan; David W. Kerr; Allen T. Lambert, O.C.; Hon. E. Peter Lougheed, P.C., C.C., Q.C.; Paul M. Marshall; Harold P. Milavsky; Alfred Powis, O.C.; John A. Scrymeour; Peter N.T. Widdrington

Source: Brascan Ltd Annual Report 1992.

EDPER ENTERPRISES LTD BOARD OF DIRECTORS

Bruce A. Bronfman; Edward M. Bronfman; Linda E. Bronfman; Peter F. Bronfman; Donald Carr, Q.C.; Jack L. Cockwell; Hon. J. Trevor Eyton, O.C., Q.C.; Jack Rabinovitch; Manfred J. Walt; Sheila Zittrer

Source: Edper Enterprises Annual Report 1992.

Exhibit 3 Royal Trustco Board of Directors

than those paid by competitors; this difference was to be compensated by increases in the value of the manager's stock.

Royal Trustco's accounting system was revamped so that management could track its products on a client-centred basis, thereby easing the process of cross-selling related financial services.[27] Account managers at the branch level were placed on a compensation system that rewarded results, including a commission component based upon the amount of loan business (and other fee-based services) written.[28] The company also set out to increase the size of its branch network from 111 to 190 branches, in order to improve its access to depositors as a source of stable and inexpensive funds.[29]

Royal Trustco survived the recession of the early 1980s, and enjoyed profitability for the remainder of the decade. The Canadian economy had climbed out of recession, and by the end of the decade was "running full steam ahead." Royal Trustco met its target of 15 per cent earnings growth every year until 1990; from 1985 to 1989, earnings had doubled. At the 1989 shareholders' meeting, Cornelissen spoke of profits doubling again in the next five years.[30]

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During the 1980s, Royal Trustco introduced several innovative products to the Canadian market. One popular product was the "Double Up" Mortgage, which allowed customers to make an additional mortgage payment without penalty.[31] Through its affiliation with Royal LePage Real Estate, Royal Trustco created the concept of the "pre-approved mortgage" for the residential market. The mortgage applications and paperwork were handled through the realtor, while the mortgage itself was issued by Royal Trustco. In addition to these innovative mortgage products, loans officers in Royal Trustco branches were given generous lending limits within which to write loans.[32]

In addition to its innovations in the residential mortgage market, Royal Trustco placed heavy emphasis on the commercial loans sector, particularly commercial real estate. In 1990, Royal Trustco's Canadian portfolio included $5 billion in commercial loans. The U.S. and U.K. subsidiaries were also aggressively lending into the commercial real estate market.

Expanding Internationally

In 1988, Royal Trustco moved into the European and U.K. markets, primarily through its U.K. subsidiary, Royal Trust Bank. The stated goal was to serve the same type of clientele as in Canada (older and affluent customers dealing with branches specifically located in neighbourhoods with high populations of wealthy and high income citizens), based upon a "relationship banking" theme. However, growth in the U.K. was fuelled by moving downscale and lending to the mid-market of small-business loans and commercial mortgages.[33]

In 1989, Royal Trustco made further moves into the United States market,[34] purchasing Seattle-based Pacific First Financial Corporation, considered to be a financially solid thrift.[35] Within twelve months, Royal Trustco purchased two savings and loan firms from Resolution Trust, the U.S. Government's liquidator of failed thrifts. Cornelissen's goal was to merge the three U.S. institutions, realize operating economies, and in the process, create a super regional bank in the U.S. Pacific Northwest.[36]

Royal Trustco's international expansion was driven by several factors. The federal government was actively reviewing the Bank Act and other financial legislation. It was expected that trust companies, banks, and insurance companies would be able to enter into each other's traditional lines of business, thus increasing competition. Canada's market was seen by management as being too small to enable Royal Trustco to maintain its earnings growth at the expected levels.[37] Royal Trustco (and the Edper group in general) had frequently been the target of comments by politicians, academics, and media commentators about the concentration of commercial and financial companies. Cornelissen was noted to have said that the protests were driving Royal Trustco into other markets, such as the United States.[38] Finally, the U.S. market was seen as being fragmented, providing room to develop a large financial institution with scale efficiencies.[39]

