

# Ethics and Contracts

## UNIT FIVE

*A party cannot escape a contractual obligation by signing with its fingers crossed behind its back, even if that clearly shows its intent not to be bound.*

—*Robbins v. Lynch*, 836 F.2d 330 (7th Cir. 1988)

*An insured should not have to consult a long line of case law or law review articles and treatises to determine the coverage he or she is purchasing under an insurance policy.*

—*Kovach v. Zurich Am. Ins. Co.*, 587 F.3d 323 (6th Cir. 2009)

When Paul Ceglia made his claim that he had a contract with Mark Zuckerberg for 50% ownership in Facebook, the two ended up in litigation. The case centered on a two-page agreement. Mr. Zuckerberg said that the signature on the second page was his, but the first page contained things that he had not agreed to. Handwriting and documents experts examined the first page and concluded that Mr. Ceglia had baked the first page in the sun to make the ink look aged. Another effect of the baking would be the expert's inability to test the ink. However, the experts found markings on that first page—clip marks where the document had been hung in the sun. One expert said that the clip markings were like the tan lines caused by a swimsuit.

There is contract law. There are standards of proof for contract agreements. And then there are the ethical issues, such as baking a piece of paper in the sun to establish that you had a contract. This section examines the ethical issues in contracts from advertising to obtain contracts to the failure to keep the promises in a contract once you have it.

# Contract Negotiations: All Is Fair and Conflicting Interests

## Case 5.1

### Facebook and the Media Buys

Media companies purchase ad time on Facebook based on metrics the company uses to calculate the average viewing time for its ads. The price the media companies pay is based on that viewing time. Quietly, in September 2016, Facebook posted a notification on its Advertiser Help Center and sent out a notice to its media customers that stated the following, “We recently discovered an error in the way we calculate one of our video metrics.”<sup>1</sup> Facebook indicated that its finding did not affect billing.

However, the statement missed the critical part of its metric discovery. Facebook had been basing its viewing time only on videos of more than three seconds. With that exclusion, what Facebook was claiming as average video viewing time to its media buyers was overstated by 60% to 80%. That reality would have affected two things in the media-buy negotiations: (1) how much they were willing to pay for Facebook space and (2) how many total Facebook buys they would make. The misrepresentation could have prevented media buys on YouTube, Twitter, and even on television. Their metrics did not exclude the lower-end view times, so their average view time would have been lower than Facebook’s.

Facebook has pledged to include all videos now in its metric. One media company explained to its client about the new Facebook metric, “Essentially, they’re coming up with new names for what they were supposed to measure in the first place.”<sup>2</sup>

#### Discussion Questions

1. What was the result of Facebook’s metric for ad buyers?
2. What does the closing statement mean—that Facebook was promising to do what it should have done from the beginning?
3. Do you think Facebook was unaware of the implications of its metric?

## Case 5.2

### Subprime Auto Loans: Contracts with the Desperate

You may have seen the ads. “Need cash? No credit history needed. Approval within hours.” You may wonder how the lenders do it. How do they make money when they are making loans to those who may not have a history or ability to pay? And how can they make the loans so quickly?

<sup>1</sup>Suzanne Vranica and Jack Marshall, “Facebook Misstates Video,” *Wall Street Journal*, September 23, 2016, p. B1.

<sup>2</sup>*Id.*, at B2.

Well, welcome to the new subprime market—auto loans! The loan companies advertise on television, have toll-free numbers, and are willing to loan just about anyone at least \$1,000. The reason these lenders are so comfortable in such risky lending is that they take a security interest in the borrowers' cars. The car, under Article 9 of the Uniform Commercial Code, can be repossessed, and the lender will get the loan repaid and then some. The reason the lenders can take the car, regardless of the amount that is due and the value of the car, is that the loans carry very high rates. Those rates climb if the borrower misses a payment, and along with late payment penalties, the borrowers, already financially shaky, find themselves in a situation they almost never escape without losing their cars. Ironically, the loss of their cars usually means they have no transportation to work, something that starts a deeper financial decline.<sup>3</sup>

Subprime auto loans were 27% of auto loans in 2013, a jump of 7% since 2009, and are generally made to those borrowers who have poor credit scores. The loans are generally one month in length and carry interest rates that range from 80% to 500%. At the end of the 30 days, the financially strapped individuals are generally not able to repay the loans, but the lenders are willing to renew, at a higher rate, and perhaps with additional fees that are added into the loan balance. The end result is either a never-ending balance, even if the borrower makes the payments, or repossession of the car. For example, a loan for \$1,000 that is renewed every 30 days over a one-year period can find the borrower owing more than 10 times the original the amount borrowed. The borrower reaches a point where the only escape is surrender of the car, because the repossession satisfies their obligation in many cases. The typical number of times for renewal for these types of borrowers is nine. One in every six car title loans results in repossession of the borrower's car.

The title loan market has grown and has attracted Wall Street investors, with stock prices in the lending companies climbing as much as 47%. Car title loans are legal in 21 states, and in those states, interest rates can go up to 300%. In other states, title loans are permitted, but there are some limits passed on interest rates and other types of regulations on renewals and fees. Other states prohibit deficiency judgments on these loans. That is, if the lender repossesses the borrower's car, the lender cannot pursue any deficiency judgment if the sale of the car does not bring enough to satisfy the loan. There are a number of states that have already passed laws regulating these types of auto loans or are in the process with legislative proposals pending.

The auto lending market, including prime and subprime car loans, topped \$1 trillion in 2015. Mortgages are an \$8.4 trillion market. Jamie Dimon of JPMorgan Chase has referred to the auto loan market as "a little stretched."<sup>4</sup> Even comedian John Oliver tackled "ultraloose approval processes" for these subprime loans on his HBO show.<sup>5</sup> According to Standard & Poor's, about 21% of all car loans are to individuals with credit scores below 620, with another 12% with scores of 620 to 659, the two score ranges considered the highest risk, with 660 being the credit score required to be considered good. Indeed, the boom in auto sales is largely due to loans to high-risk borrowers.<sup>6</sup> Only 22% of borrowers have a credit score above 780.

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<sup>3</sup>Jessica Silver-Greenberg and Michael Corkery, "Rise in Loans Linked to Cars Is Hurting Poor," *New York Times*, December 26, 2014, p. A1.

<sup>4</sup>Claudia Assis, "Subprime Car Loans Aren't Subprime Mortgages yet Still Worry Jamie Dimon and, Now John Oliver," *Market Watch*, August 15, 2016, <http://www.marketwatch.com/story/could-subprime-auto-loans-lead-to-same-economic-catastrophe-as-risky-mortgages-2016-07-27>. Last visited October 26, 2016.

<sup>5</sup>*Id.*

<sup>6</sup>Josh Zumbrun, "Surge in Subprime Auto Lending Draws Attention," *Wall Street Journal*, November 15, 2015, <http://www.wsj.com/articles/total-u-s-household-debt-rises-to-12-1-trillion-in-third-quarter-1447948826>. Last visited October 26, 2016.

### Discussion Questions

1. Describe how auto title lenders are able to make money with high-risk loans.
2. Who is affected by this type of a loan market? Are borrowers taken advantage of?
3. Does this lending present greater risks than the subprime mortgage market?
4. Is there a need for these types of loans?

## Case 5.3

### The Governor and His Wife: Products Endorsement and a Rolex

On November 3, 2009, Robert McDonnell was elected the 71st governor of Virginia. When Mr. McDonnell took office, he was struggling financially. A real estate LLC (Mobo) that he owned with his sister was losing more than \$40,000 each year. By 2011, they owed more than \$11,000 per month in loan payments. Each year, their loan balance increased, and by 2012, the outstanding balance was nearing \$2.5 million. Mr. McDonnell and his wife also had a combined credit card balance exceeding \$74,000, which, by September 2010, had grown to \$90,000.

Shortly after the election, the McDonnells met Jonnie Williams, the founder and CEO of Virginia-based Star Scientific Inc. Star was close to launching a new product: Anatabloc. For years, Star had been evaluating the curative potential of anatabine, an alkaloid found in the tobacco plant, focusing on whether it could be used to treat chronic inflammation. Anatabloc was one of the anatabine-based dietary supplements Star developed as a result of these years of evaluation.

The McDonnells had used Williams's plane during his campaign, and he wanted to thank Williams over dinner in New York. During dinner, Williams ordered a \$5,000 bottle of cognac, and the conversation turned to the gown Mrs. McDonnell would wear to the inauguration. Williams mentioned that he knew Oscar de la Renta and offered to purchase Mrs. McDonnell an expensive custom dress. Following this dinner, the McDonnells and Mr. Williams began a relationship depicted in the following chart.

Mr. McDonnell was convicted of conspiracy to commit honest-services wire fraud, three counts of honest-services wire fraud, conspiracy to obtain property under color of official right, and six counts of obtaining property under color of official right.<sup>7</sup> He appealed. The Court of Appeals affirmed the decision.<sup>8</sup> Mr. McDonnell appealed to the U.S. Supreme Court, and the court reversed his conviction on the grounds that there was no official government action taken in exchange for all the Williams favors. The case against Mr. McDonnell was then dismissed.<sup>9</sup>

### Discussion Questions

1. Give a summary of what was going back and forth between the McDonnells and Mr. Williams.
2. What was Mr. Williams looking to obtain from the governor and Mrs. McDonnell?
3. Why is the term *official act* important on appeal? Was there a quid pro quo? Is there a conflict of interest?
4. Despite what the court concluded in *McDonnell v. U.S.*, evaluate the ethics of the McDonnells and Williams's conduct.

<sup>7</sup>Mrs. McDonnell was also convicted, but their appeals were handled separately. Mrs. McDonnell's appeal to the Fourth Circuit was put on hold after the U.S. Supreme Court decision. Federal prosecutors moved to drop the case in September 2016.

<sup>8</sup>*U.S. v. McDonnell*, 792 F.3d 478 (4th Cir. 2015).

<sup>9</sup>*McDonnell v. U.S.*, 136 S.Ct. 2355 (2016).

Date	Gift/Meeting	Conversation	Action
October 2010	McDonnell plane ride with Williams on Williams's plane from California to Virginia.	Williams asked for help in promoting Anatabloc; both agreed to "independent testing in Virginia."	McDonnell agreed to introduce Williams to Dr. William Hazel, Virginia's secretary of health and human services.
April 2011	Williams took Mrs. McDonnell on a shopping spree; they lunched and shopped at Bergdorf Goodman and visited Oscar de la Renta and Louis Vuitton stores on Fifth Avenue. Williams bought Mrs. McDonnell dresses and a white leather coat from Oscar de la Renta; shoes, a purse, and a raincoat from Louis Vuitton; and a dress from Bergdorf Goodman. Williams spent approximately \$20,000 on Mrs. McDonnell during this shopping spree.	Williams sat with the McDonnells at a political rally in New York City that evening.	
April 29, 2011	Williams joined the McDonnells for a private dinner at the Governor's Mansion.	The discussion at dinner centered on Anatabloc and the need for independent testing and studies. McDonnell was "intrigued that [Star] was a Virginia company with an idea," and he wanted to have Anatabloc studies conducted within Virginia.	Two days after this private dinner, Mrs. McDonnell received an e-mail via Williams that included a link to an article titled "Star Scientific Has Home Run Potential," which discussed Star's research and stock. Mrs. McDonnell forwarded this e-mail to her husband.
May 2, 2011	Mrs. McDonnell and Williams met at the Governor's Mansion to discuss Anatabloc.	Mrs. McDonnell began explaining her family's financial woes—thoughts about filing for bankruptcy, high-interest loans, the decline in the real estate market, and credit card debt. Then, according to Williams, Mrs. McDonnell said, "I have a background in nutritional supplements and I can be helpful to you with this project, with your company. The governor says it's okay for me to help you and—but I need you to help me. I need you to help me with this financial situation." Mrs. McDonnell asked to borrow \$50,000. Williams agreed to loan the money to the McDonnells. Mrs. McDonnell also mentioned that she and her husband owed \$15,000 for their daughter's wedding reception. Again, Williams agreed to provide the money.	Williams called McDonnell to "make sure [he] knew about it" and then cut the checks requested by Mrs. McDonnell.

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Date	Gift/Meeting	Conversation	Action
May 5, 2011	McDonnell met with Secretary Hazel and Chief of Staff Martin Kent to discuss the strategic plan for the state's health and human resources office.		McDonnell directed his assistant to forward to Hazel the article about Star that Mrs. McDonnell had earlier brought to his attention.
May 23, 2011	Williams delivered two checks for the amounts discussed on May 2: a \$50,000 check made out to Mrs. McDonnell and a \$15,000 check that was not made out to anyone but was going to the wedding caterers.		
May 28, 2011			Mr. McDonnell expressed his gratitude in a May 28 e-mail to Williams: "Johnnie [sic]. Thanks so much for all your help with my family. Your very generous gift to Cailin was most appreciated as well as the golf round tomorrow for the boys. Maureen is excited about the trip to fla to learn more about the products.... Have a restful weekend with your family."
May 29, 2011	McDonnell, his two sons, and his soon-to-be son-in-law spent the day at Kinloch Golf Club in Manakin-Sabot, Virginia. During this outing, they spent more than seven hours playing golf, eating, and shopping.		
June 1, 2011			Mrs. McDonnell traveled to Florida at the start of June to attend a Star-sponsored event at the Roskamp Institute. While there, she addressed the audience, expressing her support for Star and its research. She also invited the audience to the launch of Anatabloc, which would be held at the Governor's Mansion.
June 1, 2011	Mrs. McDonnell purchased 6,000 shares of Star stock at \$5.1799 per share, for a total of \$31,079.40.		

