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CONTENTS

EDITORIAL BOARD MEMBERS iii

LETTER FROM THE EDITORS ix

THE MILTON HEALTH AND
REHABILITATION CENTER 1
Robert C. Schwab, Andrews University

INNOVATION IN EMPLOYER HEALTH COVERAGE:
THE CONSUMER DRIVEN HEALTH PLAN (CDHP)
AT LOGAN ALUMINUM 7
Robert D. Hatfield, Western Kentucky University

IS THIS A BONA FIDE OCCUPATIONAL
QUALIFICATION? 19
Neal F. Thomson, Columbus State University

VALUATION OF A DREAM:
RIVERSIDE COUNTRY CLUB FOR SALE 25
Benjamin L. Dow III, Southeast Missouri State University
David Kunz, Southeast Missouri State University

FREEZING DAD:
TAXING POTENTIAL HUMAN CAPITAL 37
Valrie Chambers, Texas A & M University-Corpus Christi
Barry Armandi, SUNY-Old Westbury

SHOE WAREHOUSE CASE: APPLICATION OF STRATEGIC INFORMATION PRINCIPLES 43
Renae K. Clark, Henderson State University
Henry Torres, Arkansas State University
Kenneth W. Green, Jr., Henderson State University
Paul J. "Jep" Robertson, Henderson State University

THE PROPOSED MERGER OF AMERICA WEST AND US AIRWAYS: WILL IT FLY? 45
Richard Cobb, Jacksonville State University
Carl W. Gooding, Jacksonville State University
Jeffrey A. Parker, Jacksonville State University

DID NAPOLEON WIN THE BATTLE OF WATERLOO? 57
Martine Duchatelet, Barry University

DISASTER RECOVERY FOLLOWING THE EVENTS OF SEPTEMBER 11, 2001 63
Jonathan Duchac, Wake Forest University
Cara Castellino, Merrill Lynch

INSHALLAH: AN EXPATIRATE CHALLENGE 73
Phillip L. Hunsaker, University of San Diego

TRANSFORMATION AT BTR 79
Gerry Kerr, University of Windsor

CALL FROM PEERLESS BANK: A CASE CONSIDERATION OF TELEMARKETING AND ETHICS 103
Gerald D. Klein, Rider University
Cynthia M. Newman, Rider University

RECRUITING AT ORGSERVICES CORPORATION 121
Woody D. Richardson, Ball State University
Brien N. Smith, Ball State University

LETTER FROM THE EDITORS

Welcome to the *Journal of the International Academy for Case Studies.* The International Academy for Case Studies is an affiliate of the Allied Academies, Inc., a non profit association of scholars whose purpose is to encourage and support the advancement and exchange of knowledge, understanding and teaching throughout the world. The purpose of the IACS is to encourage the development and use of cases and the case method of teaching throughout higher education. The *JIACS* is a principal vehicle for achieving the objectives of both organizations. The editorial mission of this journal is to publish cases in a wide variety of disciplines which are of educational, pedagogic, and practical value to educators.

The cases contained in this volume have been double blind refereed, and each was required to have a complete teaching note before consideration. The acceptance rate for manuscripts in this issue, 25%, conforms to our editorial policies. The Instructor's Note for each case in this volume will be published in a separate issue of the *JIACS.*

If any reader is interested in obtaining a case, an instructor's note, permission to publish, or any other information about a case, the reader must correspond directly with the author(s) of the case.

The Academy intends to foster a supportive, mentoring effort on the part of the referees which will result in encouraging and supporting writers. We welcome different viewpoints because in differences we find learning; in differences we develop understanding; in differences we gain knowledge and in differences we develop the discipline into a more comprehensive, less esoteric, and dynamic metier.

The Editorial Policy, background and history of the organization, and calls for conferences are published on our web site. In addition, we keep the web site updated with the latest activities of the organization. Please visit our site and know that we welcome hearing from you at any time.

Inge Nickerson, Barry University
Charles Rarick, Barry University

CASES

THE MILTON HEALTH AND REHABILITATION CENTER

Robert C. Schwab, Andrews University

CASE DESCRIPTION

This short case focuses on the problems of mixing religious values with a secular work environment. Fairness issues dealing with freedom of expression and prayer in the workplace, religious intimidation, discrimination and harassment are raised. The case has a difficulty level of four, and is best-suited for use in junior, senior, or graduate-level courses in human resource management or organizational behavior. This case can be presented and discussed in about one and a half hours, and is expected to require two to three hours of outside preparation by students.

CASE SYNOPSIS

This case is set in a private mid-western rehabilitation center. The new owner has implemented an operating philosophy based on Biblical principles, and the born-again assistant administrator now begins all staff meetings with prayer. The situation is exacerbated when the assistant administrator persists in inviting staff to attend evangelistic meetings at his church. A few workers are concerned about this new imposition of religion in the workplace, and become more alarmed when they discover that the highest raises have been given to workers who attended some of the evangelistic meetings and who regularly volunteer to pray at the staff meetings. After an employee quits and files a complaint with the Michigan Department of Civil Rights, an investigation discovers that a couple of workers have felt somewhat annoyed, while the majority at the center feel the working environment has never been better. Are the new owner's religious values appropriately expressed and displayed at work, or has the work environment become one of religious discrimination, harassment and intimidation?

THE MILTON HEALTH & REHABILITATION CENTER

The Milton Health and Rehabilitation Center is the largest private nursing home in Milton, Michigan. The owner and founder of the center recently sold the business and moved to Chicago. The new owner, Sid Southington, was a conservative man who believed he should follow Christian values in the operation of his new business.

At their first staff meeting, Mr. Southington announced that he intended to retain all the current staff, but the operating philosophy of the rehabilitation center would now be guided by

Bible-based values. The Golden Rule was to be the major guiding principle when dealing with patients, staff, visitors, suppliers, insurers and even governmental agencies. Honesty, integrity and respect for others was to be the norm, and a conservative Christian image was to be projected by all supervisors and staff. Swearing, smoking, drunkenness, and rude behavior would not be tolerated on the premises. The nods of approval Mr. Southington saw in the audience implied that the workers thought his expectations were reasonable, and the fact that no one quit in the following weeks seemed to confirm this. Most workers at the rehabilitation center were already religious and held conservative values so their level of comfort with the new operating philosophy was assumed to be high.

One person who was particularly impressed by the new philosophy was Bill Bush, an assistant administrator at the center and a "born-again" Christian. He had been hired just four months earlier by the previous owner, but was already known for his sincere concern for the staff and patients at the center. If he learned that someone had a personal problem or illness, he would often reassure them by saying that "...the Good Shepherd will take care of you," and "...I'll keep you in my prayers." He also frequently ended his conversations with the staff by saying "...May the Lord bless you in your work today." Now that the new owner wanted a Christian philosophy to permeate the center, Mr. Bush felt it was important to introduce some changes.

A few of the changes were immediately obvious. All meetings called by Mr. Bush now began with a simple prayer. Sometimes he would just offer a prayer himself, and on other occasions would ask if there were any volunteers who would "...pray for us as we begin this meeting." While most employees did not seem to mind and several willingly volunteered prayer, there were a few who seemed to be uncomfortable with the idea of praying at work.

One worker who seemed particularly troubled by the new changes was Sarah Roberts. Sarah had been employed for almost one year before the change in ownership. She was young, attractive, outgoing, and tended to dress in trendy, somewhat revealing garb. She liked to socialize and often talked with her co-workers about the parties she attended and all the people she dated, etc. She had a boyfriend who frequently visited while she was working at the center, and the rumors were that he had recently moved in with her at her apartment.

Since Sarah worked as a receptionist, she was usually the first person visitors saw when they entered the premises. Mr. Bush was concerned about the image that Sarah was projecting to the public, and he tried to explain to her that tight clothes and flashy jewelry did not project the image he and Mr. Southington wanted the public to see. He suggested that she wear more modest attire to work in the future and asked that her boyfriend not visit during working hours.

A few days later Mr. Bush stopped by Sylvia Smith's desk to sympathize with her about her daughter's poor lifestyle choices. He had learned that Sylvia was distraught about her daughter, and they had a good conversation about the evils of excessive drinking, immoral relationships, the virtues of the Christian lifestyle, and the power of God to change people's lives. Sylvia seemed quite pleased by Mr. Bush's concern and prayer for her daughter at the end of their conversation, but the entire conversation and prayer was overheard by Sarah, whose desk was located just a few feet away. Sarah wondered whether Mr. Bush had deliberately talked loudly so she could hear what was being discussed. Was he trying to give her some advice indirectly? Did he know that she sometimes drank on the weekends and had a live-in boyfriend? She felt it was none of Mr. Bush's business what she or anyone else did in their personal time outside the workplace, and she resented the idea that he might be trying to drop her a hint. After getting the reprimand a few days ago and now overhearing the conversation with Sylvia, Sarah felt even more resentful toward Mr. Bush and anything that smacked vaguely of conservative values and Christians.

A few weeks later, Mr. Bush began to invite the staff to attend his church where a series of meetings was being held by a tele-evangelist of some renown. He said, "If you're interested, come to the meeting tonight and get a real blessing from the Lord." All the workers politely turned him down but he didn't seem to mind. On subsequent days, Mr. Bush would tell whoever would listen what a blessing the previous-night's meetings had been. Again he urged his staff to try to come at least one night a week so that they too, could ... *"*see the light*"* and "...find the love of Christ that can transform your life." Some of Mr. Bush's co-workers actually did go to some of the meetings, but many were not interested and a few began to feel intimidated. Sarah thought, "How many times do we have to turn him down before he gets the hint that we don't want to hear about his church or his religion."

Sarah was quite upset about all this religious talk at work and complained to the owner, Mr. Southington, about Mr. Bush and his religious pressure. Mr. Southington listened politely to Sarah, and then stated that Mr. Bush was a sincere Christian who just couldn't contain himself. "He just wants to help others find the joy of serving Christ as their Saviour." Mr. Southington tried to reassure Sarah that it was ok to refuse Mr. Bush's offers to go to the meetings or to offer prayer if she didn't want to participate. "Just tell him ...'no thanks,' and that should take care of it," Mr Southington said.

When Sarah's received her annual performance appraisal, the evaluation was mixed. Mr. Bush made a few positive comments, but he also made several specific suggestions as to how she could improve her work performance, and he continued to express concern about her appearance on the job. Since these evaluations were linked to the annual pay raises given to the workers, Sarah was disturbed when she received only a modest increase, while other workers had received more. She noticed that the biggest raises seemed to be given to the workers who were most willing to offer an opening prayer, or to those who had attended some of the religious meetings at Mr. Bush's church.

At the staff meeting on the following week, Mr. Bush announced that a new RN, Joan DeMarco, had been hired to be the evening nursing supervisor for the north wing of the facility. Sarah was the receptionist at the center and knew that several people had interviewed for the position. One applicant had been an old high-school friend with previous nursing experience. What bothered her was that Ms. DeMarco was a member of Mr. Bush's church! To Sarah, this looked like just one more example of Mr. Bush's religious favoritism.

Sarah was really upset now and felt she had been unfairly judged by Mr. Bush because of her religion (or lack of it). She complained a second time to the owner, Mr. Southington. After listening to Sarah's concerns about religious discrimination at the center, Mr. Southington defended Mr. Bush as a person with high integrity who would never allow religion to bias his assessments, but he offered to personally review Mr. Bush's evaluations to double-check their accuracy. About a week later, Mr. Southington sent Sarah an e-mail message confirming that he had personally reviewed the performance appraisals done by Mr. Bush and had not found any evidence of unfair bias or discrimination against her. He also revealed to Sarah that he had reviewed the application materials and selection criteria that had been used by Mr. Bush to fill the RN position, and he agreed that Ms. DeMarco was the best choice from all the applicants. In other words, Mr. Southington claimed he had not found any religious bias in Mr. Bush's actions.

A few weeks later, Sarah resigned her position and filed a religious discrimination complaint with the Michigan Department of Civil Rights. She claimed that she had no choice but to resign her position because she could not acquiesce to the religious demands of Mr. Bush. His constant pressuring about prayer, changing her life and attending church was giving her a nervous breakdown and was an unfair imposition of religion on her private life. She claimed constructive discharge and sought financial compensation for her trauma.

When the Michigan Department of Civil Rights began to investigate, they talked with a number of employees at the center. Most of the workers they spoke to described Mr. Bush as a sincere and kind man who made no apologies for his belief in God and his concern for the well-being of his patients and co-workers. They noted that he prayed regularly with many of the patients and staff, but that he never imposed his religion on anyone. These workers felt that words of comfort and assurances that "God cares about you" improved the quality of life for both the patients and the staff, and they saw Mr. Bush as a good role-model to emulate as they did their work at the center. These employees did not feel offended, harassed or intimidated by either Mr. Bush, Mr. Southington, or the policies and practices of the rehabilitation center.

Two employees (who wished to remain anonymous) said that Mr. Bush was a good man, but his persistent invitations for church meetings, prayer requests, and offers to pray for THEM was a bit annoying. As one said, "Mr. Bush needs to respect our right to refuse. If I say NO, I'm really not interested in going to your church or hearing about what God has done for you today; why does he bother me again about the same thing a few days later? Why doesn't he leave me alone after I've said ...No thanks, I don't want to talk about religious things today?" Neither of these employees felt Mr. Bush had been unfair in the evaluation process, and both felt prayer and religious discussions with the patients was appropriate because it comforted them; they just wished Mr. Bush would stop trying to impose his religious views on them. These workers were Christians but their theological views were quite different from those espoused by the church Mr. Bush attended.

DISCUSSION QUESTIONS

1. Is it acceptable or inappropriate for Mr. Southington to impose his conservative values and religion-based business philosophy on the operations of the Milton Health and Rehabilitation Center?

2. Is Mr. Bush's conduct acceptable or inappropriate in this work setting? Has he created a climate of religious intimidation and harassment at the center? Explain.

3. What do you think the Michigan Department of Civil Rights will conclude? Is Sarah Roberts entitled to any damages or relief? Defend your position.

4. What specific advice would you give to Mr. Southington if he wishes to avoid or minimize future claims of religious discrimination or harassment at the Milton Center?

INNOVATION IN EMPLOYER HEALTH COVERAGE: THE CONSUMER DRIVEN HEALTH PLAN (CDHP) AT LOGAN ALUMINUM

Robert D. Hatfield, Western Kentucky University

CASE DESCRIPTION

The primary subject matter of this case concerns a particular emerging innovation in employee health care coverage called Consumer Driven Health Plans (CDHP). Secondary issues examined include issues related to healthcare costs increases in the U.S. and other developed nations. The reactions to these healthcare costs increases are categorized, defined, and illustrated. It becomes clear from the case that they may be no easy answer to rising healthcare costs. Further, issues related to employee involvement and the strategic fit between CDHP and involved employees is explored.

The case has a difficulty level of three, appropriate for junior level or above. The case is designed to be taught in one class hour after at least one hour has been spent surveying existing approaches being used by employers to provide health care insurance coverage such as HMOs. PPOs, and POS plans. The case is expected to require one hour of preparation by students.

CASE SYNOPSIS

Healthcare costs are soaring in the U.S. and in other developed nations. The model used in the U.S. is that the government provides healthcare insurance for the poor and for senior citizens, while employers traditionally provide healthcare coverage for employees. Employers and government have tried approaches to containing the costs of healthcare insurance while still providing coverage. The government created the "health maintenance organizations" (HMOs) and the marketplace created "point-of-service" (POS) and "preferred provider organization" (PPO) plan designs. Managed care approaches were introduced into virtually all plans in an attempt to control runaway costs in recent years. Some feel that the a "free ride" approach causes consumers of healthcare to have no financial stake in the costs of health services which, in turn, makes such costs hard to control.

Consumer driven health plans (CDHPs) have emerged as plans designed to get the consumer to take a normal consumer interest in the cost and quality of healthcare service. CDHPs must have two elements: some type of medical spending account and high deductible healthcare coverage insurance. Logan Aluminum manufacturing company provides a graphic illustration of the positive elements of a CDHP with lots of additional plan elements, such a wellness, financial incentives, and *free health services. Since Logan has implemented the CDHP healthcare costs have not seen the huge increases seen in the U.S. The fact that Logan uses participative management and team approaches in other areas of its operation is seen as helping to get participation and teamwork on solving the healthcare cost problems.*

INTRODUCTION OF CASE

The topics of healthcare and health insurance are never far from workplace, political, or personal discussions. In 2004, health insurance costs posted their fourth straight year of double-digit increases. Over the past four years, health insurance costs have leaped 59 percent, an amount about five times faster than both wage growth and inflation. For the first time, the total annual price tag of the common PPO (Preferred Provider Organization) plans exceeds $10,000 (*Salganik*, 2004). Paying this amount as an insurance premium would the entire paycheck of a minimum-wage employee. At this point, the employer, on average, pays $7,526 of that $10,000, while the employee's share is $2,674 (*Gabel et. al., 2004)*.

For 2004, employer-sponsored health insurance covers 161 million Americans under age sixty-five and nearly 12 million senior citizens. The average monthly cost of single coverage rose to $308 ($3,695 annually) for single coverage and to $829 ($9,950 annually) for family coverage. This includes PPO, HMO, and other comprehensive health insurance plans. The burden is similar for both the small and the larger employer. The total premiums paid by small firms for coverage are statistically equivalent to premiums paid by larger firms. The average contribution that small firms make toward single coverage also is statistically equivalent to the average contribution made by large firms but the small firms pay slightly less toward family coverage (Gabel, et. al., 2004). This means that large firms typically contribute slightly more towards the "family-coverage" premium.

The continued dramatic increase in the cost of health insurance is forcing employers to continue to react and innovate. One option is for employers to cut benefits. In an effort to contain costs, some firms plan to reduce or eliminate benefits altogether. Almost 40 percent of Certified Public Accountants (CPAs) in the U.S. said, in a 2004 survey, that their client's healthcare benefits would be reduced or eliminated (Genn, 2004).

Another option is to ask employees to pay more of the cost. Sixty percent of the surveyed CPAs said their client businesses are asking for additional employee contributions toward benefits (Genn, 2004). Healthcare cost increases are not just a U.S. phenomenon. Canadian healthcare costs have also been increasing at double-digit rates in recent years. Despite widespread discussion in the U.S. of how low drug costs are in Canada, prescription drug costs are currently rising dramatically in Canada. In response to these drug cost increases, 22 percent of Canadian employers said that they intend to introduce increased employee cost sharing in 2005. This means that employees will be paying more of the healthcare costs. Since Canada has a national government-based healthcare program, the coverage which employers offer is very limited when compared to the broad medical coverage offered by many U.S. employers. This means that in the employer "add-on" policies prescription drugs account for more than 70 percent of the Canadian employer's plan costs (Gonzalez, 2004). For this and other reasons, Canadians are losing faith in their governmental healthcare approach. In 1988 60 percent of Canadians felt that their healthcare system worked well, but in more recent years only 20 percent continue to share that positive assessment. In fact, a large majority of Canadians think that a fundamental change is needed in how healthcare is managed and or financed (Health of Nations, 2004).

Similar rises in medical costs in general and prescription drug costs in particular can be found around the world in developed countries. For instance, in Europe, Italy has been experiencing increases of at least 11 percent in each of the past five years (Rocchi, Addis, & Martini, 2004). Other countries in the European Community are now raising premiums and co-payment levels, both which the employee has to pay, in an effort to limit ever-rising public expenditures (Wendt & Thompson, 2004). The healthcare cost problem seems universal regardless of whether employers or the government pay for the coverage.

There have been a series of approaches to attempt to contain the cost to employers of healthcare insurance. One approach has been to demand premium "participation" of employees (Carrell, Elbert, and Hatfield, 2000). "Participation" is a euphemism for saying that employers are requiring employees to pay a portion of the health insurance premium. The days of having the employer pay all of the cost of medical insurance premiums are slipping away. Between 2001 and 2004, the percentage of workplaces that have"100 percent employer paid" premiums for insurance fell from 34 percent to 21 percent for single coverage and from 14 percent to only 7 percent for family coverage. In the 1970's the "100 percent paid" percentage for single coverage was closer to 75 percent. Employees in 2004 are paying about 16 percent of the cost of single coverage and 28 percent of the cost of family coverage (Gabel, et. al., 2004). "Participation" is certainly increasing. Another approach is continuing governmental intervention. The model used in the U.S. is that the government provides healthcare insurance for the poor and for senior citizens, while employers traditionally provide healthcare coverage for employees. Those differences have broken down in several instances. For instance, the President recently outlined a proposal where employers with 100 or fewer employees would be eligible for a refundable tax credit for contributions they make to employees' HSA (health savings accounts). The credit would apply to the first $500 in contributions an employer makes to each employee's HSA for family coverage and $200 per worker for individual coverage. Low-income individuals not covered by employer plans would be eligible for other tax credits. The credit would be available for both HSA-linked high-deductible health insurance coverage and for more traditional coverages (Geisel, 2004) such as those found in Preferred Provider Organizations (PPOs), Health Maintenance Organizations (HMOs), and other comprehensive insurance plans. Many other political proposals are being made ranging from the Canadian governmental model to smaller incremental changes.

HMOs were created by the federal government in 1973 in reaction to the medical insurance problems at that time. In fact, HMOs are the only employer healthcare plans specifically created by law. These plans must emphasize preventive care and only allow “in network” or participating medical providers and doctors to be used. These “in plan” or “in network” doctors and providers are generally found on a list. “Out of network” doctors or providers are almost never allowed. HMOs must be offered as an alternative to any other plan provided by the employer if an HMO operates in the area (Carrell, Elbert, Hatfield, 2000, p355).

For decades, employers responded to the huge increases in medical costs by implementing a variety of procedural and substantive medical plan design innovations aimed at controlling costs. These innovations were called "managed care" and included greater use of HMOs, the negotiation of preferred provider arrangements, the establishment of precertification and length-of-stay notification and approval protocols, second-opinion incentives, primary care gatekeepers and many others. Virtually all healthcare insurance plans today use some approach to cost controls and employ other cost saving measures that can be categorized as “managed”.

Managed care did help moderate costs (Smith, 1990). Medical costs have increased every year since 1950. However, the medical costs paid by employers through sponsorship of group health plans actually declined between 1993 and 1996.

Plan design cannot be discussed without defining the major types of healthcare plans, especially HMOs, PPOs, and POS plans. PPOs vary widely and have no special legal requirements. They are distinctive because of one aspect of their plan design: they will pay “out of network” doctors and providers, but usually at a discounted rate. For instance, a PPO may pay 80 percent of an “in network” doctor’s charges, but only 50 percent to an “out of network” doctor. Therefore, the PPO prefers its own “in network” providers, but will pay others. The HMOs will not (Carrell, Elbert, Hatfield, 2000, p356).

Both HMOs and PPOs were reactions, in a sense, to what are called point-of-service (POS) plans. POS plans allow the covered person to use any provider or doctor as long as the fee is “reasonable and customary” and is an approved medical procedure. Typically, the patient must pay a front-end deductible, perhaps $250 per person, then a co-payment of perhaps 10 or 20 percent. Like HMOs and PPOs, POS plans seek to negotiate or minimize the charges of doctors and other providers. It seems that all plans now have elements of managed care (Carrell, Elbert, Hatfield, 2000, p354).

Certain positive aspects of the HMOs, like preventative health testing and intervention, have been copied and used in some PPO and POS plans. However, HMOs have been demonized in headlines and even made-for-TV-movies for its cost controlling mechanisms. For instance, there has been a negative reaction to having a plan administrator occasionally refuse to authorize for payment a procedure or treatment prescribed by a physician. The reaction against managed care-type restrictions has been a series of new laws and regulations designed to restrain restrictive practices. Employers and insurers of managed care plans also face a risk of lawsuits.

These anti-managed care developments are already creating direct costs for insurers and employers. Some think that laws and litigation will lead to insurance costs and disruptions so significant that the costs savings built into such plans will be nullified (Kelly, 2003). There is no reason to believe this trend of anti-managed care legislation and litigation will reverse. Responses to these new risks to insurers and employers have included efforts to place new limits on employer liabilities and reduce employer involvement in plan eligibility, coverage and reimbursement decisions.

There have been a series of plan design proposals that are described as converting group health plans into "defined contribution" health plans or "consumer-driven health plans" (Kelly, 2004). What is meant by consumer-driven? Simply stated, it is the process of making an informed purchase with one's own money that results in getting the best value for the needed good or service. In applying this concept to our present health care delivery and insurance coverage system of HMO, PPOs and POS plans, consumer-driven behavior is virtually nonexistent (*Halterman*, *Camero*, *and Maillet, 2003).* For example, how often do patients ask the doctor, hospital, or other provider what the alternatives are and how much each costs? Generally the answer would be "not very often" since the patients do not perceive that they have a financial stake in their healthcare. They are comfortable in being detached from the financial aspects of today's expensive and advanced healthcare. They could be considered "free riders" where it is someone else's problem to worry about the expense. There has been considerable interest in consumer-driven health plans (CDHP) over the past few years. The plan details generally include two elements: a fairly high deductible, perhaps $1,000, and a medical savings account. This CDHP approach is growing. In 2003 only about 5 percent of firms reported offering a high-deductible plan to their employees, but this number doubled to 10 percent in 2004, including 20 percent of the largest firms (those with 5,000 or more employees). Thirteen percent of workers in all firms (and 19 percent of workers in large firms) that offer health benefits work for employers that now offer a high-deductible plan to at least some workers (*Gabel et. al., 2004)*. However, not all of these firms offer what is considered the second component of a CDHP - the medical savings account.

The theory behind CDHPs is that by empowering consumers by giving them more power over their own health care decisions and providing financial incentives to make wise financial health service decisions, health care costs will be better understood and therefore controlled. Proponents of CDHPs believe that patients have been largely kept in the dark about alternatives and the costs of health care (Meyer, 2004). Employees often think of their healthcare as free and are unaware of any objective information about either the fees or quality pertaining to the healthcare they receive. Advocates of CDHPs believe that we need to move from today's system of a medical benefit model to a real insurance model.

There are some concerns about CDHPs. Some observers believe that CDHPs might merely shift health costs from employers to employees leaving the structural and fundamental problems unaddressed. CDHPs may shift costs to providers if the patient is unable to pay his/her portion on the medical bills. Many think that some overall shift to providers would be a positive development. CDHPs may reduce the use of appropriate preventive and primary care services. Finally, without the availability of quality and efficiency information, employee consumers will be unable to make appropriate decisions about providers, drugs, and treatments (Meyer, 2004).

THE CASE OF THE CDHP INNOVATION AT LOGAN ALUMINUM

Logan Aluminum is located in south-central Kentucky about 60 miles north of Nashville, Tennessee. Logan is located in a rural setting with one community-based hospital, many medical providers locally, and access to larger hospitals and specialty physicians in Bowling Green, Kentucky and Nashville, Tennessee, both about 30 minutes away. Logan has a workforce of about 1000 employees with an average age of 43. Almost two-thirds of Logan employees have ten years or more of service. The Logan plant opened about 20 years ago. Employees tend to stay at Logan. One strong indicator of this is that the turnover rate in 2003 was only 4 percent.

After experiencing large increases in healthcare insurance costs again in 2002, like the rest of the U.S., Logan decided to make a major change to its healthcare plan design for 2003. The company moved to a CDHP model for its entire workforce. The two most expensive benefits for Logan are healthcare and pensions. Logan spent over $7 million for healthcare in 2004, which is about $7,000 per employee.

Logan believes that simply implementing the two elements of a CDHP alone will be insufficient to stem the tide of healthcare costs on the long term. While the Logan plan does include both CDHP components of a high insurance deductible and a medical savings account, the Logan plan is actually a broad and integrated approach involving multiple coordinated elements. The key elements include the innovative CDHP plan details, the wellness program, the health screening and interventions, and the financial incentives.

Employees at Logan are encouraged to take advantage of preventive care services, like blood work, x-rays, mammograms, and physicals. All preventive services are at no cost to employees and are offered through the medical department set up on-site at Logan. The medical department staff includes two RN’s, a part time physician, and additional support staff. Employees can also use preventive care options outside Logan's on-site medical department without using spending dollars from their medical account or being "out-of-pocket".

Employees at Logan are not required to pay part of a monthly premium for their healthcare. Logan is perhaps the only employer in its area that does not require such premium participation. Instead, at the beginning of each year, the company sets up an account for each employee, based on family size. Over one-half of the employees need family coverage. At Logan the family model covers the employee and two or more dependents. At the start of the year, $800 is made available in each employee’s family healthcare reimbursement account for those with family coverage. Less is provided to those with single coverage. The money can be spent for any necessary medical services, such as doctor visits, lab tests, emergency room visits, and hospital care. This means that there are no co-pays or deductibles for the first $800 of medical services. Employees are encouraged to spend the $800 wisely.

During the year, if the family spends the entire $800 for medical services, the employee then must pay the next $1,200 out of his or her own pocket. This can be considered the "employee bridge" between the two parts of the employer's coverage. The employer covers the first $800 and provides 100 percent coverage after costs hit $2,000. Therefore the employee pays the "bridge" amount if it becomes necessary.

