Case 4.13

Dennis Kozlowski: Tyco and the $6,000 Shower Curtain[175]

Tyco International began as a research laboratory, founded in 1960 by Arthur Rosenburg, with the idea of doing contract research work for the government. By 1962, Rosenburg had incorporated and begun doing work for companies in the areas of high-tech materials and energy conversion, with two divisions of the holding company, Tyco Semiconductor and Materials Research Laboratory. By 1964, the company went public and became primarily a manufacturer of products for commercial use. Today, Tyco is a conglomerate with a presence in over 100 countries and over 250,000 employees. Between 1991 and 2001, CEO Dennis Kozlowski took Tyco from $3 billion in annual sales to $36 billion in 2001 by paying $60 billion for more than 200 acquisitions.[176] Tyco's performance was phenomenal.

- From 1992 through 1999, Tyco's stock price grew fifteenfold.[177]
- Tyco's earnings grew by 25 percent each year during Kozlowski's era.[178]
- During 1999, Tyco's stock price rose 65 percent.[179]
- Tyco spent $50 billion on acquisitions in nine years.[180]
- The company's debt-to-equity ratio nearly doubled from 25 percent to 47 percent in one year (2001).[181]

In a move to reduce its U.S. tax bills, Tyco is based out of Bermuda, despite having its headquarters in Exeter, New Hampshire.[182] Tyco, with a stake in telecommunications as well, is the parent company to Grinnell Security Systems, health care products companies, and many other acquired firms, which has been its strategy for growth.[183] In fact, the troubles that Tyco experienced initially were often attributed to a skittish market reacting to the falls of Enron and WorldCom as well as problems with Global Crossing and Kmart.[184]

Shortly after Enron's bankruptcy, Tyco began to experience a decline in its share price. From December 2001 through the middle of January 2002, Tyco's shares lost 20 percent of their value.[185] In fact, following a conference in which then-CEO Dennis Kozlowski tried to reassure the public and analysts that Tyco's accounting was sound, the shares were the most heavily traded of the day (68 million on January 15, 2002), and the price dropped $4.45 to $47.95 per share.[186] However, at the same time as the

---

[175] Adapted from Marianne M. Jennings, "The Yeehaw Factor," *Wyoming Law Review* 3 (2003): 387–511.

[176] Daniel Eisenberg, "Dennis the Menace," *Time*, June 17, 2002, 47; and Mark Maremont, John Hechinger, Jerry Markon, and Gregory Zuckerman, "Kozlowski Quits under a Cloud, Worsening Worries about Tyco," *Wall Street Journal*, June 4, 2002, pp. A1, A10.

[177] Alex Berenson, "Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System," *New York Times*, June 10, 2002, p. B1.

[178] *BusinessWeek Online*, January 14, 2002, http://www.businessweek.com.

[179] *BusinessWeek Online*, January 11, 1999, http://www.businessweek.com.

[180] *BusinessWeek Online*, January 14, 2002, http://www.businessweek.com.

[181] *Id.*

[182] Information from Tyco, http://www.tyco.com; see "Investor Relations, Tyco History." See also Alex Berenson, "Tyco Shares Fall as Investors Show Concern on Accounting," *New York Times*, January 16, 2002, p. C1.

[183] *Id.* Tyco bought Grinnell, the security system and fire alarm company; Ludlow, the packaging company; and a host of others during its especially aggressive expansion period from 1973 to 1982.

[184] Kopin Tan, "Tyco's Options Soar, While Volatility Spikes on Concerns over U.S. Accounting Practices," *Wall Street Journal*, January 30, 2002, p. C14.

[185] Alex Berenson, "Tyco Shares Fall as Investors Show Concern on Accounting," *New York Times*, January 16, 2002, p. C1.

[186] *Id.*

loss of investor confidence in the accounting of public corporations came Tyco's announcement that its earnings had dropped 24 percent for fiscal year 2001.[187] By February, the share price had tumbled to $29.90, a drop of 50 percent from January 1, 2002.[188] Tyco was forced to borrow funds as it experienced what one analyst called a "crisis in confidence," noting, "The lack of confidence in the company by the capital markets to a degree becomes a self-fulfilling prophecy."[189]

Then there was another problem that emerged on January 28, 2002. Tyco announced that it had paid $20 million to one of its outside directors, Frank E. Walsh, and a charity of which he was the head, for him to broker a deal for one of Tyco's acquisitions.[190] The acquisition was CIT Group Finance, and Tyco acquired it for $9.5 billion.[191] Mr. Walsh, who would later plead guilty to a violation of a New York statute as well as a violation of federal securities laws, withheld information about the brokerage fee from the Tyco board and did not disclose the information as required in the company's SEC filings.[192] Once the SEC moved in to investigate, the company's stock continued its decline.[193] From January 2002 to August 2002, Tyco's stock price declined 80 percent.[194]

What Went Wrong: The Accounting Issues

Investors and markets are not always jittery for no reason. There were some Tyco accounting issues that centered on its acquisitions and its accounting for those acquisitions.[195] What caused investors to seize upon Tyco's financials was that it seemed to be heavily in debt despite the fact that it was reporting oodles of cash flow.[196] This financial picture resulted because of Tyco's accounting for its "goodwill."[197] When one company acquires another company, it must include the assets acquired in its balance sheet. The acquirer is in charge of establishing the value for the assets acquired. From 1998 to 2001, Tyco spent $30 billion on acquisitions and attributed $30 billion to goodwill.

