

CASE 8

Zappos: Stepping Forward in Stakeholder Satisfaction*

INTRODUCTION

Can a company focused on happiness be successful? Zappos, an online retailer, is proving it can. Tony Hsieh, CEO of Zappos says, "It's a brand about happiness, whether to customers or employees or even vendors." Its zany corporate culture and focus on customer satisfaction has made Zappos both successful and a model for other companies. Zappos has built a culture of integrity in all of its activities. The company provides an incredible example of managing ethics and social responsibility by addressing challenges and responding to stakeholder issues.

This case examines how the company's focus on stakeholder happiness contributed to its success. First, we examine the history of Zappos, its core values, and unique business model. Next, we analyze its corporate culture and how it influences its relationships with employees, customers, the environment, and communities. We then look at some of the challenges the company faced and how it plans to move into the future.

HISTORY

Nick Swinmurn founded Zappos in 1999 after a fruitless day spent shopping for shoes in San Francisco. After looking online, Swinmurn decided to quit his job and start a shoe website that offered the best selection and best service. Originally called ShoeSite.com, the company started as a middleman, transferring orders between customers and suppliers but not holding any inventory (a "drop ship" strategy). The website was soon renamed Zappos, after the Spanish word for shoes (zapatos).

In 2000 entrepreneur Tony Hsieh became the company's CEO. Hsieh, 26 at the time, was an early investor in Zappos, having made \$265 million selling his startup company to Microsoft in 1998. Hsieh was not initially sold on the idea of an Internet shoe store, but he could not help but become involved. After becoming CEO, Hsieh made an unconventional

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decision to keep Zappos going, even selling his San Francisco loft to pay for a new warehouse and once setting his salary at just \$24.

Zappos struggled for its first few years, making sales but not generating a profit. The dot-com crash forced Zappos to lay off half its staff, but the company recovered. By the end of 2002, Zappos had sales of \$32 million but was still not profitable. In 2003 the company decided in order to offer the best customer service, it had to control the whole value chain—from order to fulfillment to delivery—and began holding its entire inventory. Zappos moved to Las Vegas in 2004 to take advantage of a larger pool of experienced call center employees. The company generated its first profit in 2007 after reaching \$840 million in annual sales. Zappos started to be recognized for its unique work environment and responsible business practices, as well as its approach to customer service.

In 2009 Amazon bought the company for \$1.2 billion. Although Hsieh rejected an offer from Amazon in 2005, he believed this buyout would be better for the company than management from the current board of directors or an outside investor. Amazon agreed to let Zappos operate independently and keep Hsieh as CEO (at his current \$36,000 annual salary). Hsieh made \$214 million from the acquisition, and Amazon set aside \$40 million for distribution to Zappos employees. After the acquisition, the company restructured into 10 separate companies organized under the Zappos Family. Zappos was able to keep its unique culture and core values.

CORE VALUES

Zappos has 10 core values that guide every activity at the company and form the heart of the company's business model and culture.

- Deliver WOW through service.
- Embrace and drive change.
- Create fun and a little weirdness.
- Be adventurous, creative, and open-minded.
- Pursue growth and learning.
- Build open and honest relationships with communication.
- Build a positive team and family spirit.
- Do more with less.
- Be passionate and determined.
- Be humble.¹

These core values differ from those of other companies in several ways. In addition to being untraditional, the core values create a framework for the company's actions. This is exemplified in the company's commitment to its customers' and employees' well-being and satisfaction.

¹Zappos, "Zappos Family Core Values," <http://about.zappos.com/our-unique-culture/zappos-core-values> (accessed May 18, 2015).

ZAPPOS'S CUSTOMER-FOCUSED BUSINESS MODEL

The Zappos business model is built around developing long-term customer relationships. Zappos does not compete on price because it believes customers want to buy from the business with the best service and selection. The company strives to create a unique and addicting shopping experience, offering a wide selection of shoes, apparel, accessories, and home products, free shipping to the customer, free shipping and full refunds on returns, and great customer service.

Shopping and Shipping

Zappos strives to make the shopping experience enjoyable. The website is streamlined for an easy shopping experience. Products are grouped in specialized segments, with some (like outdoor products) on their own mini-sites. Customers view each product from multiple angles thanks to photographs taken at the company's studio, and Zappos employees make short videos highlighting the product's features. Zappos analyzes how customers navigate the site to improve features, adapt search results, and plan inventory.

