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JOURNAL OF THE INTERNATIONAL ACADEMY FOR CASE STUDIES

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LETTER FROM THE EDITORS

Welcome to the *Journal of the International Academy for Case Studies.* The editorial content of this journal is under the control 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 *JIACS* is to encourage the development and use of cases and the case method of teaching throughout higher education. Its editorial mission 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.

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CASES

YOURPRODUCTSUCKS.COM: INTERNET GRIPE SITES AT THE CROSSROADS OF TRADEMARKS AND FREE SPEECH

Leonard Rymsza, California State University, Northridge
Kurt M. Saunders, California State University, Northridge

CASE DESCRIPTION

The primary subject matter of this case concerns trademark law. Secondary issues examine trademark infringement, dilution, cybersquatting, commercial disparagement, and freedom of expression.

The case has a difficulty of level four, appropriate for senior level courses. The case is designed to be taught in three class hours and is expected to require a minimum of six hours of outside preparation. The case may be used as an in-class or take home assignment. Also, the case may be assigned as an individual student or student team project.

CASE SYNOPSIS

The Internet has made possible another forum by which dissatisfied consumers can vent their complaints about poor service or purchases of substandard products. In the typical scenario, a disgruntled consumer purchases a domain name and sets up a website, known as a "gripesite," on which to publicize their complaints and criticism about the merchant. In turn, merchants have responded with litigation to protect their trademark rights and silence the consumer. Recent cases arising from this strategy of creating gripesites have pitted the merchant's trademarks and protection of its goodwill against the dissemination of critical information about the merchant and the consumer's freedom of speech.

This case study presents a multifaceted factual setting that raises numerous issues relating to trademark infringement, dilution, cybersquatting, commercial disparagement, and freedom of expression. Consumer decided to have new carpet installed in her living and dining room. She telephoned a nationally recognized home improvement – home furnishing company. Consumer scheduled an appointment for a salesperson to come to her home to measure the floors and provide her with carpet samples. The salesperson did not keep the initial appointment and did not contact consumer to let her know that the appointment would not be kept. Consumer was unhappy with this *behavior but she, nevertheless, scheduled another appointment. The salesperson kept this second appointment but was approximately one hour late. Consumer was frustrated with the appointment mishaps but decided that since the salesperson was at her home she may as well have the rooms measured and look at the carpet samples. Consumer found a sample that was the perfect color and nap. The cost estimate for the carpet was also comparable to estimates that consumer had received from other retailers. Consumer ordered the carpet and made arrangements to have the carpet installed the next day.*

The installation of the carpet went smoothly except that a silver runner was installed instead of a gold runner as specified in the work order. Consumer paid for the carpet and installation with installers promise to return the next day and install the proper runner. The installer failed to return the next day as promised. Within a few days of the installation, consumer noticed several seams in the carpet had become visible and that un-even surfaces had begun to appear. Following several frustrating attempts to schedule the return of an installer and failed attempts to correct the problems, consumer sent a letter rescinding the carpet contract and requesting the return of the $3,000 she had paid for the carpet. Consumer's request was denied and attempts to settle the matter proved fruitless.

Consumer decided to take several courses of action. One strategy resulted in consumer registering seven different internet domain names. The domain names included the name of the home improvement company in varying forms. Consumer began using one of the internet sites. The site contained a statement summarizing consumer's entire dealings with the improvement company and her dissatisfaction with the company's actions. Consumer was contacted several times by legal representatives of the improvement company and was asked that she cease and desist from using the company's name in any domain names. Consumer refused to discuss the matter and the improvement company eventually brought suit against consumer alleging, trademark infringement, dilution, false designation, unfair competition, cybersquatting, various state law claims, and libel. Consumer countered that she was merely exercising her first amendment right of free speech.

This case study explores the intersection of electronic commerce, trademark law, and freedom of speech. As a pedagogical tool, the case can facilitate student appreciation and understanding of the complexity of arguments presented for the protection of trademarks and domain names while at the same time considering the right of consumers to freely express their opinions and views. Moreover, the case can serve as a means to promote awareness of legal risk in business decisions and to enhance the development of legal reasoning skills in business law students.

The first part of the case requires students to evaluate trademark infringement, trademark dilution, cybersquatting, and commercial disparagement claims. The second part of the case requires students to evaluate the improvement company's claims in light of consumer's freedom of speech rights.

INSTRUCTORS' NOTES

OVERVIEW OF THE APPLICABLE LAW

Trademark Law

According to the federal Lanham Act, a trademark is "any word, name, symbol, or device or any combination thereof" used in commerce[3] by a person "to identify and distinguish ... goods ... from those manufactured or sold by others and to indicate the source of the goods."[4] For example, the trademark "McDonald's" along with the its "golden arches" identify the fast food restaurant and distinguish it from competing fast food chains such as "Burger King" and "Wendy's." Similarly, color, shape, or product design and packaging can serve as a trademark. For example, the pink color of Owens-Corning fiberglass insulation or the unique shape of a Coca-Cola bottle has protectable identifying features.