The problem lies in the fact that the assets that are acquired are not carried on Tyco's books with any significant value. Assets, under accounting rules, lose their value over time. Goodwill stays the same in perpetuity. However, if Tyco turns around and sells the assets it has acquired and booked at virtually zero value, the profit that it makes is

---

[187]John Hechinger, "Tyco to Lay Off 44% of Its Workers at Telecom Unit," *Wall Street Journal,* February 8, 2002, p. A5.

[188]Alex Berenson and Andrew Ross Sorkin, "Tyco Shares Tumble on Growing Worries of a Cash Squeeze," *New York Times*, February 5, 2002, p. C1.

[189]*Id.*

[190]Kate Kelly and Gregory Zuckerman, "Tyco Worries Send Stock Prices Lower Again," *Wall Street Journal,* February 5, 2002, p. C1.

[191]Laurie P. Cohen and Mark Maremont, "Tyco Ex-Director Pleads Guilty," *Wall Street Journal,* December 18, 2002, p. C1.

[192]Andrew Ross Sorkin, "Tyco Figure Pays $22.5 Million in Guilty Plea," *New York Times*, December 18, 2002, pp. C1, C2; and E. S. Browning, "Stocks Slump in Late-Day Selloff on Round of Ugly Corporate News," *Wall Street Journal,* June 4, 2002, pp. A3, A8.

[193]Michael Schroeder and John Hechinger, "SEC Reopens Tyco Investigation," *Wall Street Journal,* June 13, 2002, p. A2.

[194]Kevin McCoy, "Authorities Widen Tyco Case, Look at Other Officials' Actions," *USA Today*, August 13, 2003, p. 1A.

[195]Floyd Norris, "Now Will Come the Sorting Out of the Chief Executive's Legacy," *New York Times*, June 4, 2002, pp. C1, C10.

[196]Mark Maremont, "Tyco Made $8 Billion of Acquisitions over 3 Years but Didn't Disclose Them," *Wall Street Journal,* February 4, 2002, p. A3.

[197]"Goodwill" is an asset under accounting rules that takes into account the sort of customer value a business has. For example, if you buy a dry-cleaning business, you are paying for not only the hangers and the pressers and racks but also for that dry cleaner's reputation in the community, the tendency of customers to return, and their willingness to bring their dry cleaning to this establishment—goodwill.

reflected in the income of the company. The only way an investor in Tyco would be able to tell what has really happened in the accounting for an acquisition would be for the investor to have access to the balance sheets of the acquired companies, so that he or she could see the value of the assets as they were carried on the books of the acquired company. The bump to earnings from the sale of the assets is lovely, but the bump to profits, with no offsetting costs, is tremendous.

There were additional accounting issues related to the Tyco acquisitions. One big one was that despite having made 700 acquisitions between 1998 and 2001 for about $8 billion, Tyco never disclosed the acquisitions to the public.[198] The eventual disclosure of the phenomenal number of acquisitions did explain the lack of cash, but it also deprived investors of the chance to determine how much of Tyco's growth was due to acquisitions versus running existing businesses.

The nondisclosure of the acquisitions also helped with another accounting strategy. When Tyco made acquisitions, its goal was always to make the company acquired look as much like a dog as possible. Tyco was a spring-loader extraordinaire. (See Reading 4.9 for a full explanation of spring-loading.) Spring-loading at Tyco involved having the company being acquired pay everything for which it has a bill, whether that bill was due or not. When Tyco acquired Raychem, its treasurer sent out the following e-mail:

> *At Tyco's request, all major Raychem sites will pay all pending payables, whether they are due or not. . . . I understand from Ray [Raychem's CFO] that we have agreed to do this, even though we will be spending the money for no tangible benefit either to Raychem or Tyco.*[199]

Tyco employees, when working with a company to be acquired, would also pump up the reserves, with one employee of Tyco asking an employee of an acquired firm, "How high can we get these things? How can we justify getting this higher?"[200] The final report of a team led by attorney David Boies (the lawyer who represented Napster, the U.S. government in its case against Microsoft, and also Al Gore in the Florida ballot dispute after the 2000 presidential election), retained by the Tyco board to determine what was going on with the company, indicates that Tyco executives used both incentives and pressure on executives in order to get them to push the envelope on accounting rules to maximize results.[201] Mr. Boies referred to the accounting practices of the executives as "financial engineering."

It was not, however, a case in which the accounting issues went unnoticed. The warnings, from the company's outside legal counsel, went unheeded. A May 25, 2000, e-mail from William McLucas of Wilmer Cutler to Mr. Mark Belnick, then–general counsel for Tyco, contains clear warnings about the questionable accounting treatments as well as the pressure those preparing the financial reports were experiencing, "We have found issues that will likely interest the SEC . . . creativeness is employed in hitting the forecasts. . . . There is also a bad letter from the Sigma people just before the acquisition confirming that they were asked to hold product shipment just before the closing."[202]

[198]Maremont, "Tyco Made $8 Billion of Acquisitions over 3 Years but Didn't Disclose Them," p. A3.

[199]Herb Greenberg, "Does Tyco Play Accounting Games?" *Fortune,* April 1, 2002, pp. 83, 86.

[200]*Id.*

[201]Kurt Eichenwald, "Pushing Accounting Rules to the Edge of the Envelope," *New York Times*, December 31, 2002, pp. C1, C2.

[202]Laurie P. Cohen and Mark Maremont, "E-Mails Show Tyco's Lawyers Had Concerns," *Wall Street Journal,* December 27, 2002, p. C1.