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<p>June 2011</p> <p>Williams then made a "\$100,000 in-kind contributor to the McDonnell campaign and the PAC" and flew the McDonnell children to the resort for a PAC retreat. McDonnell and Williams played golf together during the retreat. A few days later, Williams sent golf bags with brand-new clubs and golf shoes to McDonnell and one of his sons.</p>	<p>July 2011</p> <p>McDonnell and his family vacationed at Williams's multi-million-dollar home at Smith Mountain Lake in Virginia. Williams allowed the McDonnells to stay there free of charge. He also paid \$2,268 for the McDonnells to rent a boat. Williams provided transportation for the family: the McDonnell children used Williams's Range Rover for the trip to home, and Williams paid more than \$600 to have his Ferrari delivered to the home for McDonnell to use.</p>	<p>July 31, 2011</p> <p>McDonnell drove the Ferrari back to Richmond at the end of the vacation. During the three-hour drive, Mrs. McDonnell snapped several pictures of McDonnell driving with the Ferrari's top down.</p>	<p>July 31, 2011</p> <p>At 11:29 p.m., after returning from the Smith Mountain Lake vacation, McDonnell directed Secretary Hazel to have his deputy attend a meeting about Anatabloc with Mrs. McDonnell at the Governor's Mansion the next day.</p>	<p>August 1, 2011</p> <p>Hazel sent a staffer, Molly Huffstetler, to the meeting, which Williams also attended.</p> <p>Williams—with Mrs. McDonnell at his side—told Dr. Clore that clinical testing of Anatabloc in Virginia was important to McDonnell. Williams discussed clinical trials at the University of Virginia ("UVA") and Virginia Commonwealth University ("VCU"), home of the Medical College of Virginia ("MCV"). Then Williams and Mrs. McDonnell met with Dr. John Clore from VCU, who Williams said was "important, and he could cause studies to happen at VCU's medical school."</p> <p>After the meeting ended, Mrs. McDonnell noticed the Rolex watch adorning Williams's wrist. She mentioned that she wanted to get a Rolex for McDonnell. When Williams asked if she wanted him to purchase one for McDonnell, she responded affirmatively.</p>
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Date	Gift/Meeting	Conversation	Action
August 2, 2011	Mrs. McDonnell purchased another 522 shares of Star stock at \$3.82 per share, for a total of \$1,994.04.		
August 13, 2011	McDonnell and one of his sons returned to Kinloch Golf Club. The bill for this golf outing, which Williams again paid, was \$1,309.17.		
August 14, 2011	Williams purchased a Rolex from Malibu Jewelers in Malibu, California. The Rolex cost between \$6,000 and \$7,000 and featured a custom engraving: "Robert F. McDonnell, 71st Governor of Virginia."		Mrs. McDonnell later took several pictures of McDonnell showing off his new Rolex—pictures that were later sent to Williams via text message.
August 30, 2011	Luncheon at Governor's Mansion. Invitations bore the Governor's seal and read, "Governor and Mrs. Robert F. McDonnell Request the Pleasure of your Company at a Luncheon." Invitees included Dr. Clore and Dr. John Lazo from UVA.	McDonnell thanked the attendees for their presence and "talked about his interest in a Virginia company doing this, and his interest in the product."	Each place setting featured samples of Anatabloc, and Williams handed out checks for grant applications—each for \$25,000—to doctors from various medical institutions.
Fall 2011		Star's president, Paul L. Perito, began to worry that Star had lost the support of UVA and VCU. In the fall of 2011, Perito was working with those universities to file grant applications. During a particular call with UVA officials, Perito felt the officials were unprepared. According to Perito, when Williams learned about this information, "[h]e was furious and said, 'I can't understand it. McDonnell and his wife are so supportive of this and suddenly the administration has no interest.'"	
December 2011	Mrs. McDonnell sold all of her 6,522 shares of Star stock for \$15,279.45, resulting in a loss of more than \$17,000.		This allowed McDonnell to omit disclosure of the stock purchases on a required financial disclosure form known as a Statement of Economic Interest (filed on January 16 2012).
January 7, 2012	McDonnell made another golf visit to Kinloch Golf Club, running up a \$1,368.91 bill that Williams again paid.		Outing not disclosed, and other golf outings not disclosed on other 2011 golf trips.

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January 20, 2012	Mrs. McDonnell purchased 6,672 shares of Star stock at \$2.29 per share, for a total of \$15,276.88.	
January 2012	Williams discussed the Mobo properties with Mrs. McDonnell, who wanted additional loans.	Williams agreed to loan more money. Mrs. McDonnell was "furious when [Williams] told her that [they were] bogged down in the administration." Later, Mrs. McDonnell called Williams to advise him that she had relayed this information to McDonnell, who "want[ed] the contact information of the people that [Star] [was] dealing with at [UVA]."
February 3, 2012	Mrs. McDonnell requested another \$50,000 loan.	
February 6, 2012	Williams wrote a check to Mobo on \$50,000.	Mrs. McDonnell received an e-mail, as requested by McDonnell, containing the names of the UVA officials with whom Star had been working. She forwarded this list to McDonnell and his chief counsel, Jacob Jasen Eige, on February 9.
February 10, 2012		While riding with McDonnell, Mrs. McDonnell followed up with Eige: "Pls call Jonnie today [and] get him to fill u in on where this is at. Gov wants to know why nothing has developed w studies after Jonnie gave \$200,000. I'm just trying to talk w Jonnie. Gov wants to get this going w VCU MCV. Pls let us know what u find out after we return...."
February 16, 2012	McDonnell e-mailed Williams to check on the status of certificates and documents relating to loans Williams was providing for Mobo.	Six minutes after McDonnell sent this e-mail, he emailed Eige: "Pls see me about anatabloc issues at VCU and UVA. Thx."
February 2012	Governor's Mansion reception for the doctors and Star officials. McDonnell, Mrs. McDonnell, Williams, and two doctors went out for a \$1,400 dinner on Williams's dime.	Mrs. McDonnell invited the two doctors to stay at the Governor's Mansion for the evening—an offer the doctors accepted.

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Date	Gift/Meeting	Conversation	Action
May 18, 2012		McDonnell sent Williams a text message concerning yet another loan: "Johnnie. Per voicemail would like to see if you could extend another 20k loan for this year. Call if possible and I'll ask mike to send instructions. Thx bob."	Twelve minutes later, Williams responded, "Done, tell me who to make it out to and address. Will FedEx. Jonnie."
May 18–26, 2012	McDonnell and his family vacationed at Kiawah Island in South Carolina. The \$23,000 vacation was a gift from William H. Goodwin Jr., characterized as a personal friend of the McDonnells.		Not disclosed on McDonnell's 2012 Statement of Economic Interest.
April–July 2012		McDonnell e-mailed and texted Williams about Star stock on four occasions, each coinciding with a rise in the stock price.	
July 3, 2012		Williams texted McDonnell: "Johns Hopkins human clinical trials report on Aug. 8. If you need cash let me know. Let's go golfing and sailing Chatham Bars inn Chatham mass labor day weekend if you can. Business about to break out strong. Jonnie."	
Labor Day weekend 2012	Williams spent more than \$7,300 on this vacation for the McDonnells. Williams paid the McDonnells' share of a \$5,823.79 bill for a private clambake.	Also joining in on the weekend excursion was one of the doctors who attended the February health care leaders reception, whom Williams invited in an attempt "to try to help get the Governor more involved."	
December 12, 2012		McDonnell learned of his wife's repurchase of Star shares: "[I]t was her money that she had used for this. But I told her, you know, 'Listen. If you have this stock, you know, this is—again, triggers a reporting requirement for me. I can do it, but I need—I just don't—I really don't appreciate you doing things that really—that affect me without—without me knowing about it.'"	
December 25, 2012	Mrs. McDonnell transferred her Star stock to her children as a gift. Williams gave the McDonnell's daughter, Jeanine, a \$10,000 wedding gift.		Stock need not be disclosed for the 2012 Statement of Economic Interest.

## Case 5.4

### Subway: Is 11 Inches the Same as 12 Inches?

The *New York Post* took a ruler and discovered something interesting: the Subway Footlong is only 11 inches long. The *Post* became curious because in January 2013, a Subway customer from Perth, Australia, took a photo of his Subway Footlong Turkey next to a tape measure, and the Footlong came up one inch short. The *Post* discovered that Subway is not alone. The investigation uncovered other sub shops with similar length issues. Four of every seven sandwiches came up short on length, measuring 11 to 11.5 inches.

Subway's initial response was that "Footlong" is just the name for the sandwich and is not intended to represent the length of the sandwich. Following the posting of 100,000 likes on the customer's Facebook photo, Subway Australia posted on its Facebook page that FOOTLONG was a registered trademark of Subway and not intended to be a description. Subway Australia indicated that sandwiches do vary in length because of the construction process.<sup>10</sup>

Indeed, in many countries, the metric system is followed, where the "Footlong" is still used, as a trademarked name for the sandwich. However, franchise owners note that the length is not only shorter but that the cold-cut sizes have been cut by about 25%.

By the end of January 2013, Subway promised to elongate its sandwiches by at least one inch. However, a group of sandwich lovers filed a class action suit against Subway, seeking compensation for the one-half inch to one-inch in sandwich that they were missing when they purchased their "Footlongs."<sup>11</sup> One of the plaintiffs in the case said, "They advertise in all these commercials, 'Footlong, Footlong, Footlong,' and now I feel like an idiot." He told *The Post*, "I can't believe I fell for that trick. The sandwiches are anywhere between a half-inch to an inch shorter ... I feel cheated."<sup>12</sup> Subway issued the following statement:

We regret any instance where we did not fully deliver on our promise to our customers. We freshly bake our bread throughout the day in our more than 38,000 restaurants in 100 countries worldwide, and we have redoubled our efforts to ensure consistency and correct length in every sandwich we serve. Our commitment remains steadfast to ensure that every Subway Footlong sandwich is 12 inches at each location worldwide.<sup>13</sup>

The basis for the suits is deceptive advertising. The damage claim is \$5 million. Subway also notes that its Footlongs may vary in length because dough rises differently; baking in pans changes the shapes of some of the rolls; and shaping does produce variation in shapes and resulting variations in lengths, and that there was no intent to deliver less than a foot of sandwich.

### Discussion Questions

1. The Menu Labeling Act, a federal law passed in 2010, requires restaurant chains (with 20 or more outlets) to disclose calorie and nutrition information for the food sold in the stores. There are also state laws, known as Truth in Menu laws, that require accurate descriptions—the label cannot say "Made in Vermont," if the syrup was not made in Vermont. And jelly jars cannot say, "Made with real fruit" if there is no real fruit in the jelly. Did Subway violate any of these laws with its less-than-a-foot long Footlong?
2. Evaluate Subway's response to the public attention. Should it have done more?
3. Evaluate the actions of those who have filed suit.

<sup>10</sup>That post has since been deleted. You can find it reproduced at [http://www.huffingtonpost.com/2013/01/19/subway-response-footlong-controversy-measurment\\_n\\_2511316.html](http://www.huffingtonpost.com/2013/01/19/subway-response-footlong-controversy-measurment_n_2511316.html).

<sup>11</sup>Nadia Arumugam, "Why Lawsuits over Subway's Short Footlong Sandwiches Are Baloney," *Forbes*, January 27, 2013.

<sup>12</sup>*Id.*

<sup>13</sup>Tiffany Hsu, "Subway Pledges to Make All Its Footlong Sandwiches 12 Inches," *Los Angeles Times*, January 25, 2013, <http://articles.latimes.com/2013/jan/25/business/la-fi-mo-subway-footlong-20130125>.

## Case 5.5

### Sears and High-Cost Auto Repairs

In 1991, the California Department of Consumer Affairs began investigating Sears Auto Repair Centers. Sears' automotive unit, with 850 repair shops nationwide, generated 9% of the merchandise group's \$19.4 billion in revenues. It was one of the fastest growing and most profitable divisions of Sears over the previous two years.