The spirit of simplicity, innovation, and great service extends to Zappos's inventory and distribution systems as well. Zappos has one of the few live inventory systems on the Web. If the Zappos website displays an item, it is in stock. Once the company sells out of an item, the listing is removed from the website. This reduces customer frustration. Its inventory and shipping systems are linked directly to the website via a central database, and all its information systems are developed in-house and customized to the company's needs. Its warehouses operate around the clock, which allows it to get a product to the customer faster. Fast shipping creates an instant gratification similar to shopping in a physical store.

Most companies have a negative view toward returns, but Zappos has the opposite mentality. It sees returns as the ability to maintain customer relationships and to increase its profits. Zappos offers a 100% Satisfaction Guaranteed Return Policy. If customers are not satisfied with a purchase, they can return it within 365 days for a full refund. The customer prints a prepaid shipping label that allows all domestic customers to return the product for free. This return policy encourages customers to order several styles or different sizes and return the items that do not work out.

While this strategy seems expensive, it actually works to Zappos's advantage. The average industry merchandise return rate is 35 percent, but the company's most profitable customers tend to return 50 percent of what they purchase. The customers who have the higher return percentages are the most profitable because they experienced Zappos's customer service and return policy, which create loyalty to the company. These customers are likely to make purchases more often and to spend more on each purchase. This is what helps makes Zappos so successful.

Customer Service

What makes the Zappos business model unique is the company's focus on customer service. The company established a method of serving customers and handling their issues distinctive from the rest of the industry. Zappos believes great customer service is an opportunity to make the customer happy.

Customers are encouraged to call Zappos with any questions. The number is displayed on every page of the website. According to Hsieh, Zappos encourages people to call the company because more interaction with customers increases their personal connections with the organization. Customer service representatives actively use social media sites such as Facebook and Twitter to respond to customer issues.

Another key aspect of its customer service model is that nothing is scripted. Zappos employees have free reign in their decision making and are expected to spend as much time as they need to “wow” customers. They help customers shop, even on their competitors’ websites, encourage them to buy multiple sizes or colors to try (since return shipping is free), and do anything it takes to make the shopping experience memorable.

Zappos’s customer service representatives develop relationships with customers and make them happy. Stories about great customer service include customer support calls that last for hours, sending flowers to customers on their birthdays, and surprise upgrades to faster shipping. Some extreme cases included Zappos hand-delivering shoes to customers who lost luggage and to a groom who forgot the shoes for his wedding. Zappos has even sent pizzas to the homes of customers who tweeted to the company about being hungry.

Zappos believes great customer experiences encourage customers to use the store again. In addition, its long-term strategy is based on the idea that great customer service will help it expand into other categories. While around 80 percent of company orders come from shoes, the markets for housewares and apparel are much larger. The company says it will expand into any area it is passionate about and meets customers’ needs.

The company considers word-of-mouth marketing to be the best way to reach new customers. With over 75 percent of purchases made by repeat customers, it is evident that the Zappos mission to “provide the best customer service possible” works well for the company.

TRANSPARENCY

Transparency is a critical part of the Zappos model. Transparency is an ethical principle that involves maintaining open and truthful communication. Employees receive detailed information about the company’s performance and are encouraged to share information about the company. Zappos believes employees should develop open and honest relationships with all stakeholders in the hope this will assist in maintaining the company’s reputation. Hsieh uses Facebook and Twitter to share information with employees and customers (he has 2.78 million followers on Twitter). When Zappos laid off 124 employees in 2008, Hsieh announced the decision via Twitter and later blogged about it. Although some companies hesitate to open themselves to public criticism, Zappos feels it has nothing to hide. In fact, most of the public posts on its social media sites are praise from customers.

ZAPPOS INSIGHTS

The Zappos business model is so successful the company offers tours and workshops. Its three-day culture camp costs \$6,000 and teaches participants about the Zappos culture and how to develop their own successful corporate cultures. The company also created Zappos Insights, an online service that allows subscribers to learn more about Zappos’s business practices through blogs and videos. These programs have high profit potential for the company because they are built on what Zappos already does best.