The lawyer concluded that Tyco's financial reports smelled of "something funny which is likely apparent if any decent accountant looks at this."[203]

What Went Wrong: A Profligate Spender as CEO

Tyco was graced with a CEO whose profligate spending cost the company dearly, in dollars and reputation, and whose tight fist with his own money got him indicted. Dennis Kozlowski was a scary CEO whose philosophy was "Money is the only way to keep score."[204] Mr. Kozlowski was one of the country's highest-paid CEOs. In 2001, his compensation package of $411.8 million put him at number two among the CEOs of the Fortune 500 companies."[205] Mr. Kozlowski was featured on the cover of *BusinessWeek* and called "the most aggressive dealmaker in Corporate America."[206] He was included in the magazine's top twenty-five managers of the year. Indeed, when Tyco's problems and accounting issues emerged, many of Wall Street's "superstar" money managers were stunned.[207]

In addition to his salary, Mr. Kozlowski was a spender. There were extensive personal expenses documented that began to percolate before problems at Tyco emerged. Tyco's outside legal counsel raised concerns about payments Tyco was making to Mr. Kozlowski's then-mistress (and now Kozlowski's second ex-wife), Karen Mayo, and advised that they be disclosed in SEC documents. Employees in Tyco refused to make the disclosures and continued making the payments.[208] The e-mail from partner Lewis Liman at Wilmer Cutler, sent March 23, 2000, to Tyco's general counsel, Mark Belnick, read, "There are payments to a woman whom the folks in finance describe as Dennis's girlfriend. I do not know Dennis's situation, but this is an embarrassing fact."[209]

Before Tyco took its dive, Mr. Kozlowski had accumulated three Harleys; a 130-foot sailing yacht; a private plane; and homes in New York City (including a thirteen-room Fifth Avenue apartment, purchased in 2000),[210] New Hampshire, Nantucket, and Boca Raton (15,000 square feet, purchased in 2001); and was a part owner of the New Jersey Nets and the New Jersey Devils.[211] His Fifth Avenue apartment cost $16.8 million to buy and $3 million in renovations, and he spent $11 million on furnishings.[212] The items were delineated in the press, and the following purchases for the apartment were charged to Tyco: $6,000 for a shower curtain, $15,000 for a dog umbrella stand; $6,300 for a sewing basket, $17,100 for a traveling toilette box, $2,200 for a gilt metal

[203]Mark Maremont and Laurie P. Cohen, "Tyco Probe Expands to Include Auditor PricewaterhouseCoopers," *Wall Street Journal,* September 30, 2002, p. A1.

[204]Eisenberg, "Dennis the Menace," 47.

[205]Jonathan D. Glater, "A Star Lawyer Finds Himself the Target of a Peer," *New York Times*, September 24, 2002, pp. C1, C8.

[206]*BusinessWeek Online,* January 14, 2002, http://www.businessweek.com.

[207]Gregory Zuckerman, "Heralded Investors Suffer Huge Losses with Tyco Meltdown," *Wall Street Journal,* June 10, 2002, p. C1.

[208]Cohen and Maremont, "E-Mails Show Tyco's Lawyers Had Concerns," p. C1.

[209]*Id.*

[210]Theresa Howard, "Tyco Puts Kozlowski's $16.8M NYC Digs on Market," *USA Today*, September 19, 2002, p. 3B.

[211]Laurie P. Cohen and Mark Maremont, "Tyco Relocations to Florida Are Probed," *Wall Street Journal,* June 10, 2002, p. A3; Alex Berenson and William K. Rashbaum, "Tyco Ex-Chief Is Said to Face Wider Inquiry into Finances," *New York Times*, June 7, 2002, p. C1; and Kris Maher, "Scandal and Excess Make It Hard to Sell Mr. Kozlowski's Boat," *New York Times,* September 23, 2002, p. A1.

[212]Andrew Ross Sorkin, "Tyco Details Lavish Lives of Executives," *New York Times*, September 19, 2002, p. C1. The New York City apartment was sold for $21.8 million in October 2004. William Neuman, "Tyco to Sell Ex-Chief's Apartment for $21 Million," *New York Times,* October 9, 2004, pp. B1, B4.

wastebasket, $2,900 for coat hangers, $5,960 for two sets of sheets, $1,650 for a notebook, and $445 for a pincushion.[213]

For his then-new wife Karen Mayo's fortieth birthday, Kozlowski flew Jimmy Buffett and dozens of Karen's friends to a villa outside Sardinia for a multiday birthday celebration.[214] A memo on the party was attached as an exhibit to Tyco's 8-K, filed on September 17, 2002. The process for receiving the guests and the party schedule are described in detail, right down to what type of music was playing and at what level. The waiters were dressed in Roman togas, and there was an ice sculpture of David through which the vodka flowed. The memo includes a guest list and space for the crew of the yacht that the Kozlowskis sailed to Sardinia.[215] The total cost for the party was $2.1 million.[216] Tyco also paid Mr. Kozlowski's American Express bill, which was $80,000 for one month. A later report uncovered a $110,000 bill Tyco paid for a thirteen-day stay by Mr. Kozlowski at a London hotel.[217] Ironically, Mr. Kozlowski told a *BusinessWeek* reporter in 2001, on a tour of Tyco's humble Exeter, New Hampshire, offices, "We don't believe in perks, not even executive parking spots."[218]