While trademarks serve as indicators of source, they also aid consumers' purchasing decisions by providing visual cues that assist in brand recognition and connote product performance attributes.[5] In this way, trademarks lower consumer search costs by providing a reliable signal of product identity and quality in comparison with competing products.[6] Likewise, trademarks can signify sponsorship or authorization by the trademark owner.[7] So long as a mark is inherently distinctive, or has acquired distinctiveness through secondary meaning,[8] it may be protected as a trademark and federally registered.[9] Distinctiveness is the essence of trademark protection since lack of distinctiveness would make the mark incapable of identifying the good or service and signaling to a consumer the information needed to lower his or her search costs. The more distinctive the mark, the greater the likelihood it can be protected.

Trademark Infringement

The owner of a trademark has a cause of action for infringement against anyone who commercially uses a mark without permission that is identical or similar to a registered mark when such unauthorized use is "likely to cause confusion, or to cause mistake, or to deceive."[10] An action for trademark infringement is designed to protect the public from confusion as to the source or sponsorship of the defendant's product. The plaintiff must demonstrate that defendant's *commercial* use of a similar mark is likely to cause consumers to mistakenly believe that defendant's product or business is somehow associated with that of the plaintiff.[11] To determine whether likelihood of confusion exists, courts consider a number of key factors, including: (l) the strength of the mark; (2) the similarity between the marks; (3) the relatedness of the goods; (4) evidence of actual confusion; (5) sophistication of the buyers; (6) the defendant's intent in selecting the mark; and (7) the likelihood of expansion of the product lines.[12]

The use of an identical mark on the same product would clearly constitute infringement. If a moving company uses the mark "United," it will likely cause consumers to be confused into thinking that the moving services are provided by United Van Lines. Likewise, use of a similar though not identical mark may cause consumer confusion as well. On the other hand, using the same mark on a completely unrelated product will be unlikely lead to an infringement claim. Thus, United Van Lines and United Airlines can coexist since consumers are not likely to think that they are buying airfare on a plane owned by a moving business, and vice versa.

Trademark Dilution

In addition, the Lanham Act prohibits the dilution of "famous" trademarks.[13] A "famous mark" as one "widely recognized by the general consuming public of the United States as a designation of source of the goods or services."[14] In deciding whether a mark is famous, the courts will consider the following factors: (1) the amount of advertising and publicity; (2) the geographic extent of the market; (3) the channels of trade; (4) the degree of recognition in trading areas; (5) any use of similar marks by third parties; (6) whether the mark is registered.[15] For instance, Microsoft, Exxon, Heinz, and Disney are all considered to be famous trademarks.

Dilution protects the trademark itself from "blurring," which gradually undercuts the strength, prestige, and value of a trademark,[16] and "tarnishment," which involves use of the mark in a degrading manner or on inferior products that causes harm to its reputation.[17] A trademark can be diluted even in the absence of consumer confusion or competition between plaintiff's and defendant's products. Instead, the focus in a dilution claim is on the damage to the mark's inherent value as a symbol,[18] rather than on whether consumers are likely to have been confused as to origin or sponsorship of the product as with infringement.[19] For example, selling "Microsoft" brand microwave ovens or "Exxon" brand laundry detergent involves blurring since each dilutes the distinctive quality of the famous mark. Using the mark "Disney" to sell pornographic videos or the mark "Tiffany" to advertise poorly constructed furniture involves tarnishment since it associates the mark with an unseemly product.

Fair Use

The Lanham Act, however, provides for an affirmative fair use defense that protects one who uses a trademarked term in a descriptive sense and in good faith from liability for trademark infringement. According to the Lanham Act, it shall be a defense to an allegation of infringement "[t]hat the use of the name, term, or device charged to be an infringement is a use, otherwise than as a mark ... of a term or device which is descriptive of and used fairly and in good faith only to describe the goods or services of such party ... ."[20] Thus, it is nominative fair use to advertise a used Honda brand automobile for resale since it does not mislead or confuse consumers.