CORPORATE CULTURE

The corporate culture at Zappos sets it apart from nearly every other company. It even caught the attention of Amazon CEO Jeff Bezos, who described the company's corporate culture as one-of-a-kind. Zappos's unorthodox culture is the work of CEO Tony Hsieh, an innovative and successful entrepreneur. Hsieh built the culture on the idea that if you can attract talented people and employees enjoy their work, great service and brand power naturally develops. This culture is built on an ethical foundation that respects all stakeholders. All aspects of Zappos's operations are built on integrity.

WORK ENVIRONMENT

Zappos is famous for its relaxed and wacky atmosphere. Employee antics include nerf ball wars, office parades, ugly sweater days, and donut-eating contests. The headquarters feature an employee nap room, a wellness center, and an open mic in the cafeteria. Other quirky activities include forcing employees to wear a "reply-all" hat when they accidentally send a company-wide email. This environment isn't just fun; it's also strategic. According to Zappos, "When you combine a little weirdness with making sure everyone is also having fun at work, it ends up being a win-win for everyone: Employees are more engaged in the work that they do, and the company as a whole becomes more innovative."

Hiring and Training

The key to creating a zany work environment lies in hiring the right people. The job application features a crossword puzzle about Zappos and asks potential employees questions about which superhero they'd like to be and how lucky they are. They may also check how potential employees treat people like their shuttle driver. Zappos is looking for people with a sense of humor who can work hard and play hard. Potential employees go through both cultural and technical interviews to make sure their character fits with a high-integrity company. However, even Hsieh admits finding great employees is tough. He believes pursuing too much growth at once harms the company if the organization starts caring more about the quantity of new employees rather than the quality.

All new employees attend a five-week training program that includes two weeks on the phones providing customer service and a week filling orders in a warehouse. To make sure new employees feel committed to a future with the company, Zappos offers \$2,000 to leave the company after the training (called the "The Offer"). Amazon has adopted a similar practice.

Even after the initial training is over, employees take 200 hours of classes with the company—covering everything from the basics of business to advanced Twitter use—and read at least nine business books a year.

Benefits

Another aspect of Zappos that is unique is the benefits it provides to its employees. The company has an extensive health plan that pays 100 percent of employee medical benefits and on average 85 percent of medical expenses for employees' dependents. The company provides employees with dental, vision, and life insurance. Other benefits include a flexible

spending account, prepaid legal services, a 40 percent employee discount, free lunches and snacks, paid volunteer time, life coaching, and a car pool program.

Along with the extensive benefits package, Zappos developed a compensation model for its "Customer Loyalty Team" (call center representatives) that incentivizes employee development. At Zappos the goal is to answer 80 percent of customer inquiries within 20 seconds, although employees are encouraged to take the time needed to ensure quality service. Initially, employees were paid \$11 per hour for the first 90 days. After 90 days, the employee moved to \$13 per hour. To move beyond \$13 an hour, employees had to demonstrate growth and learning by completing specific skill set courses that allow employees to specialize in certain areas of the call center. Employees were given freedom to choose the shifts they wanted based on seniority. Although the reasoning for Zappos's compensation model is to motivate employees and promote personal growth, the base pay was less than the national hourly average of \$15.92 earned by call center representatives.

Zappos determined that the pay structure and the process for employee shift sign-ups were inefficient for the company's needs. With Hsieh's encouragement the company adopted scheduling software called Open Market. Under this new system, call-center employees would be given 10 percent time flexibility to pursue their own projects. Employees could decide when to work, but the compensation system was revamped to mimic the surge-time pricing of popular ride-sharing service Uber. With this compensation system, call-center employees working during periods of high demand would receive higher pay. In other words, Zappos's hourly compensation for its call-center employees would be based on demand. Zappos hopes to expand this system to all departments eventually. For seniority-based jobs, this system holds risks. For instance, seniority-based incentives also take into account company loyalty, camaraderie with coworkers, and dedication that are also important to work productivity. However, Zappos believes the system works well for its call-center employees because many employees are employed for shorter periods.

Work-Life Integration

One of Zappos's core values is "Build a positive team and family spirit," so the company expects employees to socialize with each other both in and out of the office. In fact, managers spend 10 to 20 percent of their time bonding with team members outside of work. Zappos outings include hiking trips, going to the movies, and hanging out at bars. Hsieh says this increases efficiency by improving communication, building trust, and creating friendships.