In the California investigation, agents posed as customers at 33 of the 72 Sears automotive repair shops located from Los Angeles to Sacramento. They found that they were overcharged 90% of the time by an average of \$223. In the first phase of the investigation, the agents took 38 cars with worn-out brakes but no other mechanical problems to 27 Sears shops between December 1990 and December 1991. In 34 of the cases, the agents were told that their cars needed additional work. At the Sears shop in Concord, a San Francisco suburb, the agent was overcharged \$585 to replace the front brake pads, front and rear springs, and control-arm bushings. Sears advertised brake jobs at prices of \$48 and \$58.<sup>14</sup>

In the second phase of the investigation, Sears was notified of the investigation, and 10 shops were targeted. In seven of those cases, the agents were overcharged. No springs and shocks were sold in these cases, but the average overcharge was \$100 per agent.

Up until 1990, Sears had paid its repair center service advisors by the hour rather than by the amount of work.<sup>15</sup> But in February 1990, Sears instituted an incentive compensation policy under which employees were paid based on the amount of repairs customers authorized.<sup>16</sup> Service advisors also had to meet sales quotas on specific auto parts; those who did not meet the quotas often had their hours reduced or were assigned to work in other departments in the Sears stores. California regulators said the number of consumer complaints they received about Sears shops increased dramatically after the commission structure was implemented.

The California Department of Consumer Affairs charged all 72 Sears automotive shops in the state with fraud, false advertising, and failure to clearly state parts and labor on invoices.

Jim Conran, the director of the consumer affairs department, stated:

This is a flagrant breach of the trust and confidence the people of California have placed in Sears for generations. Sears has used trust as a marketing tool, and we don't believe they've lived up to that trust. The violation of the faith that was placed in Sears cannot be allowed to continue, and for past violations of law, a penalty must be paid.<sup>17</sup>

Dick Schenkkan, a San Francisco lawyer representing Sears, charged that Conran issued the complaint in response to bipartisan legislative efforts to cut his agency's funding because of a state budget crunch and claimed, "He is garnering as much publicity as he can as quickly as he can. If you wanted to embark on a massive publicity campaign to demonstrate how aggressive you are and how much need there is for your services in the state, what better target than a big, respected business that would guarantee massive press coverage?"<sup>18</sup>

<sup>14</sup>James R. Healey, "Shops under Pressure to Boost Profits," *USA Today*, July 14, 1992, p. 1A.

<sup>15</sup>Gregory A. Patterson, "Distressed Shoppers, Disaffected Workers Prompt Stores to Alter Sales Commissions," *Wall Street Journal*, July 1, 1992, pp. B1, B4.

<sup>16</sup>James R. Healey, "Sears Auto Cuts Commissions," *USA Today*, June 23, 1992, p. 2B.

<sup>17</sup>Lawrence M. Fisher, "Sears' Auto Centers to Halt Commissions," *New York Times*, June 23, 1992, p. C1.

<sup>18</sup>*Id.*

Richard Kessel, the executive director of the New York State Consumer Protection Board, stated that he also had “some real problems” with Sears’ policy of paying people by commission. “If that’s the policy,” Kessel said, “that in my mind could certainly lead to abuses in car repairs.”<sup>19</sup>

Immediately following the issuing of the California complaint, Sears said that the state’s investigation was “very seriously flawed and simply does not support the allegations. The service we recommend and the work we perform are in accordance with the highest industry standards.”<sup>20</sup>

It then ran the following ad:

With over two million automotive customers serviced last year in California alone, mistakes may have occurred. However, Sears wants you to know that we would never intentionally violate the trust customers have shown in our company for 105 years.

Ten days after the complaint was announced, the chairman of Sears, Edward A. Brennan, announced that Sears was eliminating the commission-based pay structure for employees who propose auto repairs.<sup>21</sup> He conceded that the pay structure may have created an environment in which mistakes were made because of rigid attention to goals. Brennan announced the compensation system would be replaced with one in which customer satisfaction would now be the primary factor in determining service personnel rewards, shifting the emphasis away from quantity to quality. An outside firm would be hired to conduct unannounced shopping audits of Sears auto centers to be certain the hard sells were eliminated. Further, Brennan said, the sales quotas on parts would be discontinued. Although he did not admit to any scheme to recommend unnecessary repairs, he emphasized that the system encouraged mistakes, and he accepted full responsibility for the policies. “The buck stops with me,” he said.<sup>22</sup>

Sears auto repair customers filed class action lawsuits in California, and a New Jersey undercover investigation produced similar findings of overcharging. New Jersey officials found that 100% of the Sears stores in its investigation recommended unneeded work compared to 16% of stores not owned by Sears.<sup>23</sup> On June 25, 1992, Sears ran a full-page ad in all major newspapers throughout the country. The ad, a letter signed by Brennan, had the following text:

### An Open Letter to Sears Customers

*You may have heard recent allegations that some Sears Auto Centers in California and New Jersey have sold customers parts and services they didn’t need. We take such charges very seriously, because they strike at the core of our company—our reputation for trust and integrity.*

*We are confident that our Auto Center customers’ satisfaction rate is among the highest in the industry. But after an extensive review, we have concluded that our incentive compensation and goal-setting program inadvertently created an environment in which mistakes have occurred. We are moving quickly and aggressively to eliminate that environment.*

*To guard against such things happening in the future, we’re taking significant action:*

*We have eliminated incentive compensation and goal-setting systems for automotive service advisors—the folks who diagnose problems and recommend repairs to you. We have replaced these practices with a new*

<sup>19</sup>*Id.*

<sup>20</sup>Tung Yin, “Sears Is Accused of Billing Fraud at Auto Centers,” *Wall Street Journal*, June 12, 1992, p. B1.

<sup>21</sup>Lawrence M. Fisher, “Accusation of Fraud at Sears,” *New York Times*, June 12, 1992, pp. C2, C12.

<sup>22</sup>Gregory A. Patterson, “Sears’ Brennan Accepts Blame for Auto Flap,” *Wall Street Journal*, June 23, 1992, p. B1.

<sup>23</sup>Jennifer Steinhauer, “Time to Call a Sears Repairman,” *New York Times*, January 15, 1998, pp. B1, B2.

*non-commission program designed to achieve even higher levels of customer satisfaction. Rewards will now be based on customer satisfaction.*

*We're augmenting our own quality control efforts by retaining an independent organization to conduct ongoing, unannounced "shopping audits" of our automotive services to ensure that company policies are being met.*

*We have written to all state attorneys general, inviting them to compare our auto repair standards and practices with those of their states in order to determine whether differences exist.*

*And we are helping to organize and fund a joint industry-consumer-government effort to review current auto repair practices and recommend uniform industry standards.*

*We're taking these actions so you'll continue to come to Sears with complete confidence. However, one thing we will never change is our commitment to customer safety. Our policy of preventive maintenance—recommending replacement of worn parts before they fail—has been criticized by the California Bureau of Automotive Repair as constituting unneeded repairs. We don't see it that way. We recommend preventive maintenance because that's what our customers want, and because it makes for safer cars on the road. In fact, 75 percent of the consumers we talked to in a nationwide survey last weekend told us that auto repair centers should recommend replacement parts for preventive maintenance. As always, no work will ever be performed without your approval.*

*We understand that when your car needs service, you look for, above all, someone you can trust. And when trust is at stake, you can't merely react, we must overreact.*

*We at Sears are totally committed to maintaining your confidence. You have my word on it.*

*Ed Brennan*

*Chairman and Chief Executive Officer*

*Sears, Roebuck and Co.<sup>24</sup>*

On September 2, 1992, Sears agreed to pay \$8 million to resolve the consumer affairs agency claims on overcharging in California. The \$8 million included reimbursement costs, new employee training, and coupons for discounts at the service center. Another \$15 million in fines was paid in 41 other states to settle class action suits.<sup>25</sup>

In December 1992, Sears fired John T. Lundegard, the director of its automotive operations. Sears indicated that Lundegard's termination was not related to the controversy surrounding the auto centers.

Sears recorded a net loss of \$3.9 billion despite \$52.3 billion in sales in 1992—the worst performance ever by the retailer in its 108-year history and its first loss since 1933. Its Allstate Insurance division was reeling from damage claims for Hurricane Andrew in the Gulf Coast and Hurricane Iniki in Hawaii (\$1.25 billion). Auto center revenue dropped \$80 million in the last quarter of 1992, and Sears paid out a total of \$27 million to settle state overcharging claims. Moody's downgraded Sears debt following the loss announcement.

In 1994, Sears partially reinstated its sales incentive practices in its auto centers. Service advisors must earn at least 40% of their total pay in commissions on the sale and installation of tires, batteries, shock absorbers, and struts. Not included on commission scales are brakes and front-end alignments (the core of the 1992 problems). Earnings in auto centers have not yet returned to pre-1992 levels. Many of the auto centers have been closed.

There are some who have expressed concerns about the ethical culture at Sears. Although incentive systems may have created the auto center fraud problems, consider the following dilemmas involving Sears since the time of its auto center fraud cases:

<sup>24</sup>"Open Letter," *Arizona Republic*, June 25, 1992, p. A9.

<sup>25</sup>Barnaby J. Feder, "Sears Post First Loss since 1933," *New York Times*, October 23, 1992, p. C1; and "Sears Gets Handed a Huge Repair Bill," *BusinessWeek*, September 14, 1992, p. 38.

- Montgomery Ward obtained an order from a federal court prohibiting Sears from hiring employees away from Ward as it works its way through Chapter 11 bankruptcy. The order was based on an e-mail sent from Sears' regional vice president, Mary Conway, in which Sears managers are instructed to "be predatory" about hiring away Montgomery Ward managers.
- A class action civil suit was filed in Atlanta against Sears by consumers who allege that Sears sold them used batteries as new. One of the plaintiffs in the suit alleges that an investigator purchased 100 "new" batteries from Sears in 1995 (in 32 states) and that 78 of them showed signs of previous usage. A Sears internal auto center document explains that the high allowances the centers must give customers on returns of batteries cut into profits and induce the sale of used batteries to compensate. (Sears denies the allegation and attributes it to disgruntled former employees and not understanding that a nick does not necessarily mean a battery is used.)<sup>26</sup>
- Sears admitted to "flawed legal judgment" when it made repayment agreements with its credit card customers who were already in bankruptcy, a practice in violation of creditors' rights and priorities. Sears agreed to refund the amounts collected from the 2,700 customers who were put into the program. Sears warned the refunds could have a "material effect" on earnings. The announcement caused a drop in Sears' stock price of 37/8. Sears included the following notice to its credit card customers:

NOTICE: If you previously filed for personal bankruptcy under Chapter 7 and entered into a reaffirmation agreement with Sears, you may be a member of a Settlement Class in a proposed class action settlement. For information, please call 1-800-529-4500. There are deadlines as early as October 8, 1997 applicable to the settlement.

Sears entered a guilty plea to criminal fraud charges in connection with the bankruptcy issues and agreed to pay a \$60 million fine, the largest in the history of bankruptcy fraud cases.<sup>27</sup> The company also settled with the 50 state attorneys general, which included \$40 million in state fines, \$12 million for state shareholder suits, and a write-off of the \$126 million owed by the cardholders involved, which was forgiven as part of the settlement.<sup>28</sup>

Sears also settled the class action suit on the bankruptcy issue by agreeing to pay \$36 million in cash and issuing \$118 million in coupons to those cardholders affected by its conduct with regard to bankruptcy customers. Sears did not admit any wrongdoing as part of the settlement but indicated the action was taken "to avoid the litigation."<sup>29</sup> Sears spent \$56 million in legal and administrative costs in handling the bankruptcy cases.

Sears has been struggling to find its market niche for some time. In 2001, it was forced to close 89 stores as it watched its competitor, Montgomery Ward, close its doors for good.<sup>30</sup> In 2004, Kmart purchased Sears, and despite efforts, has continued to close stores through 2017.

## Discussion Questions

1. What temptations did the employee compensation system present?
2. If you had been a service advisor, would you have felt comfortable recommending repairs that were not immediately necessary but would be eventually?
3. A public relations expert has said of the Sears debacle: "Don't make the Sears mistake. When responding to a crisis, tell the public what happened and why. Apologize with no crossed fingers. Then say what you're going to do to make sure it doesn't happen again."<sup>31</sup> What are the ethical standards in this public relations formula?

<sup>26</sup>There were questions and investigations surrounding Exide Corporation, Sears' battery supplier. The questions related to the quality of the batteries, and Exide at one point announced that it expected to face criminal indictment for certain of its business practices. Keith Bradsher, "Exide Says Indictment Is Likely over Its Car Battery Sales to Sears," *New York Times*, January 11, 2001, pp. B1, B7.

<sup>27</sup>Joseph B. Cahill, "Sears Agrees to Plead Guilty to Charges of Criminal Fraud in Credit-Card Case," *Wall Street Journal*, February 10, 1999, p. B2.

<sup>28</sup>*Id.*

<sup>29</sup>Leslie Kaufman, "Sears Settles Suit on Raising of Its Credit Card Rates," *New York Times*, March 11, 1999, p. C2.