Mr. Kozlowski appeared to be financing the lifestyle through Tyco's Key Employee Corporate Loan Program ("the KELP") and relocation loan programs (see the following pages for details). According to SEC documents, Mr. Kozlowski borrowed more than $270 million from the KELP "but us[ed] only about $29 million to cover intended uses for the loans. He used the remaining $242 million of supposed KELP loans for personal expenses, including yachts, fine art, estate jewelry, luxury apartments and vacation estates, personal business ventures, and investments, all unrelated to Tyco."[219]

Mr. Kozlowski was on the board of the Whitney Museum of Art and had Tyco donate $4.5 million to the traveling museum shows that the Whitney sponsored.[220] He was an avid fundraiser for various philanthropic endeavors. In fact, he was at a fundraiser for the New York Botanical Garden when the news of his possible indictment (see the following pages) first spread.[221] Tyco donated $1.7 million for the construction of the Kozlowski Athletic Complex at the private school, Berwick Academy, which one of his daughters attended and where he served as trustee, and $5 million to Seton Hall, his alma mater, for a building that was called the Koz Plex.[222]

Mr. Kozlowski also donated personally, particularly to charities in the Boca Raton area, where he had retained a public relations executive and where he had been given a

---

[213] Kevin McCoy, "Directors' Firms on Payroll at Tyco," *USA Today,* September 18, 2002, p. 1B. These items are also listed in the 8-K for September 17, 2002.

[214] Don Halasy, "Why Tyco Boss Fell," New York Post, June 9, 2002, http://www.nypost.com; and Laurie P. Cohen, "Ex-Tyco CEO's Ex to Post $10 Million for His Bail Bond," *Wall Street Journal,* September 20, 2002, p. A5.

[215] Tyco 8-K filing, September 17, 2002, http://www.sec.gov/edgar.

[216] Mark Maremont and Laurie P. Cohen, "How Tyco's CEO Enriched Himself," *Wall Street Journal,* August 7, 2002, p. A1.

[217] Mark Maremont and Laurie P. Cohen, "Tyco's Internal Inquiry Concludes Questionable Accounting Was Used," *Wall Street Journal,* December 31, 2002, pp. A1, A4; and Alex Berenson, "Changing the Definition of Cash Flow Helped Tyco," *New York Times,* December 31, 2002, pp. C1, C2.

[218] Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, "The Rise and Fall of Dennis Kozlowski," *BusinessWeek Online,* December 23, 2002, http://www.businessweek.com.

[219] Securities and Exchange Commission, http://www.sec.gov/releases/litigation; and Kevin McCoy, "Directors' Firms on Payroll at Tyco," *USA Today,* September 18, 2002, p. 1B. These items are also listed in Tyco's 8-K filed on September 17, 2002; see http://www.sec.gov/edgar. See also Theresa Howard, "Tyco Puts Kozlowski's $16.8M NYC Digs on Market," *USA Today,* September 19, 2002, p. 3B; and Andrew Ross Sorkin, "Tyco Details Lavish Lives of Executives," *New York Times,* September 18, 2002, p. C1. And see Tyco's 8-K filed on September 17, 2002.

[220] Don Halasy, "Why Tyco Boss Fell," June 9, 2002, http://www.nypost.com.

[221] *Id.*; and Carol Vogel, "Kozlowski's Quest for Entrée into the Art World," *New York Times,* June 6, 2002, pp. C1, C5.

[222] Maremont and Cohen, "How Tyco's CEO Enriched Himself," p. A1; and John Byrne, "Seton Hall of Shame," *BusinessWeek Online,* September 20, 2002, http://www.businessweek.com.

fair amount of coverage in the *Palm Beach Post* for his contributions to local charities.[223] There is even some confusion about who was donating how much and from which tills. Kozlowski had pledged $106 million in Tyco funds to charity, but $43 million of that was given in his own name.[224] He had donated $1.3 million to the Nantucket Conservation Foundation in his own name with the express desire that the land next to his property there not be developed.[225] Tyco gave $3 million to a hospital in Boca Raton and $500,000 to an arts center there. United Way of America gave Mr. Kozlowski its "million-dollar giver" award.[226]

Mr. Kozlowski saw to it that friends were awarded contracts that Tyco paid. For example, Wendy Valliere was a personal friend of the Kozlowskis and was hired to decorate the New York City apartment. Her firm's bill was $7.5 million.[227] However, Ms. Valliere was not alone as a personal employee.[228] In 1996, Mr. Kozlowski also hired Michael Castania, a consultant who had helped him with his yacht, as an executive who was housed at Boca Raton. He was an Australian yachting expert who went on to lead Team Tyco, a corporate yachting racing team, to fourth place in the Volvo Challenge Race in June 2002.[229] Tyco also hired Ms. Mayo's personal trainer from the days when she was still married to her ex-husband and Mr. Kozlowski was still married to his ex-wife, but Mr. Kozlowski was supporting Ms. Mayo in a beach condo in Nantucket.[230]

Mr. Kozlowski was also an active player in Manhattan's art market. In June 2002 the *New York Times* reported that Mr. Kozlowski was being investigated by the district attorney's office in Manhattan for evasion of $1 million in sales tax on $13 million in art sales over a ten-month period.[231] Mr. Kozlowski resigned from Tyco immediately following the emergence of the report and before an indictment was handed down. A market that was already reeling from Enron and WorldCom dropped 215 points in one day, and Tyco's stock fell 27 percent that same day.[232] In fact, the indictment was handed down the following day.[233]

---

[223] *Id.*, p. A6. Barry Epstein, a Palm Beach PR executive, said, "I represented Dennis personally. I reported to him and guided him on community involvement." Mr. Epstein has conceded that most of the money was Tyco's, not Mr. Kozlowski's.