Employees are offered the IRS Section 125 "flexible spending account" option to cover the $1,200. Dollars contributed to such a flexible spending account through the employee's pretax deduction approach are free from federal, FICA, and state taxes. This translates to a real (net) dollar savings of between 30 and 40 percent compared to the option of paying for medical services with normal after-tax dollars. Only a third of Logan employees use this flexible spending account contribution method since the IRS regulations require that any unspent dollars accumulated in the account at the end of the calendar year must be forfeited to the IRS. Most employees are gambling that they will not need to spend the $1,200.

For the employees whose family spends the entire $800 from the health account and then spends the next $1200 out of their own pockets, employer-provided insurance then picks up and pays 100 percent for any medical services for the balance of the year. This illustrates the high deductible element of the typical CDHP. The CDHP can be seen as an insured healthcare plan that includes a $2,000 deductible. Of course the initial employer contribution toward this deductible is the first $800 of medical expenses that is followed by the "bridge" of the next $1,200 out of pocket cost to the employee. The plan looks like this: $800 employer paid followed by $1,200 employee paid followed by 100 percent of further costs paid by the employer.

From the standpoint of the employee, the employer is paying for all diagnostic testing, and the first $800 and all the rest of the healthcare costs after he or she pays the bridge in years where his or her medical costs are high. This bridge is what employees will seek to minimize. However, the bridge itself can be lessened according to the details of the Logan CDHP. If the family does not spend all the dollars in their account in any year, the unspent dollars are rolled over to the next year. For example: if the family has a good year in 2004 and only spends a total of $300 for medical expenses, the account balance or residual of $500 is rolled over into 2005. If the account balance was $800 at the beginning of the year, and $300 was spent, then $500 will be rolled over. In January 2005, the company will place another $800 in the account so that the starting balance in January 2005 is now $1300, instead of $800. Therefore, this means the maximum out of pocket expenses for the family is $700 for 2005, instead of $1200.

If an employee has enjoyed good health and has accumulated several hundred or possibly several thousand dollars, Logan's CDHP allows the account balance to pay for medical expenses during retirement years.

The success of the Logan CDHP is driving expansions. One modification in 2005 is that the employees now have an option to receive actual dollars in a "health savings account" (HSA) instead of "notional" or “on-paper-only” dollars under the current health risk reimbursement arrangement. Employees will be able to contribute pre-tax dollars to their account as well, without the fear of losing the money as is the case with Section 125 flexible spending accounts where any unused dollars are forfeited. All unused dollars, whether contributed by the company or by the employee, will grow for future use. In 2005, the HSA option also includes pharmacy that is a stand-alone plan under the current health reimbursement account.

Logan goes far beyond the minimums of a CDHP of a health spending account and high deductibles. For instance, Logan initiated its wellness program in 1993. It hired a full time wellness coordinator and began offering varied wellness services. Logan believes that its employees are healthier as a result of wellness efforts. Asking employees to practice wellness and make critical life style changes can be seen as a win/win situation. Logan encourages free annual physical exams and blood work, along with exercise, diet, and weight control.

Logan sees obesity as the next major emphasis in controlling healthcare costs. In Kentucky, where Logan is located, almost 70 percent of men and 55 percent of women are overweight or obese. Only 29 percent of Kentuckians get the proper amount of physical activity. About 20 percent of high school boys and 10 percent of high school girls are seriously overweight. The numbers for Kentucky are high but reflect an escalating trend in most every state in the United States. Kentucky ranks fourth in the nation for prevalence of obesity among adults and also has the fourth-highest death rate from heart disease, the fifth-highest percentage of adults with high blood pressure and the second-highest percentage of adults with arthritis. A recent report said obesity is responsible for $75 billion in medical expenses nationally and $1.1billion in Kentucky. Obese adults are said to have medical expenses 35 percent higher than adults of normal weight, pushing up overall healthcare costs (Ungar, 2004).

Employees have been told that each newly diagnosed case of diabetes in a young to middle age adult will cost $250,000 in healthcare cost over the person’s lifetime for medical treatment. This means that the minimizing risk factors that can accompany its wellness program should provide a substantial financial payback. However Logan emphasizes the personal or "human" payback is for those who change their lifestyle. The quality of life and the outlook for less disease can be greatly improved through wellness activities.

In an effort to address obesity and other risk factors, Logan set health status and behavior targets in 2003 for its entire workforce. To help reach the targets, it offered employees up to $250 in cash incentive, depending upon healthcare dollars saved, in five areas:

1. Body mass index (proper ratio of weight to height)
2. Exercise activity at least three times per week
3. No tobacco use

4. Using seatbelts while on the road
5. Getting an annual wellness consultation

The centerpiece of the health screening and intervention element is the health risk appraisal. The health risk appraisal (HRA) is a series of about 40 questions related to exercise, diet, health conditions, family history, and includes some biometric data such as blood pressure, cholesterol level, glucose level, etc.

Employees who complete the HRA get a report based on how they answered the 40 questions. If the results of the HRA indicate that an employee has multiple risk factors, individual counseling by an outside (non-Logan) health services provider is offered to the employee on a voluntary basis and at no cost to the employee. Multiple risk factors could include: being overweight, having a family history of heart disease, cancer, or other serious health conditions, having elevated blood pressure, limited physical activity, elevated cholesterol, glucose, or triglycerides, etc.

Depending on risk factors, an individual counselor works out a confidential action plan with the employee in an attempt to lower or eliminate some risk factors. While certain risk factors that are beyond the control of an individual (e.g. age, family history, and genetics) many risk factors can be mitigated by diet, exercise, medication, and lifestyle changes. Logan has about 250 employees, 25 percent of the workforce, who are targeted for special help through an intervention counselor. While the intervention program is voluntary for all employees considered at risk, nearly 90 percent do accept intervention help from an external counselor.

Logan receives aggregate data from the HRA vendor that is the yardstick it uses to determine progress. The data is also used in determining the efficacy of the wellness incentives.

The staff at Logan's on-site medical clinic has identified a number of diseases in the early stages that were caught during preventive physicals. Several cases of cancer, diabetes, and other conditions were identified, even without the employee having serious symptoms. Dependents of employees are offered free health screenings as well during an annual wellness fair. In 2004, nearly 50 percent of spouses of employees participated in wellness consultation, blood work, and x-rays. The free mammograms have identified early breast cancer in a number of female employees and dependents. The belief is that that early detection and early treatment will save money on the long-term and affords employees a better disease outcome in addition to avoidance of suffering and pain

One incentive is tied to the health screening and intervention element. Each employee receives $200 in their health spending account if they complete the annual health risk appraisal discussed above. In 2003, 99.7 percent of Logan employees completed the health risk appraisal. This $200 can be seen as lowering the cost of the out-of-pocket bridge.

A second incentive is tied to wellness, as discussed above. Half of the wellness incentive was tied to actual dollars spent by the company for healthcare. If the target spending level was reached, employees were rewarded with part of the savings, up to $125 per employee.

At the end of 2003, Logan had achieved most of the healthcare cost and wellness targets. Each employee received a check for $220 that included both the savings and a direct payment. Logan sees this cost as a wise investment in its human capital. It explained to its employees that if these incentives can help eliminate or minimize one case of diabetes, serious heart attack, stroke, or other major life style illness, the financial and human payback is well worth the investment.

Whether CDHPs are successful may be determined in part by how this innovative approach fits with the other elements of the employer's human resource and general management approaches. There appears to be a good fit with the HR and management theories employed at Logan. Logan has a team-based culture that emphasizes employee involvement in nearly every facet of its operation. Employees are viewed, and referred to, as "partners". Placing more decisions in the hands of partners, whether about healthcare or not, is consistent with the empowerment and team-based philosophy under which Logan manages. Leaders at Logan can be viewed as "path-goal" leaders (House, 1971) in that they are highly engaged, with the help of employees, in clarifying the target behaviors and outcomes and serve as resources to help along the path. Within such a management model, communication and employee involvement are key. Alternately, an employer running an autocratic, individual-based, directive management style may find that the fit of a CDHP would be less comfortable and effective, at least upon implementation.

Logan utilizes a 20-member task force in which employees are engaged in thoughtful discussions several times a year concerning healthcare costs and wellness. This group of employees is then expected to share information with other employees in their work group and team. This is a team-based approach aimed at keeping every employee aware of healthcare issues. Further, healthcare spending and wellness are discussed in face-to-face quarterly communications meetings with all partners. In these meetings healthcare cost is discussed as a controllable expense partially determined by partners being engaged in healthcare issues and acting as wise consumers.

Early reports indicate that the first year, 2003, healthcare costs were either stable or showed a slight decrease. Logan partners, company managers and officials, along with many outside of Logan are eager to analyze more data from 2003 and also find out what happened in 2004, the second year of the CDHP. Observers wonder if the benefits seen in the first year can be repeated in the second year, or whether the first year may have merely squeezed out some efficiencies that caused a temporary effect. This innovation in healthcare approaches at Logan is becoming a naturalistic experiment on CDHP that hopefully will shed some light on this very important of employer healthcare costs.

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IS THIS A BONA FIDE OCCUPATIONAL QUALIFICATION?

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CASE DESCRIPTION

The primary subject matter of this case concerns human resource management, particularly the issues of discrimination, and the Bona Fide Occupational Qualification (BFOQ) exception to Title VII of the civil rights act and the Age Discrimination in employment act. This case has a difficulty level of three to four, and is appropriate for an upper division, undergraduate level. This case is designed to be taught in one class hour, and is expected to require two to three hours of outside preparation by students.

CASE SYNOPSIS

This case examines the Bona Fide Occupational Qualification (BFOQ) exception in discrimination cases. Title VII of the Civil Rights Act of 1964 prohibits discrimination based on race, color, religion, sex or national origin. The Age Discrimination in Employment Act expands this protection to cover age discrimination against people over 40. However, there is an exception, the BFOQ. Under certain circumstances, an employer can discriminate, if age, gender or national origin can be shown to be a legitimate requirement, in order to perform the job. In this case, the BFOQ is defined, the criteria for a BFOQ are listed, and the limits to BFOQ are discussed. Several real examples are given of cases in which a company has alleged a BFOQ exists. Students are asked to examine each example, and determine which, if any are legitimate BFOQs. The main focus of this case is to teach students to apply the criteria from Title VII of the civil rights act BFOQ exemption, to real situations.

INTRODUCTION

In 1964, the Civil Rights Act was passed. Title VII of this act, which was targeted specifically at employers, prohibits discrimination in employment based on race, color, religion, sex or national origin. However, also included in this act is an exemption, allowing that discrimination may be acceptable, if the type of discrimination is an actual requirement to successfully perform the job. The name given to this clause was Bona Fide Occupational Qualifications (BFOQ). BFOQ can be claimed in the case of sex, religion, national origin, but not race. Later, the Age Discrimination in Employment Act (ADEA) was passed, extending the protection against discrimination to include age discrimination, for employees over 40. At this point, the BFOQ clause was also extended to the age category. In the following sections, Title VII, ADEA, and the BFOQ clause will be described in detail. Following this, you will be presented with several scenarios, in which a company claims BFOQ. Your task will be to apply the acts, and the BFOQ exemption, and determine which, if any of the claimed BFOQs are legitimate.

TITLE VII OF THE CIVIL RIGHTS ACT OF 1964

The section of Title VII which prohibits employment Discrimination says the following, according to the Equal Employment Opportunity Commission Website (www.eeoc.gov).

UNLAWFUL EMPLOYMENT PRACTICES SEC. 2000e-2. *[Section 703]*

(a) It shall be an unlawful employment practice for an employer - (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin; or (2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin.

(b) It shall be an unlawful employment practice for an employment agency to fail or refuse to refer for employment, or otherwise to discriminate against, any individual because of his race, color, religion, sex, or national origin, or to classify or refer for employment any individual on the basis of his race, color, religion, sex, or national origin.

(c) It shall be an unlawful employment practice for a labor organization- (1) to exclude or to expel from its membership, or otherwise to discriminate against, any individual because of his race, color, religion, sex, or national origin; (2) to limit, segregate, or classify its membership or applicants for membership, or to classify or fail or refuse to refer for employment any individual, in any way which would deprive or tend to deprive any individual of employment opportunities, or would limit such employment opportunities or otherwise adversely affect his status as an employee or as an applicant for employment, because of such individual's race, color, religion, sex, or national origin; or (3) to cause or attempt to cause an employer to discriminate against an individual in violation of this section.

(d) It shall be an unlawful employment practice for any employer, labor organization, or joint labor–management committee controlling apprenticeship or other training or retraining, including on–the–job training programs to discriminate against any individual because of his race, color, religion, sex, or national origin in admission to, or employment in, any program established to provide apprenticeship or other training.

(e) Notwithstanding any other provision of this subchapter, (1) it shall not be an unlawful employment practice for an employer to hire and employ employees, for an employment agency to classify, or refer for employment any individual, for a labor organization to classify its membership or to classify or

> refer for employment any individual, or for an employer, labor organization, or joint labor–management committee controlling apprenticeship or other training or retraining programs to admit or employ any individual in any such program, on the basis of his religion, sex, or national origin in those certain instances where religion, sex, or national origin is a bona fide occupational qualification reasonably necessary to the normal operation of that particular business or enterprise, and (2) it shall not be an unlawful employment practice for a school, college, university, or other educational institution or institution of learning to hire and employ employees of a particular religion if such school, college, university, or other educational institution or institution of learning is, in whole or in substantial part, owned, supported, controlled, or managed by a particular religion or by a particular religious corporation, association, or society, or if the curriculum of such school, college, university, or other educational institution or institution of learning is directed toward the propagation of a particular religion. (www.eeoc.gov/policy/vii.html)

Section (e) of the above act is the BFOQ exemption. Some key items to note in section (e) include 1) there is no reference to a BFOQ for race, and 2) the requirement that the qualification be "reasonably necessary to the normal operation of that particular business or enterprise". What constitutes reasonably necessary? This question poses problems even for legal scholars. However, we must attempt to address this. Several reasons have been accepted as constituting "reasonably necessary. Among them are: authenticity, same sex privacy, and requirements to accomplish the work. Under authenticity, the state of Oregon, Civil Rights Division, gives the example of hiring an actor/actress or model based on sex, due to the characteristics of the role they portray. (www.boli.state.or.us). In other words, its reasonable to expect that King Arthur be played by a male, and Guenevere by a female. Same sex privacy applies almost exclusively to situations in which a person must disrobe, or be viewed in a state of undress. The ability to accomplish the work means that a person of the type excluded, CANNOT reasonably accomplish the work, or the criterion is central to the product or service being sold.

Below you will find several cases, in which an employer has claimed BFOQ. Examine each case, and determine whether the BFOQ is legitimate or not, and why.

CASE 1 - ROLE MODEL

A youth foundation runs a camp for the treatment of delinquent boys. This camp has a position open for a youth counselor. Among the stated duties of the youth counselor position, is the requirement that the individual serve as a "male role model" to the children. Therefore, the foundation has advertised the position as being open only to male applicants. A female, with past experience as a youth counselor, and a degree related to the treatment of childhood mental disorders applies for the job anyway, feeling that she is qualified. The foundation rejects her. She files suit, claiming sex discrimination. The foundation responds with a BFOQ defense. (Wisconsin, 2005)

CASE 2 - FAA REGULATIONS

The FAA (Federal Aviation Administration) had a regulation requiring that airline pilots be under the age of 60. Upon turning 60, all pilots are forced to retire. While this requirement does not extend to all members of the flight crew, one airline had the policy of extending this mandatory retirement to include their flight engineers, as the flight engineer is the backup pilot, in case of emergency. Three pilots working for this airline, upon their 60th birthdays, applied for transfers to flight engineer positions, rather than retiring. This is unusual, because the flight engineer position is essentially a demotion from pilot. However, the collective bargaining agreement, between the airline and the union, allows current employees to bid on any open position, based on seniority (The ADEA, 2005).

The airline rejected their applications. The pilots filed suit, and the airline defended with a BFOQ defense. The airline's arguments included 1) pilots and flight engineers are required to meet the same stringent requirements regarding health. 2) It is cost prohibitive to individually assess all employees at the age of 60, to see if they have age related problems that make them unable to function as flight engineers. 3) the flight engineer may be called upon to pilot the plane, if the pilot and first officer become incapacitated (The ADEA, 2005).

The workers responded by stating 1) the "age related problems," such as heart disease, cited by the airline, happen to young, as well as old employees. 2) it would be extremely rare for a pilot and first officer BOTH to become incapacitated, and even more unusual for the flight engineer to then suddenly develop incapacitating health problems. (The ADEA, 2005)

CASE 3 - SEX SELLS

A popular casual sports bar/restaurant has developed what they feel is a theme. This 'theme" involves scantily clad women, working as servers, hostess, and the other publicly viewed employees. Therefore, they require, as a condition of employment, that the wait staff be female. They argue that this is a BFOQ, and that customers are buying this theme, rather than just food, and that this theme is an integral part of the business. (Wisconsin, 2005)

It should be noted here, that in the past, courts have determined that in the case of "strip clubs" sex as a BFOQ is legitimate, as the primary business is the stripping, and someone of the opposite sex would not appeal to the same customers. However, while this is true, courts have also ruled that "customer preference" was not sufficient reason to limit the sex of a salesperson, cashier, or other service provider. (Wisconsin, 2005)

Essentially, this issue in this case is: are scantily clad women what the customers are paying for, or are they coming to the restaurant to eat, drink, and watch sports.

CASE 4 - THE NURSE

An OB/GYN unit of a hospital advertised for a position opening for a Registered Nurse. The hospital had a 20 year policy of hiring ONLY female obstetric nurses. A male, who was a registered nurse, with past experience as an obstetrics nurse, applied for the position, and was turned down, as he was not female. The hospital argued that a female was necessary for this position, due to the intimate nature of obstetrics. They said that having a male OB nurse violated the privacy rights of the patients. There are no OB nurse positions that do not involve patients with their private parts exposed. Furthermore, even in cases where a male doctor is allowed, patients demand a female nurse as a "chaperone". Finally, they showed evidence that at a teaching hospital, 80% of all patients refused to allow male students to be in the room during treatment, while few refused female students. (State EEO newsletter, 2004)

QUESTIONS FOR EACH CASE

1) Is this practice discriminatory?

2) Is the BFOQ defense legitimate?

3) Why, or why not?

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VALUATION OF A DREAM: RIVERSIDE COUNTRY CLUB FOR SALE

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CASE DESCRIPTION

The primary subject matter of this case concerns the business valuation process. Secondary issues examined include the challenges of valuing small, privately held businesses and determination of an appropriate discount rate. The case requires students to have an introductory knowledge of accounting, finance and general business issues, thus the case has a difficulty level of three (junior level) or higher. The case is designed to be taught in one or two class sessions of approximately 1.25 hours (depending on the level of detail covered) and is expected to require 3-4 hours of preparation time from the students.

CASE SYNOPSIS

This case describes the challenges faced by Chris Johnson, who for years has nurtured a dream of owning a golf course. As a successful insurance agency owner and accomplished golfer, Mr. Johnson hopes to one day make his dream a reality. Opportunity arises when Golf Corp LLC, a leading national golf course owner and operator in the U.S., decides to sell Riverside Country Club, an entry-level semi-private course located near Mr. Johnson's residence, in an effort to refocus its corporate strategy toward operating higher-end properties. Mr. Johnson now has an opportunity to realize his dream, but is uncertain as to the fair value of acquiring Riverside.

CASE BACKGROUND

Golf Corp LLC was founded in 1991 with a strategy to acquire and manage golf courses in "demand driven" markets that provide opportunities for revenue growth and margin improvement through Golf Corp's integrated marketing and operational programs. The essence of Golf Corp's strategy is to "market" each course as a separate brand with well-defined customer segments, distinctive positioning, tailored "one-to-one" programs - and responsive tracking and follow-up. Golf Corp's growth is based on its proprietary marketing information systems and high-quality customer service and course conditioning.

Golf Corp's current portfolio of 18 facilities spread over nine southeastern states reflects its orientation towards higher-end properties. The portfolio features a number of marquee daily fee and resort courses, however, Golf Corp's recent growth reflects an increasing orientation towards high-level private clubs. High-level properties focus primarily on upwardly-mobile families looking for a quality private club experience. Course locations include properties in high-growth areas outside Atlanta, Nashville and Orlando.

Golf Corp currently employs three financial analysts to conduct end-of-year reviews for each of its 18 facilities as well as identify potential opportunities for further investment as capital flows permit. Analysts are responsible for preparing contribution reports and making recommendations to Golf Corp's senior managers for further action. Brent Steadman was Golf Corp's newest analyst and one of his first assignments was Riverside Country Club. Historical data on Riverside showed the country club had experienced minor losses in the first two years of operation, but had been profitable ever since. After further review, Mr. Steadman concluded: 1) there was a low probability Riverside's future profits would be able to provide a return required by Golf Corp's investors and 2) changes in current market conditions allow Golf Corp the opportunity to replace Riverside with an existing course (Bart Creek Country Club) in order to better utilize their integrated marketing and operational programs.

After reviewing all of the internal documents presented by Mr. Steadman, Golf Corp's senior management team made a call to Tom Johnson, the head golf professional and manager of Riverside Country Club and asked him to discreetly contact local individuals who might be interested in purchasing Riverside. Tom's first call was to his brother Chris, a successful independent insurance agent and avid golfer.

BUYER'S BACKGROUND

Chris Johnson is thirty-eight years old and has been in the insurance business since graduating from the University of Arkansas with a degree in marketing on a golf scholarship. Mr. Johnson is an accomplished golfer with statewide recognition, having won State Amateur Player of the Year awards on three different occasions. He sold life and health insurance for a mid-sized insurance agency for five years before starting his own independent insurance company, the Johnson Agency. The Johnson Agency, headquartered in Little Rock, Arkansas, offers group and individual health and life insurance and is a licensed provider of life and health insurance policies in Arkansas, North Carolina, Ohio, Mississippi, and Tennessee. While the first few years for the Johnson Company were lean, the business has been very successful in recent years. Mr. Johnson is currently in a financial position where the potential for realizing his dream of owning a golf course is possible.

GOLF INDUSTRY

In 1990, an estimated twenty-three million Americans were classified as golfers having played 421 million rounds of golf at approximately 11 thousand courses. By 2003, the number of American golfers has grown to over 27 million and the number of rounds played increased to approximately 495 million (see Table One for a year by year comparison of growth). In addition, the number of golf courses available for play increased to just below 15 thousand by 2003. Golfers in the US spent over $24 billion in 2003 on equipment and green fees, of which $4.5 billion was allocated to equipment spending and $19.5 billion to green fees and dues. Avid golfers (classified as playing more than 25 rounds per year) account for only 23% of all golfers, but attributed to 63% of total golf spending. Finally, approximately 15% of all golfers are permanent residents of a golf course community.

The median cost of a weekend round of golf at a daily fee course is $40. An average daily fee golf course will record 30,000 rounds played per year, employ a total of 13 full-time people and generate about $992,000 in revenues.

RIVERSIDE COUNTRY CLUB

Riverside Country Club opened in 1995 as a semi-private golf course located in Maumelle, Arkansas, a growing suburb located in the greater Little Rock metropolitan area. Riverside offers an 18-hole championship golf course spread out over 151 acres along the Arkansas River, complete practice facilities, a full-service snack bar with an ability to provide catering services, and a Pro Shop offering top quality merchandise. Riverside Country Club was originally built by Golf Corp LLC to take advantage of the surging popularity of golf that occurred during the early 1990's.

Initially, Golf Corp's strategy was to acquire and turn around underperforming golf courses in "demand driven" markets through integrated marketing and operational programs designed to enhance revenue growth and reduce costs. Golf Corp's success with this strategy during the first three years was attracting more capital from investors than there were opportunities for investment. Golf Corp's senior management team decided to look into various extensions of their current strategy in order to support continued growth. One alternative was to build a new course in a high population growth market and work with a local real estate developer who would build a community around the course. Golf Corp would operate the course initially as a semi-private course that allows play by both members (who pay a fixed monthly fee) and the general public (who pay a daily fee), and eventually convert it to a private club as home-site development around the course and interest increased. After months of research, Maumelle, Arkansas was identified as the best possible location for Golf Corp's attempt at expanding their corporate focus, and the construction of Riverside Country Club began in 1994. Riverside Country Club was completed in 1995 at a total cost of $2.1 million.

THE SITUATION

Chris Johnson's excitement of one day realizing his dream was subdued by a recent article describing the bankruptcy of a prominent heart surgeon who had built two golf courses just five years ago. However, the article did mention that, "golf is cheap right now, the explosion of golf course construction in the early 1990's has brought the industry to a point where some courses are now being bought for 50 cents on the dollar of what they were built for a few years ago." Johnson decided his approach to realizing a dream should be an investment and not an emotional decision. He would apply his capital and expertise to owning a golf course as if it were a going concern with an appropriate return on investment. Johnson first contacted Golf Corp to express his interest in the possible acquisition of Riverside. After signing a confidentiality agreement, Golf Corp provided limited financial information and recent appraisals of fixed assets. Golf Corp indicated more information would be provided if Chris decided to further pursue the acquisition. Audited Riverside financial information is provided in Table Two. Fixed assets were recently appraised at $2,500,000, and Golf Corp indicated they were willing to sell Riverside for $3,500,000.

Johnson needed more information before negotiating the potential purchase of Riverside and approached Rick Scott for help. Scott is an associate with Williams Inc, headquartered in Little Rock, Arkansas. Williams Inc. is one of the largest investment banking firms off of Wall Street and has a long historical record of private company sales. Scott informed Johnson that his firm could help with the negotiations. Scott was both familiar with golf property valuations and had developed a data base containing a number of recent golf course transactions that might prove useful in valuing Riverside. Scott also stated most business valuations are more art than science and there are numerous ways to value a business, ranging from basic industry rules of thumb to discounted cash flow (DCF) analysis. The value of a business can vary significantly from buyer to buyer, depending on each buyer's own analysis and estimates. Value may vary depending on the data used, the methodologies used, the weight placed on the various methodologies and the overall interpretation of the data. However, Scott described a number of possible valuation methods.

1. Asset Based Methods:
   a. *Accounting Book Value:* This method uses accounting values taken from the company's financial statements. This method assumes that assets values are equal to market value and the value of the firm is equal to the value of its assets. Johnson suggested using the firm's book value as a base value. Scott didn't think this method would yield a true value but agreed with Johnson that it could possibly be used as a base value and a starting point.
   b. *Adjusted Tangible Book Value Method:* This method also uses accounting values but recognizes that accounting values are based on historical information that does not always reflect market values. Fixed assets values are adjusted to reflect current

market values. It assumes the firm continues to operate and assets reflect "in use" values. Johnson commented that determining a value using this method would be easy to calculate since Riverside had relatively current appraisals for its fixed assets ($2,500,000). This method also assumes the value of the firm is equal to the value of its assets.

2. Market Comparison Methods:

a. *Direct Market Comparison Method:* This method attempts to locate similar businesses that have recently sold, and uses those comparable price figures to determine an appropriate valuation, adjusting appropriately for differences. This method is widely used for real estate sales, but may be more difficult to apply to a country club because of the unique characteristics of each country club. However, Scott did mention that his firm had access to a database of previous country club sales, and Scott decided to focus on ten courses (see Table Three) that were the most similar to Riverside. Scott suggested that some form of a weighted average might be a good approximation for Riverside, but an equally weighted average might distort the estimation process. However, applying a larger weight to more recent sales may help alleviate this distortion. Scott suggested the four courses with the most up-to-date sale price information occurring in 1998 and 1999 be applied a weight of 5% each. A weight of 7.5% was suggested for the one course with sale price information from 2000. The three courses with 2002 sale price data should be applied a weight of 12.5% each and finally, the two courses with 2003 sale price data should be applied a weight of 17.5% each. While the total weights equal 100% (4*5% + 1*7.5% + 3*12.5% + 2*17.5% = 100%), the more recent data provides a larger contribution to the estimate. Johnson also noted not every course had 18 holes, some had 27 and others had 36. However, if you divide the selling price by the number of holes, a weighted average price per hole can be estimated. Johnson felt comfortable with this approach.

b. *Multiple of Revenue or Income:* This small business valuation method estimates the price using a multiplier of revenue or income. Based on previous transactions, Scott indicated that country clubs tend to sell for 120% to 150% of golf revenue plus 60% to 70% of food and beverage revenue, in addition to the market value of real estate. Johnson had also read that country clubs generally sell for 7 to 9 time Net Operating Income, also known as Net Operating Profit After Taxes (NOPAT), in addition to the market value of real estate. To be conservative, Scott recommended valuing Riverside at 130% of golf revenue plus 65% of food and beverage revenue plus $10,000 per acre for real estate if using the multiple of revenue approach or 8 times

NOPAT plus $10,000 per acre for real estate if using the multiple of income approach.