<sup>30</sup>Amy Merrick, "Sears to Shut 89 Stores and Report Big Changes," *Wall Street Journal*, January 5, 2001, p. A4.

<sup>31</sup>Nat B. Read, "Sears PR Debacle Shows How Not to Handle a Crisis," *Wall Street Journal*, January 11, 1993, p. A14.

4. What do you believe creates Sears' culture?
5. Sears' stock price and earnings fell. What lesson is there in these consequences?
6. Compute the total costs of the bankruptcy cases to Sears.
7. Are there principles for a credo for, as an example, the mechanics at the auto centers? What about the lawyers who worked for Sears on the bankruptcy issues?

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## Case 5.6

### Kardashian Tweets: Regulated Ads or Fun?

It began in typical Kardashian fashion. Just an Instagram post showing Ms. Kardashian West holding up a bottle of Diclegis, an anti-nausea drug manufactured by Duchesnay, Inc., with the following post:

OMG. Have you heard about this? As you guys know my morning sickness has been pretty bad. I tried changing things about my lifestyle, like my diet, and nothing helped, so I talked to my doctor. He prescribed Diclegis. I felt a lot better and most importantly, it's been studied and there was no increased risk to the baby. I'm so excited and happy with my results that I'm partnering with Duchesnay USA to raise awareness about treating morning sickness, [sic] be safe and sure to ask your doctor about the pill with the pregnant woman on it and find out more. [www.diclegis.com](http://www.diclegis.com).<sup>32</sup>

The Food and Drug Administration (FDA) sent a warning letter to Duchesnay with the following concern:

The social media post was also submitted as a complaint to the OPDP Bad Ad Program. The social media post is false or misleading in that it presents efficacy claims for DICLEGIS, but fails to communicate any risk information associated with its use and it omits material facts.<sup>33</sup>

<sup>32</sup><http://www.fda.gov/downloads/Drugs/GuidanceComplianceRegulatoryInformation/EnforcementActivitiesbyFDA/WarningLettersandNoticeofViolationLetterstoPharmaceuticalCompanies/UCM457961.pdf>.

<sup>33</sup><http://www.fda.gov/downloads/Drugs/GuidanceComplianceRegulatoryInformation/EnforcementActivitiesbyFDA/WarningLettersandNoticeofViolationLetterstoPharmaceuticalCompanies/UCM457961.pdf>. Last visited October 25, 2016.

The FDA ordered the company to “cease misbranding.”<sup>34</sup> Ms. Kardashian issued a corrective post the day after the FDA letter was received explaining the limitations of Diclegis and providing a link to obtain information about this prescription drug.<sup>35</sup>

The FDA has had a rough battle with trying to rein in the use of social media in advertising prescription drugs. The FDA’s concern is that the posts do not adequately disclose the risks of prescription drugs. The problem it faces is the rapidity with which the information flows due to social media.

The FDA does have celebrity endorsement guidelines, which include, among other things, that the celebrity must actually use the product being advertised. The celebrities must also indicate their relationship with the company. Ms. Kardashian West’s statement indicated that she was “partnering” with Duchesnay. And, as in the Kardashian West ad, the celebrity cannot overstate the product’s qualities or performance.

If the statements are made independently by the celebrity, then the FDA has no control because the company is not participating. When a celebrity just posts that he or she uses a product and that it is a great product, the self-generated announcement is not FDA-regulated. If there is, however, a connection with the company, whether through compensation or through the company providing the language for the celebrity endorsement, then the FDA can control the social media use.

The FDA believes that celebrity endorsements serve to create consumer demand and patients pressuring doctors to prescribe certain drugs. The FDA worries that these prescriptions may not be in the best interests of the patient but are fueled through celebrity examples and endorsements.

In the past, the FDA has halted celebrity social media endorsements for Adderall XR. For example, Ty Pennington’s endorsement of that drug had to be changed because his endorsement focused only on the positive effects of the drug and did not disclose the risks and downside of using the prescription drug.

### Discussion Questions

1. List the requirements for celebrity endorsements of prescription drugs to be allowed by the FDA.
2. What additional information does the FDA want in celebrity endorsements of prescription drugs?
3. What are the risks of product tweets? Do celebrities have a responsibility related to their tweets about products?

<sup>34</sup>Christine Hauser, “Kardashian Promotes a Pill, and the F.D.A. strikes,” *New York Times*, August 13, 2015, p. B1.

<sup>35</sup><https://consumerist.com/2015/08/31/after-fda-warning-kim-kardashian-posts-corrected-endorsement-of-morning-sickness-pill/>.

# Promises, Performance, and Reality

Did you really perform what was required under the contract terms? There are issues about what constitutes “close enough” and questions about authority under contract terms that offer ethical dilemmas on both sides of the contract.

## Case 5.7

### Pension Promises, Payments, and Bankruptcy: Companies, Cities, Towns, and States

The city of Detroit pays out almost \$200 million per year in pension benefits to its retired workers. The city’s annual contributions to its pension plan are less than half of that sum.<sup>36</sup> As payments out have increased, payments in have decreased. How is it possible to have a fully funded pension plan with these numbers? Professionals, including auditors, fiduciaries, and actuaries, have certified that the aggressive investment policies for the fund should make up the difference.<sup>37</sup> Still, the firefighters—who one day expect to be beneficiaries and in turn receive their payouts—now recognize the harsh reality that is playing out with pension funds throughout the United States.<sup>38</sup> Despite all the imprimaturs from professionals, benefits elsewhere have been cut, plans changed, and, in some cases, payments to retirees stopped altogether.<sup>39</sup> With Detroit in bankruptcy, they appear to have few rights to collection of their pensions. The issue of pension obligations is not only one for businesses, it has been front and center at all levels of government.

### Business Pensions and Bankruptcy: A Regulatory History

When United Airlines declared bankruptcy in 2002, part of its Chapter 11 proceedings relieved the company of its pension liabilities. The ability of a company to renege on pension benefits when so many protections were built into the law under the Employee Retirement Income Security Act (ERISA) has been an ongoing concern. Congressional hearings following the losses in the United case uncovered loopholes in the accounting

<sup>36</sup>Michael Cooper and Mary Williams Walsh, “Public Pensions, Once Off Limits, Face Budget Cuts,” *New York Times*, April 26, 2011, p. A1. For more background information on pensions, actuaries, and fund losses, see Marianne M. Jennings and Sally Gunz, “A Proactive Proposal for Self-Regulation of the Actuarial Profession,” 48 *American Business Law Journal* 641 (2011).

<sup>37</sup>*Id.*

<sup>38</sup>Simon Baribeau and David Mildenberg, “State Workers Run for the Exits,” *Bloomberg Businessweek*, April 25–May 1, 2011, p. 32. See also Steven Greenhouse, “States Want More in Pension Contributions,” *New York Times*, June 16, 2011, p. B1; and Jeanette Neumann and Michael Korkery, “Public Pension Fund Squeeze,” *Wall Street Journal*, March 23, 2011, p. C1.

<sup>39</sup>Cooper and Walsh, *supra* note 36, p. A3.

processes for pension fund reporting that permitted United, and many others, to report pension numbers that made the health of the fund look better than it actually was. The loopholes were Enronesque in nature, allowing obligations to be spun off the books so that the existing levels of obligations of the plan looked small and the assets very rich.

## Federal Regulation of Pensions

Because of United's pension bailout, Congress changed the accounting for pension plans to avoid the problem of the rosy picture when the funds need further funding. The Pension Protection Act of 2006 closed the accounting loopholes and provides greater assurance for employees that their promised pensions and the funding for them would be available upon their retirement. The effect of the changes is to require companies to fund their pension plans according to the numbers they have reported to the SEC in their financials. Apparently, the numbers reported to the SEC vis-à-vis pensions are accurate, whereas the numbers reported for ERISA purposes are inflated. If United had funded its plans when its SEC numbers indicated it needed to (e.g., 1998 would have been the year when funding was first needed), the plan would have been sufficiently funded at the time of the United bankruptcy. However, under ERISA guidelines, it was not required to kick in funds until 2002, when it was grossly underfunded.

The Pension Benefit Guarantee Corporation (PBGC) was created under ERISA and provides insurance for employees for underfunded pensions.<sup>40</sup> The presence of this protection results in a moral hazard. With the presence of the PBGC as a stopgap measure for pension plans that fail or end, there is little accountability for responsible funding and management of pension plans. The pension plan no longer represents a source of exposure so that funding decisions, especially in relation to promised benefits, are often made with inflated expectations or little regard for reality. As one commentator noted,

Nevertheless, union leaders, who negotiate most pension agreements, often seek pension promises that even they know are excessive, in large part because the PBGC insures these promises. In addition, unions and their constituents rarely ensure that their pensions are fully funded: "As a result of federal pension insurance, employees lack the proper incentives to monitor their employers' funding levels because the employees will not bear the full costs of their inattention." In an effort to resolve this tension, the PBGC does not insure any and all pension promises, instead limiting yearly payouts to beneficiaries. Ironically, the PBGC does this to give employees incentives to make sure their employer funds their plans adequately. Nevertheless, many pension promises are not as insured as most employees would believe.<sup>41</sup>

A conflicts issue that arises in the funding and management of pension plans is that employers who hire actuaries often signal their concerns about the impact of increased funding on earnings. Simultaneously, beneficiaries signal their desire for continuing present funding levels that still provide promised benefits. That tension affects the role of the actuary who determines funding levels and can result in the use of overly optimistic actuarial assumptions. These conflicts and tensions have resulted in an acute crisis in pension funding and structure.

With the market's decline and increasing retirement rates, more plans failed.<sup>42</sup> By 2005, the FPGC had a deficit of \$22.7 billion because of the payouts it was making to claimants due to underfunding as well as the bankruptcies of major companies like United.<sup>43</sup>

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<sup>40</sup>29 U.S.C. § 1302 (2000).

<sup>41</sup>Joshua Gad-Harf, "The Decline of Traditional Pensions, the Impact of the Pension Protection Act of 2006, and the Future of America's Defined-Benefit Pension System," 83 *Chicago-Kent Law Review* 1409, 1417 (2008).

<sup>42</sup>*Id.*

<sup>43</sup>Marcy Gordon, "Pension Safety Net in a Jam," *Arizona Republic*, November 16, 2005, p. B1. See also Nicholas Varchaver, "Pitchman for the Gray Revolution," *Fortune*, July 11, 2005, p. 63 (noting that the FPGC assumed responsibility for the obligation to United Airlines plan members).

## Reductions in Force and Buy-Outs to Relieve Pension Tension

There have been significant reductions in force (RIF) since the 1980s, with post-2008 being a period of significant RIFs. The RIF process incorporates the pension and retirement components. Since 2001, companies that have had to downsize have taken an approach of offering employees buyouts. Indeed, 100 national and regional retailers went out of business between 2008 and 2010, with other national retailers closing large numbers of their locations. For example, Arby's closed 80 of its outlets in 2010. Closures are the ultimate form of downsizing. The following list provides some data on some of the larger companies and the steps they took, as well as some general figures for RIFs over the years as well as for the recession that followed the 2008 market crash and has continued through to 2016:

2001	Lucent Technologies offered 13,000 employees early retirement incentives.
2001	Merrill Lynch offered voluntary severance packages to a majority of its 65,900 employees.
2003	Almost 10% of the 221,000 employees of Verizon accepted an early retirement-buyout offer.
2004	Southwest Airlines offered 33,000 of its employees cash, travel privileges, and other benefits as part of a voluntary termination package.
2005	Safeway offered 5,800 clerks voluntary buyouts.
2006	GM offered 131,000 GM and Delphi employees (including 105,000 union workers in that group) buyouts with figures ranging from \$35,000 to \$140,000 per employee, depending upon their years of employment with GM or Delphi.
2008	Thirty percent of U.S. employers laid off employees.
2009	Boeing cut 10,000 jobs. Caterpillar cut 22,000 jobs. Delta forced 2,000 early retirements.
2010	Fifty percent of U.S. companies did some form of downsizing. In 2012, 283,000 were fired with 60% dismissed because of corporate restructuring or cost cutting. Hewlett-Packard cut 27,000 jobs. American Airlines cut 14,200 jobs. Lockheed Martin cut 10,000 jobs. IBM cut 9,000 jobs. Pepsi cut 8,700 jobs. RIM cut 5,000 jobs.
2013	JCPenney cut 15,020 jobs JPMorgan Chase 19,000 IBM 9,400 Boeing 5,800 American Express 5,400 Wells Fargo 5,236 Cisco 4,500 MetLife 3,150 Blockbuster 3,000 United Technologies 3000
2014	Amgen 2,950 Best Buy 3,000 Bank of America 4,146 Intel 5,350 JPMorgan Chase 5,500 Coldwater Creek 5,500 (Bankruptcy) United Continental 5,521 Cisco 6,000 Hewlett Packard 16,000 Microsoft 18,000

2015	U.S. Army 40,000 Hewlett Packard 30,000 U.S. Army (civilians) 17,000 Schlumberger 11,000 A&P 8,500 Microsoft 7,800 Baker Hughes 7,000 Halliburton 6,400 Procter & Gamble 6,000
2016	Walmart 17,500 Macy's 4,500 Hancock Fabrics 4,500 Microsoft 4700 National Oil Well Varco 6000 DuPont Pioneer 6,000 Weatherford 8,000 Bank of America 8,000 Seagate 8,100 Schlumberger 10,000 Intel 12,000 Halliburton 15,200

Because of the extensive benefits employees at these companies have, the average cost of keeping an employee is about \$67 per hour, with \$27 being wages and the remainder made up of pensions and health care benefits. One employee who works in the paint-repair shop at GM's Pontiac plant said that he would give up his \$100,000 per year salary to retire, spend more time with grandchildren, and get away from the paint fumes. However, one worker noted, "Where is anybody going to find a job paying \$28 per hour with [only] a high-school diploma?"<sup>44</sup>

One worker, who will receive a \$140,000 payment, has a small dealership in Doraville, Georgia, where the GM plant is located, at which he sells used pickup trucks. He is not married and has no children, rents out six homes that he owns, and co-owns a beauty parlor. He will retire comfortably.