[224] Kevin McCoy and Gary Strauss, "Kozlowski, Others Accused of Using Tyco as 'Piggy Bank,'" *USA Today,* September 13, 2002, pp. 1B, 2B.

[225] Maremont and Cohen, "How Tyco's CEO Enriched Himself," pp. A1, A6.

[226] *Id.*

[227] *Id.*

[228] Mark Maremont and Laurie P. Cohen, "Interior Design on a Budget: The Tyco Way," *Wall Street Journal,* September 18, 2002, pp. B1–B5.

[229] Maremont and Cohen, "How Tyco's CEO Enriched Himself," pp. A1, A6.

[230] Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, "The Rise and Fall of Dennis Kozlowski," *BusinessWeek Online,* December 23, 2002, http://www.businessweek.com.

[231] Alex Berenson, "Investigation Is Said to Focus on Tyco Chief over Sales Tax," *New York Times,* June 3, 2002, p. C1; Laurie P. Cohen and Mark Maremont, "Expanding Tyco Inquiry Focuses on Firm's Spending on Executives," *Wall Street Journal,* June 7, 2002, pp. A1, A5; and Nanette Byrnes, "Online Extra: The Hunch That Led to Tyco's Tumble," *BusinessWeek Online,* December 23, 2002, http://www.businessweek.com.

[232] Mark Maremont, John Hechinger, Jerry Markon, and Gregory Zuckerman, "Kozlowski Quits under a Cloud, Worsening Worries about Tyco," *Wall Street Journal,* June 4, 2002, p. A1; and Adam Shell, "Markets Fall as Tyco CEO's Resignation Adds to Woes," *USA Today,* June 4, 2002, p. 1B.

[233] Thor Valdmanis, "Art Purchases Put Ex-Tyco Chief in Hot Water," *USA Today,* June 5, 2002, p. 1B; Mark Maremont and Jerry Markon, "Former Tyco Chief Is Indicted for Avoiding Sales Tax on Art," *Wall Street Journal,* June 5, 2002, p. A1; Alex Berenson and Carol Vogel, "Ex-Tyco Chief Is Indicted in Tax Case," *New York Times,* June 5, 2002, p. C1; David Cay Johnston, "A Tax That's Often Ignored Suddenly Attracts Attention," *New York Times,* June 5, 2002, p, C1; Brooks Barnes and Alexandra Peers, "Sales-Tax Probe Puts Art World in Harsh Light," *Wall Street Journal,* June 5, 2002, pp. B1, B3; Susan Saulny, "Tyco's Ex-Chief to Seek Dismissal of Indictments," August 15, 2002, p. C3; Mark Maremont and Laurie P. Cohen, "Former Tyco CEO Is Charged with Two New Felony Counts," *Wall Street Journal,* June 27, 2002, p. A3; and Andrew Ross Sorkin and Susan Saulny, "Former Tyco Chief Faces New Charges," *New York Times,* June 27, 2002, p. C1.

Tyco's Culture

Mr. Kozlowski had a strategy for getting the type of people he needed to succumb to the pressure for numbers achievement. He told *BusinessWeek* that he chooses managers from the "same model as himself. Smart, poor, and wants to be rich."[234] Meeting numbers meant bonuses; exceeding those numbers meant "the sky was the limit." The CEO of one of Tyco's subsidiaries had a salary of $625,000, but when he boosted sales by 62 percent, his bonus was $13 million.[235]

Mr. Kozlowski was known for being autocratic and prone to temper flare-ups.[236] When he was CEO of Tyco's Grinnell Fire Protection Systems Co., Mr. Kozlowski had an annual awards banquet where he presented awards to the best warehouse manager as well as the worst warehouse manager. The worst manager would have to walk to the front of the room in what other managers described as a "death sentence."[237]

The Loans

Tyco's Key Employee Corporate Loan Program (the "KELP") was established to encourage employees to own Tyco shares by offering dedicated loans to pay the taxes due when shares granted under Tyco's restricted share ownership plan became vested. There was no way to pay the taxes except to sell some of the shares for cash, and the loan program permitted the officers to pledge their shares in exchange for cash that was then used to pay the income tax that was due on this employee benefit.[238] Mr. Kozlowski made it clear that the loan program was available to all of his new hires, including Mark Swartz, the CFO, and Mark Belnick, Tyco's general counsel and executive vice president.[239]

The second loan program was a relocation program, which was established to help employees who had to move from New Hampshire to New York. The idea was to provide low-interest loans for employees who had to relocate from one set of company offices to another in order to lessen the impact of moving to a much costlier housing market.[240] One of the requirements of the relocation program was the employee's certification that he or she was indeed moving from New Hampshire to New York, or, in some cases, to Boca Raton.

Mr. Belnick has explained through his lawyer that he was entitled to the loans from the "relocation program" because he had such in writing from Mr. Kozlowski. Mr. Kozlowski offered this perk to Mr. Belnick despite the fact that Mr. Belnick was a partner in a New York City law firm and would be working in New York City for Tyco. He received the relocation fee for a difference of 25 miles between his home and Tyco's New York offices, and despite the fact that he had never lived in New Hampshire as the relocation loan program required. Although he actually didn't need to move, Mr. Belnick borrowed $4 million anyway and used it to buy and renovate an apartment in New York City. Later, he borrowed another $10 million to construct a home in Park City, Utah, because he was moving his family there and would divide his time between the

---

234 William C. Symonds and Pamela L. Moore, "The Most Aggressive CEO," *BusinessWeek Online*, May 28, 2001, http://www.businessweek.com.