3. *Free Cash Flow (also called Discounted Cash Flow):* The free cash flow method estimates the present value of cash flows available for distribution to all of the company's investors discounted at the average rate of return required by all investors. Cash flows available for distribution are known as free cash flows and the average rate of return required by all investors is known as the weighted average cost of capital (WACC). Scott is in favor of this approach, but pointed out this technique requires forecasting expected future cash flows. Scott also suggested this particular situation is well suited for a two-stage growth model. The first stage assumes that Riverside will continue to operate as a semi-private club until growth is sufficient to convert to a private club. Collectively, Scott and Johnson decided that Riverside should be able to convert to a private club by 2009, at which point a horizon (or terminal value) could be obtained using a constant growth valuation. Scott noted the free cash flow model incorporates quite a number of estimates including: revenue growth during the first stage followed by constant growth during the second stage, percentage of sales estimates for costs, capital expenditure and depreciation expense estimates during the first stage, followed by an appropriate discount rate.

Johnson replied that the Maumelle community itself had grown from 6,912 in 1990 to 10,557 by 2000 and the development of home-sites around Riverside Country Club is increasing roughly in proportion to Maumelle's population growth. In addition, the greater Little Rock population, in which Riverside resides, has grown from 523,000 in 1990 to 583,000 in 2000. Johnson suggested a conservative estimate for revenue growth of 4% for 2004 and 2005, 5% for 2006 and 2007 and 6% for 2008 and 2009. After 2009, Scott pointed out a horizon value for Riverside could be estimated based on constant growth under the assumption the club could be converted from semi-private to private. Similar private clubs had averaged free cash flow growth of between 4% and 7% over the last 10 years and Scott suggested 5% constant growth after 2009. Therefore, a horizon value in 2009 could be obtained using: $\text{Value}_{2009} = [\text{FCF}_{2009}*(1+g)]/(k-g])$, where k is the appropriate discount rate for this investment and g is the constant growth assumption.

In preparing the forecasts, Scott suggested operating expenses at 60% of sales is consistent with other country clubs and could be used in this situation as well. Although these forecasts are slightly lower than the actual historical average for 2000 to 2003, Scott thought that on-site involvement by Johnson could improve operating efficiency. Johnson had read that average annual capital expenditures by semi-private clubs average about $100,000 per year, but Johnson noted that some improvements had been neglected and a better estimate might be $150,000 per year for the first two years, followed by $100,000 per year thereafter. Since annual depreciation expense was $175,000 last year, and additional capital improvements are planned, Scott suggested using $200,000 for annual depreciation expense in year one (2004) and reduce the amount by $10,000 each successive year. Scott also suggested using a projected income tax rate of 30%. Johnson asked about a forecast for working capital and Scott commented that because the historical relationship between revenues, current assets, and current liabilities was fairly consistent, they should assume current assets and current liabilities be projected at 35% and 10% of sales respectively. Johnson recognized this was an oversimplification but agreed. (See Table 4 for a preliminary worksheet created by Scott to estimate Riverside's FCF)

Johnson's biggest and final concern was an appropriate discount rate for this investment. Scott recommended a modification of the WACC as an appropriate discount rate for a private investment. Johnson was familiar with the concept of the WACC for publicly traded corporations. He remembered the cost of equity could be estimated using the Capital Asset Pricing Model (CAPM) and the cost of debt could be estimated from a company's bond rating, but Johnson was not sure how it would apply to his private investment. Scott noted that most privately held businesses utilize bank debt financing and estimated Johnson could probably obtain 60% loan-to-value financing at close to 8.5% from a large commercial bank. As far as the cost of equity, Scott suggested looking at a publicly traded company operating in the golf industry, such as Callaway Golf (ELY) as a starting point to determine an appropriate equity beta for the CAPM. However, Scott cautiously remarked that using an appropriate equity beta means accounting for both business risk and financial risk. Thus an appropriate measure of golf industry business risk must be found first and then "relevered" to reflect any additional financial risk (use of debt). Most estimates of ELY's equity beta were close to 1.3 and Scott and Johnson were comfortable with this estimate. Normally, the equity beta must be "unlevered" to separate business risk from financial risk. However, ELY has almost no debt so ELY's equity beta is equal to the "unlevered" beta. Scott pointed out the unlevered beta of 1.3 represents the relative business risk of the golf industry. Johnson agreed, but noted that Riverside's capital structure would be completely different from ELY (Johnson was considering a debt-to-equity ratio of 1.5 for Riverside, while ELY has no debt). Scott recommended relevering the unlevered beta (also known as an asset beta), using Riverside's capital structure, in order to incorporate both the business risk and financial risk Johnson would be facing.

(Unlevered Beta = (D/D+E)*BetaDebt + (E/D+E)*BetaEquity)

Once the appropriate beta of equity for Johnson is estimated, the CAPM can be used to estimate the appropriate required return for equity. However, the CAPM specifies an estimate of the risk-free rate and a market risk premium. Scott recommended 3% as an approximation of the risk-free rate and 7% as an appropriate market risk premium.

THE TASK

At the conclusion of the meeting, Scott suggested Johnson come back at the end of the week. Scott said he would put together a preliminary valuation report to help Johnson decide on an appropriate offering price for Riverside. Scott turned over a copy of his notes from his meeting with Johnson to a young associate with a message detailing what Scott needed for his next meeting with Johnson.

1. Discuss each valuation method. Describe the strengths and weaknesses of each?
   a. Asset based methods.
      i. Accounting book value.
      ii. Adjusted tangible book value,
   b. Market comparison.
      i. Direct Market Comparisons
      ii. Multiple of Revenue and Multiple of NOI
   c. Free cash flow (also called the discounted cash flow method).

2. Using methods discussed in Question 1, develop values for Riverside Country Club.

3. Recommend a fair-market value for Riverside Country Club. Support your value.

Table One: Growth of Golf in the US
Source: National Golf Foundation, http://www.ngf.com

Year	Number of Golfer (millions)	Rounds Played (millions)	Number of Golf Courses
1994	23.3	409.0	12,161
1995	23.7	431.4	12,572
1996	23.7	420.1	12,885
1997	24.9	481.5	13,196
1998	25.0	465.1	13,529
1999	25.2	496.4	13,907
2000	25.4	518.4	14,268
2001	25.8	518.1	14,550
2002	26.2	502.4	14,725
2003	27.4	494.9	14,827

Table Two : Selected Financial Information for Riverside Country Club				
Riverside Country Club ***Income Statement (000s/$) As of December 31***				
	2000	2001	2002	2003
Golf Revenue	1,012	1,104	995	1,191
Food and Beverage Revenue	124	116	110	119
Total Operating Revenue	1,136	1,220	1,105	1,310
Total Operating Expenses	879	915	862	935
Gross Margin	257	305	243	375
Depreciation	150	155	155	175
EBIT	107	150	88	200
Interest Expense	96	91	78	58
Taxes	4	19	3	51
Net Income	7	40	7	91
Balance Sheet (000s/$) As of December 31				
	2000	2001	2002	2003
Cash & Equiv.	410	420	430	390
Receivables	7	8	9	8
Inventories	5	4	5	6
Total Current Assets	422	432	444	404
Plant, Prop. & Equip. (PPE)	2,115	2,210	2,305	2,395
Accumulated Depreciation	305	460	615	790
Net PPE	1,810	1,750	1,690	1,605
Total Assets	2,232	2,182	2,134	2,009
Liabilities and Shareholder Equity				
Accts Payable	92	54	78	69
Accrued Expenses	24	25	28	27
Total Current Liabilities	116	79	106	96
Long Term Debt	916	863	781	575
Total Liabilities	1,032	942	887	671
Paid In Capital	800	800	800	800
Retained Earnings	400	440	447	538
Total Shareholders Equity	1,200	1,240	1,247	1,338
Total Liabilities & Shr. Equity	2,232	2,182	2,134	2,009

Table Three: Database of Recent Golf Course Sales				
		Number	Year	Selling Price
Course Name	**Location**	**of Holes**	**Sold**	**($Thous)**
Black Bear	Orlando, FL	18	1998	4,100
Club of the Country	Kansas City, KA	18	1998	2,600
Eagle Watch	Atlanta, GA	18	1998	6,400
			2002	5,900
Lost Oaks	Palm Harbor, FL	18	1998	5,900
			2003	2,300
Cooks Creek	Ashville, OH	18	1999	6,100
Cypress Creek	Boynton Beach, FL	18	1999	4,200
Meta-Mora	Detroit, MI	18	2000	5,900
Palm Desert	Palm Desert, CA	27	2000	5,800
			2002	4,100
Sweetwater	Orlando, FL	36	2002	3,300
Mystic Creek	Dearborn, MI	27	2003	3,500

Table Four							
Free Cash Flow Projection	2003	2004	2005	2006	2007	2008	2009
	Actual	Projected	Projected	Projected	Projected	Projected	Projected
	(000s/$)	(000s/$)	(000s/$)	(000s/$)	(000s/$)	(000s/$)	(000s/$)
Total Operating Revenue	1,310	1,362	1,416				
Total Operating Expenses	935	817	850				
Depreciation	175	200	190				
EBIT	200	345	376				
Income Tax (30%)	60	104	113				
NOPAT	140	241	263				
Operating Current Assets	404	477	496				
Operating Current Liabilities	96	136	142				
Required Net Operating Working Capital	308	341	354				
Capital Expenditures		150	150				
Required Net Plant and Equipment	1,605	1,755	1,905				
Required Net Operating Capital	1,913	2,096	2,259				
Net Investment in Total Operating Capital		183	163				
Free Cash Flow		58	100				260
(NOPAT-Net Investment in Total Operating Capital)							
Horizon Value							
PV of Free Cash Flow							
PV of Horizon Value							
PV of Future Cash Flows							

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FREEZING DAD: TAXING POTENTIAL HUMAN CAPITAL

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CASE DESCRIPTION

The primary purpose of this case is to encourage students to derive a plausible, well-supported answer to a novel tax situation (in which virtually no direction currently exists) using critical thinking skills. This case is important because practitioners inevitably face situations without finite, predetermined answers. The secondary purposes of this case are to utilize broad-based research skills and familiarize the student with Reg. Sec.1.6694-2(b) of the Internal Revenue Code of 1986, as amended) which states that to protect the preparer from penalties, a tax solution must have a better than 1 in 3 chance of being sustained on its own merits. The level of case difficulty is a 5/6 (graduate level), and is designed to be taught in 3 class hours with 6 hours of outside student preparation, or alternatively assigned as an out-of-class report with a 1-hour in-class discussion.

CASE SYNOPSIS

"Joan, we can be very wealthy in a few years, as long as the technology keeps advancing," said Jim Andrews to his sister. "I don't know, Jim, it sounds kind of eerie and science fiction-ish. And even if the technology is there and we make millions, how much is the government going to grab?" replied Joan. "Good point!" answered Jim. "Let's talk to our accountant."

Most business cases presented to students have a fixed answer either as the result of past investigation in a formal (e.g. legislation or litigation) or informal (academically studied and expert-recommended) environment. However, many problems in life contain novel elements for which no existing answer has been published. Thus it is critical that students be able to think independently of a known, existing answer, while simultaneously relying on similar existing research or tenets. The need for critical thought required to analyze such a situation and derive a tentative solution is as timeless as changes in business environment that precede legislation and litigation. Previous examples of where practitioners have faced novel situations include: the time period where equipment became increasingly more computerized (should the estimated useful life of hybrid equipment be that of the computer elements, or that of the other underlying asset?) and the estimated useful life of software (where tax software, for example was essentially good for a year, but other *applications had longer operational lives but faced acute obsolescence before they actually stopped functioning). This case, which is based on the death and subsequent litigation on the disposal of the remains of Ted Williams, has no definitive answer, and requires tax speculation supported by general logic and broad-based research.*

THE NATURAL

Robert Andrews was born in a small Midwest farm in 1922. His family, including his two sisters and a younger brother, worked hard and was close and active in school and the community. Bob's father, Arthur, loved baseball and attended as many minor league games as he could afford. He always took Bob and at an early age taught him the game. Every night they would play "catch" and Arthur would teach his eager pupil how to run the bases, slide, pitch, field, and hit from both sides of the plate. Arthur was impressed how quickly his son learned and applied his lessons.

Arthur made certain Bob was involved in as many sandlot games as possible, until Bob entered high school. Bob easily made the team and his freshman coach urged the varsity coach to take him the following year. After seeing a few games he was awe-struck by Bob's natural ability. He placed on the varsity roster the next year and for three years Bob pitched and played shortstop. The team made the playoffs all of Bob's three years, winning the State Championship the last two. Bob pitched 15 wins, with only1 loss over that span and hit thirty-five home runs. He was the Most Valuable Player the last two years and was State Athlete of the Year in his senior year.

Colleges took notice of Bob's prowess and scholarship offers came in droves. Minor league scouts had also noticed Bob, and Bob accepted a contract with the Toledo Toros for $5000, a good deal of money at that time. In his first year, Bob tore up the league, with an unusually high batting average, 45 homers, and 36 stolen bases. He pitched and won every one of his fourteen starts with an impressively low Earned Run Average (ERA) of 2.6. He was the league's Most Valuable Player and helped the Toros get to the World Series.

The following year, 1941, Bob enlisted as a pilot to fight in World War II. He was as good a pilot as he was a baseball player. He shot down twenty-two enemy planes over three years, and was internationally decorated for his service. He was honorably discharged as a major in 1946, returning to the Toros for the remainder of that year.

The following year, he batted .402 with thirty home runs and thirty stolen bases and was noticed by some major league scouts. He signed a professional contract with the Kansas City Cyclones. The Cyclones used Bob sparingly his first year. During that time he batted .330, hit twelve homers, stole 17 bases, and was 5 and 2 with an ERA of 3.1, but was then traded to the New York Colonials, who decided to use him as their full time right fielder.

Bob blossomed under the Colonial system and management. In his first year, he batted .388 with 37 home runs, 112 runs batted in (RBIs), and stole 40 bases. For the next fourteen years, Bob helped the Colonials to nine World Series Championships and twelve pennants. He had a batting average of.392, with 512 home runs, 1558 RBIs, and 587 stolen bases. He batted over .400 six times and was the League MVP eight times and the World Series MVP five times. He retired in 1966; his uniform was retired in 1967. He was elected into the Hall of Fame in 1971. In 2002, Bob passed away from a heart attack. At the memorial services, all of the old timers agreed that Bob was one of the top ten greatest ball players of all time.

THE PLAN

A few years prior to his death, Bob became fascinated with the idea of cryonics, the Genome Project, and cloning. He discussed the matter with his son, Jim, and daughter, Joan. At first they were appalled at the concept. Both were brought up to be very religious by their mother, who had passed away some ten years ago. Bob was not as religious, and therefore had no problem with the idea of being frozen with the intention of coming back some day, when medicine and technology would have eliminated most diseases. He decided to look into it further, and asked Jim and Joan to do the same.

After doing some extensive reading, Jim agreed with his father and they obtained all the necessary documentation. They decided on using Cyrotek, Inc. because of their long history and their founder, who wrote one of the first papers on the idea and subsequent procedure. Bob filled out the paperwork, set up a fund for all necessary expenses, and gave Jim and Joan power of attorney. He was convinced that in the future he would come back.

CYROTEK, INC.

In 1962 the cryonics movement started with the publication of "The Prospect of Immortality" by Robert Ettinger. After more book and articles on the subject, a number of organizations began and started to offer cryostasis services. One of these was Cyrotek and its founder Charles Wright, who believed that people could be brought back to life after rapid and intense freezing. Experiments with insects, fish, fowl, and other animals were successful.

The process of cryostasis involves an initial cool down using an anticoagulant. Then the blood is removed and replaced with a cryoprotectant, which is a solution that acts similar to antifreeze in a car. Next comes more cooling and then final immersion in liquid nitrogen at a temperature of –196 degrees celsius. The procedure must begin as quickly after the person is declared legally dead.

Approximately 200 people were frozen at Cyrotek's facility located in New Mexico. Another 77 have just their head frozen, which is called neurosuspension or "neuro". In addition to an initial cost, a fund is to be established to pay for the annual storage costs and replenishing of liquid nitrogen. This fund was estimated by Cyrotek to increase by 2% per year. Only the interest from the fund was to be used. Cyrotek estimated that the principal was $150,000 for Whole Body and $50,000 for Neuro.

THE NATURAL'S "DEATH"

Bob Andrews passed away from a heart attack on July 7, 2002 in a Texas hospital. Only his son and daughter were present. As soon as Bob was declared "clinically dead", the Cyrotek team sprang into action, wrapped Bob's body in a plastic wrap to prevent freezer burn, then packed Bob's body in dry ice, and stored it in an aluminum container. The container was transported by private jet to the Cyrotek facility and the process was completed the same day. All in all, it took seven hours from the time Bob was declared "dead" to his completed suspended animation at Cyrotek. At a wake held in Bob's honor, his friends eulogized about his character, his sense of humor, and his talent. Colleagues remarked, "if you could bottle and sell Bob's talent, you'd make a fortune."

THE REVISED PLAN

During their research on cyronics, Bob and Jim, discovered the field of genetics and cloning. Strides were made with the successful cloning of animals, and human cloning bans were lifted in Europe. Bob told Jim to look into it further, but before he could, Bob died. Jim discussed the matter with Cyrotek and it was agreed that 25 small DNA samples would be preserved. There were no additional costs for the freezing and yearly maintenance.

Jim felt that in the future cloning would become acceptable and technologically feasible. He thought that even if unfreezing his father would fail, that surely he could be cloned. Likewise, the comment that "if you could bottle and sell Bob's talent, you'd make a fortune" kept ringing in Jim's ears: he could sell off his father's DNA samples piece-meal to baseball fanatics, perhaps those who wanted their children to be athletically talented. He discussed the matter with his sister. Joan wanted to find out what the tax implications were. They decided to visit their accountant, Mike Stevens.

VISITING THE CPA

Jim and Joan explained their plan to Mike, who was shocked at first, but then he began to wonder, what were the tax implications of selling Bob's DNA? He told Jim and Joan that he would look into it and get back to them. Mike called in his staff and explained the situation. The staff noted that since this had not been done before, the tax laws on this point were likely unsettled. With no direct, existing precedent, the best they could do was construct a credible tax position, and hope that later, that tax position would be sustained.

In the next meeting with Jim and Joan, Mike told them that he had another client Jennifer Cohen, who ran two related for-profit corporate businesses, a sperm bank and an infertility clinic.

Mike told them that Jennifer was dedicated to alleviating the emotional hardship of those who were unable, but very much wish to, conceive and bear children. Mike felt that an alliance between the two could be quite worthwhile. With their concurrence, he arranged a meeting.

At the meeting, Jennifer became very intrigued at the prospect of selling DNA samples to bidders. She felt that with cloning technology, collecting, storing, and selling DNA samples from famous people (e.g. athletes, movie stars, geniuses, etc.) for purposes of reproduction can be as profitable as her current sperm bank business, which also had samples available for conception from individuals successful in their respective fields.

After much discussion, Jim, Joan and Jennifer came to an agreement and developed two plans:

> Plan 1) the celebrity's estate handles the interment (freezing) and all associated costs; DNA is received as requested and then used for conception; a generous honorarium is paid to the heirs.
>
> Plan 2) the alliance could handle the interment and all associated costs, distributing the DNA as requested and remitting a percentage of the proceeds' net of costs to the estate.

In either case, profitability depended on the willingness of the celebrities and their heirs to undergo cryogenics as their "last resting place," and their willingness in turn depended in part on the tax consequences to the celebrities, their estates, and heirs. Jim, Joan, and Jennifer believed that this was a way for celebrities to "live on" and contribute successful DNA to the generations of the future. However, they asked Mike to analyze this venture from an accounting (and particularly tax) standpoint. Mike called his staff together and gave them the following assignment, after explaining this new venture:

Under either plan:

1. What is the value to the estate of a celebrity's DNA?
2. Is the value of the remains of a celebrity sufficient enough to prompt estate tax?
3. Are the costs of cryogenics deductible by the estate? Currently (or must the costs be depreciated, depleted, or amortized)?
4. What is the estimated useful life *of a celebrity's remains?*
5. Would this plan, if profitable, produce portfolio income, ordinary income, capital gains, or other income (type - e.g. passive) for the estate? For the heirs? For our client?

Under Plan 1:

1. What is the heirs' basis in the celebrity's DNA?
2. Is the heirs' basis in the celebrity's DNA deductible against any proceeds received from DNA sales?
3. Are the costs of cryogenics deductible by the heirs? Currently (or must the costs be depreciated, depleted, or amortized)?

Under Plan 2:

1. Assuming the celebrity is interred in your facilities for further reproductive opportunities, have you purchased an asset?
2. If so, what kind of asset is it (how do you classify it)? If not, against what do you charge expenses (e.g. cost to transport the body in, etc.)
3. What is your basis in the celebrity's DNA?
4. Is your basis in the celebrity's DNA deductible against any proceeds received from DNA sales?
5. Are the costs of cryogenics deductible? Currently (or must the costs be depreciated, depleted, or amortized)?

SHOE WAREHOUSE CASE: APPLICATION OF STRATEGIC INFORMATION PRINCIPLES

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CASE DESCRIPTION

The primary subject matter of this case concerns identification of technology issues for a small business and the design of a new system. Secondary issues to be examined include implementation of a new system and data conversion issues. The case has a difficulty level of five. The case is designed to be taught in two class hours and is expected to take approximately ten hours of outside student preparation.

CASE SYNOPSIS

Students are presented with a business scenario in which they need to get a new information system installed for a small company where they have just started working. Students are asked to review the scenario, summarize the information in more organized fashion, describe the benefits of the new system and some possible solutions, then prepare a proposal for the new system they feel the company should pursue.

SHOE WAREHOUSE CASE

You've just been hired as the first full-time IT manager for a small shoe wholesaler. The company is small but very profitable. An outside sales force of 5 salespeople cover the southeastern United States selling to over 1,000 small retailers. The home office staff includes the company president and three vice-presidents (marketing, finance and operations). The vice-president for marketing is responsible for managing the sales force and implementing the marketing efforts which includes catalog preparation and distribution and frequent direct mail campaigns. The vice-president for finance is responsible for maintaining the general ledger, managing accounts payable, accounts receivable, purchasing and inventory. There are six office professionals assigned to the finance function: one each to the general ledger, accounts payable, purchasing and inventory and two to accounts receivable. The vice-president for operations is responsible for receipt and storage of manufacturer's shipments and filling and shipping customer orders. There are ten warehouse workers assigned to the operations function along with one supervisor and a clerical assistant. The office area and warehouse and shipping areas are housed within the same building but in separate areas.

The current information system is almost eight years old. There are frequent hardware breakdowns, network connections are slow or non-existent and the software is a patchwork of modified off-the-shelf accounting and personal productivity packages. Some needed applications were generated using a database management program from a company that is no longer in business. The work is getting done, but the company owners and managers are starting to get nervous about the continued performance of the system.

The company president, to whom you directly report, gives you your first assignment. She says, "You've got a budget of $75,000 to upgrade our old computer system. We want a fast, flexible network. And we want to move some of our marketing effort to the Internet. We'd also like to move toward having our salespeople use laptops to enter orders directly from customer stores.

INSTRUCTIONS TO STUDENTS

Consider the scenario and generate the following items:

Item 1: An executive summary describing the system that you would propose to the company president. (2 pages)

Item 2: An implementation plan for the new system; be sure you adequately cover the conversion of the data from the old system to the new system, as well as the necessary time line for the entire conversion process. Address whether there are any special software needs for the management of the implementation itself. (1 to 2 pages)

Item 3: A hardware budget that includes a detailed description of all hardware items to be purchased with estimated costs. *Hint*: Use the Internet sites of companies such as Dell, Gateway, Tiger Direct, and Black Box to cost items. Create this as a spreadsheet and copy it into your Word document. (1 page)

Item 4: A software budget that identifies the specific software packages with estimated costs. (May be combined with the hardware budget page from item 3.)

Item 5 : A floor plan of the facilities that indicates the location of all necessary equipment, such as servers, networked printers, desktop computers, networking equipment, Internet connections, etc.

THE PROPOSED MERGER OF AMERICA WEST AND US AIRWAYS: WILL IT FLY?

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CASE DESCRIPTION

This case discusses a proposed merger between two major airlines - America West and US Airways. The primary objective of this case is to address the critical issues required either to support or reject a merger strategy. The case would be appropriate for the senior or first year graduate level Strategic Management course, and the case should work well as a team project. The case is designed to be taught in 1 class hour and is expected to require 3 hours of outside preparation by students.

CASE SYNOPSIS

In April 2005, America West and US Airways made a public announcement concerning a proposed merger between the two carriers. The information needed to support or reject this proposal is available from company, industry, and governmental sources and generally indicates that although the proposed merger partners operate in the same industry, they have very different operating characteristics. This case challenges students to analyze the critical strategic issues which the proposed merger partners must address to consummate successfully a merger.

INTRODUCTION

The glamorous nature of the airline industry attracts investors and inspires optimism, even though wide swings in financial performance have been the pattern for the industry since the late 1970s. The industry-wide average operating profit was only 1.9% during the 1980s and 3.2% during the 1990s while operating losses have averaged over $5 billion per year since 9/11 (Air Transport Association). Additionally, based on its survey of airline industry leaders, the Air Transport Association (ATA) predicted that the current reduction in air travel spending would threaten the future of all airlines not built around a cost structure designed to yield better profitability (Donoghue and Geoff, 2003). Many industry analysts conclude that the restructuring of airline networks and fleets based on cost must be the central theme for the industry's long-term strategy for survival

(Kangis and O'Reilly, 2003). Given this changing environment, what critical merger issues need to be addressed in order for these two airlines to best achieve lower operating costs through merger?

OVERVIEW OF THE AIRLINE INDUSTRY

The low profitability of the airline industry during the modern era (see Table 1) was not evident during the growth years following WWII as the worldwide development of airports and the design of larger transport aircraft supported growth in both the scale and scope of the airline customer base. Airline travel represented a value-added activity for business travelers and offered a viable option for leisure travelers with limited travel time. Between 1950 and 1973, the industry recorded an average passenger growth rate of 13% per year while operating costs per seat mile dropped by 50% during the same period (Banks, 1993). With route structures and ticket prices controlled by the Civil Aeronautics Board (CAB), the airline industry recorded poor financial performance during the 1970s. This factor in combination with growing public dissatisfaction with airline service quality led to the passage of the Airline Deregulation Act in October of 1978. This act placed the industry under the control of the Department of Transportation (DOT), an entity focused primarily on issues of operating procedures and safety. In this newly deregulated environment, the number of certified air carriers grew from 37 to 100 between the years 1978 and 1984 (The Airline Handbook, 2003). Many of these new carriers entered the market using low-cost operating models – models which began to change the competitive landscape. Utilizing operating plans built around no-frills service, these carriers reduced costs and attracted price-conscious passengers. However, it is important to note that carriers offering low fares supported by low costs were not assured success during this period as many new discount carriers failed because of poor operating strategies or because of market pressure from the established major carriers.

Table 1: U.S. Airlines – Annual Revenues and Profits (All services)

Year	Operating Revenues ($000,000)	Annual Profit or (Loss) ($000,000)		Cumulative Profit or (Loss) ($000,000)	
		Operating	Net	Operating	Net
2004	130,766	(1,398)	(9,104)	43,528	(14,155)
2003	117,656	(2,081)	(3,632)	44,925	(5,051)
2002	106,985	(8,566)	(11,312)	47,006	(1,420)
2001	115,527	(10,326)	(8,275)	55,573	9,893
2000	130,839	6,999	2,486	65,899	18,168
1999	119,455	8,403	5,360	58,900	15,681

Table 1: U.S. Airlines – Annual Revenues and Profits (All services)					
Year	Operating Revenues ($000,000)	Annual Profit or (Loss) ($000,000)		Cumulative Profit or (Loss) ($000,000)	
		Operating	Net	Operating	Net
1998	113,810	9,328	4,903	50,496	10,321
1997	109,917	8,587	5,168	41,168	5,418
1996	102,444	6,209	2,804	32,582	250
1995	95,117	5,860	2,314	26,373	(2,554)
1994	89,037	2,713	(344)	20,513	(4,867)
1993	85,298	1,438	(2,136)	17,800	(4,523)
1992	78,357	(2,444)	(4,791)	16,361	(2,388)
1991	75,234	(1,784)	(1,940)	18,805	2,403
1990	76,141	(1,912)	(3,921)	20,590	4,343
Source: Air Transport Association					

During the 1980s, most established carriers chose not to adopt low-cost models; instead, they chose to employ innovative marketing and operational strategies to differentiate their service and continued to focus on attracting business travelers. By tracking passenger reservations, the major carriers were able to keep business travelers loyal by offering service upgrades and free tickets based on total passenger miles flown. Additionally, discount tickets were offered to leisure travelers willing to accept early bookings, no ticket refund policies, and other restrictions. These programs increased revenues and market share while still protecting seats for higher paying business travelers. To further increase revenues, airline *management science* specialists used *operations research* tools to predict demand for available seats over time. This new information allowed for the creation of a new ticket pricing strategy that focused on *yield management* techniques. For example, over a three-year period beginning in 1985, American Airlines used yield management to generate $1.2 billion in additional revenues (Smith, Gunther, Rao, and Ratliff, 2001). By using innovative marketing and pricing models, the top ten major carriers were able to defend against the discount carriers and entered the1990s controlling 90% of the market (Das and Reisel, 1997).