Similarly, it is fair use to engage in a news report or in comparative advertising in which another's trademark is used. Thus, it would be fair use if Colgate referred to "Crest" brand toothpaste in an advertisement that accurately compared product features. Finally, certain parodies of trademarks are permissible if they are not directly tied to commercial use. The rationale for this is that artistic and editorial parodies or satires of trademarks serve a valuable critical function, which is entitled to First Amendment protection. For example, the use of a pig puppet character named "Spa'am" in a Muppet movie was held not to violate Hormel's exclusive rights in the trademark "Spam."[21]

The Anticybersquatting Consumer Protection Act

Domain names are the addresses of the Internet. Users send email and locate websites through the use of domain names. As use of the Internet became more accessible and popular, and as electronic commerce emerged as a new online marketplace, businesses quickly realized that registering a domain name was an important part of establishing an Internet presence and in marketing their products and services. However, when some businesses attempted to obtain their desired domain names, they sometimes discovered that their desired domain name had already been purchased. If so, the business had to either choose a different name or contest the other registrant's ability to use the desired domain name.

Some individuals registered domain names containing well-known trademarks even though they did not own the trademark rights to those names. In some cases, they held the domain names "hostage" until the trademark owner was willing to pay an outrageous price to ransom the domain name.[22] This extortionist practice became known as "cybersquatting" and since no law specifically addressed this problem, domain name cases were usually brought as trademark infringement or dilution claims.[23]

In 1999, Congress enacted the federal Anticybersquatting Consumer Protection Act (ACPA),[24] which is intended to give trademark and service mark owners legal remedies against defendants who obtain domain names "in bad faith" that are identical or confusingly similar to a trademark. If a mark is a famous mark, the same remedies are available if the domain name is identical to, confusingly similar to, or dilutive of the mark. In enacting the ACPA, Congress found that the unauthorized registration or use of another's trademark as a domain name results in consumer fraud and public confusion as to the true source or sponsorship of products and services; impairs electronic commerce, which is important to the economy of the United States; and deprives owners of trademarks of substantial revenues and consumer goodwill.[25]

In a claim under the ACPA, the plaintiff must prove that the defendant (1) has a bad faith intent to profit from that mark, including a defendant name which is protected as a mark; and (2) registers, traffics in,[26] or uses a domain name that

(I) in the case of a mark that is distinctive at the time of registration of the domain name, is identical or confusingly similar[27] to that mark;

(II) in the case of a famous mark that is famous at the time of registration of the domain name, is identical or confusingly similar to or dilutive of that mark; … .[28]

The essential element in proving a violation of the ACPA is that the defendant has "bad faith intent to profit from the mark."[29] The ACPA provides some guidance in determining if the requisite bad faith exists. In determining if the defendant has bad faith, the court may consider the following nonexclusive factors:

I. the trademark or other intellectual property rights of the defendant, if any, in the domain name;

II. the extent to which the domain name consists of the legal name of the defendant or a name that is otherwise commonly used to identify the defendant;

III. the defendant's prior use, if any, of the domain name in connection with the bona fide offering of any goods or services;

IV. the defendant's bona fide noncommercial or fair use of the mark in a site accessible under the domain name;

V. the defendant's intent to divert consumers from the mark owner's online location to a site accessible under the domain name that could harm the goodwill represented by the mark, either for commercial gain or with the intent to tarnish or disparage the mark, by creating a likelihood of confusion as to the source, sponsorship, affiliation, or endorsement of the site;

VI. the defendant's offer to transfer, sell, or otherwise assign the domain name to the mark owner or any third party for financial gain without having used, or having an intent to use, the domain name in the bona fide offering of any goods or services, or the defendant's prior conduct indicating a pattern of such conduct;

VII. the defendant's provision of material and misleading false contact information when applying for the registration of the domain name, the defendant's intentional failure to maintain accurate contact information, or the defendant's prior conduct indicating a pattern of such conduct;

VIII. the defendant's registration or acquisition of multiple domain names which the defendant knows are identical or confusingly similar to marks of others that are distinctive at the time of registration of such domain names, or dilutive of famous marks of others that are famous at the time of registration of such domain names, without regard to the goods or services of the parties; and

IX. the extent to which the mark incorporated in the defendant's domain name registration is or is not distinctive and famous within the meaning of Section 1125(c)(1) of the Lanham Act.[30]

Courts have found bad faith where the defendant has registered confusingly similar domain names for the purpose of diverting the plaintiff's customers to other websites,[31] where defendants have registered the plaintiff's business name and offered to sell it to the plaintiff,[32] and where the defendant registered a domain name for the purpose of preventing the plaintiff's use of that domain name.[33] Nevertheless, bad faith intent will not be found in any case in which the court determines that the person believed and had reasonable grounds to believe that the use of the domain name was a fair use, a noncommercial use, or otherwise lawful.[34]