Following these pension buy-outs, GM was still in dire financial condition. In 2008, the U.S. government provided General Motors with \$5.8 billion in funds in order to allow the company to emerge from bankruptcy. As security for the loan and for the advancement of additional billions in bailout funds to the company, the U.S. government held a 10% ownership stake in the auto company. As part of the deal with the government, GM had to agree to certain management changes and promise to repay the funds. GM also had to agree to provide 39% share ownership of the company to employees of the company. GM promised to cut 40% of its car dealers and eliminate 7,000 jobs. Following its emergence from bankruptcy, GM did cut its car dealers by 40%, but following public outcry on the termination of longstanding dealers, it reinstated many of those who had been terminated. GM consolidated plants and closed its Saturn division to push toward the 7,000-job cutback. A government official said that the loss of jobs if the automaker failed was too great to risk and thus required government intervention. The pensions were saved through

<sup>44</sup>Jeffrey McCracken and Lee Hawkins Jr., "Massive Job Cuts Will Reshape GM," *Wall Street Journal*, March 23, 2006, pp. A1, A15.

government payments and RIFs. However, the problems with pensions in business were but a foreshadowing of the crisis that has been ongoing in public pension plans for cities, towns, and states.

### Conflicts Emerge in Government Pension Plans: Actuaries and Pension Experts

The struggles of businesses to meet pension obligations were only the beginning. Public pensions, fund managers, and actuaries have been the targets of corruption investigations and litigation by state and local governments that are underfunded with respect to their public employee pension plans. For example, the New York State Pension fund relied on actuarial numbers that, when made public in 2008, made little economic sense. Even under broad standards of interpretation, there was no method for reconciling the actuary firm's findings with actual funding levels. As the details of the questionable numbers that were used for continual expansion of public pension benefits emerged, so also did details about the relationships of the actuary with those affiliated with the pension plan. For example, in the New York case, the actuarial firm providing the professional opinion as to the adequacy of the fund to meet current liabilities was paid at least in part for its opinions by the existing members of the plan who had an inherent interest in the fund being deemed sufficient to cover extended benefits without additional payments, something that would trigger political budget battles.<sup>45</sup> The actuary's opinion was pivotal. Should the actuary have assessed the fund as being underfunded, by law either the legislature would have been required to allocate the funds to bring the plan up to funding level requirements, or benefits would have had to have been reduced. Both options had serious political implications, as future taxpayers would have to make good on the pension promises through increased taxes.<sup>46</sup>

The legislative standoff in the state of Wisconsin was the result of the realization of underfunding of public employees' pension plans and the inability of the state to fund the plan sufficiently for promised benefits.<sup>47</sup> The proposed and very volatile, politically charged solution was to require members to increase the amount they paid into their pension plan. An actuarial certification of adequate funding kicks the funding down the road to either cuts in benefits, changes in contributions, or increased taxes for additional funding and/or payment of benefits not covered by the plan's funds.

The examples continue of problems with funding. Loyalton, California, a town of just 700, lost its economic base when its sawmill closed in 2001. However, the town owes the California Public Employees Retirement System \$1.6 million over its annual town operating budget to cover the pensions for its four retirees. If Loyalton does not cover that amount, the pensions of, for example, their town financial officer will go from \$48,000 per year to \$19,000 per year.<sup>48</sup>

As of 2016, the long-term returns for public pension plans are expected to drop to the lowest levels ever recorded (with records kept for 16 years), and the funding gap for state

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<sup>45</sup>*Id.*

<sup>46</sup>One actuary noted the conflict and the outdated models caused "[f]inancial burdens [to be] hidden." Cooper and Walsh, *supra* note 36, p. C1. Similar standoffs loom in New York and New Jersey.

<sup>47</sup>Lisa Colangelo, "As Ground Zero in Bargaining Debate, Wisconsin Union Battle Has Repercussions," *New York Daily News*, February 22, 2011, [http://articles.nydailynews.com/2011-02-22/local/28639649\\_1\\_pension-reform-unionleaders-and-lawmakers-ground-zero](http://articles.nydailynews.com/2011-02-22/local/28639649_1_pension-reform-unionleaders-and-lawmakers-ground-zero).

<sup>48</sup>Mary Williams Walsh, "Small Town Reels Under Pension Debt," *New York Times*, October 10, 2016, p. A1.

and city pension plans is expected to be \$1 trillion.<sup>49</sup> Long-term returns have tumbled from 12% per year to 7.47%. The drop has been steady, not giving the funds opportunities to make up for bad years. The bad years just keep coming. Presently, some states are allocating portions of their budgets to make up the funding gaps. For example, in Connecticut, 10% of its budget goes to paying down unfunded pension liabilities. Those cities and states not addressing the gap find their credit ratings tumbling. Chicago, for example, has a \$20 billion pension deficit and a junk bond rating.<sup>50</sup> Pennsylvania, New Jersey, and Kentucky are confronting crises in their pension funds that will require tax increases, benefit curbs, pension reforms for employees currently paying into the plans, and some genuinely difficult politically charged issues.<sup>51</sup> Some refer to the coming crisis in government pension plans as a “financial tsunami.”<sup>52</sup>

For the second time in a decade, there are reviews of state pension funds around the country.<sup>53</sup> These reviews have not and are not producing the “adequately funded” conclusions that state governments had hoped to find. The reforms following the 2008 recession did not provide for adequate funding. On average, actuaries have underestimated the cost of providing the promised and often increasing government pension benefits by about one-third.<sup>54</sup> For instance, California’s public employee pension fund continues to be underfunded with 68 cents in assets for every dollar in pension liabilities.<sup>55</sup> The scope of that underfunding is understood better when translated to per capita costs; the underfunding costs for California have been computed as \$35,700 per California household.<sup>56</sup> The Pew Center study on the condition of state pension funds places the states into three categories: solid performers, need improvement, and serious concerns.<sup>57</sup> The Pew Center lists California as being in the middle category, which raises grave questions about the state of funds in those 19 states the Pew Center study placed in the serious concerns category.<sup>58</sup> Those serious concerns translate to underfunding that reaches levels of 50%.

## The Role and Liability of Actuaries

There were a number of lawsuits against actuaries in Alaska; Texas; San Diego, California; Milwaukee, Wisconsin; Evanston, Illinois; and Fort Worth, Texas.<sup>59</sup> The theory underlying these lawsuits is that pension benefits were widely given and expanded because the actuarial methods used undervalued the benefits. The plaintiffs in these suits sought recovery

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<sup>49</sup>Timothy W. Martin, “Pension Returns To Hit New Lows,” *Wall Street Journal*, July 26, 2016, p. A1.

<sup>50</sup>Monica Davey and Mary Williams Walsh, “Pensions and Politics Fuel Crisis in Illinois,” *New York Times*, May 26, 2015, p. A9.

<sup>51</sup>*Id.*

<sup>52</sup>*Id.*

<sup>53</sup>“Ugly Truth about State Pensions Begins to Emerge,” *USA Today*, May 3, 2010, p. 8A; Timothy W. Martin, “Pension Returns to Hit New Lows,” p. A1.

<sup>54</sup>*Id.*

<sup>55</sup>“California’s Pension Funding Crisis Just Got Worse,” *Fortune*, July 19, 2016, <http://fortune.com/2016/07/19/pension-underfunded/>. Last visited October 25, 2016.

<sup>56</sup>*Id.*

<sup>57</sup>*Id.*

<sup>58</sup>Pew Center on the States (noting that “solid performer” states are Arizona, Arkansas, Delaware, Florida, Georgia, Idaho, Maine, Montana, Nebraska, New York, North Carolina, Ohio, South Dakota, Tennessee, Utah, and Wisconsin; “need improvement” states are Alabama, California, Iowa, Michigan, Minnesota, Missouri, New Mexico, North Dakota, Oregon, Pennsylvania, Texas, Vermont, Virginia, Washington, and Wyoming; the “serious concern” states are Alaska, Colorado, Connecticut, Hawaii, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Nevada, New Hampshire, New Jersey, Oklahoma, Rhode Island, South Carolina, and West Virginia).

<sup>59</sup>See Cooper and Walsh, *supra* note 36, p. C7 (noting that San Diego’s pension numbers were so off base that the SEC took action against the city for securities fraud).

from the professionals who provided their certification that the numbers supported a sufficient investment pool and returns to meet cash distributions at the times provided for in the plan to the full range of plan beneficiaries.<sup>60</sup> However, the suits have not been slam dunks for the government pension plans unless the actuaries committed malpractice, such as by using outdated actuarial tables on age and death. Optimistic return rates are not necessarily malpractice and the courts have held the line on recovery by the cities, towns, and states. Further, actuaries are the expert witnesses in these cases and they are not likely to turn on their fellow professionals. Still, the Connecticut Carpenters Pension Fund (\$170 million in assets) recovered \$40 million from Watson Wyatt. However, government pension funds are finding that actuarial firms are requesting liability limitation clauses before they will undertake government pension work.<sup>61</sup>

Two examples illustrate the role actuaries have played in defunct pension plans or plans with significant deficits. In Fort Worth, Texas, an investigation was launched when the city discovered that its pension plan was suffering a \$410 million deficit.<sup>62</sup> A 1990 actuary's opinion had concluded that the city could put less money into the pension plan but still expand benefits.<sup>63</sup> The opinion was based on an assumed 10.23% return on pension investments. Fort Worth's pension plan had never earned a return on investment of 10.23%. Over the years, the actuary "tweaked" numbers here and there to keep the benefits at the promised, increased levels.<sup>64</sup> Again, apparent satisfaction with the quality of the actuarial opinion led to renewed contract arrangements with the actuary, presumably because of the "good news" effect of the actuary's findings. In the Alaska litigation, the actuary assumed that health care cost increases would fall by 4.5%, when, in reality, health care costs have not declined in the past 30 years.<sup>65</sup>

In addition to the questionable actuarial opinions and the conflict created by beneficiaries paying for those favorable opinions, there are also pending charges of corruption regarding the retention of investment advisers, actuaries, and other professionals for pension plan management.<sup>66</sup> In 2009, four actuary firms entered guilty pleas in connection with their retention of fund management contracts for New York's public pension fund.<sup>67</sup> California filed a suit against several private equity firms for their relationships with CalPERS executives that included perks and that, the suit concludes, resulted in "improper relationships" between the firms and the public pension fund.<sup>68</sup>

In 2009, with the recession ongoing, states began to address the ethical issues raised by the funding shortfalls.<sup>69</sup> They addressed the relationships between and among fund managers, consultants, and pension boards. For instance, Illinois now prohibits pension

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<sup>60</sup>*Id.*

<sup>61</sup>Edward Siedle, "Actuarial Limitations of Liability (LOL) Laugh Out Loud!" *Forbes*, September 9, 2010, <http://www.forbes.com/sites/edwardsiedle/2010/09/09/actuarial-limitations-of-liability-lol-laugh-out-loud-december-1-2002/#4bd68f5e676a>.

<sup>62</sup>*Id.*

<sup>63</sup>*Id.*

<sup>64</sup>*Id.*

<sup>65</sup>*Id.*

<sup>66</sup>Michael J. de la Merced, "4 Firms Agree to Settlement in New York Pension Fund Inquiry," *New York Times*, August 19, 2009, p. B1.

<sup>67</sup>*Id.*

<sup>68</sup>Gina Chona, "Brown Targets Pension Middleman," *Wall Street Journal*, May 7, 2010, p. C5b (noting that the suit alleges executives were offered standing employment opportunities and trips to New York and Florida that resulted in \$63,000 in expenses being reimbursed by the company that was awarded \$700 million in a CalPERS fund investment).