As the measured growth of the industry began to stabilize during the 1990s (see Table 2), airline analysts began to consider life-cycle effects (Costa, Harned, and Lundquist, 2002). The 13% growth rate in passenger traffic recorded during the 1970s slowed to a 6% annual growth rate during the 1980s and then down to a 4.0% rate during the 1990s. As the industry matured, yield began to decrease, and the rate of passenger growth became equal to the rate of economic growth. In this environment, many carriers found that the successful growth strategies of the past were less effective. As air service became more standardized, there was industry-wide overcapacity, demand was mass-market driven, and no carrier held a technological advantage. Also, the first widespread use of electronic ticket information allowed customers to compare fares and promotions that helped them to consider airline seats as perfect substitutes between carriers. The effects of a mature market led the major airlines to shift emphasis from passenger growth to revenue growth as they employed more aggressive yield management techniques aimed at business travelers. These techniques grew in sophistication during the 1990s as airlines found that frequent business travelers were willing to pay even higher prices. For example, Carey (2002) reported that business passengers generated 46% of revenue but represented only 9% of passengers for one carrier. With the allure of this type of success in revenue growth through the use of *yield management* techniques, major carriers found it difficult to adopt strategies that would today deal more effectively with the problem arising from industry maturity, changes in internet and communications technology, or the success of discount carriers using low-cost operating strategies.

INDUSTRY FINANCIAL CRISIS

A major industry recessionary cycle began in 2000 as business travelers began to seek alternatives to the increasingly higher and higher fares charged by the major carriers. Also, the terrorist attacks of 9/11 lead to a reduction in all travel and accelerated the industries decline. Even with a turnaround in revenue passenger miles in 2003 (see Table 2), net losses for the industry exceeded $30 billion by the beginning of 2005 (see Table 1). In this operating climate, most historical marketing and operational remedies were not available, and most carriers faced a difficult task of reorganization with some having to liquidate, some having to enter bankruptcy protection, and others having to seek government support. One form of government support - the Air Transportation Safety and System Stabilization Act - was passed by Congress on September 24, 2001, to provide loan guarantees for qualified carriers.

By 2004, the effects of the industry's worst financial downturn in history left low-cost carriers controlling 20% of the U.S. market with analysts predicting future market growth to 40-50% for this group (Velocci, 2004). In this environment of dramatic industry change, both merger partners seek the reorganization needed to support a low-cost operating network. In an interview with the Associated Press, David Bonner, CEO of the Retirement System of Alabama, a major investor in US Airways, concluded that because they would complement each other geographically, a combined US Airways – America West would compete better against discount carriers (Flynn, 2005). The CEO of America West, Douglas Parker, said that "the merger will create the first nationwide full-service, low-cost airline" (Reed, 2005).

Table 2: U.S. Airlines – Annual Operations, Traffic, and Capacity (Scheduled Service)				
Year	Enplanements (000)	Revenue Passenger Miles - Pax (000,000)	Available Seat Miles - ASM (000,000)	Load Factor (%)
2004	697,792	731,926	968,976	75.5
2003	646,276	656,909	893,824	73.5
2002	612,877	641,102	892,554	71.8
2001	622,129	651,700	930,511	70.0
2000	666,150	692,757	956,950	72.4
1999	635,959	652,047	918,419	71.0
1998	612,885	618,087	874,089	70.7
1997	594,725	603,419	857,232	70.4
1996	581,234	578,663	835,071	69.3
1995	547,773	540,656	807,078	67.0
1994	528,848	519,382	784,331	66.2
1993	488,520	489,684	771,641	63.5
1992	475,108	478,554	752,772	63.6
1991	452,301	447,955	715,199	62.6
1990	465,560	457,926	733,375	62.4
Source: Air Transport Association				

Company Profile – America West Airlines

America West entered airline service in August of 1983. Based in Phoenix, the initial small fleet of three aircraft was supported by 280 employees who worked successfully to grow the company during the early years following deregulation. The carrier expanded rapidly and achieved major-airline status by 1990 when, with over 12,000 employees, it generated annual revenues exceeding $1 billion. The company's growth was interrupted during the 1990-1995 airline industry recession as the effects of rapid expansion, increased fuel costs, and concerns over middle-Eastern tensions led to a financial crisis that forced America West to file for bankruptcy protection on June 27, 1991. Flight operations were reduced to include 87 aircraft, and the total work force was reduced to 10,000 employees by 1994 when the company successfully emerged from bankruptcy (Field, 2002).

To grow during the early 1990s, the company added service and entered into cooperative agreements with several other carriers. This growth included the introduction of regional airline service in 1992 with the launch of American West Express and expanded international routes through strategic alliances with British Airways, Virgin Atlantic Airways, and several other international carriers. By 1999, this strategy helped the company to grow revenues to over $2 billion (see Table 3).

Table 3: America West Airlines – Financial and Operating Data

Data Type
- A – Total Operating Revenue – ($000,000)
- B – Operating Profit or (Loss) – ($000,000)
- C – Asset Productivity – (total aircraft operating expense / revenue passenger miles) – ($/Pax)
- D – Operating Margin - (operating profit or (loss) / operating revenue) – (%)
- E – Market Share - (revenue passenger miles / industry total) – (%)
- F – Labor Burden – (total salaries and benefits / total operating expense) – (%)
- G – Average Aircraft Utilization/Day – (Hours/Day)
- H – Revenue Passenger Miles (Pax) - (000,000 miles)
- I – Available Seat Miles (ASM) - (000,000 miles)

Year	A	B	C	D	E	F	G	H	I
2004	2,482	(24.4)	.061	-.010	.031	.281	10.88	23,333	30,153
2003	2,224	23.8	.061	.008	.032	.312	10.04	21,285	27,871
2002	2,021	(164.1)	.061	-.085	.030	.288	9.48	19,878	27,008
2001	2,035	(423.3)	.069	-.240	.027	.262	9.75	19,080	26,545
2000	2,310	(12.7)	.069	-.000	.027	.258	10.99	19,113	27,109
1999	2,163	197.9	.058	.091	.026	.272	11.80	17,710	25,911
1998	1,983	197.8	.054	.099	.026	.269	12.10	16,375	24,309
1997	1,887	162.5	.054	.086	.026	.258	12.38	16,204	23,568
1996	1,752	68.6	.052	.037	.025	.245	11.88	15,322	21,625
1995	1,562	154.7	.047	.099	.024	.285	11.42	13,312	19,421
1994	1,415	146.3	.046	.103	.023	.271	11.19	12,233	18,061
1993	1,331	121.0	.049	.090	.022	.261	10.67	11,221	17,190
1992	1,302	(74.8)	.054	-.057	.024	.247	10.31	11,780	19,271
1991	1,419	(104.5)	.056	.075	.028	.263	10.30	13,032	20,629
1990	1,321	(31.6)	.058	-.022	.024	.271	10.29	11,115	18,287

Source: Bureau of Transportation Statistics (Air Carrier Form 41 and 298C)

The terrorist attacks of 9/11 helped to push the industry into its worst financial downturn in history and forced many airline executives to ask Congress to approve emergency loans. On January 18, 2002, America West was granted a $380 million government loan guarantee that allowed the company to access a $429 million term loan. By the beginning of 2005, the company operated 143 large aircraft and had positioned itself as a low-cost, full-service airline with hubs in Phoenix and Las Vegas. From these hubs, 96 destinations were served. Most routes were concentrated in the western U.S., with some long-range routes linking cities in the eastern U.S., Mexico, Canada, and Costa Rica. Plans were announced to expand regional jet service to smaller markets, and in April a proposal was made public concerning a possible US Airways merger.

Under the terms of the merger proposal, America West would retain managerial control, and the merged companies would retain the name of US Airways. Stated motives for the proposal emphasized the complementary nature of the western network of America West combined with the northeastern, European, and Caribbean routes of US Airways. Still, many issues remained to be addressed by the management team, including the mixture of aircraft fleet types, employee representation (see Table 4 & 5), benefits considerations, vendor relations, creditor requirements, government oversight requirements, and stockholder acceptance (www.americawest.com).

Table 4: Airline Operating Information (2005)

Category	America West	US Airways
Employees	14074	30100
No. of Aircraft	143	276
Avg. Fleet Age	10.7 years	11.2 years
Aircraft Leased	95%	75%
Revenue	$2.34 billion	$7.10 billion
Cities Served	96	181
Headquarters	Phoenix, AZ	Arlington, VA
Aircraft Type	Quantity (seats) by Carrier	
A319	34(124)	64(120)
A320	59(150)	24(142)
A321		28(169)
A330		9(266)
B737-300	37(132)	67(126)
B737-400		44(144)
B757	13(190)	13(190)
B767		10(203)
Source: www.americawest.com		

Table 5: Airline Labor Union Representation (2005)						
Category	America West			US Airways		
	Union	Employees Covered	Term	Union	Employees Covered	Term
Attendants	AFA	2682	negotiations	IAM	5332	renew 2011
Fleet Service	TWU	2459	renew 2010	IAM	4450	renew 2009
Pax Service	IBT	2327	negotiations	CWA	3753	renew 2011
Pilots	ALPA	1888	renew 2009	ALPA	2957	renew 2009
Mechanics	IBT	845	negotiations	IAM	3848	renew 2009
Reservations	IBT	1269	negotiations	CWA	1578	renew 2011
Stock Clerks	IBT	67	renew 2008			
Dispatchers	TWU	38	renew 2008	TWU	130	renew 2009
Flight Instructors				TWU	53	renew 2011
Sim Engineers				TWU	24	renew 2011

Unions
AFA : Association of Flight Attendants – Communications Workers of America
ALPA: Airline Pilots Association
CWA : Communications Workers of America
IAM : International Association of Machinists and Aerospace Workers
IBT : International Brotherhood of Teamsters
TWU : Transport Workers Union
Source: www.americawest.com

Company Profile: US Airways

In 1939, US Airways began airmail service as All American Aviation. The airmail carrier grew and in 1949 added passenger service using modern DC3 aircraft to serve Pennsylvania and the Ohio valley areas. All American became Allegheny Airlines in 1953 and continued to grow with the addition of DC9 jet aircraft in 1966 as the carrier began a period of growth through mergers and acquisitions that would allow it to reach sixth largest in terms of passengers.

Allegheny expanded its Midwest and northeastern routes by absorbing Lake Central Airlines in 1968 and Mohawk Airlines in 1972 respectively. In 1979, following passage of the 1978 Airline Deregulation Act, Allegheny changed its name to USAir. During the 1980s, USAir grew dramatically with the introduction of its frequent traveler program in 1985, the purchase of Pacific Southwest Airlines (PSA) in 1988, and the purchase of Piedmont Airlines in 1989. With this last purchase, long-range aircraft and international routes were added to its network. During the 1990s, revenues grew (see Table 6) as additional transatlantic routes along with new Airbus aircraft were added. USAir officially changed its name to US Airways in 1997. In April of 1998, Trump Shuttle was bought to expand further the east coast routes between New York, Washington, and Boston.

Table 6: US Airways – Financial and Operating Data

Data Type
- A – Total Operating Revenue - ($000,000)
- B – Operating Profit or (Loss) - ($000,000)
- C – Asset Productivity – (total aircraft operating expense / revenue passenger miles) – ($/Pax)
- D – Operating Margin - (operating profit or (loss) / operating revenue) – (%)
- E – Market Share - (revenue passenger miles / industry total) – (%)
- F – Labor burden – (total salaries and benefits / total operating expense) – (%)
- G – Average Aircraft Utilization/Day – (Hours/Day)
- H – Revenue Passenger Miles (Pax) - (000,000 miles)
- I – Available Seat Miles (ASM) - (000,000 miles)

Year	A	B	C	D	E	F	G	H	I
2004	7,073	(347.9)	.072	-.052	.054	.314	9.45	40,504	53,991
2003	6,762	(421.3)	.076	-.065	.056	.341	9.47	37,782	51,565
2002	6,916	(919.3)	.080	-.134	.061	.366	9.71	40,034	56,352
2001	8,253	(1,181.4)	.094	-.177	.063	.400	9.49	45,964	66,720
2000	9,181	(44.4)	.085	-.007	.066	.385	10.07	46,880	66,555
1999	8,460	307.5	.067	.022	.059	.398	9.46	41,552	59,230
1998	8,556	990.0	.071	.115	.065	.399	9.42	41,369	56,860
1997	8,500	586.1	.078	.068	.067	.396	9.31	41,748	58,495
1996	7,705	368.7	.077	.046	.066	.429	9.03	39,241	57,231
1995	6,984	234.6	.075	.032	.068	.424	9.05	38,080	58,672
1994	6,578	(505.1)	.083	-.080	.071	.408	9.10	39,394	61,538
1993	6,622	(128.7)	.082	-.020	.070	.417	8.81	35,528	59,863
1992	6,236	(375.5)	.084	-.061	.072	.397	9.18	35,436	60,051
1991	6,049	(202.1)	.083	-.035	.075	.403	9.13	34,398	58,573
1990	6,084	(543.2)	086	-.091	.076	.408	9.14	35,750	59,713

Source: Bureau of Transportation Statistics (Air Carrier Form 41 and 298C)

In May of 2000, *United Airlines* announced a proposal to buy *US Airways* for $4.3 billion. However, both airlines were losing money as the industry settled into a major industry down cycle. This fact, combined with labor union opposition and questions of legality from government regulators, forced *United Airlines* to withdraw its proposal in July of 2001.

The terrorist attacks of 9/11 were especially hard on US Airways and its east coast market concentration, which included Washington and New York. The company filed for Chapter 11 bankruptcy protection on August 11, 2002, and applied for and was granted a $900 million government loan on February 11, 2003. The loan through the Air Transportation Stabilization Board plus network cost-cutting efforts allowed the carrier to emerge from bankruptcy on March 31, 2003. However, the restructuring gains were not sufficient to maintain profitable operations, and the company once again entered Chapter 11 bankruptcy protection on September 12, 2004.

At the time of this case writing, the courts had granted several relief measures to US Airways covering reductions in pay, pension, and retiree benefits. Merger negotiations with America West were made with the carrier still operating under bankruptcy protection (www.usairways.com).

CONCLUSIONS

More than forty airline mergers have been approved since the deregulation of the U.S. airline industry in 1978. In fact, the industry profile of US Airways shows how mergers and acquisitions played a major role in the growth of this carrier. Now, with the backing of the bankruptcy courts, it has been able to cut drastically its operating costs and make itself a merger candidate for the financially stronger America West. Combined, these carriers would be the fifth largest when measured in terms of revenue passenger miles. However, with record high debt and overcapacity, size alone does not guarantee success in an industry that is restructuring to compete more on the basis of lower operating costs and higher quality.

ASSIGNMENT

Use data or information available from company, industry, and government sources to identify and analyze the critical issues that must be addressed in order to consummate the proposed merger of America West and US Airways. An abundance of information may be found in the Investors Relations section of www.americawest.com and www.usair.com, particularly within their respective SEC filings. Also, proprietary sites such as Standard and Poors NetAdvantage provide quality information. From your analysis, answer the following questions.

Question 1. Evaluate the internal and external environment and analyze major obstacles to making this merger successful.

Question 2. An increase of $1/barrel increases the merged airline's costs by $36M. The merger model was based on $50/barrel. At $66/barrel, how much does this increase the merged company's fuel costs? What options does it have to offset this increase?

Question 3. In preliminary merger discussions, it was agreed that the existing top level of management at AWA will become the top level of management for the proposed merged company. Does the data presented in the case indicate any areas wherein the merged management team may be able to improve overall operating results? The team would accomplish these improvements by applying differing managerial practices to the larger portion of the merged company which was *US Airways?*

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DID NAPOLEON WIN THE BATTLE OF WATERLOO?

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CASE DESCRIPTION

The primary subject matter of this case concerns the value of information. A secondary issue raises the question of the effect of technical progress in the dissemination of information on the organization of markets. The case has a difficulty level of 3 to 4, it was designed for an audience of juniors and seniors with elementary knowledge of statistics, economics, and finance to illustrate the concept of value of information for the private citizen and for society at large. The class discussion easily fits within a 50 minutes class and is expected to require no longer than 60 minutes of outside preparation by students. The unfamiliar historical setting for the case and the well-known personalities featured typically captivate student interest.

CASE SYNOPSIS

This case evokes the financial uncertainty on the London stock market on the eve of the Battle of Waterloo in 1815. The lack of accurate information offered opportunities for tremendous profit for economist David Ricardo and banker Nathan Rothschild. The case illustrates numerically the rates of returns that could be achieved in such circumstances and makes us appreciate the value of instantaneous, accurate information in today's global markets.

CASE

Imagine the atmosphere in London, England the week of June 18, 1815. The country was reeling after 23 years of war waged by England and its allies on the European continent first against the French Revolutionary Government and next against the megalomaniac Emperor of France, Napoleon Bonaparte, whose ambition was to control the entire continent.

In order to finance the war effort, England had borrowed heavily by selling "consols" or obligations of the British Government with a par value of 100 British pounds and a fixed 3 % coupon payment indefinitely. In other words, consols were perpetuities issued by the British Government to finance its National Debt, they were traded on the London Stock Exchange.

As Bonaparte initially swept successfully through Europe, replacing ruling heads of states with members of his family and staff, the entire financing of the allied war effort rested on England alone. Furthermore, England's economy suffered from the embargo imposed on trade with the Continent, embargo that disrupted time-honored trading patterns for locally manufactured cloth and for exotic goods imported from the British Colonies. English troops had survived the prolonged, unspeakable rigors of the Spanish/Portuguese Peninsula campaigns, often starving, in rags, and lacking armament until they pushed the French troops back into France and Napoleon into exile at Elba. After barely a few months of peace and before the Congress of Vienna could agree on repartitioning Europe to repair Napoleon's defacement of national frontiers, Bonaparte broke free from Elba. He raised his faithful French partisans to form a formidable force and marched towards the Northern borders of France to confront the allied European powers (England, Russia, Prussia, Austria, the Netherlands, etc.) under the command of English General Wellington and Prussian Marshal Blucher. The fate of Europe hung on the results of the upcoming battle. If the Allied forces could not win decisively, England would be totally bankrupt and no longer be able to sustain its war effort leaving Bonaparte the uncontested Master of Europe.

Allied troops slowly amassed around Brussels, Belgium, some walking from as far as Prussia, Austria and what we now call Germany. The French troops were massing along the Franco/Belgian border. It took several months to bring the armies in the same vicinity to prepare for a decisive battle. Wellington and the allied troops counted 67,000 men. The French had assembled 74,000 men. Wellington trusted troops and staff from the peninsular war had been disbanded, many sent to the American continent in the belief that Napoleon was safely out of commission. Wellington was facing a battle for the fate of Europe with raw recruits and without his trusted cadre of officers. In mid-June, he sent news to his government that a decisive engagement was imminent. Everyone in London waited anxiously for news, some in anguish for loved ones, some in anguish for the sake of their portfolios.

One must understand how slowly news traveled in 1815. General Wellington was actively leading his troops during a battle that lasted two full days and nights and whose outcome remained uncertain to the very last minute when reinforcements finally arrived from afar, led by Marshal Blucher, to disband the wary French troops. The battlefield was a scene of confusion and carnage with 37,000 men and 15,000 horses felled on approximately two and a half square miles. After the victory, in the late evening of June 18th, 1815, the allied troops were so exhausted they could hardly see to their own wounded comrades before they slept. It is only the next day (June 19th) that Wellington handwrote his official dispatches to be delivered to the British government with all speed. From Wellington's headquarters in the small village of Waterloo, at the edge of the battlefield, a trusted courier hand-carried the dispatches on horseback all the way to the port of Ostend (Belgium), a distance of about 100 miles. This necessitated changing horses as they tired quickly from the hurried pace. Then, the dispatch carrier chartered a sailboat to cross the Channel, waiting for the tide to ebb and help carry the boat to sea and working with what wind happened to be blowing to reach England. Once on English soil, the courier rode on as speedily as feasible, changing mounts as needed, to reach London, approximately another 100 miles from the coast.

A young banker, Nathan Rothschild, recently naturalized citizen of England, had established himself in London as the most active and influential financial power in sustaining the war effort.

His personal wealth and that of his banker brothers established throughout Europe rode entirely on the success of England. He was a well-known figure in financial and political circles. His energy, his commitment to England, the astuteness of his financial deals and his unparalleled network of agents providing him with speedy hard-to-get information were legendary. No one was surprised when an exhausted Rothschild courier arrived in the Capital in the morning of June 20th to bring Nathan Rothschild news of the battle. Historical accounts vary widely on the subsequent events. The most credible version is that Nathan Rothschild read the news and immediately rushed to the mansion of Lord Castlereagh, the Foreign Secretary, only to first be denied entry by a snooty butler and next be disbelieved by a puffed up nobleman. Rothschild then proceeded to the Stock Exchange where he stood in front of an old pillar, as was his custom. Rothschild and his agents started dealing relentlessly throughout the day and the next day (June 21st.) Some accounts report that Rothschild, looking gloomy, started selling, this precipitated a panic with the price of consols precipitously dropping. Other accounts (Cowles. 1973) have him and his agents simply buying and sweeping up consols at the price brought about by uncertainty and earlier discouraging news of British setbacks in preliminary engagements before the full-fledged battle. Forty hours after the Rothschild courier, the official dispatches arrived in London with captured flags and the news of a victory at Waterloo finally became official in the evening of June 21st. By then, rumor has it that Nathan Rothschild had totally cornered the consols market (Carmack, 2003). Meanwhile, David Ricardo, the famed economist, had kept his cool and hung on to his portfolio of consols throughout the tumultuous week of June 18, 1815 to become a very wealthy man in his own right (Skousen, 2002).

QUESTIONS FOR DISCUSSION

1. Compare the uncertainties associated with the Battle of Waterloo to the uncertainties associated with a recent battle, say during the American invasion in Iraq. Could any one citizen, however influential, have a temporary monopoly on crucial, accurate information today?

2. David Ricardo, the economist celebrated for developing the theory of International Trade based on comparative advantages, is reported to have held on his holdings of consols in spite of rumors and panics (Skousen, 2002). We know that consols closed at 69 & 1/16 pounds on Friday, June 16th, and stayed at that price until the 20th when Rothschild started buying. The price was up to 70 pounds even on Wednesday the 21st before the victory became official news, and closed at 71 & ½ on Friday the 23rd (Cowles, 1973). What rate of annualized return would Ricardo have realized on his consols holdings over the week of June 16th to June 23rd, 1815?

3. Consider the following (fictitious) numbers and compute the expected value of accurate information about the outcome of the battle for Nathan Rothschild. Make the following assumptions:

   a. The French and the Allied Forces had a 50-50% chance of winning the decisive battle.
   b. Rothschild had 200,000 British pounds in cash available for speculation (roughly the equivalent of 20 million U.S. dollars today).
   c. Rothschild assumed that on the news of an imminent battle, uncertainty and panic selling would bring the price of a consol as low as 50 British pounds, and that the price would sink and stabilize at 20 pounds in the case of a British defeat or would rise and stabilize at 73 pounds in the case of a British victory.
   d. Rothschild was confident that his sources would tell him the results of the engagement a full 24 hours before the official confirmation would arrive.
   e. On the news of a victory, Rothschild would not attempt to aggravate the panic by selling first to bring prices even lower and buy later at the new bottom price.
   f. Rothschild would not engage in hedging operations. He would enter the market only upon news of a confirmed victory.
   g. Does this little historical example illustrate to you an aspect of the role of technology in economic markets that may not come immediately to mind? Does this example suggest that, through the ages, we have come closer or further from what economists define as "perfect competition?" Explain.

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DISASTER RECOVERY FOLLOWING THE EVENTS OF SEPTEMBER 11, 2001

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CASE DESCRIPTION

This case analysis examines the process of developing and implementing a disaster recovery plan. The case (1) discusses some of the inherent problems that large organizations face in developing an effective disaster recovery plan, and (2) highlights the challenges of implementing a disaster recovery plan in the face of real world events that vary from the plan's initial assumptions. This material is appropriate for undergraduate and graduate courses in risk management, information systems, and business continuity planning. The case is designed to supplement a general discussion of disaster recovery planning, and disaster risk management.

CASE SYNOPSIS

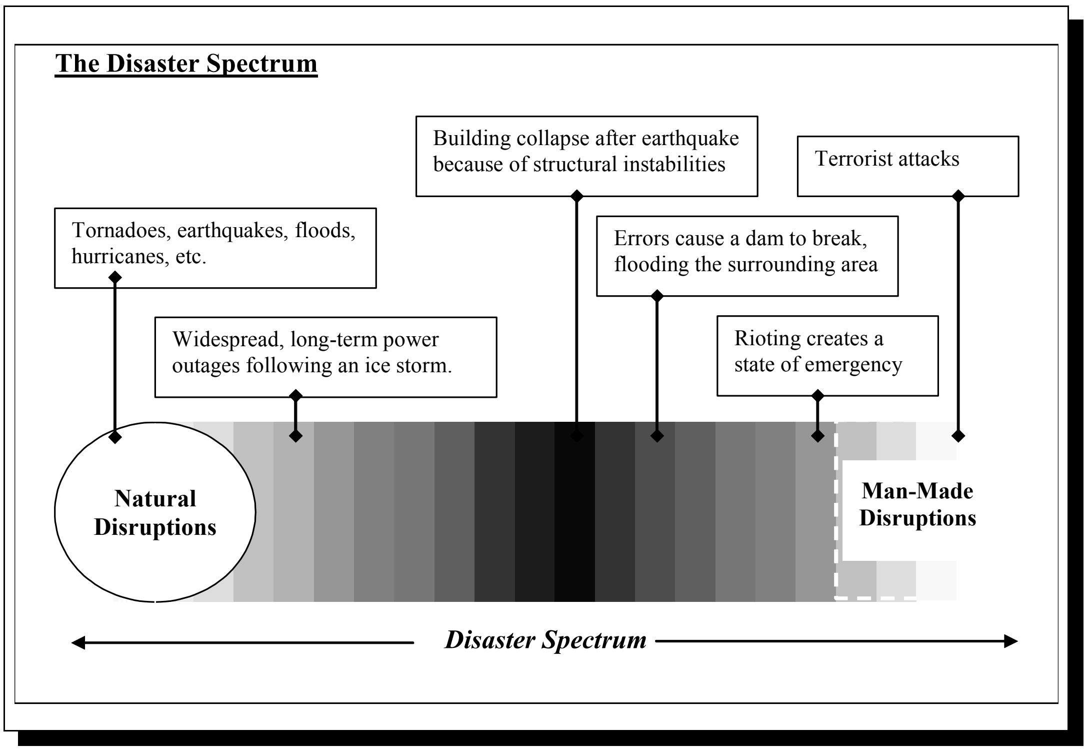
Developing a disaster recovery plan is a challenging process for most organizations, requiring plan developers to strike an appropriate balance between breadth and detail. In 2001, the Chief Financial Office organization began a disaster recovery process that was completed in the early part of September 2001. This case reviews the process used by Merrill Lynch's CFO organization to develop a disaster recovery plan, and the challenges faced in implementing this plan following the events of September 11, 2001.

INTRODUCTION

A broad scope of disasters can incapacitate a company's operations. The "disaster spectrum" can range from natural catastrophes, such as a tornado or hurricane, to "man-made" tragedies such as terrorist attacks. Developing a plan that can handle the gamut of possible events is particularly challenging, because plan developers must weigh the benefits of broad applicability against the need for sufficient detail to be useful in the event of a disaster.

Given that it would be infeasible to formulate specific responses for the entire disaster spectrum, plan developers often struggle to devise a plan that strikes the appropriate balance between sufficient plan detail and broad based applicability.

If the plan is too focused, the company may find itself with a well formulated plan that does not apply to the disaster at hand. Conversely, if the plan is too broadly developed its usefulness may be limited in the event of an actual disaster. It is therefore imperative that companies frame their business continuity planning parameters to ensure some flexibility, while at the same time providing a detailed enough framework to be effective across the broad spectrum of possible disasters.