Where the court finds a violation of the ACPA, it may order forfeiture or cancellation of the domain name, transfer to the trademark owner, and damages.[35] As an alternative to bringing an action under the ACPA, trademark owners may file a complaint under the Uniform Dispute Resolution Policy (UDRP) of the Internet Corporation for Assigned Names and Numbers (ICANN), a private-sector nonprofit organization responsible for the management of the Internet domain name system. The UDRP serves as a "fast-track" alternative dispute resolution procedure under which a prevailing trademark owner receives an order from an arbitration panel that the domain name be cancelled or transferred the trademark owner.[36]

Commercial Disparagement

Commercial disparagement occurs when one makes a false statement of fact that tends to denigrate the goods or services sold by another.[37] Although disparagement originally developed at common law as a tort cause of action, a claim may also be brought under the Lanham Act, which prohibits misrepresentations "in commercial advertising or promotion" as to "the nature, characteristics, qualities or geographic origin of his or her or another person's goods, services or commercial activities … ."[38]

Establishing a prima facie case of disparagement requires proof that: (1) the defendant published a false and offensive statement of fact which disparaged the plaintiff's product or service; (2) the defendant acted with "malice"; and (3) the plaintiff sustained special damages due to the disparagement.[39] A false statement is offensive when it can be reasonably understood to cast doubt on quality of the plaintiff's goods or services. Malice is proved when the defendant knew that the statement was false or acted in reckless disregard as to whether it was untrue.[40] The plaintiff incurs special damages when he or she suffers actual, specific economic harm to his or her business, such as lost sales or customers.[41]

The truth of the statement made is an absolute defense to a claim of commercial disparagement.[42] Competitors can make truthful factual comparisons of their products or services without incurring liability.[43] Likewise, competitors are privileged to make unfavorable comparisons if no specific factual statements are made. Such statements constitute "puffing" – 'sales talk' or general statements of opinion to the effect that the defendant's goods are superior or that the plaintiff's goods are inferior.[44] For instance, one might claim without liability that his or her service is "the best in the business" or that a competitor's product is "not very good." Puffing is permitted because courts assume that consumers expect this and do not rely on or take it seriously; moreover, it is difficult to prove if one product is 'better' than another since consumer preferences and opinions are highly subjective.[45]

The First Amendment and Freedom of Speech

The First Amendment to the United States Constitution prohibits Congress from "abridging the freedom of speech."[46] However, the right to free speech is not absolute.[47] There are categories of communication to which the protection of the First Amendment does not extend because their social value is outweighed by their harmful effect. Defamation and obscenity, for instance, are such types of speech.[48]

When considering a claimed violation of the Lanham Act, the courts are sensitive to concerns that trademark law should not become a means for unconstitutional censorship of ideas and opinions.[49] In resolving cases of government regulation of speech a distinction has been made between commercial and noncommercial speech.[50] The application of a regulation to noncommercial speech may impermissibly restrict expression whereas the application of that same regulation to commercial speech may result in a permissible restriction of expression of ideas or points of view.[51]

The trademark infringement and false designation of origin provisions of the Lanham Act do not use the term "noncommercial." However, the provisions state that they apply only to the use of a mark "in connection with the sale, offering for sale, distribution, or advertising of any goods or services," or "in connection with any goods or services."[52] The provisions, however, have not been given a narrow interpretation by the courts. The term "services" has been construed broadly to apply to certain instances of non-commercial public commentary.[53]

In contrast to the trademark infringement and false designation of origin provisions of the Lanham Act, recent amendments to the Lanham Act leave little doubt that Congress did not intend trademark laws to infringe the freedom of speech rights of the First Amendment. The Federal Trademark Dilution Act of 1995 (FTDA) states that the "[n]oncommercial use of a mark" is not actionable.[54] In determining if an individual has cybersquatted, the Anticybersquatting Consumer Protection Act of 1999 (ACPA) provides that courts may consider whether the use of the mark is a "bona fide noncommercial or fair use."[55]

In each of these instances, trademark owners have made several arguments to convince the courts that the trademark is being used "in connection with" the trademark and therefore is violation of the Lanham Act. One argument is based on the owner's using the website to promote, either directly or indirectly, the sale of goods or services. Another argument is based upon the view that the only purpose for registering the domain name is "commercial," i.e., to sell the domain name to the trademark holder. A third argument contends that the registration of the domain name prevents consumers from purchasing or using the goods or services of the trademark holder and therefore has an "effect on commerce."

Commercial vs. Noncommercial Speech: The "In Connection With" Determination

The Lanham Act regulates only commercial speech, which has lesser protections under the First Amendment.[56] In determining whether use of another's trademark is noncommercial, and therefore First Amendment protected speech, the inquiry generally comes down to a determination of whether one is using another's trademark "in connection with a sale of goods or services."[57] If the answer to this inquiry is no, then the use is deemed noncommercial and not a violation of the Lanham Act.