<sup>69</sup>Matthew Goldstein, "The New Pension Threat," *BusinessWeek*, December 15, 2008, p. 40.

trustees, employees, and consultants from benefiting from investment transactions.<sup>70</sup> Several states introduced more competitive processes for procuring consulting and investment services.<sup>71</sup> Other states now require their pension systems to conduct performance reviews of consultants and managers, including a comparison of costs of services.<sup>72</sup> The reforms brought a breather in the litigation and funding concerns as well as from the public backlash of poor decisions and calculations in a wild market. However, with the reality of seven years of diminishing returns, the pension funds and cities, towns, and states have begun the task of figuring out how to make up for the funding deficits. This time the actuaries cannot be blamed because their returns were not the excessive ones factored in pre-2009. The time for budget and plan adjustments has arrived.

### Discussion Questions

1. Describe the regulatory cycles on pension fund accounting and pension funding.
2. Explain the conflicts issue in the management of pension plans.
3. Give a list of the economic and ethical issues in pension funding, employee wages, and RIFs.
4. Did noble goals on all sides result in unintended consequences at United, GM, and for the public employees at bankrupt government entities?
5. What ethical issues do you see in the management of pension funds?
6. Explain the ethical obligations of elected officials with regard to underfunding of pension plans.

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## Case 5.8

### "I Only Used It Once": Returning Goods

Even the well-seasoned Dillard's manager was taken aback by this one. A customer brought in a pair of moderately expensive dress shoes, expressing a desire to return them because they just weren't quite right. As the manager processed the order, she checked inside the box to be sure that the shoes in the box were the shoes that matched the box—past experience dictated that follow-up on returns. The shoes were the correct ones for the box, but the customer had another issue. The shoes had masking tape on the bottom—masking tape that was dirty. Returning to the customer, the manager said, "You forgot to remove the masking tape from your shoes." The customer responded, "I only wore them once. That's all I needed them for."

From Neiman Marcus to Saks to Dillard's and back, managers have to stay one step ahead of customers—or rather, lessees—who buy—or rather, lease for free—dresses and now shoes for one use with premeditated intent to return the merchandise. Stores now place tags strategically so that the dresses cannot be worn without cutting them off and there are no returns if the tags are cut off on formal wear.

Lest you think that the problem is limited to women and formal wear, talk to your Ace Hardware or Home Depot manager about the folks who "buy" a special tool, use it once,

<sup>70</sup>Mary Williams Walsh, "Illinois Plan for Pensions Questioned," *New York Times*, January 26, 2011, p. B1.

<sup>71</sup>*Id.*

<sup>72</sup>PEW Center on the States, *supra* note 58, at 11.

and then try to return it. The hardware/home improvement stores are left with opened packaging and used goods by buy-it-temporarily customers.

Amazon led the way down a new path on returns policies with its return whatever, at Amazon's expense, and Amazon will take it back. Other online retailers as well as the brick-and-mortar stores have had to adjust. As a result, stores such as Macy's have adopted very liberal return policies. Macy's advertises that it will take anything back, anytime. The horror stories abound. Macy's employees in the luggage department call their area "the rental luggage department," because customers buy the luggage, use it on a trip, and then return it. If the customer says he will be leaving in the morning and returning in a week, the clerks note that so they can time the return of that luggage; they will also be back to return their newly purchased luggage in a week.<sup>73</sup>

An unanticipated consequence of the liberal returns policies is the effect on employee pay. There are employees who are on commission plan for a certain amount of income in a week or believe that they have earned a certain amount of income. However, with these types of return policies, they can lose their commissions on any returns within six months after purchase. The policies on commission were created to stop employees from having friends and family come in and purchase goods, allowing the employee to earn the commission but then returning the goods. Without the hit to the employee on commission loss for returned goods, there would be gaming of the system. However, customers seem to be gaming the system. In 2014, customers in the United States returned \$284 billion in goods, a 53% increase in five years. The amount returned is 8% of total sales.

Union leaders are pressing the major department stores to change their return policies to 150 or 120 days instead of 180 days so that employees can better budget and plan on incomes, and possible reductions in income due to returns. A recent university study found that sales employees believe that returns have become too lax. The impact on earnings for retailers from so many returns has resulted in reductions in the number of sales employees, with many who remain being reduced to part-time schedules.

On the customer side, and from the legal perspective of contracts, if the store advertises a 180-day-no-questions-asked return policy, the store must honor what has been advertised. And, after 180 days, the customer could have fit in a great deal of walking on those shoes and quite a few trips with the luggage, along with a few proms and other formal events.

### Discussion Questions

1. What is the ethical category here?
2. Who is affected by the returners and their conduct?
3. Explain the impact of return policies.

## Case 5.9

### Government Contracts, Research, and Double-Dipping

Included in government research grants to universities are indirect cost payments designed to compensate for the researchers' use of the schools' facilities.

Stanford University received approximately \$240 million in federal research funds annually. About \$75 million went to actual research, whereas Stanford billed the federal government \$85 million, or 20% of its operating budget, for its overhead.<sup>74</sup> The rest of the research

<sup>73</sup>Rachel Abrams, "The Sting of a Liberal Retail Returns Policy," *New York Times*, June 14, 2016, p. B1.

<sup>74</sup>Colleen Cordes, "Universities Review Overhead Charges; Some Alter Policies on President's Home," *Chronicle of Higher Education*, April 3, 1991, p. A1.

funds went toward employee benefits. An audit of Stanford's research program in 1990 by U.S. Navy accountant Paul Biddle revealed that the school billed the government \$3,000 for a cedar-lined closet in president Donald Kennedy's home (Hoover House); \$2,000 for flowers; \$2,500 for refurbishing a grand piano; \$7,000 for bed sheets and table linens; \$4,000 for a reception for trustees following Kennedy's 1987 wedding; and \$184,000 for depreciation for a 72-foot yacht as part of the indirect costs for federally funded research.<sup>75</sup>

In response to the audit, Stanford withdrew requests for reimbursement totaling \$1.35 million as unallowable and inappropriate costs. Stanford's federal funds were cut by \$18 million per year.<sup>76</sup>

Kennedy issued the following statements as the funding crisis evolved:

**December 18, 1990:** What was intended as government policy to build the capacity of universities through reimbursement of indirect costs leads to payments that are all too easily misunderstood.

Therefore, we will be reexamining our policies in an effort to avoid any confusion that might result.

At the same time, it is important to recognize that the items currently questioned, taken together, have an insignificant impact on Stanford's indirect-cost rate....

Moreover, Stanford routinely charges the government less than our full indirect costs precisely to allow for errors and disallowances.

—From a university statement

**January 14, 1991:** We certainly ought to prune anything that isn't allowable—there isn't any question about that. But we're extending that examination to things that, although we believe are perfectly allowable, don't strike people as reasonable.

I don't care whether it's flowers, or dinners and receptions, or whether it's washing the table linen after it's been used, or buying an antique here or there, or refinishing a piano when its finish gets crappy, or repairing a closet and refinishing it—all those are investments in a university facility that serves a whole array of functions.

—From an interview with the Stanford Daily

**January 23, 1991:** Because acute public attention on these items threatens to overshadow the more important and fundamental issue of the support of federally sponsored research, Stanford is voluntarily withdrawing all general administration costs for operation of Hoover House claimed for the fiscal years since 1981. For those same years, we are also voluntarily withdrawing all such costs claimed for the operations of two other university-owned facilities.

—From a university statement

**February 19, 1991:** I am troubled by costs that are perfectly appropriate as university expenditures and lawful under the government rules but I believe ought not be charged to the taxpayer. I should have been more alert to this policy issue, and I should have insisted on more intensive review of these transactions.

—From remarks to alumni

**March 23, 1991:** Our obligation is not to do all the law permits, but to do what is right. Technical legality is not the guiding principle. Even in matters as arcane as government cost accounting, we must figure out what is appropriate and act accordingly. Over the years, we have not hesitated to reject numerous lawful and attractive business proposals, gifts, and even federal grants because they came with conditions we thought would be inappropriate for Stanford. Yet, with respect to indirect-cost recovery, we pursued what was permissible under the rules, without applying our customary standard of what is proper....

The expenses for Hoover House—antique furniture, flowers, cedar closets—should have been excluded, and they weren't. That the amounts involved were relatively small is fortunate, but it doesn't excuse us. In our testimony before the subcommittee I did deal with this issue, but I obviously wasn't clear enough. I explained that we were

<sup>75</sup>Maria Shao, "The Cracks in Stanford's Ivory Tower," *BusinessWeek*, March 11, 1991, pp. 64–65.

<sup>76</sup>Gary McWilliams, "Less Gas for the Bunsen Burners," *BusinessWeek*, May 20, 1991, pp. 124–126; and Courtney Leatherman, "Stanford's Shift in Direction," *Chronicle of Higher Education*, September 7, 1994, p. A29.

removing Hoover House and some similar accounts from the cost pools that drew indirect-cost recovery because they plainly included inappropriate items. What came out in the papers was that Stanford removed the costs because it was forced to, not because it was wrong. . . . That is not so. To repeat, the allocation of these expenses to indirect-cost pools is inappropriate, regardless of its propriety under the law.

—From remarks to alumni<sup>77</sup>

By July 1991, Kennedy announced his resignation, effective August 1992, stating, “It is very difficult . . . for a person identified with a problem to be a spokesman for its solution.”<sup>78</sup> Gerhard Casper, who was hired as Stanford’s new president, said, “I just want this to remain one of the great universities in the world. I ask that we question what we are doing every day.” Kennedy remains at Stanford, teaching biology.<sup>79</sup>

Stanford’s donations declined that year; 1999 was the first time it saw an uptick in its donations since the time of this government overhead issue.<sup>80</sup>

Ultimately, Stanford settled with the federal government for \$1.3 million, a small percentage of the \$185 million of alleged overcharges that appeared in Biddle’s report. The federal government also concluded that there was no fraud by Stanford. Biddle filed suit, seeking recovery of the statutory whistleblower fee of 10% for finding the submitted costs that the government ultimately recovered from Stanford. His suit was dismissed.

## Discussion Questions

1. Did Kennedy’s ethics evolve during the crisis? Contrast his March 23, 1991, ethical posture with his December 18, 1990, assessment.
2. Is legal behavior always ethical behavior?
3. Do Casper’s remarks reflect an ethical formula for Stanford’s operations?
4. In a 2000 interview for an internal Stanford publication, Kennedy offered the following when asked about research and cost issues as he assumed the editorship of *Science*:

One of the factors in the explosive growth of Stanford during the ‘60s and continuing into the ‘70s and ‘80s was the availability of federal funding for research. The policy behind that support was always that the government benefited from basic research because it eventually produced findings that could be converted to human service in one way or another and so the government continually built that capacity and built that capacity in universities. Its policy was that it would pay the full cost of research, including not only the direct cost that could be associated with particular programs but the indirect costs that had to be made by the university in order to stay in the business of doing sponsored research.

Over time, the percentage of all research funding that was allocated to indirect cost grew. And it grew to a point in the late ‘80s and early ‘90s when it seemed to many people, some in Congress and some on this faculty, that it was

an unacceptably large percentage and we recognized that though, probably not soon enough, made some efforts to constrain it, but in fact it was high enough to trouble people and it was calculated, the indirect costs were calculated on the basis on a pool accounting mechanism no one in the public understood and indeed few people on the faculty understood. And when Congressman Dingell decided to make that the subject of a very high profile Congressional investigation and made Stanford the subject of it, we had a very, very bad time. We took a beating. It was sufficiently bad that after the hearings and during the summer of 1991, it became clear to me that there was so much faculty concern about the ruckus and whether Stanford would continue to be a target for this kind of thing that I decided that if you’re part of a problem, you can’t be part of a solution and so I resigned. I think that steadied things down considerably. It wasn’t any fun to do that. It was not any fun to take a certain amount of newspaper abuse in connection with it. Stanford’s recovered nicely. We’re still not paid the indirect cost rate I think we are entitled to under articulated government policies, but the sequelae to the whole furor, I think, made it plain to everybody that Stanford hadn’t engaged in any wrongdoing.

I think there were a few people in other institutions who got caught up in the problem later

<sup>77</sup>Karen Grassmuck, “What Happened at Stanford: Key Mistakes at Crucial Times in a Battle with the Government over Research Costs,” *Chronicle of Higher Education*, May 15, 1991, p. A26.

<sup>78</sup>“Embattled Stanford President to Quit,” *Mesa Tribune*, July 30, 1991, p. A6.

<sup>79</sup>Associated Press, “Stanford’s Chief Resigns over Billing Controversy,” *Arizona Republic*, July 30, 1991, p. A8.

<sup>80</sup>Leatherman, “Stanford’s Shift in Direction,” p. A29.

when it was revealed that they had engaged in exactly the same practices we had who did a little finger pointing and said “Well, Stanford was pushing the envelope.” But in fact we weren’t. Our indirect cost rate was high but it was in a cluster of other high rates, two or three or four other institutions which were comparable or within three or four percentage points. So you can’t make the case that we were doing stuff that others weren’t also doing.<sup>81</sup>

List the rationalizations you see in this statement. Does he think Stanford did anything unethical?