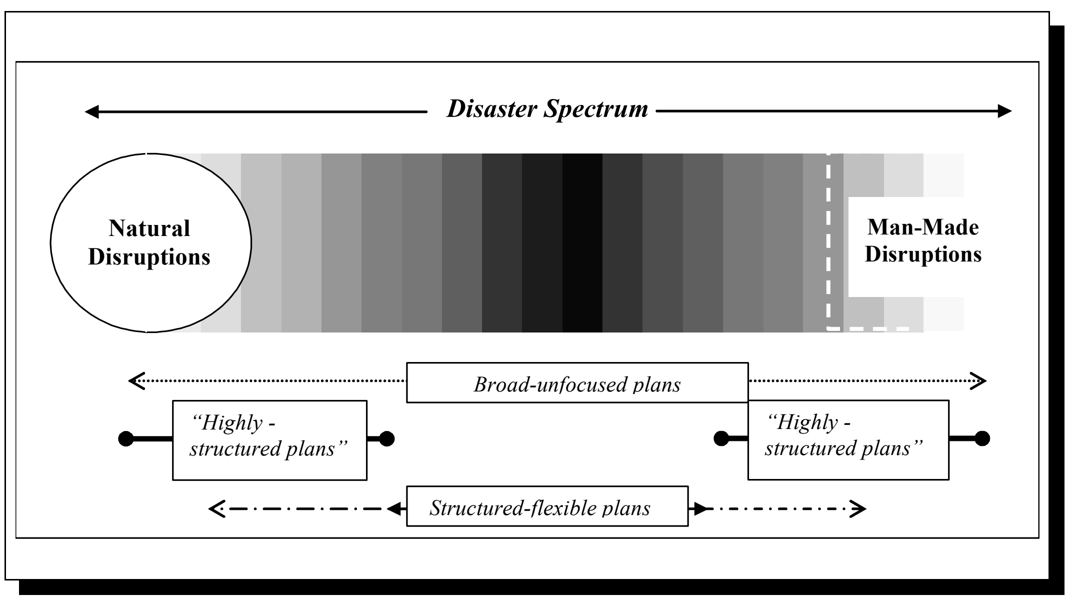


One of the most critical aspects in developing a comprehensive disaster plan involves choosing the parameters and assumptions to use during plan development. These elements define the ultimate structure of the plan and, therefore, its elasticity and effectiveness. A number of situational factors will often influence this choice. A company's location in southern California, for example, may make it particularly susceptible to earthquakes; a business site close to the North Carolina coast, on the other hand, may make hurricanes more pertinent. Aside from explicit spectrum considerations, however, corporate culture or employee biases and attitudes may also drive the parameters and implicitly affect the assumptions. It is important for developers to consciously recognize these influences so that they can evaluate what areas on the disaster spectrum are vulnerable.

STRUCTURING DISASTER RECOVERY PLANS

A common error that many companies make in developing a disaster recovery plan is that they focus on developing detailed protocols at the expense of plan flexibility. These "structured plans" outline in detail the actions that business units and individuals must take in the event of a disaster. They often include implicit or explicit assumptions about the nature of the disaster event, which directly influence the design of disaster protocols and recovery procedures. However, the usefulness of the plan could be severely diminished if the observed conditions vary significantly from the plan assumptions.

While the functionality of "structured plans" can be limited by their lack of flexibility, plans that are developed with insufficient depth can be equally problematic. If the plan is too broadly developed, it may be thin and without substance, thereby failing to provide sufficient guidance and structure in the event of an emergency. Thus, the challenge in developing an effective disaster recovery plan is to provide sufficient detail to provide effective disaster recovery guidance, while at the same time offering enough flexibility to be applicable across the spectrum of possible disasters. Thus, an effective plan should have substance, while at the same time be flexible enough to mold to a variety of situations without destroying its functionality.



MERRILL LYNCH CFO UNIT'S DISASTER RECOVERY PLAN AND THE EVENTS OF SEPTEMBER 11, 2001

The events of September 11 provide an unfortunate but useful illustration of the repercussions of implementing business continuity plans in a real emergency scenario. In this section, we review the development and implementation of the disaster plan for Merill Lynch's CFO unit following the events of September 11, 2001.

Business continuity planning (BCP) at ML used ten general phases:

Phase 1	Define Business Continuity Program
Phase 2	Define Program Objectives
Phase 3	Risk and Business Impact Analysis
Phase 4	Current Capability Analysis
Phase 5	Requirements Analysis
Phase 6	Recovery Strategy Analysis
Phase 7	Implement Recovery Strategies
Phase 8	Document Plans
Phase 9	Testing
Phase 10	Ongoing Plan Maintenance and Testing

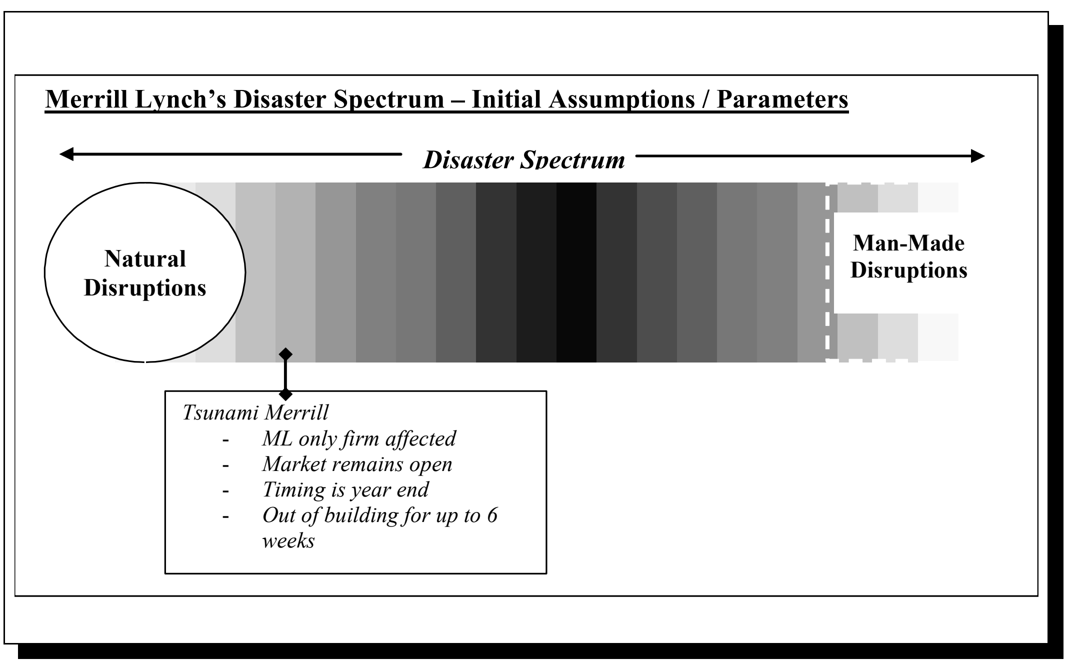
The size and diversity of ML's operations and functions, however, precluded the development of a single firm-wide plan. Instead, ML utilized a business focus methodology that effectively combined structure and flexibility in the company's BCP process. This approach gave individual units flexibility in structuring their BCP, provided that the process focused on four broad categories.

Phase 1	Program Definition & Setup
Phase 2	Analysis: Risk, Business Impact, Recovery Requirements and Strategy
Phase 3	Implementation
Phase 4	Quality Assurance, Testing & Maintenance

Each division of the company formed a BCP team, which coordinated divisional efforts for recovery, including data gathering, prioritization of business functions, solving real estate and technology issues, and identification of disaster recovery liaisons.

Once the process was started, the Chief Financial Office (CFO) unit was given a one-year time frame to form a comprehensive disaster recovery plan for the division. The team operated under ML's "worst-case scenario assumptions." Some of these parameters were explicit; they were obvious from the division's location, composition, functions, and requirements. The World Trade Center, ML's neighbor, had already been the target of a terrorist bombing, so the history of the area was a consideration; however, security had subsequently increased significantly, so further terrorist attacks seemed an unlikely threat.

The group's main site is located in the World Financial Center in downtown Manhattan, which is on the waterfront of the Hudson River. The BCP teams therefore focused on natural disasters, as was evident in the plan's name: "Tsunami Merrill." The team also assumed that in the event of a disaster, Merrill would be the only firm affected. This meant that, among other things, other financial services firms would still be running under normal conditions and the financial markets would remain open. They assumed that the disaster would occur at the worst possible time of year - year end closing - and that Merrill would receive no extensions or preferential treatment from the SEC allowing a late filing.



After setting the group's explicit parameters, the team sent templates to managers asking for departmental business requirements, including major functions, department objectives, and necessary support tasks. The templates encouraged managers to use a three-tier approach to categorize their processes. Tier One functions include the unit's most essential business functions that must be maintained to ensure the survival of the company. The inability to perform these functions within four hours of the disaster's occurrence would be crippling, causing irreparable harm to the firm and a noticeable impact on earnings and profits. Tier Two functions are the company's essential business functions that must be recovered within a slightly longer time period to avoid severe financial losses to the firm. Finally, Tier Three functions are the company's remaining business functions that if not performed would not directly threaten the company's continued existence.

The BCP team reviewed the categorizations of each department to ensure that the business functions were at a high level rather than the task or process level. The team's focus was predominantly on a critical business function recovery processes through the first six weeks of a disaster. The likelihood of a longer time frame was remote, and disasters lasting six weeks or longer mandated further considerations, such as financial, regulatory, reputation, client, and interdependency risks.

The manager templates also gathered critical information about each group, giving the BCP team comprehensive summary documents for each department. The templates tracked the number of employees in each group and how many were needed during each of the first six weeks of recovery. This gave the team an indication of space, hardware, and supply requirements. The templates also listed all critical software applications necessary to conduct business, as well as how quickly these applications needed to be up and running. The BCP team also asked for primary contacts of internal and external constituencies that departments dealt with frequently, so that the team could incorporate these interconnections and interdependencies into the recovery plan.

After compiling the results of the group templates, the CFO's BCP team needed to coordinate efforts with the company's real estate and technology groups. This created some difficulties because of the large number of divisions developing individual disaster recovery plans. These competing demands were handled by having each department "register" their individual needs with the real estate department so that space demands could be prioritized and assessed.

Instead of planning for the rental or purchase of additional disaster recovery space, the company planned on using the company's existing properties in the New York-New Jersey area for disaster recovery. The firm's three downtown Manhattan spaces, two Jersey City locations, and their new Hopewell facility were all available for recovery space. Since the CFO group was located in the World Financial Center in downtown Manhattan, they planned recovery in the new Jersey City office across the river. Excess overflow could go to the Hopewell site, but since many employees lived in close proximity to Manhattan, a major recovery there would cause commuting strain. The team contemplated several options, including a "shift" based recovery, in which employees would rotate their work times, and "flex time" schedules with modified workweeks, such as a 4 on, 3 off model.

To ease real estate concerns, the unit also considered using the Global Remote Access System (GRAS) to allow some employees to work from home. This system, however, had a capacity issue at the time and was initially infeasible. The BCP team also met with technology to discuss a realistic outlook for technological backup as well as develop timetables for getting critical applications operational.

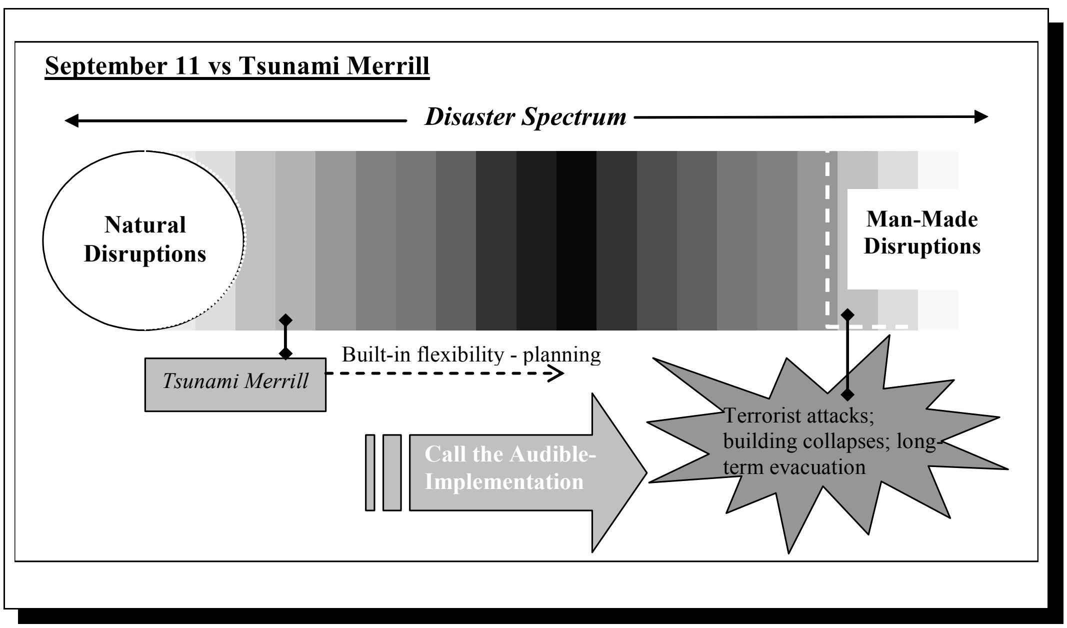
IMPLEMENTATION ON SEPTEMBER 11, 2001

On the morning of September 11, terrorists attacked the World Trade Center towers. Employees in the World Financial Center were unsure what was happening, but most began to leave promptly. Few anticipated the extreme repercussions of these events, and most employees assumed they would return to work later that day or the next. The CFO unit had just completed their final draft of the disaster recovery plan. Plan documents were still in hard copy form, and had not yet been input into the company's computer system. Ironically, the computerization delay was a blessing in disguise. The group had not yet run a test simulation with the plans, so the events of September 11, 2001 would be the test scenario when the team would see what worked and what needed adjustment. The team found itself faced with the daunting task of reconciling their plan to the actual circumstances. Without a trial run, it would be an acid test of the plan's flexibility and effectiveness.

The contingency teams formed 24-hour corporate response teams and command centers. The groups held conference calls and ran live phone lines that were updated as new information became available. The teams worked in close connection with the human resources department to track all employees. Counselors came onsite as part of Merrill's Employee Assistance Program, remaining for an extended period of time to give employees the opportunity to join in group therapy after the tragedy. As the events began to unfold, it became obvious that the newly developed BCP would have to be altered to fit the characteristics of this specific disaster. Like in a fast-paced football game, the team had to continually reassess their positions and be ready to "call the audible," changing their approach in an instant to better react to their surroundings.

The first issue emerged rapidly, snowballing after the team discovered what had happened at the Trade towers. Because of the extensive damage to all buildings downtown, ML employees had to vacate all three of their downtown locations for a much longer time period than the recovery teams had anticipated. Prior to September 11, planners had assumed a vacating time frame of up to three months. On September 12, conference calls with officials and company leaders indicated that they would need to plan on at least three months. This meant that once the team met with managers and handed them the hard copy recovery plans, groups needed to reassess necessary headcount. Groups that had conceded to using only three people for the first couple of days when planning for a six week recovery could now theoretically need space for 35 employees, since all employees would eventually have to return.

Second, because the damage was more extensive and widespread than anticipated, real estate became a serious problem. Two other ML divisions had recovery plans using real estate at the 222 Broadway location, which was now unusable. The groups tried to recover at 101 Hudson Street, in Jersey City, where their support personnel worked, but they needed specialized communication equipment that would take a week to install. The only other feasible location was 95 Greene Street - the Jersey City location earmarked for CFO unit's recovery that also housed the company's technology department.



But technology had its own issues. The backup servers were in the same area as the primary servers - downtown Manhattan. Furthermore, since all three downtown sites were out of commission, there was a shortage of hardware and ready computers. The technology group had to adapt to the situation. Working around the clock for three days, the group installed approximately 2,500 functioning PCs at the Jersey City location. However, with the addition of three divisions to the building, there were capacity concerns. The location was originally outfitted for 150 people per floor, and although each desk had two LAN lines and two phone lines built in, the extra LAN lines were inactive. The company had to physically restructure the space, moving the filing cabinets out of the building and dropping shelves to desk height. After quickly acquiring chairs, the Jersey City facility was ready for 300 people per floor - fire code capacity. In addition to finding physical capacity for these employees, the recovery and technology teams needed to get them connected technologically. With both primary and backup servers located in downtown New York, there was some concern as to how much technology equipment the Jersey City site could handle. Fortunately, the company had built the location with wireless capability, which ran off of a different system. The technology capacity constraints could therefore be eased by using about 100 wirelessly connected laptops per floor.

CONCLUSION

Today, the CFO unit's plans are electronically documented and groups are trained on how to access them in the event of a disaster. Every employee has telecommuting capabilities. BCP groups have implemented "tabletop" exercises, which involve gathering a group in one space, giving the employees a disaster scenario, having the recovery plans on hand, and assessing the comfort level of the group with regards to how successful they think the plans could be implemented.

Despite the challenges, the turnaround ML achieved after the Trade Center tragedy is impressive. Immediately after September 11, downtown Manhattan was completely closed down. On September 12, Merrill convened to execute plans. By the following Monday morning, the company was fully operational. After two to three weeks, most employees had returned to work. Executive management and the relevant support functions moved back into the Manhattan headquarters site in the beginning of November, sooner than anticipated. The remaining units returned to the Manhattan sites incrementally between November and February.

An examination of this application to reality provides critical insight into the implementation of disaster recovery plans. While ML's team was quick to recognize the explicit parameters, the implicit assumptions had a significant impact on plan flexibility. The reluctance, for example, to use more remote locations in New Jersey because of logistical problems, could have been potentially disastrous if the real estate problems at Jersey City were unsolvable or if that site had also been affected.

To summarize, it is useful to remember a short checklist when creating and implementing a business continuity plan. First, assess the disaster spectrum: recognize where your company's explicit factors place your plan on the spectrum. Candidly assess what implicit biases your company will face and how they will affect the plan's flexibility along the spectrum. Second, during the planning stage, aim for a plan that gives your business substance and a foundation in the event of an emergency but at the same time is flexible and comprehensive enough to cover most of the spectrum. Third, in the event of implementation, be prepared to call the audible. The effectiveness of any implementation, like the effectiveness of any sports team, will ultimately depend on the ability to make sound decisions in real time.

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INSHALLAH: AN EXPATIRATE CHALLENGE

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CASE DESCRIPTION

The primary subject matter of this case concerns how lack of understanding and appreciation of cultural differences can undermine potentially beneficial joint ventures. Secondary issues examined include awareness of cultural differences, the role they play in crafting international alliances, the consequences of violating cultural norms, and the steps expatriates should follow to form successful interpersonal relations with foreign counterparts. Students also become more aware of their own readiness for assignments in foreign cultures through assessments of their empathy, flexibility, and analytical skills as they identify with the American expatriate and assess what actions he should take. The case has a difficulty level of five, appropriate for first year graduate level. The case is designed to be taught in one hour and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

Bladeco is a United States company that has recently undertook an international joint venture with a Saudi Arabian company in the precision steel products market. The newly appointed Middle Eastern Manager is eager to apply his international relations skills to enhance the sales of Bladeco products in Saudi Arabia. He enthusiastically accepts the overseas assignment as an opportunity for gaining international experience and advance his career with Bladeco. But as an American expatriate, he immediately meets intense cross-cultural obstacles. What the Middle East Manager must determine is how to effectively communicate with his Saudi counterparts in order convince them to honor their commitments to aggressively market Bladeco products in order to reverse declining sales.

INTRODUCTION

Sweat trickled down Jack Adams neck as he lay on his bed and watched the ancient fan go around. His mind drifted off to the lull of the buzzing fan. For the past six weeks he had been trying to convince his business partner, Mustafa Al Amin, that immediate action was needed to save his parent company's Middle-Eastern Division from an imminent demise. His efforts had been as successful as the fan fighting off the Riyadh heat.

Over the past five years the Bladeco Corporation, an American manufacturer of precision steel products, had been very successful in exporting razors and fine cutting blades to Saudi Arabia. Bladeco had decided to enter the uncertain precision steel market in Saudi Arabia as opposed to the highly competitive European markets because of the lack of competition and potential future market growth if the Islamic culture became more westernized. This venture was definitely risky but paid off handsomely as more liberal Saudis began wearing Levis and adopting a more Westernized styles.

Bladeco marketers had been able to create strong distribution channels within the local markets of most major cities that resulted in significant sales increases every year. Jack's predecessor had contracted with several small Saudi manufacturers to produce standard blades to supplement Bladeco's imports of more sophisticated cutting instruments, which lowered costs and increased supply to meet the growing Saudi demand. Bladeco's manufacturing and import business in Saudi over the last five years had produced an outstanding average return on investment of 65 percent, making Bladeco the leading precision steel product supplier in the country.

BLADECO

A large part of Bladeco's success could be attributed to an aggressive marketing approach unique to Saudi business practices. No time or money was spared to gain awareness of Bladeco's products within the newly developing razor blade and precision cutting instrument market. The use of an integrated marketing communications mix contributed to the rapid spread of brand awareness throughout the country. Bladeco utilized television advertisements, sales promotions, public relations, personal selling and direct marketing communications in an effort to enhance market awareness and surpass the small number of fledgling local competitors. Bladeco also actively marketed their products on a personal level by hiring local sales representatives who approached potential consumers at a grassroots level. These sales representatives passed out fliers at grocery stores, courtyards, business hubs, public events and also infiltrated the local mail with promotional advertisements. This direct form of communicating with the individual consumer was completely unorthodox in Saudi Arabia but it achieved extraordinary success for Bladeco.

Bladeco's success and unorthodox marketing practices did not go unnoticed by Saudi Arabian officials. After five years of growth, Bladeco's had become a substantial business entity whose success via Western products and marking methods did not set well with native business competitors. Consequently, Saudi government officials evoked historical statutes governing foreign enterprises doing business in their Saudi Arabia which levied costly tariffs and trade restrictions on Bladeco's operations.

These statues did stipulate, however, that the tariffs and trade restrictions would not apply if Bladeco formed a joint venture with a national company. Such joint ventures required that the domestic firm would have majority control governing both manufacturing and product promotion within the country.

Without a joint venture of this nature, Bladeco's business in Saudi Arabia would become much less lucrative and maybe not even worthwhile. With a joint venture there were also a number of advantages that Bladeco would benefit from. Bladeco's Saudi counterpart would be able to reduce expenses by obtaining local labor and raw materials and manufacturing more products locally, as opposed to more expensive imported materials and products that now had prohibitive tariffs. Furthermore, the Saudi business partner would have additional market opportunities because of the prestigious Saudi Arabian company name and insider's perspective to the market. Perhaps most important, however, the Saudi company management understood local business and cultural practices which Bladeco's expatriate personnel often were unaware of or confused by.

After much research and consideration, Bladeco management decided to form a contract with Mid-East Steel Merchants, a subsidiary of the Al Amin family conglomerate. The Al Amin family was an impressive collection of leading Saudi industrialists, led by Mustafa Amin, who had built a fortune in the production of industrial steel products like picks and shovels. Bladeco felt that they had partnered with the right organization; the Al Amin family was properly equipped with the resources needed to produce razors and blades and they had a fleet of steel manufacturing plants throughout the country. In addition, the Al Amin family expressed a strong interest in expanding into new product categories, which suggested that they shared Bladeco's strategy of market capitalization. Moreover, the utilization of the Al Amin local connections and prestigious family name would enable the products to be more freely accepted by the growing market. Merging Bladeco and Mid-East Steel Merchants provided a full range of quality products at competitive prices. The business relationship seemed like the perfect win-win situation.

The contract with the Al Amin family stipulated that Bladeco products would be actively promoted throughout the region at Al Amin's discretion. The advertising mediums suggested in the contract had included special promotions, television advertisements, and print advertisements as examples. However, such details were not set forth in a specific contract because the Al Amin family seemed to take personal offense whenever Bladeco negotiators attempted to obtain written agreements on specific details for conformance. The Al Amin's saw such suggestions as a sign that they were not trusted. Consequently, Bladeco withheld from specifying further conditions in the contract in order to prevent the loss of the business relationship altogether. Nevertheless, Bladeco management felt optimistic about the venture because they believed they had clearly verbalized their desire to continue the aggressive marketing strategy that had previously been used to successfully build Bladeco's sales. Although they never signed anything in writing, the Al Amin family did not directly disagree with this marketing strategy indicating to Bladeco's representatives that they had agreement on these expectations

Almost immediately after the merger, under Al Amin management, Bladeco's sales began a steady decline. After several inquiries to Saudi retailers it became evident that the Al Amin's were no longer advertising Bladeco products. Bladeco executives applied increasing pressure for more marketing activity through direct correspondence to no avail. Finally, Bladeco CEO Amy Johnson decided to visit the senior Al Amin to see if the two leaders could work things out. But to her chagrin Mustafa Al Amin refused to meet with her. Al Amin's representative's response insinuated that she must have been mad to think that Mustafa would conduct business with a woman. Towards the end of the first year of the merger Bladeco's Middle Eastern manager resigned after all attempts to reverse the sales plummet failed.

Jack Adams, a twenty seven year old Californian, was chosen as the Middle Eastern manager's replacement because of his outstanding success as the account representative in his home state. With a recent MBA from a prestigious West coast university, Jack felt like he knew what kind of opposition he was up against. He had been with Bladeco since his undergraduate days when he served as an intern and eventually was hired on full time. Jack had requested the overseas assignment because of his desire to obtain international experience. Jack was at the right place and right time. Bladeco was downsizing its staff in an effort to cut back on costs and by picking Jack for the assignment it would not be necessary to hire an outside representative who was not familiar with the company. Consequently, with his Arabic dictionary under his arm, Jack had embarked on his first international mission.

A whining ring stirred Jack back to his senses. His exhausted body still ached from the day before. He had endured a full day of sand skiing in an attempt to form and alliance with the Al Amin's youngest son, Ahmed. He had hoped in a last ditch effort that he would be able to convince Ahmed that his father's business practices were outdated. At first Ahmed responded as though he was interested and agreed with Jack. But as Jack continued speaking, he realized that Ahmed was so agreeable because he wanted Jack to stop badgering him. All of Jack's suggestions and questions were answered with the word "Inshallah," or God willing.

The first time Jack had heard the word was in an early conversation with Mustafa Al Amin regarding a joint corporate mission. It still left a vivid imprint in his mind because Jack could barely suppress his anger when Mustafa Al Amin's vocal intonations when saying "Inshallah" indicated a rude way of saying "I don't care." A brief excerpt of the conversation went as follows:

Jack:	"Will you consider television advertising?"
Mustafa:	"Inshallah."
Jack:	"Can we create an incentive scheme to motivate your salesman?"
Mustafa:	"Inshallah."
Jack:	"Is setting a goal of increasing sales by 20% reasonable?"
Mustafa:	"Inshallah."
Jack:	"In-shall-ee??"

This conversation was one of many that Jack had with the patriarch. Each time Jack suggested something should be done in order to increase sales the elder Al Amin shrugged off his suggestions with "Inshallah," regardless of how logical and valuable Jack thought they were. It was not only Jack spoke with Ahmed when he finally got a better grasp of what the word "inshallah" meant. As Jack understood from his conversation, "inshallah" didn't have a true definition, it was more of a feeling or cultural norm. It was how Islamic people carried on. They were not the type to fret about the future because the future was already determined by God. So when Jack would question Al Amin, the elder would simply tell Jack not to worry because he could trust him and because he, Al Amin, was wiser. When Jack confronted Mustafa about his failures to meet the advertising specifications in the contract, he was met by a brick wall. The old man's eyes darkened and Jack knew he was treading in dangerous territory.

Jack painfully rolled over in bed to answer the phone. It was his boss once again checking up on his progress. Jack had been sent on the assignment with the goal of improving sales of Bladeco products any way he could possibly do it. The only problem was that Jack's primary assets included his American education and his American business savvy. Neither of which could have prepared him for his disastrous arrival in Saudi Arabia.

Standing in line on the blazing runway at Riyadh airport, Jack had pulled a bottle of water out of his carry on and gulped down a long drink. Moments later he was surrounded by police, arrested, and taken to a holding cell at the city jail. How was he supposed to know that it was the holy month of Ramadan, and that eating and drinking in public was forbidden during daylight hours?

After two days in jail Jack was released at the bequest of Bladeco's partner, Mustafa Al Amin, the President of Mid-East Steel Merchant Company. It was clear that a great deal of "wasta," or connections was tapped to accomplish this, and Jack was concerned that irreparable damage may have occurred to the relationship with counterpart. Although he had apologized profusely, it seemed to fall on deaf ears, and ever since that day, Jack felt that Mustafa considered him to be both a disrespectful and ignorant foreigner. Mustafa had even gone so far as to demand Jack's passport for supposed safekeeping.

The holy month of Ramadan had continued for another three weeks in which it seemed the entire country was at a standstill. Working hours seemed both short and arbitrary, and every request for a meeting was delayed for a later date. After Ramadan followed the week long festival of Eid, a religious holiday in which all business and government offices were closed, and a week in which Jack continued to accomplish nothing. He attended dinners and drank countless cups of coffee, something his travel guide had pointed out as being extremely important to maintaining business relationships. But Jack had his doubts about his guide. "What did this guide know anyway? He was simply the cheapest guide Jack could find on the internet." Jack was absolutely stressed out, fed-up, and irritated at the slow pace that business seemed to move in this country. Mustafa was proving to be a very difficult partner to accomplish anything with.