The issue of commercial versus noncommercial speech in cases involving a trademark arises out of various types of conduct. Alleged violations of trademark laws and the concern for recognizing First Amendment free speech rights are clearly evident in cases where one is using another trademark as a means to express dissatisfaction with the trademark owner's goods or services. Restrictions on noncommercial criticisms of a business can be considered a burden on free speech.[58] In recent years, cases involving the alleged unauthorized use of another's trademark have stemmed from registration of Internet domain names that contain the trademark. Following the registration of the domain name the site owner will then compose a web page for the site.

Websites Directly Promoting Sales of Goods or Services

Commercial use of a trademark is undisputed in settings where the core function of a website is to advertise one's business. In such a case the purpose for using the trademark is to draw attention to a website that is promoting the sale of goods or services other than those of the trademark holders. In *Nissan Motor Co. v. Nissan Computer Corp.,*[59] the Nissan Motor Company sued Nissan Computer Corporation because of the use of the Internet websites www.Nissan.com and www.Nissan.net.[60] The apparent purpose of defendant's domain name was to use the recognized name of Nissan to advertise his computer business. Unsuspecting users of the Internet, believing they would be directed to the Nissan Motor Company website, were instead directed to defendant's site. Moreover, the defendant received a payment for each time a user clicked on a link to the website of an advertiser, and its website contained links to both automobile-related goods and services. The District Court granted a preliminary injunction ordering Nissan Computer to refrain from displaying automobile-related information, advertisements, and links.[61]

Linking to Another Website

Use of a trademark in a domain name of a website that is otherwise noncommercial or the use of a trademark in a website that is otherwise noncommercial may nevertheless be held to be used in connection with the sale of goods or services when the site contains a link to a commercial site.[62] However, linking to another noncommercial website which in turn contains advertising is viewed as an indirect path to the advertisers and thus "too attenuated" to render a site commercial.[63] Also, identifying the representing law firm and providing a link to the firm's website does not convert a noncommercial site into a commercial site.[64]

Attempt to Arbitrage a Domain Name

Merely using another's trademark in one's domain name is not automatically a commercial use under the Lanham Act.[65] However, an attempt to sell a domain name containing the trademark may be considered a commercial use of the trademark. In this instance the registration of a domain name is not as benign as it appears. To register a trademark as a domain name for the purpose of selling the domain name to the trademark owner has been held to be a commercial use of the trademark.[66]

Preventing User's From Obtaining Goods or Services of the Trademark Holder: The "Effect on Commerce" Test

Another approach to the "in connection with" requirement is based upon a conclusion that, although a website might not have a commercial purpose and is not selling any goods or services in connection with the site, the site nevertheless violates the Lanham Act because it prevents users from obtaining or using the trademark holder's goods or services.[67] The proposition here is that the commercial use requirement is satisfied because the unauthorized use of the trademark as the domain name deters customers from reaching the actual site of the trademark holder. This conclusion, however, has not been reached by all courts. This contrary view concludes that such an approach would place all consumer commentary under the restrictions of the Lanham Act.[68]

RECOMMENDATIONS FOR TEACHING APPROACHES

Teaching Objectives

This case study is intended to lead students to appreciate the legal issues that arise between businesses and consumers that implicate business trademarks and goodwill and consumer freedom of speech. The main objectives for teaching the case are as follows:

1. Recognize the importance of trademarks in business;
2. Acquire an understanding of trademark law, unfair competition law, and First Amendment protection of commercial speech;
3. Identify legal issues involving the intersection of trademarks and free speech;
4. Apply the legal principles of applicable law to a fact situation to reach a conclusion as to the scope of liability.

Potential Uses of the Case

The main pedagogical use of case studies is a means to promote awareness of legal risk in business decisions and to enhance the development of legal reasoning skills in business law students. This case study can be used in courses that may include treatment of trademarks, business torts, electronic commerce, consumer protection, marketing, and freedom of speech.

Case A Questions – Trademark Infringement - Trademark Dilution - Cybersquatting - Commercial Disparagement

1. Can Wahl assert prima facie claims for trademark infringement and dilution against Flora on the basis of the domain names she registered or her "gripesite"?

Trademark Infringement.