235 *Id.*

236 Bianco, Symonds, Byrnes, and Poleck, "The Rise and Fall of Dennis Kozlowski," http://www.businessweek.com.

237 *Id.*

238 This information was obtained from the press release that the SEC issued when it filed suit against Mark Swartz, Dennis Kozlowski, and Mark Belnick for the return of the loan amounts. http://www.sec.gov/releases/litigation.

239 In an 8-K filed with the SEC on September 17, 2002, Tyco outlined the loans, the spending, and its plans for the future. The 8-K is available at http://www.sec.gov/edgar. A synopsis of the information filed in the 8-K is available at http://www.tyco.com under "Press Releases."

240 The rate as disclosed in the 2002 proxy was 6.24 percent.

two locations and the extensive international travel his job required.[241] Mr. Belnick got Mr. Kozlowski's approval for both loans, but he didn't do the corporate paperwork for relocation.

Mr. Belnick told friends from the time that he began his work with Tyco that he was uncomfortable because he was not in the loop with information from either Mr. Kozlowski or the board. However, Mr. Kozlowski offered him more lucrative contracts and additional loans, and Mr. Belnick remained on board.[242] However, as noted in the case, there are e-mails from Tyco's outside counsel, the Wilmer Cutler firm, that indicate some information was seeping through to Mr. Belnick, and that outside counsel had concerns that were kept silent once transmitted to Mr. Belnick.

During the same period, CFO Swartz availed himself of $85 million of KELP loans. However, he used only $13 million for payment of taxes and spent the remaining $72 million for personal investments, business ventures, real estate holdings, and trusts.[243] Mr. Swartz used more than $32 million of interest-free relocation loans, and, according to SEC documents, used almost $9 million of those relocation loans for purposes not authorized under the program, including purchasing a yacht and investing in real estate.[244]

Patricia Prue, the vice president for HR at Tyco and the one responsible for processing the paperwork for the forgiveness of the officers' loans, and who had benefited from the loan forgiveness program herself, approached Mr. Kozlowski in September 2000 and asked for documentation that the board had indeed approved all the loan forgiveness for which she was doing the paperwork. Mr. Kozlowski, without ever producing board minutes, wrote a memo to Ms. Prue, "A decision has been made to forgive the relocation loans for those individuals whose efforts were instrumental to successfully completing the TyCom I.P.O."[245] Ms. Prue had received a loan of $748,309, had the loan forgiven, and then was given $521,087 to pay the taxes on the loan forgiveness.[246] Ms. Prue's bonuses totaled $13,534,523, and she was given $9,424,815 to pay the taxes on the bonuses.[247]

The issue of board approval on the loans remains a question, but compensation committee minutes from February 21, 2002, show that the committee was given a list of loans to officers and also approved Mr. Belnick's new compensation package. There was no public disclosure of these developments or the committee's review.[248] In grand jury testimony, Patricia Prue, who testified in exchange for immunity from prosecution, indicated that board member Joshua Berman pressured her in June 2002 to change the

---

[241] Nicholas Varchaver, "Fall from Grace," *Fortune,* October 28, 2002, 112, 115; Amy Borrus, Mike McNamee, Williams Symonds, Nanette Byrnes, and Andrew Park, "Reform: Business Gets Religion," *BusinessWeek Online,* February 3, 2003, http://www.businessweek.com; and Jonathan D. Glater, "A Star Lawyer Finds Himself the Target of a Peer," *New York Times,* September 24, 2002, p. C1.

[242] Glater, "A Star Lawyer Finds Himself the Target of a Peer," pp. C1, C8.

[243] Securities and Exchange Commission, http://www.sec.gov/releases/litigation. The SEC has also filed suit against Mr. Swartz, seeking the return of these funds. Mr. Swartz was also indicted by the State of New York and spent some time in jail as his family scrambled to post his bail.

[244] Securities and Exchange Commission, http://www.sec.gov/releases/litigation. These exhibits and lists are found in the 8-K for September 17, 2002, at http://www.sec.gov/edgar. Andrew Ross Sorkin and Jonathan D. Glater, "Tyco Planning to Disclose Making Loans to Employees," *New York Times,* September 16, 2002, p. C1; and "Ex-Chief of Tyco Posts $10 Million in Bail," *New York Times,* September 21, 2002, p. B14.

[245] *Id.;* and Kevin McCoy, "Kozlowski's Statement in Question," *USA Today,* January 9, 2002, p. 1B.

[246] Andrew Ross Sorkin, "Tyco Details Lavish Lives of Executives," *New York Times,* September 18, 2002, pp. C1, C6.

[247] "Helping Fatcats Dodge the Taxman," *BusinessWeek Online,* June 20, 2002. http://www.businessweek.com.

