

CASE 1

The Volkswagen Scandal: An Admission to Emission Fraud*

INTRODUCTION

In 2016 Volkswagen (VW) became the world's largest automaker in car production, surpassing Toyota to take its title. However, this title can quickly change in a short amount of time. Not only is the car industry highly competitive, but all is not well at Volkswagen. In early 2017 the automaker pled guilty to three criminal felony charges that included defrauding the U.S. government, violating environmental regulations, obstructing justice, engaging in wire fraud, and violating import regulations. It agreed to pay \$2.8 billion in criminal charges, only a small portion of the total costs it will have to pay to resolve this scheme. Worse still, VW's reputation has been dealt such a blow that it will likely take years to recover. As a global firm, VW has lost the trust of regulators, which will be a major obstacle in future global relationships.

HISTORY

Volkswagen was founded in 1937 in Nazi Germany as a "pet project" of dictator Adolf Hitler, who desired to develop what he termed the "people's car" (*Volkswagen* translates into "the people's car" in English). Headquartered in Wolfsburg, Germany, the automaker's continued existence was precarious after Germany lost the war. However, a British major opted to keep Volkswagen open, and the firm continued to grow.

Sales of Volkswagen were slower in the United States than in other areas because of its questionable founding, but the introduction of the Volkswagen Beetle caused U.S. sales to skyrocket. Soon the Beetle had become the best-selling car import in the United States. When sales began to decline in the 1970s, VW began introducing new generations of cars. It also started making a series of acquisitions, most notably acquiring the Bentley and Lamborghini brands in 1998 and the Porsche brand in 2012.

In the decades since its founding, Volkswagen became a formidable competitor to global car makers such as Toyota, Ford, and General Motors. Its cars have been widely successful, winning a number of global awards. In 1999 the Volkswagen Beetle was selected the fourth runner-up as the Car of the Century, after the Model T, the Mini, and the Citroen DS. In 2015 VW was elected to 43rd place among *Fortune* magazine's World's Most

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Admired Companies. Earlier that year, the VW Golf had been named the North American Car of the Year.

Until recently, VW was highly valued for its sustainability goals. It became the first car manufacturer to adopt ISO 14001 principles, international environmental principles that act as standards for global firms. It adopted a number of sustainability goals in 2002 at a time before sustainability became a hot topic. VW began investing in vehicles that would reduce carbon emissions early, including electric and diesel vehicles. In 2014 VW introduced the VW XL1, which it claimed to be the most fuel-efficient car in the world at the time. Its reputation for sustainability was so great that it won an international sustainability award. VW's reputation for sustainability worsened the blow to its reputation when it all came crashing down years later.

THE SCANDAL

VW's downfall stemmed from the same thing that enabled it to commit such wide-scale misconduct in the first place: technology. Although the impact of technology has created benefits for businesses and consumers alike, it has also provided a greater opportunity to cheat ethical and legal requirements. Volkswagen, once lauded for its green reputation, saw its reputation crumble after it was discovered the company had purposefully fooled regulators and consumers with its emissions claims. Volkswagen used a "defeat device" in its software that changed the vehicle's performance depending upon the environment. For instance, the software was able to detect when vehicles were undergoing emissions testing. During this testing, the software made the vehicles run below performance, which released fewer emissions and met requirements. However, on the road the cars ran at maximum performance and gave off up to 40 times the allowable limit for emissions in the United States.

Volkswagen estimates that 11 million vehicles in the United States and Europe were affected by this defeat device. Until the scandal broke, VW had promoted itself as an eco-friendly company. Its commercials featured Volkswagen rally driver and host on *Top Gear* USA Tanner Foust driving elderly women around town in a TDI Volkswagen to dispel the myth that diesel is slow. As a result of its marketing, Volkswagen made large in-roads in gaining acceptance for its clean diesel vehicles, even though many car buyers had a negative view of diesel previously. This green image was highly beneficial for Volkswagen as consumer values are changing to value greener products.

While technology allowed VW to cheat the system, it also played a large part in its downfall. Discovery began when European testers noticed that VW vehicles did not perform as well on emissions testing on the road as they did in the lab. They commissioned a team in West Virginia to conduct research on VW vehicles made for Americans because the United States has some of the toughest emissions standards in the world. The team in West Virginia used a portable emission system measurement to measure emissions on the road. They found that the measurements did not nearly match up with what was shown in lab tests. The results were reported to the Environmental Protection Agency, which confronted Volkswagen with the evidence. Volkswagen eventually admitted it had designed and installed a defeat device that could detect when the vehicle was being tested and modify its performance levels so that it would meet emissions requirements. A whistle-blower later filed a lawsuit against VW claiming that it began destroying documents that could implicate the firm and fired him when he refused to get rid of documents. Volkswagen denies that the employee's departure had anything to do with the emissions scandal.