As the owner of two federally registered trademarks, "Wahl to Wahl Today" and "Wahl to Wahl," Wahl might consider bringing an action for trademark infringement against Flora. To prove its claim Wahl will need to prove that Flora used its marks in commerce without permission and that such use was likely to cause confusion among consumers.[69] Based on the original facts, Wahl may have a difficult time proving that Flora is using its mark for commercial purposes.[70] Use of a mark in commerce involves use or display of the mark in connection with the sale or advertisement of goods or services. Flora does not appear to be selling anything on her website or holding the domain names that incorporate the Wahl trademarks for resale or for ransom. On the other hand, selling t-shirts, charging fees, earning revenue from advertising on the sites, or accepting "donations" that result in a profit to her may amount to commercial use.[71]

Assuming that Wahl can prove commercial use, it will next have to demonstrate that Flora's use of its marks in the domain names and on her site is confusingly similar. One argument that Wahl may assert is that of initial interest confusion. That is, consumers might type in a domain name using "wahltowahl" or some version of this in a search engine or in the address line of their browsers expecting to find the Wahl homepage. When they are instead diverted to Flora's gripesite, they may be confused into thinking that they are connecting to or have arrived at Wahl's website. This may also be true even with a misspelled domain name.

In response, Flora might argue that consumers will immediately realize that they are not at Wahl's site due to the content of the webpage they are viewing. She might also argue that she is protected by fair use in that the use of Wahl's trademark is necessary in describing and commenting upon the quality of their services.[72]

Trademark Dilution.

A second claim that Wahl might consider bringing is that of trademark dilution.[73] To prove dilution, Wahl will first have to demonstrate commercial use of its "famous" mark. The problems with proving the commercial use element have been discussed earlier.[74] According to the facts, Wahl is a "nationally recognized home improvement and home furnishing company" that "has been in business for over fifty years." It is likely that this will be sufficient to establish the requisite degree of general fame to constitute a famous mark for purposes of this analysis.[75]

Next, Wahl will have to prove that Flora's use of its famous mark is likely to diminish its distinctiveness or degrade its standing as a source identifier.[76] Here, the most likely argument will be that Flora's use of the mark leads to tarnishment of the reputation and goodwill associated with the mark.[77] Wahl may have difficulty in demonstrating a causal link between the alleged tarnishment of its marks and the likelihood of harm. It is possible that customer complaints may increase and sales may decrease after Flora's gripesite is available online, but will the complaints increase or sales decrease as a result of the gripesite or because of Wahl's poor service?

In addition, Wahl's dilution by tarnishment argument may be problematic as to some of the domain names since Flora's gripesites clearly signal the critical nature of the site by including "sucks" in the name. The reference to the mark is meant to indicate that she believes Wahl's services to be shoddy or of low quality, which is much different than using the mark in an unwholesome, unsavory context in which no criticism is apparent. Once again, this also suggests that Flora may have a fair use defense to a dilution claim.[78]

2. Has Flora violated the provisions of the Anticybersquatting Consumer Protection Act by registering the domain names?

To prove a violation of the ACPA, Wahl must show that Flora, in registering domain names incorporating its mark, harbored a bad faith intent to profit from using the Wahl mark in a manner that was confusingly similar or dilutive of that mark.[79] The analyses of infringement and dilution discussed above are pertinent here as well. Whether Flora possessed a bad faith intent is a highly relevant issue. Courts have denied relief where a trademark owner has failed to prove defendant's bad faith intent to profit from use of the mark because the primary motivation for creating the gripesite was criticism and commentary.[80]

Here, Flora registered multiple domain names using variations of the mark and can claim no rights or prior legitimate use of the mark. It is possible that she may want to divert potential Wahl customers to her site in order to "warn" them and lessen Wahl's goodwill. On the other hand, the facts do not suggest that she has done this before or that she supplied false information in securing the domain names. Moreover, if she can successfully argue noncommercial fair use of Wahl's mark, she will also have a defense against liability under the ACPA.[81] As one court explained, consumers are free to shout that a merchant sucks from the rooftops and "[t]he rooftops of our past have evolved into the internet domain names of our present."[82]

3. Does Wahl have a tort claim for commercial disparagement against Flora?

Wahl might consider asserting a claim for commercial disparagement against Flora. A prima facie case of disparagement involves proof that: (1) the defendant published a false and offensive statement which disparaged the plaintiff's product or service; (2) the defendant acted with "malice"; and (3) the plaintiff sustained special damages due to the disparagement.[83] The key for Wahl to proving such a claim will be to show that the statements made by Flora were false, and that these false statements were offensive in that they could be reasonably understood to cast doubt on quality of Wahl's services. Wahl must also prove that Flora knew that the statements she made on her site were false or that she acted in reckless disregard as to whether the statements were false. Furthermore, Wahl will need to prove that Flora's has made false statements of *fact*, since statements of opinion are not actionable. In this case, depending on what statements are posted on her site, Wahl's greatest challenge may be in proving that those false statements were the cause of actual economic harm to its business.

4. For each of the claims discussed above, what defenses or counterarguments might be available to Flora?

The defenses or counterarguments that might be available to Flora are discussed in the above answers to Questions 1, 2 and 3.

Case B Questions - First Amendment Free Speech

5. If Flora claims that her site is merely a vehicle by which she is exercising her First Amendment free speech rights, how will a court rule?