5. The problems with universities and research funding continue. The U.S. Attorney for the District of Connecticut reached a settlement with Yale University on allegations that Yale violated federal regulations on grant administration and accounting. Without admitting guilt, Yale agreed to pay the federal government \$7.6 million, half as damages and the other half as penalties. The investigation focused on the problem of funds left in federal grants. When the grant ends, the Feds get the funds back. The government alleged those at the university, however, transferred the funds to other unexpired grants for continuing use.

Also, the investigation focused on faculty summer salaries. Faculty members often serve under nine-month contracts. They are not paid in the summer unless they have summer school classes or have research dollars. However, to get those summer research dollars, faculty members must be devoted to research. Yale faculty, allegedly, did other things besides research during those summer periods but still billed the government for 100 percent of their salaries. They were compensated for those additional activities during the summer. The result is that the faculty has two sources of compensation. However, the activity reports faculty members must sign/certify that they have devoted 100 percent of their time to the lab and, because they are required by federal law, are signed under penalty of perjury. Why is the university responsible for the conduct of the faculty members? What advice would you offer to universities for the management of their grant funds?

Should this all matter if the faculty are indeed performing the required research under their grants?

## Case 5.10

### When Corporations Pull Promises Made to Government

The interrelationships of corporations with government entities have become a critical part of community development and economic redevelopment. However, sometimes there are benefits but reneged promises. The following scenarios illustrate the types of problems that result from these interrelationships.

#### Susette Kelo, Little Pink Houses, and Pfizer

When the U.S. Supreme Court decided *Kelo v. City of New London*, 545 U.S. 469(2005), a constitutional and legislative shock wave rumbled across the country. States changed their statutes and constitutions on when and how local government could take private property for redevelopment purposes, and property owners began resisting local redevelopment plans.

The *Kelo* case began in 1978 when the city of New London, Connecticut, undertook a redevelopment plan for the area in and around the existing park at Fort Trumbull. The plan had the goals of the ambience a state park should have, including the absence of existing pink cottages and other architecturally eclectic homes that had long been part of the area, one of which was owned by Susette Kelo. The central focus of the plan was getting the Pfizer pharmaceutical company to bring its new research facility to the Fort Trumbull area with a hoped-for economic boost from a major corporate employer.

Under the plan Kelo’s and others’ homes would be razed to make room for Pfizer and its facilities. The homeowners filed suit, challenging New London’s legal authority to take their

<sup>81</sup><http://becoming.stanford.edu/interview/donaldkennedy.html>. Accessed July 10, 2010.

homes. The trial court issued an injunction preventing New London from taking certain of the properties, but allowing others to be taken. The appellate court found for New London on all the claims; the Connecticut Supreme Court affirmed (in a 4–3 decision); and the landowners appealed to the U.S. Supreme Court, which affirmed the Connecticut Supreme Court decision by a 5–4 vote.

Ms. Kelo's home and 15 others were razed. Pfizer merged with Wyeth in 2009 and closed all company operations in New London. The Fort Trumball area has no houses, no research park, no businesses, and is now an undeveloped land. However, following Hurricane Irene, officials from the city of New London announced that the citizens of their fair city could dump their branches and fallen trees at the site where Ms. Kelo's home once sat. In short, the Fort Trumball area is now a landfill.

Journalist Jeff Benedict, whose book *Little Pink Houses* documents the story of Ms. Kelo and her neighbors and the failed project, spoke at a dinner honoring the members of the Connecticut Supreme Court. Ms. Kelo was in the audience along with the justices who decided her case. Mr. Benedict told the story of the failed city project and the impact on Ms. Kelo and others. Afterward, Justice Richard Palmer thanked Mr. Benedict for telling the story and then apologized to Ms. Kelo for what happened to her. Ms. Kelo cried because she said it was the first time in the 12-year-battle that anyone had offered an apology.

### Tax Incentives to Come and/or Stay

Nike wants to expand, and Nike says it will stay in Oregon as the state's second largest company, but it wants a 40-year assurance that its taxes will not increase. So, the governor has scheduled a special legislative session to tackle the "Keep Nike" problem.

The director for the Oregon Center for Public Policy characterizes the Nike demand for assurances as Nike putting "an economic gun to the governor's head." Then-Governor John Kitzhaber explains that Nike executives met with him to explain that the company had offers from other states and wants to stay put but that it needs to have stability in its tax rates. Nike officials explain that the company is offering to invest \$150 million in the state for its expansion, an expansion that will create 500 more jobs.

Tax incentives to lure or keep businesses within a state are not new, but they are becoming more frequent as the states become more competitive. And some states, such as Kansas and Missouri, battle against each other to lure companies back and forth across their borders.

Film Director Oliver Stone knew he could film 2010's *Wall Street* only in New York City, but he negotiated with New York City and got \$10 million in tax credits to film there, saying, "It's good. Or basically the way business is done. I don't understand what the moral qualm is."<sup>82</sup>

Still, there have been ongoing bad feelings, litigation, and questions about government's role and authority in changing tax structures to recruit or retain businesses. For example, during the 1990s, GM was able to obtain several deals from state and local governments in order to locate plants in their economies. GM's North Tarrytown, New York, plant was located there in 1987 because union members voted to accept innovative and cooperative work rules to replace expensive practices under the old contract. Also, state and local governments contributed job training funds, gave tax breaks, and began reconstructing railroad bridges to win the minivan production plant. By 1995, GM had all but closed down the plant, following a series of massive layoffs. The money spent by the state and local governments could not be recovered. The estimate is that cities and townships alone give up \$80 billion in tax revenues each year in order to keep companies in their locations.

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<sup>82</sup>Louise Story, "As Companies Seek Tax Deals, Governments Pay High Price," *New York Times*, December 1, 2012, p. B1.

Texas spends about \$19 billion per year to recruit and retain businesses. Alaska, West Virginia, and Nebraska spend the most per capita in order to recruit and retain businesses in their states.

What rights do government entities have when businesses obtain the tax breaks but then do not follow through on their promises to build plants, create jobs, or remain in operation in exchange for the government tax breaks? Well, the government entities are not without rights if their agreements on the taxes are carefully drafted.

In February 1993, GM announced the closure of the Willow Run plant in Ypsilanti Township, Michigan, a loss of 2,200 jobs. However, Ypsilanti Township and Washtenaw County fought back on the closures. The government entities filed suit challenging the closure, because GM had promised to build cars at Willow Run through the late 1990s in exchange for tax abatements. The suit alleged that GM owed \$13.5 million in back taxes by GM for reneging on its promise to operate the plant. GM settled the suit in 1994 by agreeing to pay half the abated taxes. The key to the agreements is spelling out the terms for departure or closure, a sticky topic of negotiations because companies want to have changed business conditions and economic factors be permissible reasons for closing or moving that will not trigger tax provisions or some form of liquidated damages for the government entities. In tough economic times, the companies hold the bargaining power, and most government entities do what it takes to recruit or retain corporations, without any damage clauses for their closure or departure.

The contracts and agreements between corporations and government entities are not unconscionable because of the experience levels of the negotiating parties. The tax rates, as in Oregon, are set by statute and can be written to favor certain types of businesses. However, the ethical and social questions continue to swirl as more companies leave states, cities, and counties after extracting everything from development funds to tax breaks.

### Discussion Questions

1. What do the incentives do, and how are they accomplished?
2. What are the rights of the parties if the company pulls out after receiving government benefits or tax breaks?
3. Apart from the legal rights here, are there any "moral qualms" about accepting and/or promising
4. List the stakeholders and discuss the impact on them when a corporation reneges on a mutual development promise.

## Case 5.11

### Intel and the Chips: When You Have Made a Mistake

Intel, which makes components used in 80% of all personal computers, introduced the powerful Pentium chip in 1993. Intel had spent \$1 billion developing the chip, and the cost of producing it was estimated to be between \$50 and \$150 each. When the Pentium chip was finally rolled out, Intel shipped 4 million of the chips to computer manufacturers, including IBM.

In July 1994, Intel discovered a flaw in the "floating-point unit" of the chip, which is the section that completes complex calculations quickly.<sup>83</sup>

<sup>83</sup>Evan Ramstad, "Pentium: A Cautionary Tale," *Arizona Republic*, December 21, 1994, p. C1.

The flaw caused errors in division calculations involving numbers with more than eight digits to the right of the decimal, such as in this type of equation:<sup>84</sup>

$$\frac{4,195,835}{3,145,727} \times 3,145,727 = 4,195,835$$

Pentium-equipped computers computed the answer, in error, as 4,195,579. Before introducing the Pentium chip, Intel had run 1 trillion tests on it. Those tests showed that the Pentium chip would produce an error once every 27,000 years, making the chance of an average user getting an error one in 9 billion.

In November, Thomas Nicely, a mathematician at Lynchburg College in Virginia, discovered the Pentium calculations flaw described above. On Thanksgiving Day 1994, Intel publicly acknowledged the flaw in the Pentium chip, and the next day its stock fell from 651/8 to 637/8. Intel stated that the problem had been corrected, but flawed chips were still being shipped because a three-month production schedule was just ending. Intel initially offered to replace the chips, but only for users who ran complicated calculations as part of their jobs. The replacement offer carried numerous conditions.<sup>85</sup>

On December 12, 1994, IBM announced that it would stop all shipments of its personal computers because its own tests indicated that the Pentium flaw was far more frequent than Intel had indicated.<sup>86</sup> IBM's tests concluded that computer users working on spreadsheets for as little as 15 minutes per day could produce a mistake every 24 days. Intel's then-CEO Andrew Grove called IBM's reaction "unwarranted." No other computer manufacturer adopted IBM's position. IBM's chief of its personal computing division, G. Richard Thoman, emphasized that IBM had little choice: "It is absolutely critical for this industry to grow, that people trust that our products work right."<sup>87</sup> Following the IBM announcement, Intel's stock price dropped 6.5%, and trading had to be halted temporarily.

On December 20, 1994, CEO Grove announced that Intel would replace all Pentium chips:

We were dealing with a consumer community that was upset with us. That they were upset with us—it has finally dawned on us—is because we were telling them what's good for them . . . I think we insulted them.<sup>88</sup>

Replacing the chips could have cost up to \$360 million. Intel offered to send owners a new chip that they could install or to have service firms replace chips for customers who were uncomfortable doing it themselves.

Robert Sombric, the data-processing manager for the city of Portsmouth, New Hampshire, found Intel's decision to continue selling flawed chips for months inexcusable: "I treat the city's money just as if it were my own. And I'm telling you: I wouldn't buy one of these things right now until we really know the truth about it."<sup>89</sup>

Following the replacement announcement, Intel's stock rose \$3.44 to \$61.25. One market strategist praised the replacement program: "It's about time. It's very clear they were fighting a losing battle, both in public relations as well as user confidence."<sup>90</sup>

<sup>84</sup>Janice Castro, "When the Chips Are Down," *Time*, December 26, 1994, p. 126.

<sup>85</sup>James Overstreet, "Pentium Jokes Fly, but Sales Stay Strong," *USA Today*, December 7, 1994, p. 1B.

<sup>86</sup>Ira Sager and Robert D. Hof, "Bare Knuckles at Big Blue," *BusinessWeek*, December 26, 1994, pp. 60–62.

<sup>87</sup>Bart Ziegler and Don Clark, "Computer Giants' War over Flaw in Pentium Jolts the PC Industry," *Wall Street Journal*, December 13, 1994, pp. A1–A11.

<sup>88</sup>Jim Carlton and Stephen Kreider Yoder, "Humble Pie: Intel to Replace Its Pentium Chips," *Wall Street Journal*, December 21, 1994, pp. B1–B9.

<sup>89</sup>Jim Carlton and Scott McCartney, "Corporations Await More Information: Will Consumers Balk?" *Wall Street Journal*, December 14, 1994, pp. B1–B5; and Stephen Kreider Yoder, "The Pentium Proposition: To Buy or Not to Buy," *Wall Street Journal*, December 14, 1994, p. B1.

<sup>90</sup>Carlton and Kreider Yoder, "Humble Pie," pp. B1–B9; "Intel Eats Crow, Replaces Pentiums," *Mesa Tribune*, December 21, 1994, p. F1; and Catalina Ortiz, "Intel to Replace Flawed Pentium Chips," *Arizona Republic*, December 21, 1994, pp. A1–A8.

Grove responded that Intel's delay in offering replacements was based on concerns about precedent. "If we live by an uncompromising standard that demands perfection, it will be bad for everybody," he said.<sup>91</sup> He also acknowledged that Intel had agreed to sell the flawed Pentium chips to a jewelry manufacturer.<sup>92</sup>

By December 16, 1994, 10 lawsuits in three states involving 18 law firms had been filed against Intel for the faulty chips. Chip replacement demands by customers, however, were minimal.