1990: The Recession Hits

The U.K. economy went into a severe recession early in 1990. The Canadian and U.S. economies started to slow down in late 1990, and went into full recession in 1991. In all three cases, the recession resulted in a decline in values in the real estate market, into which Royal Trustco had lent funds.[40] Further, the housing market in southern Ontario, where Royal Trustco had a large residential mortgage portfolio, declined along with the commercial markets.[41,42]

Royal Trustco's fourth quarter loss in 1990 was $251 million, the total loss for the year was $65 million. Loan loss provisions for the year increased from $23 million in 1989 to $220 million; the largest portion of the increase was for European loans.[43] This loss only affected shareholders in part. While the value of the stock dropped, the firm maintained its common share dividends at previous levels.[44]

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1991: Happy Days are Here Again

The U.S. operations had been affected because of declines in the value of the California real estate market. First Pacific had been hit by non-performing loans, especially in California where it had a large loan portfolio in the commercial real estate market. While the recession had weakened the market, it was predicted that eventually the continuing growth in California's population would pick up the slack.[45]

In spite of the apparent gloom coming from the U.S. operations, 1991 turned out to be a good year for Royal Trustco. The company reported a net income for the year of $107 million. Shareholders were told that the worst of Royal Trustco's loan problems were behind it, with appropriate provisions having been made for potential loan losses.[46]

1992: The Loan-Loss Steamroller

In 1992, Royal Trustco sold its United States operations. First Pacific was draining cash out of its Canadian parent, and U.S. regulators had started to watch the company.[47] In their efforts to clean-up First Pacific, regulators and managers discovered even more problems in the lending department.[48] Furthermore, a wave of mergers in the U.S. had created several large regional competitors to the Royal Trustco operations.[49] In order to complete the sale of its U.S. subsidiary, Royal Trustco had to keep $900 million in non-performing loans; with the sale of First Pacific, Royal Trustco took a charge of $193 million against earnings.[50]

The publicity surrounding Royal Trustco's problems led to further revenue problems for the company. Depositors started taking their money out of Royal Trustco and placing it elsewhere. The result was that earnings from operations declined for the 1992 fiscal year.[51]

In 1992 came the announcement that Michael Cornelissen would be stepping down as president and CEO of Royal Trustco, and serving as vice-chairman in a non-executive role.[52] Following a search for a successor, James Miller, an accountant formerly with Touche Ross (now Deloitte Touche) in Vancouver, was appointed president and CEO.

Dividends

Even though Royal Trustco had lost money in 1990, it maintained its policy of holding dividends constant. In 1991, the company paid out $73 million in preferred dividends, and $108 million in common dividends; earnings in 1991 were $107 million. In 1992, despite losing $852 million for the year, the company declared and paid out $55 million in preferred dividends (meeting the full obligations on preferred shares), and $80 million in common dividends. Common dividends had been changed for 1992: for the second quarter onward, common dividends had been reduced from 18.5 cents per share to 10 cents per share; for the third quarter onward, they were reduced to five cents per share.[53]

Miller and the End of the Dream

Upon taking over in December 1992, Miller brought in independent consultants to review the loan portfolio. The conclusion of the review was that provisions for loan losses were inadequate.[54] Miller's action had been prompted, in part, by a visit from Michael Mackenzie, the federal government's top bank and trust company regulator. Mackenzie had visited Miller to issue a warning to watch out for Toronto real estate, as prices were in what he called a "free fall."[55]

Miller's conclusion was that in order to save the trust company, especially its depositors and assets, the only option was to sell the company outright.[56] Earlier in 1992, Royal Trustco had started looking for a partner willing to inject equity into the firm—in Miller's view, that was no longer an option. The response to Miller's

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analysis by the Royal Trustco board was disbelief; members did not believe things were as bad as Miller claimed.[57]