Irrespective of whether a trademark is used to facilitate a commercial transaction or to communicate ideas or beliefs, restrictions on the ability to use another's trademark are subject to intermediate constitutional scrutiny to ensure that trademark laws do not abridge the right of free speech. Accordingly, Flora may have a viable counterargument that her site is protected by the First Amendment in response to Wahl's trademark and ACPA claims. She can assert that even if economic loss results to Wahl, the First Amendment protects criticism where there is no consumer confusion as to source and where the speech is not misleading. This in fact was the holding in *Taubman Co. v. Webfeats,*[84] where the Sixth Circuit held that the defendant's registration of gripesites incorporating the plaintiff's trademarks into domain names such as shopsatwillowbendsucks.com and willowbendmallsucks.com was protected speech.[85]

Likewise, the court in *Northland Insurance Co. v. Blaylock*[86] rejected trademark dilution and infringement claims against a defendant who had registered the domain name northlandinsurance.com for a site that redirected the user to a gripesite where he criticized the plaintiff's business practices. Critical to the court's determination was the noncommercial nature of defendant's gripesite.[87] The holdings in *Taubman* and *Northland* support the position that Flora's website and domain name constitutes a noncommercial use of Wahl's trademark,[88] and underscore the longstanding concern that courts burden speech no more than is necessary to serve a significant governmental interest.[89]

6. Assume that Flora's free speech argument is successful. Would any of the following additions to her website lead a court to reach a different conclusion?

a. A warning statement that the site is not the official site of Wahl with a link to Wahl's website.

b. A link to a Wahl competitor or other commercial website.

c. A link to commercial websites from which Flora receives a fee each time the link is clicked on by a user.

d. A link to www.complaints.com a website where consumers can post complaints about goods or services they have received.

e. A link to www.wahltowahltodaysucks.com or to the www.wahl-to-wahl.sucks.com website.

f. A solicitation on Flora's website seeking donations for the "fight" against Wahl.

g. An offer to sell an anti-Wahl t-shirt featuring an anti-Wahl slogan, or an offer to provide a "free" anti-Wahl t-shirt with a charge for shipping and handling.

If Flora's free speech argument is upheld, we must then consider the variations on the facts posed for consideration and the effects those changed facts would have on her free speech argument. Once again, we assume that the noncommercial free speech protection available to Flora will be diminished or lost if the website is deemed to be "commercial" in nature. Including a warning statement (as in a.) that the site is not the official site of Wahl with a link to Wahl's website will not convert Flora's site to commercial status. The courts view this addition as merely informing the user that he or she is not at the official site of the trademark holder thus avoiding any confusion on the part of the user. Moreover, assuming that the www.wahltowahltodaysucks.com or the www.wahl-to-wahl-sucks.com websites are noncommercial, linking to these sites (as in d.) will not convert Flora's site to a commercial site. Similarly, providing a link to a noncommercial consumer complaint website (as in e.) does not convert a noncommercial site into a commercial site.

A direct link to any commercial website (as in b. and c.), on the other hand, will result in an otherwise noncommercial site being converted into a commercial site based upon the site being used in connection with the sale of goods or services. An illustration of this point can be found in *Lamparello v. Falwell,*[90] where the court held that the defendant infringed plaintiff's trademarks and violated the ACPA as a result of his operation of a typosquatting site, www.fallwell.com, at which he criticized the Rev. Jerry Falwell's views on homosexuality and expressed his own contrary views on that subject. The court reached this decision even though the defendant's site featured a prominent disclaimer advising users that it was not Falwell's official site. However, the gripesite also informed interested visitors of a book plaintiff considered relevant to this discussion, and provided a link to Amazon.com at which they could purchase it.[91]

Accordingly, the sale of an anti-Wahl t-shirt either for a set price or given for free as long as the purchaser pays shipping and handling charges (as in g.) will convert Flora's noncommercial site into a commercial site. Likewise, providing a free t-shirt in return for a donation (as in f.) will also likely result in converting Flora's noncommercial site into a commercial site since the t-shirt can be seen as a promotional item commonly used to draw customer attention.

CONCLUSION

This case study has offered a means to investigate the intersection of electronic commerce, trademark law, and freedom of speech. Trademark law serves the purposes of protecting product identification, preserving the merchant's goodwill, and reducing consumer search costs. At the same time, there is an ostensible free speech interest in criticizing trademark owners. Gripesites serves this purpose and also function as a means of exchanging information online about merchants that protects consumer interests.[92] As a pedagogical tool, the case can facilitate student understanding of the rational for protecting trademarks and domain names while at the same time considering the right of consumers to freely express their opinions and criticism of merchants' goods and services.[93] If the gripesite is noncommercial, then it is unlikely that the trademark owner will be able to enjoin the use of its mark since allowing it to do so could shield it from criticism by forbidding the use of its mark in a context critical of its business practices. Finally, this case study can serve as a means promote awareness of legal risk in business decisions and to enhance the development of legal reasoning skills in students.