Along with creating friendships, employees are encouraged to support each other. Any employee can give another employee a \$50 reward for great work. Zappos employees compile an annual "culture book" comprised of essays on the Zappos culture and reviews of the company. The culture book helps employees think about the meaning of their work and is available unedited to the public. This is based on the principle of transparency.

As with its customers, the foundation of Zappos's relationships with its employees is trust and transparency. The company wants its employees, like its customers, to actively discuss any issues or concerns that come up. Hsieh does not have an office; he sits in an open cubicle among the rest of the employees. He believes "the best way to have an open-door policy is not to have a door in the first place." Zappos's management is open with employees by regularly discussing issues on the company blog.

However, this positive work environment comes with the expectation employees will work hard. Employees are evaluated on how well they embody the core values and inspire

others; Zappos fires people who do great work if they do not fit with the culture of the company. This helps maintain a culture of integrity. The organization wants employees to be dedicated to the firm and believes appropriate conduct will not occur unless employees share the same visions and values of the organization.

Zappos's New Structure

In 2015 Tony Hsieh made a controversial decision to completely change the structure of the organization. For the past year the company had been transitioning toward an organizational structure that abandons the top-down managerial hierarchy in favor of a redistribution of power. Called a Holacracy, this organizational structure places empowerment at the core of the organization. Employees become their own leaders with their own roles. To be effective, a Holacracy requires periodic governance meetings where each employee understands his or her roles and responsibilities. Teams hold tactical meetings to discuss key issues. While governance meetings focus on clarity and role structure, tactical meetings are used to “sync and triage next actions.” It is believed that this distributed authority increases clarity and transparency and decreases cognitive dissonance by recognizing tensions before they become a problem.

As Zappos continues to grow, there is a risk its expansion will make it harder to manage employees and control productivity. Hsieh cites statistics that demonstrate how growth often causes innovation and productivity per employee to go down. However, he also claims that when cities double in size, productivity and innovation per resident increases by 15 percent. Hsieh believes the key to sustainable growth at Zappos is to operate more like a city than a business. This is why he decided to restructure the organization. He feels the best way to handle growth is to become a Teal organization, starting out by using the Holacracy structure and evolving from there. In his book *Reinventing Organizations*, Frédéric Laloux uses a color scheme to describe the development of human organizations, with Teal being the highest. The concept of a Teal organization is based on three premises: self-management developed through peer relationships, involving the whole person in the work, and allowing the organization to grow and adapt instead of being driven. A Teal organization is structured under the premise that all units will work “together to support the whole.” For Zappos this involves adopting a new structure promoting self-organization and self-management.

The transformation of Zappos's organizational structure started off slowly. However, Hsieh believed this slow transition hindered the company's transformation toward self-organization and self-management. He therefore sent an email to all 1,500 employees to inform them the organization was going to take immediate action to transform Zappos into a Teal organization. This involved eliminating bosses and the traditional functions of finance, technology, marketing, and merchandising to create task-oriented circles structured around specific businesses. Managers became employees and no longer engaged in traditional management functions, although their salaries stayed the same throughout 2015.

Hsieh handled the email carefully, making sure to praise traditional managers for their past contributions but stating they are no longer required for a Teal organization. He realized there would likely be much resistance from managers and other employees who did not agree with the new system. To address these concerns, Hsieh extended “The Offer.” Zappos agreed to provide employees who wanted to leave severance pay for three months. Approximately 14 percent of employees chose to take the package.

This will have strong implications for Zappos, but Hsieh believes employees must be committed to the changes and acknowledges that some will not feel that the new structure is right for them. It is clear that this new organizational approach has divided up the company, but Hsieh believes this approach is necessary to handle the company's growth and maintain the same quality service and zany culture that has made it so successful.

CORPORATE SOCIAL RESPONSIBILITY

Zappos takes an unconventional approach to corporate social responsibility (CSR) and philanthropy. Many companies have CSR programs dedicated to a certain area or cause such as education, but Zappos prefers to support a variety of programs based on the needs of communities and the interests of employees.