Jack used the word "partner" sparingly because he felt that Mustafa was doing little to help Bladeco's position in the local market. In fact, during his travels, Jack found Bladeco products were being sold from Al Amin warehouses with virtually no sales effort and that promotion was limited to a few newspaper advertisements and a scattering of posters distributed by the Mid-East Steel Merchants' regular salesmen. No additional salesmen had been added for Bladeco accounts and the selling activity fell far short of Bladeco's former program and that of its leading competitor. His mission for this supposedly "high profile assignment" had been to convince Mustafa to more aggressively advertise Bladeco's products throughout the Middle East. The Al Amin family seemed entirely nonchalant towards the dwindling sales and clearly placed minimal importance on Jack's concerns. Jack could not understand why his sense of urgency was being ignored. It was like time held no value to the Mid-East partners. Jack had been suffering in Riyadh for six weeks now and had literally nothing to show for his efforts. What he did have was an on-going list that he posted on his bedroom wall of what not to do in an Arab country it was the most work he had to show for his efforts. The list read:

WHAT NOT TO DO IN SAUDI

Do not eat or drink in public during the holy month of Ramadan

Avoid corporate meetings with any member of the Al Amin family if you do not intend to stick around all day or if you have anything planned to do afterwards

Do not show the bottom of my feet (I have my travel guide to thank for this one, too bad he told me after I had been here two weeks!)

If an Arab tells you they can fit you in their car for a ride, TURN THEM DOWN. Opt to walk or take a taxi, as anything is better than feeling like a sardine squished between two thick blankets in the hot desert sun. Their idea of spacious is a joke

By the way, make sure you fix your taxi rate before getting in the cab… I got ripped off because I failed to know this perplexing system

Don't ever go sand skiing again

Don't act like something is important because the Arabs will sense this and allot the mandated 5,000 years worth of time to honor it

Do not turn down a cup of coffee or any gift from your host (Remember the time I really irritated the Al Amin's by not accepting a cup of coffee at 10 o'clock one night!)

"Snap out of it!" Jack told himself as he splashed cold water on his sweaty cheeks. "You can do this!" he challenged himself with another onslaught of water to his face. As he looked himself in the eye in the bathroom mirror, he hardly recognized the sunburned face and chapped lips that stared back at him. An entire summer in Southern California did not compare to heat experienced in one day in Riyadh. Jack didn't know how much more heat he could stand, both physical and conflict induced from being caught between the pressure from his home office and the resistance from his Saudi partners. As he regained his composure, Jack wondered what he should do now.

TRANSFORMATION AT BTR

Gerry Kerr, University of Windsor

CASE DESCRIPTION

The primary subject matter of this case concerns the viability of the transformation being undertaken in a large, widely diversified company with a storied past. Secondary issues include assessing merger and/or acquisition partners and the ability to assess organizational "fit" with its environment, between its headquarters and businesses, and across the portfolio. The case has a difficulty of six (appropriate for the second-year graduate level). The case is designed to be taught in three class hours and is expected to require six hours of outside preparation by students.

CASE SYNOPSIS

The story of BTR spans exactly 200 years and includes some of the most prominent leaders in British industry. The decision to be made in the case is the direct result of a successful corporate strategy coming out of phase with the changes going on during the 1990's. New management attempts to refocus the firm, but the plan is not well formulated initially, requiring adjustment and a protracted period of implementation.

The case describes the recent history of BTR in two major phases. The short first section begins in 1965 and is marked by the application of a niche-oriented business acquisition policy. In using this policy, management scanned the environment for wayward businesses that would respond to BTR's methods. Heavy reliance was placed on sound financial reporting and oversight, after a period of transformation.

By the end of 1995— after exactly 30 years— BTR's performance had sharply deteriorated. Forces outside and inside the firm incited mammoth change in the company. Initially, BTR was to be an "international manufacturing and engineering company," a more focused firm, better able to exploit relationships between the businesses. The depth and pace of the changes required were underestimated, however, and corporate management was forced to re-develop BTR the following year into a "leading global engineering company". But, the difficulties of the changes, and the complicating factors of BTR's decreased dividend and an over-extended warrant program, suggest that time and patience may have run out on the firm. At the end of the case, management is left to decide whether to finish implementing the current strategy or to seek partners for merger.

TRANSFORMATION AT BTR

On the way to yet another meeting, Elwyn Eilledge took a moment at an office window to consider the situation and decisions facing him. The year was looking much like the previous two, the point at which Eilledge had taken over at the company. After all, the Chairmanship of BTR would have been a daunting position, in the best of times: the role had been filled in past decades by legends of British industry. This group included Sir David Nicolson, Sir Owen Green and most recently Norman Ireland, leaders who had formed a new company in 1965 from out of an already distinguished past. Only as recently as four or five years ago, BTR was the focus of those writing on excellence in management (Kay, 1993; Levi, 1993; Stubbs, 1994). Now, the company bore the brunt of an altogether different kind of attention.

The familiar questions for today's meeting concerned the plan for restructuring the firm and the amount of time that was left. Was the plan for restructuring properly designed? Did the long history of BTR, and the many challenges already overcome, offer some kind of direction for, and hope in, the final success of what was currently being implemented? Or, was the moment really here to find a partner for merger?

DIVERSIFICATION AND HIGH-MARGIN MANAGEMENT AT THE "NEW" BTR

A Strategy of Acquisition and Transformation

The history of the company that became BTR stretched back to 1798, growing and diversifying through the sale of rubber-based products and then, later, through plastics as well. But a fundamental shift in the strategy of BTR occurred in 1965, with the implementation of a niche-oriented business acquisition policy. Chairman Sir David Nicolson, Managing Director Owen Green and Chief Financial Officer Norman Ireland directed the plan (Reier, 1993). In the three decades that followed, Nicolson, Green and Ireland held the position of Chairman in succession and continued, with some differences in emphasis, essentially the same strategy. It involved the purchase of businesses that held substantial positions in focused segments or well-defined positions in larger markets.

Management scanned the environment for under-valued or -managed assets that would respond to BTR's methods. These methods were based on the application of superior management practices on the acquired businesses, with heavy emphasis placed on sound financial reporting and oversight (The Economist, 1987; The Economist, 1991b). Activities sharing between the businesses were largely eschewed as a means of adding value from the corporate level. The units were allowed almost total autonomy (BTR Annual Report, 1987; BTR Annual Report, 1997), open to sustained influence by the corporate level only in the areas of human resources management; organizational culture management; finance and reporting; and structure, most notably during the acquisition process.

Human Resource Management and Fostering Organizational Culture

The control of human resources at BTR, with a focus on training and varying job experience at the management level, was the primary means whereby value was added at the corporate level, a common culture was created, and goodwill generated between management and workers (Caulkin, 1994; Littlefield, 1994). The BTR Development of Executive Potential program supported BTR's risk-taking culture (Lorenz, 1995). At the same time, an ersatz management school was established at the firm for teaching organizational members the principles of general management, as practiced at BTR. These basic principles were then applied to the varied businesses, and to the many takeover targets sought out by the company.

Another primary objective, aimed at the twin pursuits of creating a common culture and generating goodwill in the greater population, was developing the charitable and environmental activities of BTR. Employment and hiring practices at the firm were intended to create a valuable linkage with the community and to attract and retain workers of high quality (BTR Annual Report, 1987; Littlefield, 1994). Staff were encouraged to sit on local committees and to give time freely in making the presence of the individual businesses in their communities as socially productive as possible.

Managing Acquisitions and Their Financial Demands

While “soft” mechanisms like training and organizational culture had their reach, financial controls were the primary means through which the corporate level influenced the businesses. Acquisition and divestment policies were only the most visible means of affecting the operations of the existing businesses. Corporate management also affected capital expenditure. Oversight of investment gave corporate management a powerful lever in affecting new product development and in implementing and transferring process engineering (Lorenz, 1995).

At the center of the value created by corporate management at BTR was a series of programs and perspectives quickly injected into the operations of the acquired company (Alexander, Campbell & Goold, 1995). First, and perhaps most important, the profit-planning process was intense, creating stretch in the businesses, identifying issues and problems early, and inciting high personal motivation in managers to deliver improvement. Second, corporate skills in identifying and integrating acquisitions were built up, within an environment of strict cost containment. Third, a company-wide cultural change was supported that motivated all those in the company toward innovation and constant improvement, while maintaining personal responsibility for results. Lastly, the portfolio was made up primarily of manufacturing firms with medium levels of technology and capital intensity, suitably controlled mainly through financial means. Thus, a fit was achieved between management style and the portfolio.

Superior financial management techniques were cultivated. They guided both massive restructuring in acquisitions and incremental improvements in the established businesses. As stated, the corporate level was active throughout all phases of BTR's development, injecting investment capital. Another important goal of the company, the maintenance of capital availability through both debt and equity markets, was supported through bond floats and the liberal use of warrants issues (Lorenz, 1998). Begun in the late 1980's, the warrants program fed off the decades-long escalation of share values and the presumptions about the future these results instilled in investors.

The warrants program was generally hailed as a masterstroke, eliminating the need for some debt and linking aspects of the company's strategy in a virtuous circle (Lorenz, 1998). The purchase of warrants partially funded the next round of acquisitions of under-performing firms, which responded to BTR's methods by increasing their margins and spurred a higher stock price in the parent. The warrants, in turn, were rendered value and exercised.

Simultaneously, corporate management established a competency in managing debt so as to minimize the cost of borrowing (Euroweek, 1995; Spink, 1996), a competency that placed the company among the lowest-cost borrowers in Britain (Lawless, 1993). These low costs were, in turn, also effective in increasing the margins of BTR. The company maintained a long history of high and continuously expanding dividends (BTR Annual Report, 1994). As well, an impressively long record of profit increases was established.

The Portfolio of Businesses and its Supporting Structure

A number of characteristics defined BTR's portfolio management. First, the basic structure of the divisions remained remarkably stable throughout the period. The divisions were broad in focus and reflected only the most superficial levels of relatedness among the businesses. The most extreme example of the phenomenon was the consumer-related division, which typically included businesses in paper technology, sporting goods, and healthcare. But, the transportation sector also exhibited wide diversity, made up of businesses in the automotive, aerospace, and rail industries. Moreover, the industrial division contained businesses in power transmission and electrical motors, materials handling, batteries, general engineering, and polymers. Thus, while the division titles themselves suggested a wide diversity of activities, equally disparate were the businesses within many of the divisions.

Another signal attribute of portfolio management at BTR was the large number of acquisitions and the relatively low number of disposals. Fitting the corporate strategy, acquisitions were quite widely scattered by industry sectors. As time passed, major acquisitions by BTR included businesses in plastic and glass packaging, industrial seals, control systems, and a variety of automotive-related products. The company's already broad diversity, therefore, continued to grow substantially.

But, a different category of acquisition more dramatically affected BTR's level of diversity. BTR was increasingly taking over large, already diversified companies. Probably the most obvious example was the £1.5 billion ($2.65B.)[2] takeover of the Hawker Siddeley Group, in 1991. Equally diversified takeover targets included Stewart-Warner Corp. in 1987 and Rexnord in 1993. Not all of the efforts were successful, however. For example, the effort to take over Norton, a diversified industrial firm, ended in expensive failure (The Economist, 1991a; Reier, 1993; Zurier, 1990).

By comparison, divestment activities at BTR were infrequent and mainly composed of write-offs, minority positions in a number of companies, and in a few examples, businesses broken off from large acquisitions. Indeed, the only divestments of note during the last eight years under Owen Green happened at the end of his tenure and were more related to changes implemented by Alan Jackson, Managing Director for the end of the Owens tenure and for most of the Ireland years (Lorenz, 1998; Reier, 1993). The first was the sale of Pretty Polly Hosiery in 1991, a move considered by some commentators to mark the extent of BTR's ability to handle unrelatedness, and to signal a strategy more focused on higher-margin businesses (The Economist, 1991a). The second initiative, in 1992, was the disposal of a number of mostly minority shareholding positions.

STEADY IN THE FACE OF THE STORM: THE NORMAN IRELAND YEARS

Beginning in 1993, the leadership of Norman Ireland, along with that of Alan Jackson, was a continuation of the existing strategy, with only a few important differences. Alterations were made to the policies for acquisitions, investment in the businesses, and divestment. One major change in the acquisition policy occurred, with a new stress placed on purchasing technology and expertise rather than primarily finding under-valued assets for turnaround. Technological expertise provided the core for groups of related businesses that were then clustered into "families" (BTR Annual Report, 1994). Investment policy was also altered, with increasing monies devoted to identifying critical areas of technology and/or business acquisition. At the same time, Ireland accelerated the divestment process underway at BTR since 1990. Two important patterns guided the divestments. First, low-margin distribution businesses were sold, especially those dealing with manufactured goods emanating outside the firm. It was believed, for example, that the distribution businesses substantially blocked the development of cohesion among the businesses because of their primary linkages outside the firm. Evidence from customers also existed that the company's management never came to fully understand the industrial supply & distribution business (Zurier, 1990). Second, the policy of acquiring and retaining all of an acquisition target's assets was relaxed. Alan Jackson stated that the company could foresee selling up to 40% of the assets of an attractive target (The Economist, 1991a). This last point, along with the asset sales, also prompted the discontinuation of the warrants program in 1994 (BTR Annual Report, 1994). But, millions of warrants remained outstanding.

BTR'S FALTERING PERFORMANCE AND THE NEW WORLD OF BUSINESS IN THE 1900'S

The strategy of BTR had been successful for a long period of time, was dissected in both academic (Goold & Campbell, 1987) and popular business publications (The Economist, 1987) and pronounced both sound and worthy of emulation. BTR sustained continuous profit increases for twenty-three years before they finally ended during the recession of 1990. Moreover, shareholders were happy because about two-thirds of the profits were routinely returned to them in the form of dividends (Fisher, 1999). An enormous amount of trust and goodwill had built up in financial markets since the creation of the new strategy at BTR. Furthermore, BTR was recognized for its excellence in management, being the winner, even as late as 1993, of the British Quality of Management Awards (Stubbs, 1994).

Yet, financial performance gradually deteriorated at the very end of the Owens tenure and worsened under the watch of Ireland. BTR under-performed average market returns for four of six years between January 1991 and January 1996 (Lorenz, 1998). Clearly, something about the world had changed, while BTR had not.

How were business conditions different? For openers, through much of the past two decades or so, BTR had operated under very challenging inflationary conditions. BTR management ensured profitability in that environment by making sure it got its price increases early and often, by keeping costs low, by maintaining margins and avoiding price cuts to grow market share, and by holding investment to depreciation levels (Lorenz, 1995; Lorenz, 1998). The firm, as well, chose not to cultivate leading positions in its markets, but instead focused on being "a good number two." Thus, the company's businesses largely followed the technological trends in the industry, rather than led them.

But, by the time the recession of the early 1990's had passed, international markets were in a period of robust growth, and macroeconomic and market conditions had clearly shifted (The Economist, 1991b; Lorenz, 1995). Inflationary conditions were largely absent. Yet, only in 1991 would management abruptly modify its opinion regarding the macro-economy, stating that: "The marked reduction in world rates of inflation and in the volatility of the main exchange rates may provide firmer foundations on which sustained recovery can be built" (BTR Annual Report, 1991, p. 4).

Moreover, the reduction in inflation in most markets was hardly the end of the story. Important changes were underway, as well, in the way customers of many of BTR's businesses were carrying out their activities. The shift in producer-supplier relations, invoked by the Japanese and begun in a few industries like automobiles, was gradually being adopted by most (Lorenz, 1995;

Lorenz, 1998). Gone were the relationships based in adversity that had characterized most producer-supplier interactions in industrial goods. Instead, long-term supplier contracts were becoming the norm, with decreasing prices for products built into the arrangement. Thus, as the era of quickly passing price increases onto customers was coming to an end, so too were the dynamics of confrontation and white-knuckle, time-consuming negotiations.

A trend was underway, simultaneously, increasing both the knowledge intensity and the service element in many manufacturing industries. Applied technology and process engineering—hardware, software and systems— were demanding new depth in relationships. Successful firms were building long-term relationships based on high-level skills sharing and technology applications.

Yet, internally, the margin-enhancement strategy and the tactic of aggressively dealing with customers had a profound impact on the orientation and culture of BTR. First, the marketing skills of the businesses had become atrophied, woefully short of the standard in a new time of co-operation and the long-term development of business relationships (Lorenz, 1998). Furthermore, the main planning document at BTR, the method through which the margin-enhancement strategy was operationalized, had become too taxing. In the later stages of profit planning, management at all levels was being involved for between one-quarter and one-third of the year (Lorenz, 1998). Moreover, the planning process used only financial parameters, when the changes in business conditions seemed to require the use of broader-based measures. Worse, the planning process had contributed to years of under-investment, hampering both innovation and service levels (Lorenz, 1995; Lorenz, 1998). Finally, international markets were increasingly opened and active over the period, radically changing the strategies of multinationals. Large-scale rationalization was ongoing in a number of industries. Places in the competitive landscape were available for acquisitive firms, certainly, but the orientation and skills required seemed quite different from those held by BTR. The agenda at BTR historically identified under-managed firms, mainly in manufacturing, and improved upon them, regardless of industry. The new conditions, by contrast, seemed to offer opportunities to restructuring firms that were able to stake out niches in industries that were concentrating and/or globalizing and complete the process.

Unfortunately for the organization, BTR's mixed performance over the first half of the decade exposed the impact of massive changes underway in its markets and the shortcomings of the established strategy (Lorenz, 1995). The economic downturn revealed the portfolio's sensitivity to the business cycle, certainly a negative characteristic for a widely diversified firm¾ given that a prominent part of a conglomerate strategy should be its ability to flatten the effects of economic contraction (The Economist, 1991a). The presence of such a large contingent of consumer goods, building materials, car parts and glass businesses heightened, rather than reduced, the effects of economic downturns.

AGENTS FOR CHANGE: THE LEADERSHIP OF ELWYN EILLEDGE AND IAN STRACHAN

BTR faced severe threats on a number of fronts, emanating from both outside and inside the organization. Compounding the problems was the perception that the pool of prime leadership candidates had dried up within the firm (Lorenz, 1995). This situation prompted the hiring of Elwyn Eilledge, former Senior Partner of Ernst & Young and Chairman of Ernst & Young International, and Ian Strachan, former Deputy Chief Executive of RTZ Corporation, a mining concern.

Establishing "The Industrial Manufacturing and Engineering Company"

Fiscal year 1996 was a pivotal year, even in the long history of BTR. The company's top management changed at the beginning of the fiscal year. A new strategy was soon proposed and approved. The strategy was:

> *aimed at generating profitable growth by building worldwide on the core industrial manufacturing and engineering businesses in which we currently excel or have the potential to excel. The Group was comprehensively restructured, reducing 32 semi-autonomous product groups to seven Business Groups, with management's responsibilities redefined accordingly. The dividend was reduced to release funds for profitable investment and growth. And a major programme of disposals, aimed at divesting the Group of low performance businesses, is well on the way to completion (BTR Annual Report, 1996, p. 5).*

The strategy was informed by a series of new objectives. These objectives, in turn, were closely linked to action:

- ♦ *to focus on those industrial manufacturing and engineering businesses that are, or have the potential to become, world leaders;*
- ♦ *to build competitive advantage in our key product areas by investing in leading technologies and new product development;*
- ♦ *to leverage our world class skills through best practice transfer across the Group, providing global service to global customers;*
- ♦ *to undertake acquisitions which bring synergies with existing activities, thus enhancing the organic growth potential of the Group;*
- ♦ *to increase BTR's involvement in fast-growing emerging markets, particularly in Asia and Latin America; and*

- *to divest low return, low growth activities where under-performance has been eroding value, and reinvest the proceeds where growth prospects are good (BTR Annual Report, 1996, p. 6).*

The changes made to the objectives at BTR in 1996 were multi-dimensional, related to portfolio content, acquisition and divestment policies, investment procedures, and international business. The stress of achieving the objectives was intense, weighing heavily on management and on the organization as a whole (BTR Annual Report, 1997; Fisher, 1999; Lorenz, 1998).

The new orientation centered on an understanding of the new economy that was emerging and BTR's anachronistic strategy in light of the changes underway (Lorenz, 1998). In place of a focus on markets in the OECD, from which 90% of the company's sales had originated historically (BTR Annual Report, 1996; BTR Annual Report, 1997), BTR would become fully global in scope. Rather than using acquisitions as simple investment platforms, they would be utilized instead to join the company in the larger trend of industry consolidation, within the more focused parameters set by corporate management. BTR was becoming, like ITT, Hanson, and a few other contemporaneous examples, a more focused, multi-product firm (Kochan, 1995). Divestment would remove the low-knowledge, low-margin businesses. Competition would be met with a new investment policy devised to remedy years of under-investment. The goal was now to be number one, on a global scale, in the chosen industries; BTR was no longer to be "a good number two." Finally, margin enhancement was perceived to offer no long-term benefits for a company already turning out margins in the region of 19%. The new strategy substituted revenue growth— top-line growth— as the new financial by-words, within the bounds of healthy profitability. The change program was therefore entitled "Delivering Profitable Growth" (Lorenz, 1998). Of course, cultural change was suffused through all of the transition at BTR.

As stated, a major part of the push to establish an “industrial manufacturing and engineering company” involved culling the portfolio. In re-fashioning the collection of businesses, a combination of strategically and financially oriented criteria was employed. Divestments were focused on businesses: "with limited growth potential within BTR, which do not fit the strategy or meet our testing investment criteria..." (BTR Annual Report, 1996, p. 10). The core of the control & electrical, transportation and construction businesses were sold. As well, selected businesses from the industrial category were divested, "in order to eliminate low growth activities which would otherwise be a continuing drag on the Group's performance" (BTR Annual Report, 1996, p. 3). BTR's portfolio was re-positioned to include a far-higher proportion of businesses with greater growth and knowledge intensity.

The new corporate structure at the company was a mixture of primary and secondary units. The Major Global Groups were positioned for building leading positions in global markets, while the Smaller Global and Regional Groups were businesses requiring acquisitions to attain global competitiveness. The major business units included automotive, power drives, process control and packaging. Secondary units included specialist engineering, building products and polymeric products.

In 1996, acquisitions were organized to supplement and strengthen the businesses, in effort to establish leading positions in each of the Major Global Groups (BTR Annual Report, 1996). The acquisitions of BTR in 1996 were, as also would be expected, tightly concentrated on the new industrial and engineering focus of the company. The acquired businesses were mainly in the automotive and electronics sectors. However, the overall number of acquisitions was fairly low, due in large part to the tremendous strain on management caused by the massive divestment activities underway at the time. Yet, the resulting portfolio for most of 1996 was a set of businesses still widely diversified, joined by few common attributes outside their status as manufacturing entities.

Toward "The Leading Global Engineering Company"

While a monumental shift in objectives was set for the organization in 1996, a gap was exposed between the requirements imposed by corporate management and the existing skills and capabilities of the company. The strategy required more time to be realized than was initially allotted. The financial markets, a primary provider of resources, quickly grew impatient, driving BTR's stock price to new lows. The massive sale of assets also greatly affected the revenue line, at least for the short term. Compounding the negative developments, the large dividends of the past were ended, and the culture of BTR, strongly predicated on margin enhancement, was also being shattered and remade. Finally, resistance to change was rife at BTR. Between the start of 1996 and the end of 1997, 19 of 50 of the top executives left the firm (Lorenz, 1998).

Fiscal year 1997 then brought further adjustments to the strategy and objectives of BTR. Many issues required even more attention, the most pressing of which was finding tighter focus in the businesses. The second stage of restructuring was announced in September, 1997 and involved the contraction of the firm into a "leading global engineering company":

> *We are achieving a steady shift in emphasis from "managing for margin" to long-term value creation. This has involved restructuring BTR's widely-spread portfolio into groups of inter-linked businesses, as the basis of a new strategic planning system which underpins our drive for profitable growth (BTR Annual Report, 1997, p. 6).*

A new set of goals was also put forward, representing a refinement of what had been stated the previous year:

> *If wealth is to be maximized for shareholders, BTR's engineering businesses, which for many years were virtually autonomous, have to be knitted together to form a*

> *unified engineering group with: one set of values; a common culture; and a set of business processes designed to ensure that resources are allocated, experiences shared and skills deployed wherever they can generate most value for the Group (BTR Annual Report, 1997, p. 6).*

While the second iteration of the new strategy for BTR in the late 1990's was much more focused than that previously put forward, the demands on top management and the organization as a whole remained enormous and were growing. Nothing less than a complete reorientation of the firm was being put into play.

At the corporate level, the resident skills were to change from identifying, first, prime acquisition targets and, later, proper divestment assets, to acquiring bolt-on acquisitions and stimulating organic growth. As well, in the previous strategy of Nicolson, Owens and Ireland, the corporate level was instrumental in establishing a culture of community service and environmental awareness. In its new strategy, headquarters was to be instrumental in supporting a culture of engineering and innovation. Finally, the corporate level formerly oversaw, with a stern eye, the injection of investment capital and the establishment and maintenance of high margins in whatever industry the businesses happened to compete. The new strategy required a more balanced approach to investment, with a longer time horizon, and with goals equally divided between completing strategic acquisitions and fostering internal growth. At the same time, of course, the businesses must work closely together, for the sake of both efficiency and entrepreneurship.

In the transformation to a focused engineering concern, the corporate level was to function much more decisively within the businesses. Headquarters undertook a complete reorientation of the way in which profits were generated at BTR (BTR Annual Report, 1997). The myriad profit centers were amalgamated so that more profound strategic thinking could be fomented across the company. Corporate management instituted a plan to realize savings throughout the businesses, using a corporate-led purchasing initiative. At the business level, therefore, for the first time in many decades, the units were being asked to function together, jointly undertaking many tasks. The degree of interaction among the businesses was expected to go from sporadic or virtually non-existent connections to complex inter-relationships. Also, from the corporate level, matrix organizations were put in place so that related services and products, spread across groups but serving a single customer set, could be joined under common management. Group-wide resource planning was instituted, supporting allocation guided by a single strategy. Finally, Research and Development centers were established, a direct result of functional sharing and the common strategy put in place through corporate intervention.

The somewhat awkward structure of the firm in 1996 created obvious difficulties for a management attempting to build seven divisions to world leadership (Lorenz, 1998). In the following year, three large divestments were undertaken¾ of the polymer, packaging and building products units¾ to focus exclusively on the engineering-related businesses. Acquisitions that followed were designed to build positions in the key businesses, with control systems, power drives and automotive all receiving sizeable additions.

The structure of BTR in 1997 reflected the major divestitures going on, leaving the firm's businesses arranged afterwards in a single rubric, engineering. As a result, two of the three Smaller Global and Regional Groups were sold, as was the large packaging and materials group. The acquisitions process was streamlined. But, at the same time, a new pressure was placed on management to create value directly among the businesses, a process not much cultivated at BTR in more than three decades.

STAY THE COURSE OR SEARCH FOR PARTNERS?

The financial results for 1997 were, at best, a mixed story. BTR's stock remained under intense pressure (Fisher, 1999; Lorenz, 1998). Almost two-thirds of the company's market capitalization had disappeared in the past few years (Fisher, 1999). More than 130 million warrants had lapsed as worthless in 1997 alone— and more than 100 million seemed destined for the same fate in 1998 (BTR Annual Report, 1997). The weakness was met by public opinion, resounding in some quarters of the business press, running stridently against the firm (Fisher, 1999; Gabelli et al., 1997). Still, the company remained solidly profitable and many of the financial categories looked quite strong (see Tables 1 and 2). Prospects seemed acceptable, even positive, if the past year was any indication. Furthermore, the restructuring was almost fully completed, ahead of the planned timetable and generating more than the projected returns (Fisher, 1999).

Yet, much more did remain. Fundamental questions lingered about the company Elwyn Eilledge was scheduled to hand off to new leadership at the end of the year. Would the stubborn difficulties of drastically changing strategy, structure, controls and culture be completely overcome? Was there some other combination waiting for BTR that promised even better returns? (See Table 3 for a listing of BTR's Principal Subsidiaries and Divisions.) Did more unforeseen obstacles remain?

On another front, profound issues also presented themselves. If a new combination was sought out, what was the ideal profile for a merger partner? While a deal could certainly be negotiated in weeks, the major issues concerned the shape and logic of an integrated portfolio, the ability of a combined leadership to generate value in the businesses, and the likely success of the "marriage." Was the right answer the completion of the current strategy or was it a merger with a leading engineering company like Emerson Electric, Siebe, or Siemens? (See Tables 4 through 9 for a comparison of the companies.)

Still carrying many unanswered questions, Eilledge turned away from the window and glanced down at his watch. The meeting at which he was needed was beginning momentarily. He picked up the pace, unsure if he would be late.

