

it the case, as many of their critics contend, that they have conspired for more than 16 years to both deny and cover up any knowledge of the short- and long-term effects of wearing the Shield?

2. Even if Robins is not guilty of conspiring to misinform its customers, why didn't simple prudence lead the company to go public immediately when "single physician experience" and the results of their own and outside testing procedures indicated from the beginning that there were serious drawbacks, limitations, and dangers inherent in the product? Moreover, after suspending production in 1974 because of FDA findings, why did Robins wait until 1984 to recommend that all women still wearing the Shield have it removed?

3. Is the 1978 Federal Bankruptcy code a proper and valid means of seeking relief from immediate and possible future liability?

• *Case Study* •

## Dorrence Corporation Trade-offs\*

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Arthur Cunningham, Chief Executive Officer of the Dorrence Corporation, was reflecting on the presentations by the various divisions of the company of their operating plans and financial budgets for the next three years, which he had heard during the past several days. A number of critical decisions would have to be made at tomorrow's meeting of the nine senior executives who formed Dorrence's Corporate Operating Committee. Although Dorrence's tradition was one of consensus management, Cunningham knew that he was expected to exercise leadership and would have the final word, as well as the ultimate responsibility for the subsequent performance of the company.

Dorrence, a large U.S.-based pharmaceutical company with sales and operations throughout the world, had achieved an outstanding long-term record of growth in sales and profits. The company had not incurred a loss in any year since 1957 and profits had increased over the prior year in 28 out of the past 32 years. During the past 10 years, sales had grown at an average compound rate of 12% per year and profits had increased at a 15% average annual rate. Dorrence's profit as a percent of sales was considerably higher than that of the average U.S. industrial concern.

This growth had produced a huge increase in the value of Dorrence's stock. There are approximately 30,000 Dorrence shareholders, but as with many large American corporations, about 65% of Dorrence shares are held by a relatively small number of pension funds, mutual funds, university endowments and insurance companies. Dorrence grants stock options to its executives and permits employees in the U.S. and several other countries to purchase

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Dorrence stock through the company's savings plan. Dorrence executives own about 2% of the company's shares and all other employees about 1%. Thus, directly and indirectly, Dorrence is owned by millions of people who are affected to some degree by the market place of Dorrence shares.

Dorrence's fine record of growth had also brought benefits to the company's customers, employees and the communities in which the company had operations. Dorrence had steadily expanded its research expenditures at a greater rate than its sales growth and had developed important new products that extended life and improved the quality of life for millions of people. Because of its profitability, Dorrence was able to pay higher than average salaries to its employees, pay sizeable incentive awards to middle and upper management and bonuses to all employees based on the success of the company. Dorrence's growth also had provided unusual opportunities for career growth to many of its people. The company prided itself on being a good citizen in the communities in which its laboratories and factories were located. It contributed to local charities and encouraged its employees to work constructively in community organizations.

Cunningham felt that 1989 was however, a very disappointing year. The company fell short of the goals management had established at the start of the year.

Growth in sales and profits was far below the rate of recent years and below the levels achieved by several of Dorrence's peers in the pharmaceutical industry. Management incentive awards and employee bonuses were, therefore, about 5% smaller than those distributed for 1988. The value of Dorrence stock was about 20% below its high point.

Consequently, Cunningham considered it important that Dorrence achieve at least a 13% profit growth in 1990, and higher rates in the two years beyond that. He recognized that such a goal would not be easy to reach. It would not only require the best efforts of the entire organization, but also force some tough decisions.

The 1990 budgets proposed by the divisions added up to a growth rate of only 8% in profit-after-taxes, five percentage points below what Cunningham considered a minimum acceptable level. As a rough rule of thumb he calculated that each percentage point increase in the profit growth rate required about \$8 million additional profit-before-taxes. Thus, each percentage point improvement could be achieved in a number of ways: \$13 million additional sales volume accompanied by normal incremental costs, or \$8 million additional revenue from price increases, or \$8 million reduction in expenditures. During the course of the three days of presentations he had identified several possibilities for such improvements about which decisions would have to be made. In his notes he had summarized them as follows.

*1. Size of the research budget:* Dorrence's total expenditures for research and development had climbed annually, not only in absolute dollars but also as a percent of sales. During the current year they totaled about 17% of sales, one of the higher levels in the pharmaceutical industry. The proposed budget included a further increase and Cunningham knew that many promising projects required additional funding if the company were to demonstrate the safety and efficacy of important new drugs in a timely manner.