Philanthropy

Zappos is involved in a variety of philanthropic efforts. Programs include donating shoes and gifts as well as giving gift cards to elementary school students. Zappos donates money to organizations such as the Shade Tree, a nonprofit that provides shelter to women and children, and the Nevada Childhood Cancer Foundation. The company even partnered with Britney Spears to hold an event at the zoo to raise money for the foundation. Zappos also has a donation request application available on its website.

Sustainability

Zappos started a campaign to improve the company's impact on the environment. A group of employees created the initiative, known as Zappos Leading Environmental Awareness for the Future (L.E.A.F.). The campaign focuses on several environmental efforts, including a new recycling program, community gardens, and getting LEED certification for the company. For instance, Zappos created an annual children's art contest that awards prizes for the best drawing involving a recycling-based theme. The winner was awarded a \$50 Zappos.com Gift Card. Like the rest of the company, L.E.A.F. is open, with its progress posted on its Twitter account and blog.

Another area on the company's blog is a section on "Eco-friendly Products." Here, the company highlights new products that are organic or manufactured using environmentally friendly procedures. The postings also list ways customers can live more sustainable lifestyles, including tips on how to throw an eco-friendly party and green product recommendations.

Recognition

In addition to being the number one online shoe retailer, Zappos has been recognized for its innovative business practices. The company appeared on several prestigious lists including *Fortune's* "Best Companies to Work For," *Fast Company's* "50 Most Innovative Companies," *BusinessWeek's* "Top 25 Customer Service Champs," and *Ethisphere's* "World's Most Ethical Companies." The company continues to get recognized for its efforts in creating an environment and business model that encourages transparency and strong relationships among all stakeholders.

ETHICAL CHALLENGES FOR ZAPPOS

Like any company, Zappos faced some challenging business and ethical issues in the past. When these issues occur, Zappos handles situations in a professional and efficient manner. However, the transparency at Zappos makes some business and ethical issues more complex as the company strives to solve problems while keeping its stakeholders informed.

Laying Off Employees

Zappos is known for its commitment to its employees, but the company faced hard economic times that demanded tough decisions. In October 2008, Sequoia Capital, a venture capital firm that was a controlling investor in Zappos, met to discuss the problems presented by the economic downturn and its effect on their portfolio companies. Sequoia Capital instructed Zappos to cut expenses and make the cash flow positive. As a result, Hsieh made the difficult decision to lay off 8 percent of employees. This was not a desired event, but was required by Sequoia Capital.

Zappos strived to handle the layoffs in a respectful and kind manner. Hsieh sent an email notifying employees of the layoff and was honest and upfront about the reasons behind the decisions, even discussing the move on Twitter. Employees who were laid off received generous severance packages, including six months of paid COBRA health insurance coverage. Because of the company's honesty and transparency, employees and customers were more understanding of the tough decision Hsieh and Zappos had to make.

Acquisition by Amazon

In 2009 Zappos was acquired by e-commerce giant Amazon.com. Many Zappos customers were confused by the unexpected move and expressed concerns about the future of the company's culture and customer service. Most CEOs would not feel any obligation to address customer concerns over the acquisition, but Tony Hsieh values the support of Zappos's employees and customers.

Shortly after the acquisition, Hsieh issued a statement about why he sold Zappos to Amazon. In the statement, Hsieh discussed the disagreement between Zappos and Sequoia Capital over management styles and company focus. Specifically, Hsieh said, "The board's attitude was that my 'social experiments' might make for good PR but that they didn't move the overall business forward. The board wanted me, or whoever was CEO, to spend less time on worrying about employee happiness and more time selling shoes." Hsieh and Alfred Lin, Zappos's CFO and COO, were the only two members on the board committed to preserving the company's culture. The board could fire Hsieh and hire a new CEO who focused more on profits.

Hsieh decided the best way to resolve these issues was to buy out the board, but he could not do this on his own. After meeting with Amazon CEO Jeff Bezos, Hsieh committed to a full acquisition, as long as Zappos could operate independently and continue to focus on building its culture and customer service. Many customers were concerned Amazon was not a good fit for Zappos, but Hsieh addressed those concerns, stating Amazon and Zappos have the same goals of creating value for the customer but different ways of how to do it. He also assured customers Zappos would continue to maintain its unique corporate culture. Although consumers were not pleased with the acquisition, they at least understood why it occurred. Moreover, Hsieh's commitment to his beliefs and management style resonated with consumers.