Table 1: BTR Ten-Year Record
Fiscal Year Ended Dec. 31

millions (Pounds Sterling)	1997	1996	1995	1994	1993	1992	1991	1990	1989	1988
Sales	8091	9531	9778	9444	9772	8841	6742	6742	6904	5460
Profit before int. and tax (before Exceptional Prov.)	1448	1515	1673	1546	1431	1270	1042	1081	1211	902
Exceptional Provisions		-622								
Finance Costs	-155	-214	-170	-134	-157	-192	-132	-146	-164	-92
Profit before Tax	1293	679	1503	1412	1274	1078	910	935	1047	810
Earnings -- Total	882	431	960	871	802	677	554	536	608	485
Capital Employed										
Fixed Assets	3448	3962	4548	4368	4485	4261	3670	2648	2680	1694
Net Trading Assets	1020	647	1091	846	781	881	917	813	917	735
TOTAL	4468	4609	5639	5214	5266	5142	4587	3461	3597	2429
Financed by:										
Issued Capital	1023	1006	949	909	870	497	491	435	434	424
Reserves	1133	1253	1328	1781	1177	1343	942	1166	1163	941
BTR Shareholder Interests	2156	2259	2277	2690	2047	1840	1433	1601	1597	1365
Minority Interests	167	367	437	1175	1151	1116	879	770	698	517
Deferred Taxation	-74	-117	-5	-6	7	9	2	22	26	18
Net Debt										
Long-term	773	1143	1486	463	887	666	514	448	1026	775
Short-term (net)	1446	957	1444	892	1174	1511	1759	620	250	-246
TOTAL	4468	4609	5639	5214	5266	5142	4587	3461	3597	2429
(pence per share)										
Shareholder Interests										
Earnings (before Ex. Prov.)	21.6	22.3	26	24.5	23.8	20.6	18.9	18.5	21.1	17.2
Earnings (after Ex. Prov.)		10.7								
Dividends	9.6	9.6	14.7	13.5	12.3	10.8	9.9	9.5	9	7.2
Shareholders' Funds	52.7	56.3	61.6	75.5	60.8	56	48.9	55.3	55.1	48.3
Financial Statistics										
Net Debt/ Tot. Cap. Em. (%)	49.7	45.6	52	26	39.1	42.3	49.6	30.9	35.5	21.8
£ to $	1.639	1.562	1.579	1.532	1.503	1.766	1.769	1.785	1.639	1.781

(Source: BTR Annual Report, 1997, p. 72)

Table 2: BTR Sales, Profit (before tax) and Average Operating Net Assets
(by Division and Geographical Region)

millions (Pounds Sterling)	Sales	Profit before Tax	1997 Average Operating Net Assets	Sales	Profit before Tax	1996 Average Operating Net Assets
1. Analysis of Sales, Profit before Tax and Average Operating Net Assets						
Business Groups						
Control Systems	1358	242	632	1208	223	576
Power Drives	1047	203	476	1037	233	453
Automotive	1327	136	860	1402	149	874
Specialist Engineering	1163	193	660	1129	233	627
Engineering Group	4895	774	2628	4776	838	2530
Packaging and Materials	1374	250	1465	1455	309	1542
Building Products	676	86	379	677	100	370
Polymeric Products	211	23	140	228	38	146
Phase I Divestment Group	279	11	202	322	22	224
Corporate Activities	656	304	307	2073	208	1424
Exceptional Provisions					-622	
Finance Costs		-155			-214	
TOTAL GROUP	8091	1293	5121	9531	679	6236
2. Geographical Analysis						
United Kingdom	1127	173	610	1061	239	544
Other Europe	1149	141	632	1224	134	715
The Americas	3029	552	1842	2875	585	1714
Australasia	1562	211	1257	1675	268	1359
Asia	389	48	355	417	53	348
Other	179	19	118	206	28	132
Corporate Activities	656	304	307	2073	208	1424
Exceptional Provisions					-622	
Finance Costs		-155			-214	
TOTAL GROUP	8091	1293	5121	9531	679	6236
£ to $	1.639	1.639	1.639	1.562	1.562	1.562
(Source: BTR Annual Report, 1997, p. 53)						

<table>
<tr><th colspan="4">Table 3:The Principal Subsidiaries and Divisions at BTR in 1998</th></tr>
<tr><td colspan="4">The major management companies and divisions analyzed by business group are listed below. Unless otherwise stated, the percentage held is 100%.</td></tr>
<tr><td colspan="4">Management, Holding and Public Listed Companies</td></tr>
<tr><td colspan="2">BTR Australia
BTR Dunlop Holdings (Delaware) Inc.
BTR (European Holdings) BV
BTR Finance BV
BTR France SAS
BTR Inc.
BTR Industries Ltd.*
BTR International Ltd.*
BTR Nylex Ltd.
Dunlop Holdings Ltd.*
Dunlop International AG
Hawker Siddeley Group Ltd.*
Nylex (Malaysia) Bhd (52%)</td><td colspan="2">Australia
U.S.A.
Netherlands
Netherlands
France
U.S.A.
U.K.
U.K.
Australia
U.K.
Switzerland
U.K.
Malaysia</td></tr>
<tr><td colspan="4">Engineering Divisions</td></tr>
<tr><td>Control Systems</td><td>Automotive</td><td>Power Drives</td><td>Specialist Engineering</td></tr>
<tr><td>Flow Control Systems
Metering Systems
Power Systems
Sensor Systems</td><td>Sealing Systems
Anti-vibration Systems
Engineered Polymers
Drive Train Systems</td><td>Brook Hansen
Fasco
Rexnord</td><td>Aerospace
Environmental
Nylex Malaysia (52%)
Paper Technology
Rail</td></tr>
<tr><td colspan="4">Divestment Group</td></tr>
<tr><td>Packaging & Materials</td><td colspan="2">Building Products</td><td>Polymeric Products</td></tr>
<tr><td colspan="4">*Investment held directly by BTR plc</td></tr>
<tr><td colspan="4">(Source: BTR Annual Report, 1997, p. 70)</td></tr>
</table>

Table 4: Emerson Electric: Strategy, Leadership and Portfolio Management	
Strategy and Leadership	Beginning five years previously, the primary goal of this 100-year-old company has been to "refocus on top-line growth." "The global market and technology leadership of each of Emerson's businesses, combined with the focus on cost management, forms a strong base for the expansion of our market positions throughout the world" (Emerson Electric Company Annual Report, 1998, p. 2). The results speak for themselves: Emerson Electric has posted 40 consecutive years of earnings increases. Incentive pay is linked most heavily to revenue growth, but earnings growth, return-on-equity and other traditional measures are also factored in (Martin, 1998).
	The major supports for growth are the acceleration of new product introductions, rapid expansion of Asian market penetration, the redeployment of key assets into joint ventures, and the development of strong momentum in the acquisition program.
	The key factors in determining the success of acquisitions were achieving full integration, inducing the continued involvement of targets' top management, and raising margins through improved processes and selected investments.
Portfolio Management	In general terms, Emerson Electric "is engaged principally in the worldwide design, manufacture and sale of a broad range of electrical, electromechanical and electronic products and systems" (Emerson Electric Company Annual Report, 1998, p. 39).
	The products manufactured by the company are classified into two broad groups, Commercial and Industrial Components and Systems and Appliance and Construction-related Components.
	The company is made up of seven businesses within the two broad segments: Commercial and Industrial Components and Systems - Process control instrumentation, valves and systems - Industrial motors and drives - Industrial machinery, equipment and components - Electronics Appliance and Construction-related Components - Fractional motors and appliance controls - Heating and air conditioning components - Tools
	The planning process plays a key role in the company's success, with no separation between strategists and those who implement the plans. Decisions are based on 500-page reports that are shared by all and never summarized. Open, non-political discussions are the norm. Issues identification and actions emanate from the divisional and business levels, while corporate leaders provide a sounding board, an oversight function and a set of goals for growth and profitability (Strategic Direction, 1997).
	The company purchased InterMetro Industries (a producer of ventilated shelving, for approximately $275 M.) and F.G. Wilson (a U.K.-based manufacturer of prime and stand-by power generators, for approximately $274 M.). As well, the Process Control division was acquired from CBS (for $265 M.). Leading joint venture partners include Caterpillar and General Signal in the United States, and numerous partners in India and China, especially.

Table 5: Emerson Electric Co. Ten-Year Record
Fiscal Year Ended Sept. 30

(Dollars in millions except per-share amounts)	1998	1997	1996	1995	1994	1993	1992	1991	1990	1989
Net Sales	13447	12299	11150	10013	8607	8174	7706	7427	7573	7071
Gross Profit	4852	4433	3985	3533	3054	2884	2651	2586	2572	2409
Interest Expense	152	121	127	111	89	119	91	113	117	78
Profit before Tax	1924	1784	1609	1425	1238	1112	1044	1003	989	954
Net Earnings	1229	1122	1019	908	789	708	663	632	613	588
As a % of Sales	9.1%	9.1%	9.1%	9.1%	9.2%	8.7%	8.6%	8.5%	8.1%	8.3%
Return on Average Shareholders' Equity	21.9%	20.8%	19.9%	19.7%	19.1%	18.5%	19.0%	20.2%	20.2%	20.0%
Per Share of Common Stock:										
Basic Earnings	2.80	2.52	2.27	2.03	1.76	1.57	1.48	1.41	1.37	1.31
Diluted Earnings	2.77	2.50	2.25	2.01	1.75	1.56	1.47	1.40	1.37	1.31
Cash Dividends	1.18	1.08	0.98	0.89	0.78	0.72	0.69	0.66	0.63	0.56
Book Value	13.24	12.30	11.96	10.88	9.71	8.71	8.31	7.27	6.69	6.90
Year-end Financial Position:										
Working Capital	980	874	1166	503.4	721	381.7	1165	895	803	1317
Current Ratio	1.2 to 1	1.2 to 1	1.4 to 1	1.2 to 1	1.3 to 1	1.1 to 1	1.6 to 1	1.4 to 1	1.3 to 1	1.9 to 1
Property, Plant and Equipment (net)	3012	2735	2451	2135	1947	1880	1695	1583	1536	1198
Total Assets	12660	11463	10481	9399	8215	7815	6627	6364	6376	5408
Long-term Debt	1057	571	773	209	280	438	448	450	496	419
Shareholders' Equity	5803	5421	5353	4871	4342	3915	3730	3257	2990	3073
Total Debt to Total Capital	30.8%	27.1%	24.5%	24.7%	21.7%	29.3%	19.1%	27.2%	32.1%	19.5%
Other Data:										
Capital Expenditures	603	575	514	421	332	306	346	311	310	286
Average Number of Employees	111800	100700	86400	78900	73900	71600	69400	69500	73700	72600

(Source: Emerson Electric Company Annual Report, 1998, p. 43)

Table 6: Siebe: Strategy, Leadership and Portfolio Management

Strategy and Leadership	The primary goal of Siebe, a leading British engineering firm, is to achieve and maintain manufacturing excellence. Until February, the company had been led by Sir Barrie Stephens. His leadership developed the firm since 1964 from a small manufacturer of diving equipment. Today, an ambitious and relatively young CEO, Allen Yurko, leads the company. The current vision for the firm is "to be the recognised leading global corporation in [our businesses] by providing our customers with the highest total value, our employees with a challenging and participative work environment and our shareholders with the best long-term return on their investment when compared to our peer group" (Siebe plc Annual Report and Accounts, 1997, p. 1). Financial measures are carefully matched with objectives, through the "5, 10, 15, 20 Divisional Growth Targets." The numbers correspond to the following improvements: Five-percent reductions expected in production costs; ten percent increases in organic revenues, with a further 15% in organic earnings growth; and 20% was set for increases in inventory turns. Performance results have been remarkably consistent, providing top-line growth as well as the ability to squeeze costs and grow profits. Siebe was recently identified as one of the top seven international growth stocks (Kalb & Kalb, 1997). As well, the company has employed extensive benchmarking, with its five-year results besting its peer group of engineering firms, the FTSE engineering sector, and the U.K. market in both EPS growth and total returns to shareholders (Siebe plc Annual Report and Accounts, 1997). The company has worked to develop employee empowerment, as well as education, training and employee participation.
	The major supports for generating shareholder value were the acceleration of the Six Sigma/Lean Manufacturing Programme (as well as related margin-enhancement initiatives), R&D activities, product development, and cost-effective capital spending.
	The key factors in determining the success of acquisitions were maintaining a strong pace of acquisitions without losing the strategic focus of being "the leader in the global Controls and Automation industry" (Siebe plc Annual Report and Accounts, 1998, p. 7). Each acquisition must add to global market share while offering significant savings in technology, manufacturing and marketing. At the same time, divestments were a constant part of managing the portfolio.
Portfolio Management	The products manufactured by Siebe the company are classified into three broad groups, Intelligent Automation, Controls, and Industrial Equipment (with 85% of sales related to controls).
	The company is made up of fourteen businesses within the segments: Siebe Intelligent Automation - The Foxboro Company (total automation solutions provider to industry) - APV (automation supplier to food, beverage and pharmaceutical processing industries) - Siebe Environmental Controls - Siebe Instrument and Valve - Wonderware (factory automation software) Siebe Controls - Appliance controls - Climate controls - Automotive - Power controls - Aerospace and sensors Siebe Industrial Equipment - CompAir (compressors) - Pneumatics - North Safety Products (worker protection devices) - Specialist equipment (electrical cable trays)
	Besides numerous small acquisitions, the company purchased APV (for approximately £349 million), Eaton's Appliance Control Operations (for approximately £190 million), and Wonderware (for approximately £225 million). As well, divestments (representing more than £300 million in sales) were completed or announced.

Table 7:L Siebe plc Ten-Year Record

Fiscal Year Ended Apr. 5										
(Pounds Sterling in millions except per-share amounts)	1998	1997	1996	1995	1994	1993	1992	1991	1990	1989
Revenues	3670	3005	2599	2146	1864	1619	1628	1481	1372	1215
Profit before Interest, Taxation, Depreciation and Amortization	738	629	501	418	364	319	304	266	246	210
Depreciation and amortization	182	147	121	100	94	77	67	53	40	35
Profit before Interest and Taxes	556	482	379	318	270	243	237	212	206	175
Net Interest Payable	70	58	48	43	53	61	68	53	24	23
Profit before Taxes	486	424	331	275	217	182	170	159	181	153
Net Profits	310	254	193	160	127	103	92	89	106	95
Dividends	85	73	57	52	47	39	35	32	29	22
Per Share:										
Earnings	62	54.1	45	37.5	31.4	26.3	23.5	22.8	27.1	24.4
Dividends	16.20	14.70	13.31	12.10	11.00	9.86	8.95	8.14	7.40	5.61
Year-end Financial Position:										
Fixed Assets	1957	1532	1424	1211	1189	1058	941	925	560	512
Current Assets	2068	1618	1523	1393	1456	1084	946	930	774	706
Research & Development	155	141	115	87	76	66	68	55	47	45
Interest Coverage	8.0	8.3	7.9	7.4	5.1	4.0	3.5	4.0	8.5	7.7
Long-term Debt	916	698	631	446	544	618	489	644	253	253
Market Capitalization	6300	4671	3737	2354	2534	1752	1168	869	877	898
Other Data:										
Capital Expenditures	293	253	189	150	123	96	78	84	61	43
Average Number of Employees	54939	43364	35968	35031	31998	29638	31570	33918	30591	30314
£ to $	1.658	1.639	1.562	1.579	1.532	1.503	1.766	1.769	1.785	1.639

(Source: Siebe plc Annual Report and Accounts, 1998, p. 64)

Table 8: Siemens: Strategy, Leadership and Portfolio Management

Strategy and Leadership	With a history that extends back to 1847, Siemens today calls itself "the world's largest electronics and electrical equipment company" (NYSE Magazine, 2002). Heinrich Pierer leads Siemens and has vigorously constructed new strategies, set new goals and opened new markets in the past few years. The current vision for the firm is "sustainable growth in profitability" (Siemens Annual Report, 1999, p. 3). To support this achievement, the firm instituted the "Ten-Point Program." The program contained measures in three important areas, re-orienting the business portfolio, applying a set of binding management tools (including, most prominently, EVA), and preparing to list Siemens on the New York Stock Exchange. The changes in Siemens were profound, with performance-based pay, commitment to employee development and the pursuit of corporate responsibility providing other major portions of the massive transformation. However, performance results have been disappointing for shareholders, with the company historically being able to ignore equity markets because of ample available financing from retained earnings and the German banks (Steinmetz, 1998). Although markets reacted very favorably to the restructuring announcement, Siemens has just finished one of the most challenging years of its existence. The portfolio shuffling, lackluster performance in many key businesses, and the Asian currency crisis all took a heavy toll on performance.
	The major supports for achieving the over-riding goal of sustainable growth include the pursuit of the Ten-Point Program mentioned above to restructure the portfolio of businesses. Sustainable growth is also fostered by efforts to measure the performance of the businesses through EVA, to support steady innovation, to open new markets, and to nurture employee development.
	The key factors in determining the success of acquisitions were in their ability to fill gaps either within the portfolio or within individual businesses already within the portfolio. Sustainable profits were envisioned to be a direct result of the proper portfolio, properly managed.
Portfolio Management	Siemens' operations are divided into seven broad groups: Energy - Power Generation - Power Transmission and Distribution Industry - Automation and Drives - Industrial Projects and Technical Services - Production and Logistics Systems - Siemens Building Technologies Transportation - Transportation Systems - Automotive Systems Information and Communications - Information and Communications Networks - Information and Communications Products - Siemens Business Services Health Care - Medical Engineering Lighting Components -Infineon Technologies
	Major asset sales encompassed the defense-related and dental-equipment businesses, while large acquisitions included the Westinghouse power plant and services and the Elektrowatt building technologies businesses. Recent strategic alliance partners are a near who's who of industry, including Motorola, Fujitsu, Microsoft, Acer, GEC, and a host of others.

Table 9: Siemens Recent Financial Record				
Year Ended Sept. 30				
(In millions DM)	1998	1997	1996	1995
Net Sales	117969	106930	94180	88763
Gross Profit on Sales	31916	30300	27470	26637
Research and Development	9122	8132	7296	7274
Income after Tax before Extraordinary Items	2658	2608	2491	2084
Extraordinary Items and Accounting Changes	(1741)	0	496	0
Net Income	917	2608	2987	2084
Assets and Funds Employed:				
Non-current Assets	51989	46372	40608	37025
Current Assets	60035	51731	46893	44952
Shareholders' Equity	30292	28407	25198	22491
Pension Accruals	19801	19612	18649	17747
Other Accrued Liabilities	23550	20080	19840	20471
Debt	14484	9204	6179	5141
Total Assets	112024	98103	287501	81977
Cash Flows:				
Net Cash Provided	3907	4073	4666	5394
Depreciation and Amortization	7588	5259	4708	4677
Net Cash Used in Investing	(5735)	(7211)	(6295)	(6693)
Purchases of Investments	(7597)	(2973)	(2104)	(2388)
Additions to Intangible Assets; Property, Plant and Equipment; and Equipment Leased to Customers	(7263)	(6733)	(6411)	(5444)
Net Cash (used in) Provided by Financing Activities	3837	1861	(971)	1190
Net (decrease) increase in Cash and Cash Equivalents	1812	(1219)	(2516)	(155)
Other Data:				
R&D as a % of Sales	7.6%	7.6%	7.7%	8.2%
Debt-Equity Ratio	.48 to 1	.32 to 1	.24 to 1	.22 to 1
Average number of Employees (in thousands)	416	386	379	373
DM to $	0.569	0.578	0.665	0.699
(Source: Siemens AG Annual Report, 1999, p. 96)				

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ENDNOTES

[1] The author thanks Rebecca Fahringer for her able assistance in preparing the manuscript for publication.

[2] At the effective exchange rate of 1.769 $/£. (See http://www.oanda.com/convert/fxhistory [accessed September 8, 2005]). Please note that all average annual exchange rates were taken from the same source.

CALL FROM PEERLESS BANK: A CASE CONSIDERATION OF TELEMARKETING AND ETHICS

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CASE DESCRIPTION

The primary subject matter of this case concerns marketing ethics and strategy. Secondary issues examined include the evaluation and selection of direct marketing tactics. The key words for the case indicate the major areas for student learning: marketing ethics, marketing strategy, direct marketing, telemarketing, consumer privacy, banking and credit cards. The case is most appropriate for the junior level or above, including the graduate level, so it has a difficulty level ranging from three to five. The case is designed to be taught in two class hours and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

Rebecca MacDonald receives a call concerning a "special opportunity" being offered to Peerless Bank's Visa cardholders, a program called "Basics" which offers discounts at retailers and reimbursement for haircuts in exchange for an annual fee charged against her Visa card. Rebecca is interested but unable to obtain literature without consenting to enroll for a trial period. After deciding not to enroll, she wonders about the ethics of the bank's marketing tactics and considers whether to put herself on a do-not-call list. Following a review of the regulatory environment pertaining to consumer privacy, telemarketing and banking, the case transitions to a discussion of these issues by Peerless' management that could well be taking place in light of the times. Management questions the choice and execution of the telemarketing strategy and decides to re-evaluate the offering and its promotion in light of ethical, regulatory and competitive concerns. The Note on the Commercial Banking Industry, especially prepared for this case, places this episode in its larger and important context.

CALL FROM PEERLESS BANK: A CASE CONSIDERATION OF TELEMARKETING AND ETHICS

Rebecca MacDonald poured herself a cup of coffee and sat down to reflect on the call she had received from a Peerless Bank representative. Peerless Bank was a leading regional commercial bank. It was 10:12 A.M. on a Saturday morning.

The representative had called that morning to let her know of a "special opportunity being offered to Peerless Bank's Visa cardholders." This opportunity was a program called "Basics."[1] Rebecca was told that once enrolled in the program she would, for "a small annual fee," be able to take advantage of discounts of up to 20% from retailers like Eddie Bauer and LensCrafters, and receive fifty dollars a year "for haircuts for the family no matter where they were done." While interested in the program - she and her husband had made purchases from among the few retailers mentioned - she had reluctantly declined the enrollment opportunity and was pondering not only her decision but also the ethics of this special promotion and actions she might take.

Before the morning call from Peerless Rebecca had been thinking about the things she would try to accomplish on Saturday and Sunday. As usual, the weekend was going to be a busy one. Work consumed most of Monday through Friday for Rebecca and her husband, John. Both were involved in challenging careers that left the weekends, holidays, vacations and personal days to deal with the responsibilities of house, children and family. The demands on their time were many.

While the children were married and on their own, Rebecca and John were involved in planning birthdays and baby showers and helping refurbish the homes that each had bought. They also assisted in the care of an ill parent of a daughter-in-law. Proud of their house and grounds, the MacDonalds did as much work as possible on and around the house, both to keep fit and to reduce expenditures. Every weekend there always were routine and, it seemed, non-routine things to do. Their own aging parents and aunts and uncles imposed almost weekly demands upon them, as well.

It was with this myriad of current responsibilities in mind that Rebecca had declined the opportunity to enroll in the "Basics" program. Enrollment in "Basics" would be something else she would have to remember. The Peerless representative had offered a free three-month trial membership. After three months the annual membership fee of $59.95 would automatically be charged to their Visa account. The MacDonalds could cancel their enrollment at any time in the three month period by calling an "800" number. While the fee would be charged to their account at the three-month mark, this special promotional program permitted them to cancel membership within the first year for a full refund. An enrollment fee would be automatically charged to their Visa account in every following year unless the MacDonalds notified the company in advance that they no longer wished to remain enrolled.

Rebecca was certainly interested in the offer but she wasn't sure if she and her husband would realize enough annual benefits to offset the annual fee that was charged. She was concerned that there may well be restrictions and other limitations on the discounts and on the reimbursement for haircuts that would limit the benefits that she and John would eventually realize. The representative had offered to send along "information material that would clarify the program" but only if Rebecca consented to be automatically enrolled after three months.

While Rebecca wasn't sure, it may have been possible for her to have received sufficient information over the phone from the Peerless representative that fully addressed her concerns. Her distinct preference, though, was to receive literature through the mail, which could then be studied at her leisure and shared with her husband. Had they concluded that the program's benefits were worth the annual cost she was certain they would have called back to enroll. The Peerless call had come at a most inopportune time; she was not prepared to take a portion of her Saturday morning to explore the "ins and outs" of the program over the phone, even assuming this was possible. She had planned to spend her Saturday taking care of countless other things. She was quite surprised to learn that the literature absolutely could not be sent without her authorizing program enrollment in advance.

Yes, she could have given her consent, she thought, but she would have done so reluctantly. She wondered if, in the context of her busy life, she would later remember to associate the information brochure or packet received in the mail with this earlier call. Once received, would the envelope sit unopened until after the three-month mark? Offers similar to this one, as well as information on investment opportunities and the like, did have a way of piling up in the MacDonald house. Would the "Basics" brochure or packet remind Rebecca that she had the option to cancel her enrollment within the first year?

The enrollment fee for "Basics" would appear once, on one monthly Visa statement from the bank. Increasingly, it seemed, she and John were making a monthly payment against their Visa charges or paying the entire balance owed without carefully reviewing the list of individual transactions. Their many responsibilities sometimes just did not permit the time to do this. In the press of their lives would they even notice the "Basics" enrollment fee this year, or even next?

The more Rebecca thought about the call the more she wondered if the program had been deliberately constructed to take advantage of people leading full and busy lives, or the barely literate and those living with the infirmities of age. Rather than providing a "special opportunity" for Peerless Bank's Visa cardholders, were the people who crafted "Basics" hoping for and counting on that, over time, a proportion of consumers might forget to apply for benefits as "Basics" members – reimbursement for haircuts, for example? Such direct reimbursements, of course, reduce the overall profits of the program. Had the program been purposefully designed to take advantage of consumers who did not take the time to examine their Visa bills and statements carefully? Rebecca was sure that there were consumers for whom the reconciliation of their monthly Visa statement – with its array of numbers and codes, and parent corporation names substituting for the names of outlets where purchases had actually been made – was a daunting task. They, and busy people like the MacDonalds, would either occasionally or regularly pay on their accounts without examining the underlying charges. How many consumers, she wondered, would know how to contest charges on their credit card statements and have the confidence or the time to contest them?

Rebecca had read that banks had turned to a variety of means in an effort to build revenue that did not rely on customer deposits or loans and the investment income and interest payments they generated, respectively. The "Basics" program seemed like one such means. (See the Note on the Commercial Banking Industry that follows the case.) Certainly, Rebecca thought, Peerless had much to gain and little to lose financially from enrolling her, John and others in the "Basics" program. Peerless Bank was proud of its history and reputation and constantly sought to enhance its stature in the communities where it offered banking services. For example, Peerless often contributed its personnel and dollars to a range of community activities. Thinking back on that early morning call, she wondered if the "Basics" program was the best basis upon which to build a revenue stream for a bank presumably concerned with its reputation and its name.

Because of legislation in Rebecca's state a consumer who did not want to receive telemarketing calls was able to place his or her name on the state's do-not-call list. The United States Congress had recently created a national do-not-call list. Thinking about that call, Rebecca thought it might be a good idea to add her name to those lists.

THE LEGISLATIVE AND REGULATORY CONTEXT

Peerless Bank was operating at a time when new legislation and regulation were influencing the tactics banks and other organizations could use to reach potential customers. In order to understand more fully Rebecca MacDonald's options and choices and the decision-making situation faced by Peerless, it is important to consider the legislative and regulatory environment as it pertains to consumer privacy.

Consumer privacy issues relating to telemarketing and banking industry practices are addressed by four areas of legislation:

- Telephone Consumer Protection Act (TCPA) of 1991
- Fair Credit Reporting Act (FCRA) (as amended in 1996)
- Gramm-Leach-Bliley Financial Services Modernization Act (FSMA) of 1999; and,
- Do-not-call (DNC) lists maintained by state consumer protection boards and public utility commissions, as well as by the Federal Trade Commission.

Telephone Consumer Protection Act

The Telephone Consumer Protection Act, under the administration of the Federal Communications Commission (FCC), restricts the hours during which telephone solicitations can be made. The TCPA also prescribes the type of information these callers must provide to consumers, and requires that callers maintain lists of and honor consumer do-not-call requests. The regulations and prescriptions of the TCPA, however, do not apply to tax-exempt not-for-profit organizations or to persons or organizations "with whom the receiver has an established business relationship" (Consumer Information Bureau, http://www.fcc.gov/cib/conusmerfacts/tcpa). This exception would include telephone calls made to a bank's existing customers offering them membership in a program like "Basics" that the bank decided to add to its product mix.

Fair Credit Reporting Act

Another issue of concern to consumers is information sharing and the impact this common practice has on an individual's right to privacy. The Fair Credit Reporting Act (FCRA), as amended in 1996, "specifies that banks can share transaction and experience information with their affiliates". It further states that "if other customer data are shared … banks must disclose to consumers that their information may be shared among affiliates and must give consumers the ability to opt-out of such sharing practices before they take place" (Gillespie, 1999). To help allay consumer concerns about information sharing, banks are urged to go beyond the requirements of FCRA. Banks should inform customers of their privacy policies in writing, "adhere to them strictly," and write contracts with third-party marketers that "force them to maintain confidentiality" (Leuchter, 1999). Even though a "Consumer Bankers Association survey found that 90% of banks have privacy policies" (Gillespie, 1999), consumer privacy concerns persist. In particular, some have questioned the readability of policy content and the clarity with which these policies are presented to consumers.