Intel's internal employee newsletter had an April 1, 1995, edition that spoofed the infamous chip.<sup>93</sup> A spoof form provided in the newsletter required customers with Pentium chips to submit a 5,000-word essay on "Why My Pentium Should Be Replaced."

In 1997, Intel launched two new products: Pentium Pro and Pentium II. A new potential bug, again affecting only intensive engineering and scientific mathematical operations, was uncovered. Intel, however, published the list of bugs, with technical information and remedies for both of the new processors. One analyst commented on the new approach, "They have learned a lot since then. You can't approach the consumer market with an engineering mindset."<sup>94</sup>

### Discussion Questions

1. Should Intel have disclosed the flaw in the Pentium chip when it first discovered it in July 1994?
2. Should Intel have issued an immediate recall? Why do you think the company didn't do that? Discuss what issues their executives missed by applying the models you learned in Unit 1.
3. Was it ethical to offer limited replacement of the chip?
4. A joke about Intel's Pentium chip (source unknown) circulated on the Internet: Top Ten Reasons to Buy a Pentium-Equipped Computer:
  - (10) Your current computer is too accurate.
  - (9) You want to get into the Guinness Book of World Records as "owner of most expensive paperweight."
  - (8) Math errors add zest to life.
  - (7) You need an alibi for the IRS.
  - (6) You want to see what all the fuss is about.
  - (5) You've always wondered what it would be like to be a plaintiff.
  - (4) The "Intel Inside" logo matches your decor perfectly.
  - (3) You no longer have to worry about CPU overheating.
  - (2) You got a great deal from the Jet Propulsion Laboratory.
  - (1) And the number one reason to buy a Pentium-equipped computer: It'll probably work.<sup>95</sup>
5. Based on this circulating joke, discuss the long-term impact on Intel of this chip and Intel's decisions on how to handle it.
6. Assume that you are an Intel manager invited to the 1994 post-Thanksgiving meeting on how to respond to the public revelation of the flawed chips. You believe the failure to offer replacements will damage the company over the long term. Further, you feel strongly that providing a replacement is a balanced and ethical thing to do. However, CEO Grove disagrees. How would you persuade him to offer replacements to all purchasers?

### Compare & Contrast

Consider the following analysis (from "Intel Eats Crow, Replaces Pentium," *Mesa Tribune*, December 21, 1994, p. F1):

Regarding your article "Bare Knuckles at Big Blue" (News: Analysis & Commentary, Dec. 26), future generations of business school students will study Intel Corp.'s response to the problems with the Pentium chip as a classic case study in how to transform a technical problem into a public-relations nightmare. Intel's five-point plan consisted of the following:

1. Initially deny that the problem exists.
2. When irrefutable evidence is presented that the problem exists, downplay its significance.

<sup>91</sup>Ziegler and Clark, "Computer Giants' War over Flaw in Pentium Jolts the PC Industry," pp. A1–A11.

<sup>92</sup>Otis Port, "A Chip on Your Shoulder—Or Your Cuffs," *BusinessWeek*, January 23, 1995, p. 8.

<sup>93</sup>Richard B. Schmitt, "Flurry of Lawsuits Filed against Intel over Pentium Flaw," *Wall Street Journal*, December 16, 1994, p. B3.

<sup>94</sup>James Kim, "Intel Proactive with Potential Buy," *USA Today*, May 6, 1997, p. 1B.

<sup>95</sup>From memo furnished to author by Intel employee at the time of the Intel chip problems.

3. Agree to only replace items for people who can demonstrate extreme hardship.
4. Continue running your current ad campaign, extolling the virtues of the product as if nothing has happened.
5. Count the short-term profits.<sup>96</sup>

List other companies discussed in this book or in other readings that followed this same five-point pattern.

### Compare & Contrast

In 2003, the math department at the University of Texas at Austin complained to Dell Computers that its computers were failing. Dell examined the computers for the university, one of its major customers and a major tie-in to the student body there, and concluded that the computers were failing because those using them in the math department were performing too many complex math calculations that overtaxed the computers.

However, internal e-mails that surfaced in the discovery process of a class action lawsuit indicate that the computers sent to UT–Austin had faulty electrical components that were leaking chemicals into the computer, thus resulting in the failures. Ironically, the cause was so clear and so common that all of the computers shipped with these faulty parts failed at the same time.

Despite this knowledge, Dell employees were instructed to tell customers that the problems were not a big issue. Many companies using the computers were relying on the faulty calculations that resulted prior to the failure.

There were also e-mails and instructions to employees about downplaying the problem, telling them, “Don’t bring this to the attention of the customer proactively. Emphasize uncertainty.”<sup>97</sup> In fact, there were safety issues because of the risk of fire from the failed computers with leaking components.

### Discussion Questions

1. Was Dell’s response similar to or different from Intel’s?
2. Dell has settled the litigation that resulted from the failed computers. Is this a difference from Intel’s response?
3. Dell has been a Harvard Business School case since its initial success for its unique strategy,

supply chain, production, and distribution. What conclusions can you draw about business acumen and praise and ethical lapses? Why do you think the employees participated in the cover-up of the underlying problems with the computers?

## Case 5.12

### Red Cross and the Use of Funds

Following the September 11, 2001, attacks on the World Trade Center and Washington, DC, there were many who had lost loved ones, their homes or businesses, or both.

The outpouring of support from the American public was overwhelming. The public donated \$543 million for the September 11 disaster relief fund.<sup>98</sup> However, the Red Cross indicated it would use the funds for infrastructure support and not necessarily all of it would go to victims and their families.

When the decision to use the funds in this manner was made, Dr. Bernadine Healy resigned as president of the Red Cross, giving up her \$450,010 annual salary and position.

<sup>96</sup>“Intel Eats Crow, Replaces Pentiums,” p. F1.

<sup>97</sup>Ashlee Vance, “Suit over Faulty Computers Highlights Dell’s Decline,” *New York Times*, June 29, 2010, pp. B1, B2.

<sup>98</sup>Marvin Olasky, “Charity Doesn’t Have to Mean Bureaucracy,” *Wall Street Journal*, November 21, 2001, p. A15.

The American public was outraged and demanded that the funds go to the victims and their families. The Red Cross eventually relented, admitted an error in judgment, and agreed to the limited and intended use of the funds.

### Discussion Questions

1. Did the Red Cross commit an ethical violation in its initial decision?
2. What do you think of Dr. Healy's decision? Is she a whistleblower?
3. What policies should the Red Cross establish for the future in fundraising and fund disbursement?

## Case 5.13

### The Nuns and Katy Perry: Is There a Property Sale?

The Sisters of the Most Holy and Immaculate Heart of the Blessed Virgin Mary have a bone to pick with their archdiocese as well as property law. The good sisters have an eight-acre convent (in which no one has lived for 40 years) that they decided to sell because, well, it is valued at \$15 million and the sisters are not getting younger. The sisters claim that the property was given to them and that they would be entitled to the proceeds, a nice retirement for all of them. However, the archbishop has different ideas for the proceeds and maintains that the archdiocese owns the property. There are two parties vying for the property, singer Katy Perry and developer Dana Holister.

There are five surviving nuns of the convent, which the nuns acquired in 1971 through a bequest to them. Sisters Rita Callahan (77) and Catherine Rose Holzman (86) filed court documents opposing the sale of the property. Ms. Perry used her legal name of "Katherine Hudson" for her offer in September 2014 and the sisters were not aware that she was actually Katy Perry until they began evaluating the offers.<sup>99</sup> In e-mails attached to their filings, the sisters wrote, "In selling to Katy Perry, we feel we are being forced to violate our canonical vows to the Catholic Church." The three remaining sisters, Sister Kean-Marie, Sister Marie Victoriano (88), and Sister Marie Christine Munoz Lopez (82) support the archbishop in his decision to sell to Ms. Perry.<sup>100</sup> They have signed statements of their desires and expressed their support for the sale.

However, in their filings, Sisters Rita and Catherine noted that Sister Marie Christine was "woozy" when she signed her statement, being under the influence of morphine. Sister Marie Christine no longer responds to questions from her care facility. None of the nuns actually resides in the convent, but if they have ownership rights in the property they would be entitled to the proceeds. Sister Rita said in an interview, "Well, I found Katy Perry, and I found her videos and ... if it's all right to say, I wasn't happy with any of it. I thought, is that a way to make money?"<sup>101</sup>

Ms. Perry has met with the nuns, sung "Oh Happy Day" for them, and showed them her tattoo of Jesus on her wrist. Ms. Perry explained that she was the daughter of pastors. The nuns were still concerned about Ms. Perry's duet video with Missy Elliot.

The archdiocese's use of the funds bequeathed to the order along with the property in 1971 has presented complex legal questions. The 1971 bequest was to the nuns, but the archdiocese has had its hand in the management and upkeep of the property but has not accounted for the funds in the bequest.

<sup>99</sup><http://www.latimes.com/local/lanow/la-me-ln-convent-dispute-katy-perry-20150720-story.html>.

<sup>100</sup>Michael Cieply, "Citing Vows, Nuns Remain Resistant to Sale of Convent to Pop Singer," *New York Times*, July 20, 2015, p. A12.

<sup>101</sup><http://www.people.com/article/katy-perry-buying-convent-nuns-oppose>.

Because of their Perry objections, the nuns gave Ms. Holister a deed in exchange for \$100,000 in cash (although some court documents indicate the amount in cash so far is only \$44,000) and a promissory note for \$9.9 million. That agreement is oral and payments of \$300,000 per year begin in 2018. Ms. Holister has vowed to honor her oral agreement and has begun renovating the property. Ms. Hollister has recorded the deed from the sisters. Apparently, the oral transaction was completed without escrow and a formal title search.

Ms. Perry's offer, accepted by the archdiocese, consists of a total of \$15 million for the property, comprised of \$10,000,000 for the property (with very little in cash) and up to \$5,000,000 in order to find a place for the nuns to have their retreat location, which will probably be an existing priests' retreat. Ms. Perry's offer allows control of the funds and the substitute property to remain with the nuns. Ms. Perry plans to move into the property with her mother and grandmother.<sup>102</sup>

And so the legal battle began.<sup>103</sup> At a July 2015 hearing, a Los Angeles Superior court judge banished Katy Perry from both the archdiocese and the property until the case was resolved. The nuns and their supporters sometimes booed the archbishop and his lawyer in court.<sup>104</sup> In a follow-up e-mail to a Bloomberg report, Sister Jean-Marie said that the archdiocese was short on "humility and honesty" and "rather obsessed with their misconception of their sovereign, ecclesiastical canonical importance."<sup>105</sup>

At an April 14, 2016, hearing, another Los Angeles Superior Court judge held that the permission of the archdiocese was required to sell the property and that the side deal that two of the sisters made with Ms. Hollister was done without authority. The court rescinded the Hollister deed, something that would have allowed Ms. Perry's contract with the archdiocese to proceed.<sup>106</sup> A court of appeals stayed the order granting the right of the archdiocese to proceed. The sale to the nuns was not blocked, but the sale to Ms. Perry was postponed until several matters could be resolved. One of the matters to be resolved is that the nuns' lawyer is expecting letters from the Vatican that will weigh in on the situation.<sup>107</sup> In other words, the courts will hear more evidence, the sale is postponed, and the battle continues.

## Discussion Questions

1. What do you learn about human nature from the battle between the nuns and the archdiocese?
2. What values were the nuns concerned about?
3. What are the rights of the nuns in the care home with regard to the property?

<sup>102</sup>Michael Cieply, "Citing Vows, Nuns Remain Resistant to Sale of Convent to Pop Singer," *New York Times*, July 20, 2015, p. A12.

<sup>103</sup>*Roman Catholic Archbishop of Los Angeles v. Hollister*, BC585604, Los Angeles County Superior Court.

<sup>104</sup>Edward Peterson, "What's Next in Katy Perry's \$15 Million War with Two Nuns," *Bloomberg*, July 20, 2015, <http://www.bloomberg.com/news/articles/2015-07-30/katy-perry-and-the-archbishop-go-to-court-against-the-nuns-today>.

<sup>105</sup>*Id.*

<sup>106</sup><https://www.washingtonpost.com/news/morning-mix/wp/2016/04/15/katy-perry-could-wind-up-in-a-convent-after-all-despite-the-nuns-objections/>.

<sup>107</sup>Michael Cieply, "Judge Postpones Action on Nuns' Request in Property Dispute with Katy Perry," *New York Times*, July 20, 2015, [http://www.nytimes.com/2015/07/21/us/judge-postpones-action-on-nuns-request-in-property-dispute-with-katy-perry.html?\\_r=0](http://www.nytimes.com/2015/07/21/us/judge-postpones-action-on-nuns-request-in-property-dispute-with-katy-perry.html?_r=0); and Matt Reynolds, "Appeals Court Halts Katy Perry's Battle with Nuns," *Courthouse News Service*, June 1, 2016, <http://www.courthousenews.com/2016/06/01/appeals-court-halts-katy-perrys-battle-with-nuns.htm>.