Cunningham was keenly aware that pharmaceutical research and development was a very risky activity. The failure rate was high. Many years of effort

were required before the success or failure of a new product could be known. Typically, it took seven to ten years from the identification of a potential new drug to receiving the approval to market it from the Food and Drug Administration and its sister bodies in other countries. On average, a pharmaceutical company brought to successful conclusion only one new drug development program for each \$100 million of R&D expenditures.

Clearly, there was a trade-off between investing for future growth and achieving acceptable profits in the short run. On Cunningham's list of possible changes in the proposed 1990 budget was a \$10 million reduction in the amount of money requested for R&D.

**2. Export sales:** The International Division had presented an opportunity for a \$4 million sale to the Philippine government which was not included in the 1990 budget because of lack of product availability. It was for Savolene, a new Dorrence injectable drug for the treatment of serious viral infections, including measles. The drug was difficult and expensive to manufacture and had been in very short supply since its introduction.

A large lot, costing about \$1 million, had been rejected for the U.S. market on the basis of a very sensitive new test for endotoxins recently required by the U.S. Food & Drug Administration in addition to another test that had been the FDA standard for many years. The new test had shown a very low level of endotoxins on this batch of Savolene, even though no endotoxins has been revealed by the older test.

Cunningham had asked whether this ruled out shipping the batch to the Philippines. The company's chief medical safety officer had answered, "Officially the Philippines and a lot of other countries still rely only on the old test. It always takes them a while to follow U.S. practice, and sometimes they never do. Endotoxins might cause a high fever when injected into patients, but I can't tell you that the level in this batch is high enough to cause trouble. But how can we have a double standard, one for the U.S. and one for Third World countries?"

However, when Cunningham asked Dorrence's export vice president the same question, she said, "It's not our job to over-protect other countries. The health authorities in the Philippines know what they're doing. Our FDA always takes an extreme position. Measles is a serious illness. Last year in the Philippines half the kids who had measles died. It's not only good business but also good ethics to send them the only batch of Savolene we have available."

**3. Capital investments:** Among the capital investments that had been included in the proposed budgets was a \$200 million plant automation program for Dorrence's Haitian chemical plant. The purpose of the investment was to permit a dramatic reduction in the cost of Libam, Dorrence's principal product whose U.S. patent would expire in a couple of years. Patent protection had already ended in most other countries and chemical manufacturers in Italy, Hungary, and India were selling Libam's active ingredient at very low prices. Once there was no longer patent protection in the U.S. these companies, and others, could capture a large share of Dorrence's existing sales unless Dorrence could match their low prices. Automating the Haitian plant was essential to achieving such lower cost. Successful implementation of the new technology would enable the plant to achieve the required output with far fewer

people than currently employed at the plant. What to do about these surplus workers presented a difficult problem for which no solution had yet been worked out.

Dorrence was currently earning about 9% interest on its surplus funds. The proposed automation project would use up \$200 million of those funds and thus reduce the interest income earned by the company. The 1990 impact of such a reduction was about \$9 million. If the automation program were stretched out over a longer period, almost half of that interest income reduction would be postponed a year, thus adding \$4 million to 1990 profits. The risk was that the automated plant would not be in operation in time to meet the expected competition.

**4. Employee health insurance costs:** Like all U.S. companies Dorrence was experiencing rapid escalation in the cost of its employee health insurance program. Dorrence paid 100% of the premium for its employees and 80% of the premiums for their dependents. After meeting certain deductibles, employees are reimbursed 80% to 90% of their medical and dental costs. The company's cost of maintaining the plan was budgeted to increase 22%, or \$12 million in 1990. An important issue, therefore, was whether the plan should be changed to shift all or a portion of that cost increase to the employees through reducing the share of the premiums paid by the company, or increasing the deductibles, or reducing the percent reimbursement, or some combination of those changes.

**5. Closing Dorrence's plant in Argentina:** Dorrence had purchased a small pharmaceutical company in Argentina in the early 1950s when prospects for growth in the local market seemed excellent. However, in most years since then Argentina has been plagued by hyper-inflation. With rapidly rising wage rates and other local costs on the one hand, and strictly controlled selling prices for pharmaceuticals on the other hand, Dorrence's Argentine subsidiary had consistently lost money. The 1990 budget projected a loss of \$4 million.

For the past year Dorrence had tried to find a buyer for its Argentine subsidiary who would utilize the existing Dorrence 120-person sales force and continue to operate Dorrence's Buenos Aires factory with its 250 employees. No such buyer had been found, but recently a local company had offered to purchase the rights to Dorrence's product line. It would manufacture them in its underutilized plant and distribute them through its own sales force. If Dorrence accepted this offer, the 370 Dorrence employees in Argentina would be laid off. Dorrence had already created a financial reserve for the government-mandated severance payments. Thus if Dorrence decided to end its operations in Argentina, corporate profits would improve by \$4 million in 1990.