[248] Andrew Ross Sorkin and Jonathan D. Glater, "Some Tyco Board Members Knew of Pay Packages, Records Show," *New York Times,* September 23, 2002, p. A1. Mr. Belnick was fired before he was indicted on felony charges. Laurie P. Cohen, "Tyco Ex-Counsel Claims Auditors Knew of Loans," *Wall Street Journal,* October 22, 2002, p. A6.

minutes from that February compensation committee meeting.[249] Mr. Berman denies the allegation. However, Ms. Prue did send a memo on June 7, 2002, to John Fort, Mr. Swartz, and the board's governance committee with the following included: "As a result of the fact that I was recently pressured by Josh Berman to engage in conduct which I regarded as dishonest—and which I have refused to do—I will decline to have any personal contact with him in the future. In addition, I ask that Josh not go to my staff with any requests for information or directions."[250]

Mr. Kozlowski paid $56 million in bonuses to executives eligible for the KELP program, then gave them $39 million to pay the taxes on the bonuses, and then forgave the KELP loans given to pay taxes on the shares awarded in addition to the bonuses. A report commissioned by the Tyco board following the Kozlowski departure refers to the Tyco culture as one of greed and deception designed to ensure personal enrichment.[251]

The relocation loan program was a source of $46 million for Mr. Kozlowski, and SEC documents allege that he "used at least $28 million of those relocation loans to purchase, among other things, luxury properties in New Hampshire, Nantucket, and Connecticut as well as a $7 million Park Avenue apartment for his then (now former) wife."[252]

Mr. Kozlowski's officer team was small and obedient.[253] Tyco had only 400 employees at its central offices and Kozlowski only interacted with a few, a means of keeping information close to the vest.[254] Mark Swartz, Tyco's former CFO, was forty years old at the time of Tyco's fall and his indictment on thirty-eight counts of grand larceny, conspiracy, and falsifying business records.[255] Tyco hired him in 1991, away from Deloitte & Touche's due diligence team. By 1993, he was head of Tyco's acquisitions team, and by 1995, he was Tyco's CFO, at age thirty-three. Mr. Kozlowski nominated Mr. Swartz for a CFO award that year, and *CFO Magazine* honored Mr. Swartz with its 2000 Excellence Award.[256] Indeed, Mr. Kozlowski and Mr. Swartz were inextricably intertwined, with Mr. Swartz even serving as trustee for one of Mr. Kozlowski's trusts for holding title to real property.[257] Both men also used a loophole in securities law to sell millions of shares of Tyco stock even as they declared publicly that they were not selling their shares in the company.[258]

Tyco's Fall

Mr. Kozlowski and Mr. Swartz were indicted under New York State laws for stealing $170 million from the company and for profiting $430 million by selling off their shares while withholding information from the public about the true financial condition of Tyco.[259] The charges against the two were based on a state law that prohibits a criminal

[249] *Id.*, p. A22.

[250] *Id.*, p. A22. Both sides acknowledge the authenticity of the memo from Ms. Prue.

[251] Andrew Ross Sorkin, "Tyco Details Lavish Lives of Executives," *New York Times*, September 18, 2002, p. C1. These bonuses are from the year 2000. Kevin McCoy, "Tyco Spent Millions on Exec Perks, Records Say," *USA Today*, September 17, 2002, p. 1B.

[252] *Id.;* and Cohen, "Ex-Tyco CEO's Ex to Post $10 Million for His Bail Bond," p. A5.

[253] Alex Berenson, "Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System," *New York Times,* June 10, 2002, p. B1.

[254] Anthony Bianco, William Symonds, Nanette Byrnes, and David Polek, "The Rise and Fall of Dennis Kozlowski," *BusinessWeek Online,* December 23, 2002, http://www.businessweek.com.

[255] Nicholas Varchaver, "Fall from Grace," *Fortune,* October 28, 2002, 112, 114; and Andrew Ross Sorkin, "2 Top Tyco Executives Charged with $600 Million Fraud Scheme," *New York Times*, September 13, 2002, pp. A1, C3.

[256] *Id.*

[257] Alex Berenson, "From Dream Team at Tyco to a Refrain of Dennis Who?" *New York Times,* June 6, 2002, p. C1.

[258] *Id.*, pp. C1, C5.

[259] Andrew Ross Sorkin, "Ex-Tyco Chief, Free Spender, Going to Court," *New York Times*, September 29, 2003, pp. A1, A15.

enterprise, a type of crime generally associated with organized crime. Their joint trial began in October 2003 and ran until April 2004, when the case ended in a bizarre mistrial. When the jury began deliberations, one juror, Ruth Jordan, was labeled by some of her fellow jurors as a holdout who refused to deliberate the case. Some courtroom observers felt that Ms. Jordan had flashed an "OK" hand signal to the defendants and their counsel.[260] The judge urged the jurors to continue deliberating despite obvious rancor. Ms. Jordan came to be labeled "holdout granny" and "batty blueblood" in the media.[261] However, several media outlets published her name (one with a photo), and when she reported to the judge that she had received a threat, the judge declared a mistrial.[262] The thrust of the defense was that everything Mr. Kozlowski and Mr. Swartz did was in the open, with board approval, and therefore did not fit the requirements for a criminal enterprise.[263]

Mr. Belnick was also indicted and tried, and was acquitted of all charges.[264]

Mr. Kozlowski and Mr. Swartz were retried and convicted on the charges of embezzlement and fraud. The two were convicted on twenty-two of the twenty-three counts of larceny in their indictments. The total amount the prosecution proved was looted from the company was $150 million.

Mr. Kozlowski took the stand to testify, and the jurors indicated that he was simply not a credible witness. When asked why he did not report $25 million in income, he responded that he just wasn't thinking when he signed his tax return. Jurors found an oversight of $25 million difficult to believe.

One portion of the case focused on the use of Tyco funds to buy and redecorate Mr. Kozlowski's New York City apartment (at a cost of $18 million). He acknowledged that he did not oversee it as he should have and that some of the decorations purchased were expensive and "godawful." He told jurors that he later stuffed many of the items "into a closet."[265]

Mr. Kozlowski paid $21.2 million to settle charges related to sales tax evasion on his purchases and sales of his personal art collection. Mr. Kozlowski also settled federal income tax evasion charges. Mr. Swartz's trial for tax evasion was postponed in April 2010. The evasion charges related to the underreporting of the income gleaned from the larceny for which they were convicted.