More than Shoes Campaign

To bring awareness to the fact Zappos sells more than just shoes, Zappos created a marketing campaign in 2011 designed to catch people's attention. The company released several advertisements that featured people who appeared to be naked doing daily activities such as running, hailing a cab, and driving a scooter. The creative advertisements had certain parts of models' bodies blocked off with a box that said "more than shoes."

The campaign received criticism from several groups because of their "sexual nature." However, the catch with these ads was that the subjects of the ads were not actually nude; they wore bathing suits or small shorts that were later covered by the box. Because of the negative attention, Zappos pulled the ads and released an apology that explained the production process.

Technical Difficulties

Also in 2011 Zappos experienced some technical difficulties that resulted in delays and problems in customers' orders and shipments. Zappos upgraded one of its processing systems, and in the process many orders were deleted or delayed. Some orders had the incorrect shipping information, and products were shipped to the wrong location. Although this upset several customers, Zappos handled the problems and reassured customers that it would get them their merchandise as soon as possible. The company also offered different perks, depending on the circumstances of each customer experience.

Another problem Zappos encountered was that every item from 6pm.com, one of its websites, was priced at \$49.95 for six hours in 2010. The company shut down the website for a few hours to solve the problem. Zappos honored all the orders from the pricing mistake, which resulted in a \$1.6 million loss.

Theft of Customer Information

In 2012 hackers broke into Zappos's computer system, and the company had to respond to the theft of 24 million customers' critical personal information. The stolen data included customers' names, email addresses, shipping and billing addresses, phone numbers, and the last four digits of their credit cards. Zappos immediately addressed the situation by sending an email to customers notifying them of the security breach. Zappos assured customers the servers containing their full credit card information were not hacked. Its next move was to disconnect its call center, reasoning that the expected amount of calls would overload the system.

While Zappos has a reputation for delivering customer service that is unmatched by any competitor, some customers were unhappy with how Zappos handled the hacking. Many customers were upset by their information being hacked, but the situation was made worse by the company's action of disconnecting its call center. Although this situation caused problems for Zappos and blemished its customer service record, the company has worked to restore its reputation.

THE FUTURE OF ZAPPOS

Zappos remains committed to serving its customers and employees. So far, the company has retained its unique culture and continues to expand into new product categories. In one interview, Hsieh talked about the growth of Zappos and how he believes expanding

into the clothing and merchandise market will help the company to grow. Hsieh says “the sky is the limit” for Zappos, and growing and expanding into many different types of businesses is Zappos’s future. Hsieh continues to look for talented and creative individuals. He has pledged \$1 million in partnership with Venture for America to bring at least 100 graduates to the Las Vegas area over a five-year period. As Zappos expands, it will have to work harder to hire the right people, avoid ethical issues, and maintain its quirky culture. The company’s new organizational structure and compensation system for its call-center employees are major steps to expand without compromising Zappos’s unique culture. Although many employees ended up leaving the company, Zappos believes these moves are the right ones to make and will enable the firm to continue growing both in employees and productivity.

Ethical leadership is a key factor in the success of any company, and for Zappos having Tony Hsieh as a leader is a strong indicator for future success. Hsieh expressed that he will do whatever it takes to make his employees, customers, and vendors happy. The future for any company looks bright when its leadership is committed to such strong values. However, Zappos needs to make sure it continues to focus on its stakeholders and its long-term vision with or without Hsieh.

Ultimately, Zappos intends to continue to deliver happiness to its stakeholders. Hsieh says, “At Zappos, our higher purpose is delivering happiness. Whether it’s the happiness our customers receive when they get a new pair of shoes or the perfect piece of clothing, or the happiness they get when dealing with a friendly customer rep over the phone, or the happiness our employees feel about being a part of a culture that celebrates their individuality, these are all ways we bring happiness to people’s lives.”

QUESTIONS FOR DISCUSSION

1. Does Zappos effectively focus on stakeholder happiness, and how does this approach affect the ethical culture?
2. Has Zappos developed long-term relationships with customers and employees that provide a competitive advantage in the purchase of shoes and other products?
3. Has Zappos effectively managed ethical risk, and what are potential ethical risks in the future?

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