IMPACT

As a result of the scandal, Volkswagen's CEO resigned and governments are demanding answers. Such a fraud does not only violate ethical standards but also laws and regulation in Europe and the United States. The company agreed to pay up to \$17.5 billion to compensate consumers affected by its defeat devices, which included retrofitting and buying back impacted vehicles. Those who knew about or were responsible for the defeat device's installation could face jail time. Six executives and employees have been indicted for knowing about the conspiracy. One of the executives arrested was VW's emissions compliance manager. Germany has also launched a probe into whether former CEO Martin Winterkorn had knowledge about the misconduct beforehand. Winterkorn claims he did not become aware of the misconduct until the scandal erupted.

Perhaps the worst impact the scandal has caused is to VW's reputation. Many VW customers claim they purchased the cars because they believed them to be better for the environment and felt utterly betrayed by the company. Consumer rights were violated because consumers did not have accurate information, meaning they were not able to make informed purchasing decisions. Its reputation for sustainability has been shattered, and two awards it had been given for "Green Car of the Year" were pulled.

VW is not the only company implicated in the conspiracy. U.S. lawyers accuse German parts supplier Robert Bosch GmbH of designing the defeat devices and knowing that they were being installed in VW vehicles to cheat emissions standards. A 2008 email was used as evidence in which Robert Bosch allegedly demanded that VW indemnify the firm for any future legal repercussions, suggesting that the company knew full well that it was violating laws. Robert Bosch did not admit to wrongdoing but agreed to pay \$327.5 million to settle the civil claims.

VW agreed to plead guilty and pay a criminal fine of \$2.8 billion in the United States, as well as an additional \$1.5 billion for breaking civil, environmental, customs, and financial regulations. The penalty could have been as high as \$34 billion under U.S. laws but was reduced because of VW's cooperation with the investigation. In total, criminal and civil fines and settlements are estimated to cost VW \$22 billion in the United States. This included a settlement with the Federal Trade Commission to settle allegations that it had engaged in false advertising by marketing its automobiles as "clean vehicles."

Even after pleading guilty to U.S. charges, VW's troubles are far from over. Europe is conducting its own criminal investigation, and a class-action lawsuit has been filed against VW in the United Kingdom. The problem could be even more serious than in the United States because VW vehicles are more common in Europe.

Volkswagen has begun to take steps to restore consumer trust. For instance, it recalled vehicles and offered a \$1,000 goodwill package to its American car owners. It agreed to curb executive compensation as a result of the scandal. Yet even with incentives, Volkswagen will have to face this loss of goodwill for years to come. VW is also taking a different tactic in Europe. Because of less consumer-friendly laws, VW has not been as willing to compensate European drivers for damages. One major reason is that if it is forced to pay out to the same extent in Europe as it had in the United States, the company may very well go bankrupt. VW is also claiming that under European definitions, its software does not qualify as illegal defeat devices. This approach seems to be working for VW. In Germany, where consumer-protection laws are lower than in some other countries, VW has won more than 75 percent of lawsuits filed against it by German consumers. How other countries in Europe will approach VW in terms of fines depends largely on the countries' laws as well as how many consumers file lawsuits against the firm.

CONCLUSION

VW hopes its settlement with U.S. regulators will be the first step toward putting the scandal behind it. As part of its plea, VW agreed to a three-year probation, a ban on selling diesel vehicles in the United States, and an independent compliance monitor who will oversee VW's operations over the next three years. However, truly restoring its reputation will require VW to incorporate ethics and appropriate practices into the organization from the inside-out, something that was severely lacking in the firm's corporate culture prior to the scandal.

Because it is one of the world's largest carmakers operating in an oligopoly, other global car companies may benefit from the scandal and gain market share from Volkswagen. At the same time, while they might benefit from a competitive standpoint, VW's conduct has caused problems for the industry as a whole. Consumers are now questioning the environmental claims of other car brands, and automakers will have to work harder to prove that their claims are accurate. Consumer trust is easily lost and is not restored overnight.

QUESTIONS FOR DISCUSSION

1. Explain how the culture of Volkswagen created this ethical scandal.
2. While Volkswagen claimed to support ethics and sustainability, how can they recover from this ethical disaster?
3. Do you believe this scandal will lead to tougher scrutiny of companies' environmental claims in the future? Why or why not?

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