**6. Price increase on principal product sold in the U.S.:** The budget proposed by Dorrence's U.S. pharmaceutical division already assumed a 5% price increase on all its current products at the end of the first quarter of the year, producing a \$40 million increase in sales revenues. A substantially higher price increase on Libam, its largest selling product, could probably be implemented without adversely affecting sales volume. For example, if the budgeted price increase were 10% instead of 5%, an additional \$12 million would be generat-

ed. Alternatively, if two 5% price increases were implemented six months apart, Dorrence would earn \$4 million above the proposed budget. Libam is used by chronically ill patients, many of them elderly.

In most countries pharmaceutical prices are controlled by the government. The United States is one of the few countries in which pharmaceutical companies are free to decide what prices to charge for their drugs. Physicians generally prescribe the drug which they feel will be most beneficial to their patients regardless of price. Unless the patent on a drug has expired and a generic equivalent is available, the demand for a prescription drug is not very sensitive to its price. Consequently, drug prices in the United States are substantially higher than in most other countries.

Cunningham was, however, very conscious of the growing public concern about health care costs. Although drugs constitute only a small fraction of the nation's total health care bill, drug prices are an easily identified target and drug companies were becoming increasingly under attack for their price increases.

**7. New Costa Rican manufacturing plant:** \$10 million in sales of a new lifesaving drug developed by Dorrence had been removed from the budget because of an unexpected problem at the new plant that had been constructed to produce the product.

Three years earlier Dorrence had chosen a small town in Costa Rica after evaluating various possible sites for the plant. The town had won the competition for the new plant because of the availability of inexpensive land, relatively low wages, certain tax concessions, and a promise by the local government to build a new municipal waste treatment facility by the time the plant would be completed. In addition Dorrence felt it would be fulfilling its social responsibilities by providing jobs in an area of high unemployment.

A few days before Dorrence's budget meeting the company had learned that the completion of the municipal waste treatment plant was delayed at least a year. Although Costa Rica's environmental regulations are less stringent than those of industrialized countries, local law does prohibit the discharge of untreated factory waste water into streams. Without a means of disposing of its waste water, the Dorrence plant could not operate.

A message from the Dorrence plant manager received yesterday seemed to solve the problem. The city sanitation commissioner had given Dorrence a special exemption which would allow it to discharge its waste water into a stream behind the plant until the city's waste treatment facility was completed. Cunningham had immediately asked for a fuller report on the situation. The plant manager had sent the following additional details:

The stream is used to irrigate sugar cane fields and small vegetable plots on which people in this area depend. There is, therefore, a chance that substances in the waste water would be absorbed by the crops that people are going to eat. I wonder if that is acceptable. On the other hand, I fear that all the good we have accomplished here will go down the drain if we don't begin manufacturing operations. Construction of the plant was completed on schedule three months ago. Building our own waste treatment facility now would add \$5 million to the cost of the plant and would take at least 12 months. I've already hired over 100 workers and have given them extensive training. We obviously can't pay the workers for a year to sit around in an idle plant. Losing their jobs would be devastating to them and the

whole community. Besides, there is no other Dorrence facility or plant of another company which could accomplish the synthesis required for this new product. Lots of people in the United States are anxiously waiting for this new drug.

**8. Pricing of an important new product:** Finally, there was the issue of what price to charge for another new Dorrence drug, *Miracule*, which was expected to be introduced late in the year. In most cases patients for whom *Miracule* was prescribed would require the drug for the rest of their lives, unless an even more effective drug became available. The budget had assumed a price which would result in a daily cost of \$1.75 (including wholesaler and drug store markups) for the average patient. A price of \$2.50 would yield an additional \$8 million profit to Dorrence during 1990 and far greater sums in subsequent years.

Despite the difficulties surrounding each of the issues Cunningham had identified, he felt it was critical that the 1990 budget be improved to call for 13% profit growth over 1989. He believed that a second year in a row of below average profit growth would be viewed very negatively by the investment community, be demoralizing to the company's management, and could result in a substantial drop in the value of the company's stock as investors switched to pharmaceutical companies with better 1990 results. He also recognized that large institutional investors, such as pension funds, were taking a more active role in demanding better performance from the managements of the companies in which they invested the funds entrusted to them.

### Questions for discussion

1. What should Cunningham do to obtain his 13 percent goal? Cut costs? Raise prices?
2. What responsibilities does Cunningham have to the investors? The employees? The customers? The suppliers? The company itself?
3. Do the stockholders' interests take priority over those of everybody else involved?