Notes

1. This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Royal Trustco or any of its employees.
2. The name "Royal Trustco" is used in the balance of the case. Although founded as Royal Trust, the parent company eventually came to be known as Royal Trustco, with Royal Trust as one of its operating divisions.
3. Ivey Business School Case #9A86B044 "Royal Trust (A)."
4. Ibid.
5. "Royal Bust," *Canadian Business,* November 1992, p. 46.
6. "Campeau makes bid for Royal Trust," *Globe & Mail,* August 28, 1980, pp. B1, 4.
7. "Royal Trustco management to fight Campeau takeover," *Globe & Mail,* August 29, 1980, p. B1.
8. "Battle heats up for Royal Trustco," *Globe & Mail,* September 9, 1980, p. B1.
9. "Royal Trustco to appeal ruling," *Globe & Mail,* September 17, 1980, p. B1.
10. "OSC allows Campeau to take up Royal Trustco shares," *Globe & Mail,* September 19, 1980, p. B1.
11. TD buys interest in Royal Trustco," *Globe & Mail,* October 7, 1980, p. B1.
12. "Brascan buys 14.9 per cent of Royal Trustco," *Globe & Mail,* March 26, 1983, p. B1.
13. "Trilon purchases 42 per cent of Royal Trustco," *Globe & Mail,* July 29, 1983, p. B1.
14. "Royal Bust," *Canadian Business,* November 1992, p. 36.
15. Ibid, p. 38.
16. Ibid, p. 37.
17. Ibid, p. 38.
18. "Blue chip turns red, investors go white," *Globe & Mail,* March 30, 1993, p. B1.
19. Royal Trustco Annual Report 1984.
20. The philosophy, as described in "Royal Bust," included such aspects as managers becoming shareholders to unlock their entrepreneurial flair, a culture of hard work and dedication.
21. "Royal Bust," *Canadian Business,* November 1992, p. 39.
22. Ibid, p. 40.
23. Ibid.
24. "How the loan plan went wrong," *Globe & Mail,* March 29, 1993, p. B1.
25. "The Hollow Men," *Report on Business Magazine,* August 1993, p. 13.
26. "Royal Bust," *Canadian Business,* November 1992, p. 40.
27 Ibid.
28. Ibid.
29. Ibid, pg. 42.
30. "A question of governance," *Globe & Mail,* July 19, 1993, pp. B1, 6.
31. Royal Trustco Annual Report 1984.
32. "Royal Bust," *Canadian Business,* November 1992, p. 42.
33. "Royal Bust," *Canadian Business,* November 1992, p. 44.
34. In 1987, Royal Trustco had purchased 9.9 per cent of a California savings and loan called GlenFed Inc.
35. "Royal Trustco," Canadian Research Flash, Prudential–Bache Securities, February 9, 1989.
36 "Royal Bust," *Canadian Business,* November 1992, p. 44.
37. "The Hollow Men," *Report on Business Magazine,* August 1993, p. 12.
38 "Royal Trustco to buy U.S. financial firm," *Globe & Mail,* February 7, 1989, pp. B1, 6.
39. Ibid.
40. "Blue chip turns red, investors go white," *Globe & Mail,* March 30, 1993, pp. B1, 8.
41. Royal Trustco Annual Report 1990.
42. According to the 1992 Royal Trustco Annual Report, as of December 31, 1992, Royal Trustco's net Ontario residential mortgage portfolio stood at $4,604 billion, or 51.4 per cent of its total Canadian residential mortgage portfolio. Net commercial real estate loans in the Ontario market totaled $2,463 billion, or 52.8 per cent of the company's Canadian commercial real estate loan portfolio.
43. Royal Trustco Annual Report 1990.
44. "Blue Chip turns red, investors go white," *Globe & Mail,* March 30, 1993, pp. B1, 8.
45. Royal Trustco Annual Statutory Report 1991, p. 17.
46. Ibid, pp. 28,29.
47. "Royal Bust," *Canadian Business,* November 1992, p. 44.

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48. Ibid.

49. Ibid.

50. "Royal Trust sells prize assets," *Globe & Mail,* March 19, 1993, pp. B1, 6.

51. Royal Trustco Annual Report 1992. "Net investment income" dropped by $132 million in 1992 over 1991. During this same period, "Fees and other income" increased by $14 million, for a net decrease in operating income before allowances for loan losses of $118 million.

52. "Royal Bust," *Canadian Business,* November 1992, p. 37.

53. Royal Trustco Annual Report 1992.

54. "A question of governance," *Globe & Mail,* July 19, 1993, p. B3.

55. Ibid.

56. Ibid.

57. Ibid.