Gramm-Leach-Bliley Financial Services Modernization Act

The Gramm-Leach-Bliley Financial Services Modernization Act (FSMA) of 1999 was designed to look "for ways to address privacy concerns without jeopardizing the large number of services and conveniences made possible by information sharing" (Whitney, 2000). The FSMA privacy rules were intended to balance the "one stop" convenience of allowing "banks, brokers and insurers to join forces" with the threat of these companies selling personal data without customer knowledge and/or agreement (France, 2001). The FSMA requires that financial services organizations (1) establish and disclose on an annual basis a privacy policy and (2) give customers that ability to opt-out of information sharing with unaffiliated third parties, with some exceptions. As of June 2001, opt-out forms were "being returned by about 1 in every 20 consumers" (France, 2001). This low rate of return may be an indication of a lack of either consumer concern about privacy issues or sincerity by financial services organizations in complying with the Act (e.g., privacy notices printed in very small type, written using highly legal language, sent mixed with other account and promotional material). The FSMA also prohibits "disclosure of account numbers or credit card account information to third parties for use in telemarketing, direct-mail marketing or electronic-mail offerings" (Stein, 2000). However, "institutions are allowed to share account numbers with nonaffiliated third parties … for the purposes of marketing their own products and services" (Bahin, 2001). Consequently, examination procedures concerning compliance with the FSMA privacy provisions are "more vigorous" for opt-out institutions and include a review of joint marketing contracts (Bahin, 2001).

Benefits of Information Sharing

Despite consumer concerns about information sharing practices, a number of consumer benefits derive from information sharing. These include:

- quick approval of loan and credit applications
- ability to have on-line financial services
- prevention and detection of fraud
- notification of higher-return investments to those with high balances in low-return accounts
- advisement against risky investment
- home equity loan debt consolidation programs
- account aggregation, making it easier to meet minimum balance requirements
- lower priced bundled services (Whitney, 2000).

Benefits also accrue to the organizations that engage in information sharing, such as:

- facilitation of product customization
- cross-selling of affiliate offerings
- more efficient risk management
- reduced marketing costs
- higher customer retention rates (Stein 2000).

Do-Not-Call Legislation

The TCPA, FCRA, and FSMA are federal pieces of legislation relating to consumer privacy. One should be aware that more stringent state privacy legislation would preempt federal legislation (Stein 2000). The growth in the number of states with DNC lists has been tremendous. In 1998 "only Florida and Georgia had state-managed do-not-call lists" but by 2001 23 states had "passed legislation to adopt no-call lists" (Sullivan, 2001). New Jersey's do-not-call list took effect in May 2004 (Ramirez, 2004), bringing the number of states with a do-not-call list to 38.

On the federal level, "the Federal Trade Commission … proposed a national 'do-not-call' registry through which consumers will be able to permanently prevent telemarketers" from calling them (Bischoff, 2002). After various court hearings and appeals, the FTC's national DNC registry was instituted late in 2003 (Foley, 2003). As of March 2004, over 58.4 million consumer phone numbers had been placed on the national registry (Federal Trade Commission, 2004). While the list does not prevent all telemarketing calls, "the FTC estimates the rules will stop … 80% of unwanted calls" (Foley, 2003).

Do-not-call legislation at state and federal levels announced a date in the future when their new requirements would take effect. This permitted organizations a period of time or "grace period" to modify their marketing practices.

THE BANK'S DILEMMA

Recent legislative and regulatory changes that impact consumer privacy and important changes in the banking industry have prompted much commentary. This commentary comes from banking executives and consultants, analysts and other experts in commercial banking, credit cards and telemarketing. From these comments it is easy to imagine the following discussion taking place at Peerless Bank.

> *Richard Hall, Senior VP of Marketing at Peerless Bank, was well aware that time was of the essence in determining how Peerless was going to respond to changing regulatory and consumer environments. Hall had met earlier in the week with members of his staff and with Sarah Bloom, Senior VP of Finance, and Frederick Becker, VP of Government Relations, to discuss "Basics" and similar programs offered to holders of Peerless' Visa card. They had met to discuss, among other things, how do-not-call lists created by legislation at both state and federal levels might affect these bank offerings. They also met to weigh the complaints consumers were expressing about telemarketing that had led to this legislation. If Peerless were to continue to offer such programs to its customers, the bank had to be certain that its tactics met the requirements of new legislation and regulation. That is, Peerless had to make sure its marketing approach respected current law and regulation.*
>
> *In light of both negative reactions of some consumers to telemarketing and new regulations concerning privacy, Hall questioned whether such "enhancement programs" should continue at all. However, Sarah Bloom emphasized that these*

offerings were a good source of fee revenue for Peerless. She encouraged Hall and his staff to do everything they could to continue these programs.

The meeting ended with Hall and his staff deciding to start by developing a revised marketing plan for "Basics". The plan could still include telemarketing but also might include other marketing strategies and tactics. Hall cautioned his staff that whatever the mix of components the plan employed, the integrity and reputation of Peerless as an ethically responsible corporate citizen had to be protected. Before turning their attention to the promotion section of the plan, it was vital to consider the current structure of the "Basics" program. Hall wondered if the nature of the program needed to change to be more clearly aligned with Peerless' desire to be perceived favorably by external constituents.

Once he and his staff decided on the product, they then had to decide on a promotion strategy for the product. Should Peerless continue to implement and promote "Basics" using an out-bound telemarketing strategy or should they use another direct marketing approach? What were the pros and cons of using targeted e-mails, direct mail promotions coupled with in-bound telemarketing, personal selling, or newspaper, magazine or broadcast advertising? Hall recognized that more than minor adjustment to a plan might be required. Given the regulatory and ethical context surrounding consumer privacy, the situation seemed to require re-evaluation of promotional choices and other earlier decisions.

NOTE ON THE COMMERCIAL BANKING INDUSTRY

Industry Overview

Peerless Bank was a commercial bank, defined by law as a financial institution that accepts deposits and makes commercial loans. Commercial banks are important in the United States economy. They hold about eighty percent of all assets held by U.S. banks – savings institutions and credit unions hold the rest. Commercial banks range in size from a small community bank with a single facility and a few million dollars in assets to large, global institutions with numerous locations and billions in assets. According to the Federal Deposit Insurance Corporation (FDIC), in the United States, the number of commercial bank main offices held steady at around 13,000 to 14,000 from the 1930's through the mid-1980's, with the number of bank branches rising from 17,000 in the 1930's to 44,000 in the mid-1980's. By 1998, however, the number of main offices had dropped to just fewer than 9,000, while the number of branches ballooned to more than 70,000 as banks tried to make access to their products and services more convenient for customers.

Larger banks are owned by bank holding companies (BHC), which may also own non-bank subsidiaries offering other financial services. Commercial banks, their holding companies and subsidiaries offer a wide range of products and services. The major services offered include deposit accounts, credit services, investment banking services, agent or fiduciary services and consulting services.

Deposit Accounts

One important function for a commercial bank is to serve as a depository for cash. There are two basic types of deposit accounts: demand and time deposit. There are also interest-bearing accounts that capture the features of both. Demand deposit accounts are commonly referred to as checking accounts. Time deposit accounts include savings accounts that pay interest on balances and certificates of deposit – interest-bearing savings accounts with a fixed maturity date, typically from a few months to several years. A money-market account functions like a savings account but permits limited check writing, transfers and electronic withdrawals.

Credit Services

Commercial banks provide loans to individuals, to companies and to not-for-profit organizations. Short-term loans are provided to businesses typically for working capital purposes while long-term loans are provided for capital improvements. Banks may also provide long-term – mortgage – financing for the purchase of residential or commercial real estate.

Banks typically offer customers credit cards that permit the user to acquire a short-term loan from the bank. The bank acquires revenue from the interest paid on outstanding credit card balances on the cards that it issues. The average annual credit card interest rate for U.S. households was 14.71% in 2003, though the rate for those with mixed or poor credit ratings can be as high as 19%. The balances on the original charge cards, which were used only for department store purchases, travel and restaurant meals, had to be paid in full at the end of each month. Today, about sixty percent of credit card users do not pay their balances in full each month. The following statistics point to the popularity of credit cards and provide other information about their use:

> *By the end of 2002, Americans owed nearly $661 billion on 785.3 million credit cards.*
>
> *The average amount owed per household has climbed steadily, from $2966 in 1990, to $4400 in 1997, and to what some consider a troubling $9205 by 2004.*

In 1973 there were about 23 million Visa credit cards in the United States. By 2004 there were 258 million, and consumers in 150 countries carried more than one billion Visa-branded cards, including credit, debit, prepaid and other cards. Together, by 2004 Visa and MasterCard accounted for about 75% of all purchases on credit cards. Discover and American Express were the other major brands.[2]

185 million Americans (8 out of 10 U.S. households) have at least one credit card, and the average card-carrying American has 2.7 bank credit cards (such as those issued by Visa and MasterCard), 3.8 retail credit cards (issued by stores and gasoline companies), and 1.1 debit cards (bank ATM cards that can be used for purchases).

Credit card balances written off as uncollectible represented 6.70% of all balances in December 2003. The December 2003 delinquency rate, which measures the proportion of account balances for which payment is more than 30 days late, was 5.04%

In 1970, to reduce their fraudulent use, the government prohibited the mass mailing of unsolicited credit cards. Prior to this cards frequently just arrived in a household's mail.

Investment Banking Services

Acting as agents for companies, commercial banks place the commercial paper of their customers – unsecured short-term promissory notes – with investors. Banks may also arrange or place long-term loans on behalf of customers with insurance companies and other institutional investors. Some banks handle the sale of corporate stock and bonds through subsidiaries.

Agent or Fiduciary Services

Commercial banks also provide a series of fiduciary services where assets belonging to customers are managed by the bank. Banks invest, manage and distribute monies as instructed in wills, trusts and estates, and manage portfolios of investments for their customers. Banks may also act as agents for corporations in establishing and managing employee pension programs. Banks serve as transfer agents by keeping records of the sale and purchase of stocks and bonds. Banks may also receive funds from the issuer of stocks or bonds to pay dividends to stockholders and interest to bondholders.

Consulting Services

Commercial banks may provide consulting services for corporate customers in areas such as treasury management, mergers and acquisitions and corporate financial structure.

Other Services

Recent legislation, to be discussed below, permits banks to offer customers financial planning, insurance, securities and other financial services through BHC subsidiaries.

BANK REVENUE

At commercial banks customer accounts generate three basic types of revenue: income from customer deposit balances, interest from loans, and fee income.

Investment Income from Deposit Balances

Customer deposits in checking and savings accounts are invested in a variety of securities and generate revenue for the bank.

Interest from Loans.

For most banks short, medium and long-term loans are a significant bank asset and an important source of bank revenue.

Credit card balances carried forward is a form of loan, with these balances generating interest earnings for the bank issuing the credit card. These loans might comprise ten percent or more of a bank's domestic consumer loan portfolio and the earnings from interest payments and card fees can be a significant portion of bank revenue. In 2004, at Citigroup, the nation's largest issuer of credit cards, card revenue accounted for 28% of all revenue. At BankAmerica, the third largest issuer of credit cards behind MNBA, card revenue was 31% of all revenue in 2004. Historically, about eighty percent of credit card revenue is from interest that consumers pay on card balances.

Fee Income.

A growing and important source of revenues for banks has been the fees assessed and collected for various services to customers. For the nation's largest bank holding companies in 1999, revenue received from fees, which is known as the "payments business" in banking, was estimated to generate from one-third to two-fifths of overall revenue. In 2004 at Citigroup, the nation's largest bank, revenue received from fees was 27% of all revenue.

The fees assessed by banks include fees for credit cards, checking accounts, transactions at bank ATM terminals, late payments, bounced checks and the payment of customer bills by the bank electronically. Investment banking, consulting, and agent and fiduciary services generate fees, as well.

If bank customers can be induced to purchase goods and services, such as insurance, travel or consumer-goods discount programs – such as Peerless Bank's "Basics" program - through bank-sponsored mailings or telemarketing efforts, a bank will typically receive revenue of about 20% of these sales when these programs are assembled by other organizations, including telemarketing organizations. Bank revenue from these programs - called "enhancement programs" in the banking industry - is of course greater when they are developed by the bank and sold by a bank's own telemarketers.[3]

An important source of fees for the larger banks like Peerless is the revenue generated when a bank's credit or debit cards are used by customers to purchase goods and services. Debit cards are used primarily for small purchases, such as gasoline and food, while credit cards are used for larger purchases, such as appliances, cars, electronics and expensive meals. When a purchase is made a number of parties receive a portion of the transaction amount including: the bank issuing the card; an organization like Visa or MasterCard, responsible for promoting the credit card brand; the organization that persuaded the merchant to accept the particular brand of credit card used in the transaction; and the organization that actually processes the transaction. This last organization assures that the various parties receive the income to which they are entitled. When a purchase is made using a credit card the merchant receives about 98% of the amount charged. The remaining 2% is divided among the above parties, with about 1.4% paid to the bank issuing the credit card. When a debit card is used a merchant receives about 98.5% of the amount charged. Because the risk of losses is less when a consumer uses a debit card, merchants pay a lower fee on these sales.

IMPORTANT CHANGES IN BANKING

Beginning in the 1980's and 90's and continuing into the twenty-first century, the commercial banking industry has been characterized by rapid and significant change. Dominant among these changes have been new legislation removing restrictions on the physical location and activities of banks, the influx of new competitors, and bank mergers and acquisitions.

New Legislation

Major new legislation and their features in this period that had an impact on commercial banking were the following:

Garn-St. Germain Depository Institutions Act (1982)

- *Extended the legal lending limit of banks to 15 percent of capital and surplus for unsecured loans and 25 percent for secured loans.*
- *Allowed the Federal Deposit Insurance Corporation (FDIC), which insures most customer deposits, to arrange mergers of banks across state lines when suitable intrastate partners could not be found.*
- *Allowed banks to offer money-market deposit accounts.*

Riegle-Neal Interstate Banking and Branching Efficiency Act (1994)

- *Permitted bank holding companies to acquire a bank located in any state, effective September 1995.*
- *Allowed commercial banks in one state to merge with banks in another state beginning June 1997, as long as neither state took legislative action to prohibit interstate mergers.*
- *Allowed banks to establish new branches in states where they do not maintain a branch if the host state passes a law expressly permitting such branches.*

Gramm-Leach-Bliley Financial Services Modernization Act (1999)

- *Eliminated many of the remaining barriers among banking, insurance and securities businesses.*
- *Permitted the creation of financial and bank holding companies (FHC, BHC), which can engage in any activity considered "financial in nature, incidental to finance or complementary to it."*
- *Allowed easier entry by foreign banks into the U.S. financial services market.*
- *Required financial institutions to establish privacy policies and disclose them at the start of a customer relationship and once a year thereafter. Also required banks to give customers a chance to block the sharing of confidential financial information with third parties. Additional information about this feature of the act was provided earlier in this case.*

Competition from Non-Bank Competitors

From primarily the 1980's onward non-bank competitors located outside of the traditional banking industry began to offer product and service alternatives to banks and began to attract customers. For example, brokerage firm Merrill Lynch offered customers a Cash Management Account, a money-market account with check writing ability, access to funds through a credit card, and brokerage account privileges. Banks once had exclusive right to offer checking accounts but now other firms like Merrill Lynch could offer checking account equivalents, auto manufacturers could lend money to car purchasers, and mortgage bankers and brokers could lend to home buyers. Non-merchant specific, general purpose credit cards were once almost exclusively issued by banks. In 1990, telecommunications company AT&T entered the credit card market with the introduction of its Universal Card. By 1997, AT&T was the nation's seventh largest credit card issuer. The company eventually sold its credit card portfolio to Citibank in 1998. The second-largest issuer of credit cards in 2003 was MNBA, a non-banking organization whose sole business is issuing credit cards. MNBA issues both Visa and MasterCard credit cards.

Just as there has been a decline in the number of banks since the 1980's, there has been a decline in the banking industry's share of the total financial assets managed by financial organizations.

Bank Mergers and Acquisitions

From the 1980's and continuing into this century bank mergers and acquisitions are at the heart of a massive restructuring of the industry. Helped by a large increase in market capitalization of banking companies, which greatly assists in the acquisition of other organizations, and the changes in regulation described above, banks merged with or acquired other banks, savings and loan associations, and non-banking companies, such as mutual funds, finance companies and mortgage banking companies. Bank profitability, which depends on the revenue received from all sources including credit card balances and the payments business, directly influences the value of a bank's stock and thus its ability to merge and acquire.

Mergers and acquisitions permit banks to reduce their credit risks through product and geographic diversification. More importantly, such expansions permit banks to add customers and to offer new products and services to existing customers because of the professional capacities and delivery systems of other firms. For example, in 1998 Citibank merged with the Travelers Group, which offers an array of insurance and investment products. Mergers and acquisitions also permit significant cost savings when identical departments in each bank are combined and surplus workers eliminated. Volume purchasing and the realization of other economies-of-scale lead to a reduction of costs, as well. Such cost savings enable the new organization to aggressively compete with banks whose costs are higher.

Mergers and acquisitions also permit banks to reduce the costs of competing with other banks for customers. To the detriment of customers, the interest rates associated with deposit accounts may be lower and the interest rates charged for loans may be higher because there is less competition, at least from similar institutions.

Peerless Bank, a regional bank, had become prominent through its merger and acquisition activity. Other major players in the banking industry were such regional banks such as Wachovia, FleetBoston, Wells Fargo, BankAmerica, BankOne, SunTrust, SouthTrust, U.S. Bancorp and Bank of New York. Recently, though, J.P. Morgan Chase and one of these regional banks, BankOne, had announced a merger, making them the second largest bank in the United States behind Citigroup, Inc. Shortly afterwards, two other prominent regional banks, BankAmerica and FleetBoston, announced a merger, as well. BankAmerica and FleetBoston became the nation's third largest bank. In 2004, Wachovia acquired SunTrust. Wachovia is now the nation's fourth largest bank. In 2004, as well, BankAmerica acquired MNBA, the credit card issuer. The purchase doubled BankAmerica's card business and permitted the company to surpass Citigroup as the nation's largest issuer of credit cards. These developments made it imperative that, for competitive reasons, Peerless Bank continue to find ways to build revenue while controlling and reducing its costs.

ENDNOTES

[1] Peerless" and "Basics" are pseudonyms for a real bank and program operating in the northeastern United States.

[2] Visa and MasterCard, both started in the mid-1960's, are non-profit competing organizations controlled by the banks that are members. The organizations are responsible for promoting the brand and for improving the infrastructure that processes consumer purchases. Organization membership requires banks to pay an application fee and quarterly service fees based on the volume of card transactions. For a bank, these costs are usually small in relation to the bank revenue generated by the cards.

[3] A bank's telemarketers can handle in-bound calls, initiate out-bound calls, or can do both. In-bound calls are from customers responding to an ad or to a bank-sponsored mailing they have received. Out-bound calls are made to sell products or services. One outcome of do-not-call laws, which permit companies to call its current customers, may well be the establishment or acquisition of telemarketing organizations by banking and other organizations.

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RECRUITING AT ORGSERVICES CORPORATION*

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CASE DESCRIPTION

The case presents a good springboard for discussing the recruitment process in general and to illustrate the level of students' interest in less well-known organizations. The case also demonstrates the common practice of sending employees to their alma maters to recruit. The case presents a good opportunity to explore student's expectations regarding the job market in general and their specific desires regarding a suitable employer by evaluating the presentation of OrgServices. You may ask students to visit your own career center or one of the many websites providing salary information to obtain salary ranges for jobs of interest to each of the majors represented in your class. This may serve as a "reality check" for many of the students who have not been collecting this information. This case is intended for use in an Employee Selection class in a discussion of recruitment practices; therefore its difficulty level is a three (junior-level). The case is short enough to be easily covered in one class period or as a part of class period if using a recruitment lecture. Alternatively, the case can be used early in the Business Policy or General Management course to stimulate discussion of job-related topics. In either case the case should require less than 1 hour of outside preparation by students.

CASE SYNOPSIS

The case follows, Jason and Patrick, two service area managers for OrgServices Corporation as they return to their alma mater to recruit for the company's Management Training Program. A senior-level Business Policy class constitutes their audience for the presentation. OrgServices is the largest uniform provider in the United States with sales of over $2 billion in 2001. Jason and Patrick briefly present a description of OrgServices and its outstanding achievements (e.g. over 20 consecutive years of growth in revenues and profits, making Fortune's list of Most Admired Companies, etc.). They project that the company will expand its workforce from its current level of 20,000 to 39,000 in 10 years. They also describe the 2-year Management Training Program open to all business majors where trainees rotate through all aspects of the business.

At the close of the presentation only 3 students pick up information on the company leaving Jason and Patrick to wonder what went wrong. Patrick and another alumnus of the University

were scheduled to visit a junior-level class in one month. As the case closes the two are in a quandary over what if anything should be done differently for their next visit to campus.
While based on real events the company and individual names have been disguised at the company's request.

RETURNING TO CAMPUS

As Patrick Kantner pulled onto the campus on a bright spring day in 2002, the new bell tower immediately caught his eye. The alumni publication he received from his alma mater had featured the carillon bells and tower that now anchored the north end of Ball State University. The sudden jolt from a huge pothole redirected Patrick's eyes to the street ahead. As he gazed at the potholes and tar patches he thought that the poor condition of the campus streets had changed little in the four years since his graduation. He parked his car and quickly strode past the "Frog Baby" fountain to the entrance of the College of Business where Jason Truell, a former classmate, was waiting.

Patrick extended his hand to Jason, a fellow service manager at OrgServices Corporation (http://www.OrgServices.com/). "How have you been?" "Oh, I can't complain," Jason replied as he firmly returned Patrick's hand shake. "I'm looking forward to making the presentation and to seeing some of our old professors." "Ahh, but it's going to be a little weird standing in front of the class rather than sitting behind a desk," Patrick said. "Yeah, but I'm sure that the students will be receptive to the OrgServices story which should make it a little easier. After all, we're not presenting for a grade today," said Jason. "I'm not so sure," Patrick interjected. "Fred seemed pretty intent on us recruiting some Ball State grads for our Management Training Program." "I guess as General Manager, Fred can't have too much of a good thing," Jason chuckled. "Let's see, besides the two of us there is Tara in your plant and Ann in HR in my office also graduated from here. The professor said he'd meet us in room 140 just before class, so we'd better get inside," Patrick said as he opened the door for Jason, who was carrying a box of promotional materials on OrgServices.

After introducing themselves to the senior class of business policy students, Patrick asked, "How many of you have heard of OrgServices?" Only 2 of the 30-plus students raised their hands. "We're not surprised," Patrick continued. "When Jason and I were sitting where you were four years ago, we hadn't heard of OrgServices either." "First, I'll give you a little background on the company and what it does and then Jason will tell you about our management training program." Patrick continued, "Please feel free to ask us questions at any point in the presentation and remember we'll be at the Career Fair over in the coliseum all afternoon."

ORGSERVICES CORPORATION – THE CLASS PRESENTATION

Patrick began his overview of the company.

OrgServices is a leader in the uniform rental and corporate identity apparel industry. Approximately 75% of company sales come from the rental business. In addition to uniform rental and sales, OrgServices also provides facility services (e.g. mats, soaps, etc.), first-aid supplies, and cleanroom services. Under the direction of Tom T. Harris, who was listed on Forbes 400 Richest Americans in 2001, OrgServices has recorded over 200 years of consecutive growth in sales and profits (http://www.Forbes.com).

In 2001, OrgServices recorded over $2 billion in sales and over 4 million people went to work in an OrgServices uniform. The company's profits were in excess of $220 million in 2001, a compound growth rate of 25% from 1998-2001. OrgServices was listed on NASDAQ in 1983, and traded under the symbol "CTAS". An investment of $1,000 in OrgServices stock in 1983 would be worth $50,000 in 2001. Fortune magazine ranked OrgServices as the No. 1 outsourcing services business in its 2001 list of "America's Most Admired Companies.

Uniform Rental and Sales.

The company designs and manufactures corporate identity programs that it rents or sells throughout the United States and Canada. Over 400,000 companies use OrgServices and its client list includes Honda, Pfizer, Coca-Cola, Wal-Mart, TruGreen, NASCAR, Marriott, Delta Airlines, NAPA, DHL Worldwide Express, Firestone and many others. Its services include advice on the proper fabric, color, style and type of uniform for the type of job. Then OrgServices measures each employee and issues a set of uniforms for each individual. These uniforms would include the company name or logo and the individual wearer's name, if desired. Rental customers receive regular deliveries each week to pick up soiled uniforms and drop-off professionally cleaned uniforms. Rental service also includes exchanges for worn garments or garments that no longer fit properly due to weight loss or gain.

Since the terrorist attacks of September 11, uniform sales customers including hotels, airlines, and entertainment businesses have delayed uniform purchases due to slowdowns in their businesses. However, company executives' feel this would result in pent-up demand that would benefit OrgServices as the economy recovers.

Facility Services.

This service area provided by OrgServices includes entrance mats, soaps, air fresheners, and other cleaning supplies. The mat service is aimed at reducing dust entering the workplace and improving employee and customer safety while the hygiene services are aimed at improving sanitation and appearance of restrooms, and eliminating the need for on-site inventories. The hygiene services include hand care and air freshener stocking and maintenance.

Through the years these services and others have been added to the uniform rental trucks that visit clients on a weekly basis. As customers develop a relationship with OrgServices, the addition of these services became a natural outgrowth of our business.

First Aid and Safety.

The fourth service area provided by OrgServices is first aid and safety. OrgServices services its clients' first aid needs through its OrgServices's Xpect First first aid line of products. These include bandages, gauze, ointments, sprays, tablets, eyewashes, burn care, and the cabinetry to house the supplies. This service areaXpec also provides training and industry updates on OSHA and other government agency workplace requirements.

Cleanroom Resources.

The final service area offered by OrgServices is its cleanroom operations. OrgServices seeks to provide equipment, supplies, training, apparel rental, and precision laundering service to microelectronics, pharmaceuticals, biotechnology, medical device and other manufacturing industries. OrgServices was the first apparel service company to receive ISO-9002 registration.

MANAGEMENT TRAINING PROGRAM

Now that you've heard a little about what OrgServices does, I'll let Jason fill you in on the Management Training Program at OrgServices, Patrick said. Patrick and I both went through the Management Training Program right out of school, and I'd like to tell you a little about it, now" Jason continued. It is a 2-year program designed to develop future managers and executives who are committed to the OrgServices principles and values. Management trainees rotate through all aspects of the business from sales, office operations, plant, and delivery. Trainees also attend seminars at the headquarters in Indianapolis, OH. Selection into the program is competitive with salaries starting in the mid-30's. Management's goal for every trainee is to prepare him or her to be a General Manager in 10 years.

"I recall thinking as I folded uniforms, loaded and unloaded trucks – I went to college for this?" Jason grinned. "But I remember what my mentor at OrgServices told me, it's easier to manage people if you have first-hand experience of what they are doing. Now, I believe that Patrick and I are more effective service area managers for having that breadth of experience in our training," Jason said. "This experience is critical to effectively manage a diverse workforce. Over

40% of the customer service representatives (route drivers) that Patrick and I manage as Service Area Managers have college degrees while the workers in the laundry plants may not have completed high school." Jason flipped on the overhead projector and said, another benefit to the breadth of the training is that we are not limited to any one business major in our recruiting."

OPPORTUNITIES AT ORGSERVICES

As Jason placed a transparency on the overhead projector he continued, before we take your questions we'd like to give you some idea of the opportunities at OrgServices. As you can see we project the potential uniform rental market alone to be $12 billion! As he put up the next slide he continued, in 2001, we were the largest player with only 8% of the uniform rental market share, but our nearest competitor only has about 2% with most of the market made up of small, single location suppliers. By 2005 we project OrgServices will capture 13% of this market. We have 3% of uniform sales and 5% of the entrance mat and first aid markets this year. We expect to double our positions in these markets by 2005.

ORGSERVICES MARKET SHARE

Our projections for our other business services mirror those of uniform rentals."Patrick placed a map of the U.S. on the overhead. OrgServices is in 280+ of the top 325 U.S. markets and has a location practically anywhere you might like to live and work, continued Jason. As the company expands the number of employees needed is expected to reach 39,000 in the next 10 years nearly double the 2001 level of 20,000. Patrick and I obviously feel that the growth opportunities are exciting at OrgServices and we'd be more than happy to discuss the career opportunities at OrgServices, Jason concluded.

THE REACTION

Patrick handed an OrgServices coffee mug to both students who asked a question. The questions seemed to be obligatory aimed at pleasing the professor rather than ones based on a genuine interest in the company. After the last question, Jason reminded the students of the Career Fair and suggested that the students pick up a business card and a brochure on the Management Training Program as they left the class. The professor thanked Jason and Patrick then dismissed the class. As the students filed out only 3 picked up any information. Jason and Patrick headed to Patrick's car to get some lunch before they manned the booth at the career fair that afternoon.

As the car door shut Patrick began, "Can you believe that they only picked up three of our cards?" "No, I thought the soft job market and the fact that we were willing to talk to seniors of any major that we'd have gotten more of a response," replied Jason. "Do you think my mention of folding clothes turned them off?" asked Jason. "Probably, but it is a fact and besides what is wrong with folding clothes, anyway? Patrick pulled into the restaurant parking lot and continued, "OrgServices is a great company with exceptional opportunities for those willing to work, and if they can't see that then I'm not sure what to do. I guess uniform rental, mats, and soap just isn't as exciting as some of the other companies recruiting on campus. The professor asked Ann Baxter from HR and me to speak to his Principles of Management class next month. I wonder what students are looking for these days? Do you think we should alter our approach or was this just a strange class?"