Kozlowski and Swartz were both sentenced on the larceny convictions to between 8 1/3 and twenty-five years in New York State prison. Mr. Kozlowski was also ordered to pay $167 million in restitution and fines. Mr. Swartz was ordered to pay $72 million in fines and restitution. Both were handcuffed and immediately remanded to state prison following their sentences being imposed. The judge did not grant their motion to remain free while their appeals were pending.[266] The two men have exhausted their appeals and continue to serve their prison sentences in New York.

Tyco agreed to pay $3 billion to settle class action suits brought by its shareholders for fraud committed by Kozlowski and Swartz, the fourth largest shareholder settlement

---

[260] David Carr and Adam Liptak, "In Tyco Trial, an Apparent Gesture Has Many Meanings," *New York Times*, March 29, 2004, pp. C1, C6.

[261] *Id.*

[262] Andrew Ross Sorkin, "Judge Ends Trial When Tyco Juror Reports Threat," *New York Times*, April 3, 2004, pp. A1, B4; and "Mistrials and Tribulations," *Fortune*, April 19, 2004, 42.

[263] Jonathan D. Glater, "Tyco Case Shows Difficulty of Deciding Criminal Intent," *New York Times*, April 8, 2004, pp. C1, C4.

[264] "Ex-Tyco Official Says Actions Were Proper," *New York Times*, June 26, 2004, p. B14.

[265] Andrew Ross Sorkin, "Ex-Chief and Aide Guilty of Looting Millions at Tyco," *New York Times*, June 18, 2005, pp. A1, B4.

[266] Andrew Ross Sorkin, "Ex-Tyco Officers Get 8 to 25 Years," *New York Times*, September 20, 2005, pp. A1, C8; Kevin McCoy, "Ex-Tyco Chiefs Whisked Off to Prison," *USA Today*, September 20, 2005, p. 1B; and Mark Maremont, "Tyco Ex-Officials Get Jail Terms, Big Fines," *Wall Street Journal*, September 20, 2005, pp. C1, C4.

of the Enron era.[267] Tyco's share price dropped from $240 per share in 2002 to less than $25 by 2003. Since 2007, the share price has remained at below $50.

Discussion Questions

1. Recall your readings from Unit 2 on the relationship between ethics and economics. How did Tyco's initial problems establish this connection as a very real one for the U.S. markets? What made Tyco's stock price fall initially? Evaluate this comment from a market observer: "When a CEO steps down for (alleged) tax evasion, it sends the message that all of Corporate America is crooked."[268] "It makes you think, 'Why did he do it? Is there another shoe to drop?'"[269]
2. Warren Rudman, former U.S. senator and a member of the board at Raytheon, who knew and worked with Mark Belnick, was astonished at Mr. Belnick's indictment when it was issued. Mr. Rudman said, when told of Mr. Belnick's fall from grace: "I don't understand. Ethical, straight, cross the t's, dot the i's—that's my experience with Mark Belnick."[270] Mr. Belnick was acquitted of all charges after a jury trial in the summer of 2004. Does his acquittal mean that he acted ethically? What ethical breaches can you find in his behavior at Tyco? What provisions in a credo might have helped Mr. Belnick see the issues more clearly?
3. What do you think of the ethics of Ms. Prue?
4. How do you think the spending and the loans were able to go on for so long?
5. What questions could Mr. Kozlowski and Mr. Swartz have asked themselves to better evaluate their conduct?
6. Evaluate the e-mails from Wilmer Cutler to general counsel and others in the company. Why were these warnings signs unheeded?
7. Make a list of the lines Mr. Kozlowski crossed in his tenure as CEO. Can any of those items help you in developing your credo? Mr. Kozlowski said, when he was named CEO of the Year by *BusinessWeek,*

   > Most of us made it to the chief executive position because of a particularly high degree [of] responsibility. . . . We are offended most by the perception that we would waste the resources of a company that is a major part of our life and livelihood, and that we would be happy with directors who would permit waste. . . . So as a CEO I want a strong, competent board.[271]

   What was he not seeing in his conduct? Had he grown complacent? Is it difficult for us to see ethical breaches that we commit?

Case 4.14

Bausch & Lomb and Krispy Kreme: Channel Stuffing and Cannibalism

The Hong Kong division of Bausch & Lomb enjoyed double-digit growth during the 1980s and 1990s. In some years, earnings increased 25 percent; by 1993, the Hong Kong operation had total revenues of $100 million. Earnings on contact lenses sales seemed to be absolutely unbeatable, with sales increasing at a double-digit pace.

It was in 1994 that Bausch & Lomb's twelve continuous years of double-digit growth in both sales and earnings (excluding one-time events) came to a halt with a company announcement that excessive distributor inventories would result in a significant reduction in 1994 earnings. The final result was a decline of 54 percent in earnings to

[267] Floyd Norris, "Tyco to Pay $3 Billion in Settlement," *New York Times,* May 16, 2007, pp. C1, C14.

[268] *Id.*

[269] Adam Shell, "Markets Fall as Tyco CEO's Resignation Adds to Woes," *USA Today,* June 4, 2002, p. 1B.

[270] Glater, "A Star Lawyer Finds Himself the Target of a Peer," pp. C1, C8.

[271] "Match Game," *Fortune,* November 18, 2002, p. 34.