ENDNOTES

1 A gripesite has been described as a "website at the domain criticizing the mark owner and airing his dissatisfaction with the mark owner's business practices. In contrast to the squatter, the cybergriper's aim is to disparage the mark owner's business, rather than to profit from the domain name or website." Ryan J. Gilfoil, Note, *A Judicial Safe Harbor Under the Anti-Cybersquatting Consumer Protection Act*, 20 BERKELEY TECH. L.J. 185, 185 (2005). We believe that this term was initially used in Kelly Hearn, *"Gripe Sites": Consumers Complain in Chorus, Online*, CHRISTIAN SCI. MONITOR, July 17, 2000, at 15 (referring to gripesites as "consumer advocacy for the digital age").

2 *See* Bally Total Fitness Holding Corp. v. Faber, 29 F. Supp.2d 1161, 1168 (C.D. Cal. 1998).

3 "Use in commerce" must be a bona fide use of the trademark in the ordinary course of trade or sales, and not use simply made to reserve rights in the mark. *See* Zazu Designs, Inc v. L'Oreal, S.A., 979 F.2d 499 (7th Cir. 1992).

4 15 U.S.C. § 1127.

5 *See* Itamar Simonson, *Trademark Infringement from the Buyer Perspective: Conceptual Analysis and Measured Implications*, 13 J PUB. POL'Y & MARKETING 181 (1994).

6 For an economic analysis of trademark protection, *see* William M. Landes & Richard A. Posner, *Trademark Law: An Economic Perspective*, 30 J. L. & ECON. 265 (1987).

7 *See* 1 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 3:4 (4th ed. 2001).

8 A "merely descriptive" mark may be registered if the applicant shows that it "has become distinctive of the applicant's goods in commerce," i.e., that it has acquired secondary meaning.15 U.S.C. § 1052(f); *see also* Park N Fly, Inc. v. Dollar Park and Fly, Inc., 469 U.S. 189, 196 (1985). See also Two Pesos v. Taco Cabana, Inc., 505 U.S. 763, 769 (1992) (stating that descriptive marks may acquire the distinctiveness which affords them protection under the Lanham Act).

9 *See* 2 McCarthy, *supra* note 5, § 11:2-28; *see also* Restatement (Third) of Unfair Competition §§ 13-17 (1995).

10 15 U.S.C. § 1125(a)(1)(A)

11 The defendant's use of the plaintiff's trademark must be in connection the sale or advertising of the product. *See id.* §§ 1125((1)(a) & 1125(a)(1).

12 *See* Polaroid Corp. v. Polaraid Elec. Corp., 287 F.2d 492, 495 (2d Cir.).

13 The Lanham Act provides:

> The owner of a famous mark shall be entitled, subject to the principles of equity and upon such terms as the court deems reasonable, to an injunction against another person's commercial use in commerce

of a mark or trade name, if such use begins after the mark has become famous and causes dilution of the distinctive quality of the mark, and to obtain such other relief as is provided in this subsection. 15 U.S.C. §1125(c).

14 *Id*. § 1125(c)(2).

15 *Id*. § 1125(c).

16 *Id*. § 1125(c)(2)(B). This section articulates six factors a court may consider in determining whether dilution by blurring is likely: (i) the degree of similarity between the diluting mark and the famous mark; (ii) the degree of distinctiveness of the famous mark; (iii) the extent to which the owner of the famous mark is engaged in "substantially exclusive use of the mark; (iv) the degree of recognition of the famous mark; (v) whether the defendant intended to create an association between it and the famous mark; and (vi) any actual association between the diluting mark and the famous mark. *Id*.

17 *Id*. § 1125(c)(2)(C).

18 15 U.S.C. §1125(c)(1)(proscribing use of a mark "that is likely to cause dilution" of the famous mark "regardless of the presence or absence of ... actual economic injury").

19 *See* Toho Co., Ltd. v. Sears, Roebuck & Co., 645 F.2d 788, 793 (9th Cir. 1981).

20 15 U.S.C. § 1115(b)(4).

21 *See* Hormel Foods Corp. v. Jim Henson Prods., 73 F.3d 497 (2d Cir. 1996); *see also* Jordache Enters., Inc. v. Hogg Wyld, Ltd., 828 F.2d 1482 (10th Cir. 1987).

22 *See* Daimler-Chrysler v. The Net, Inc., 388 F.3d 201, 204 (6th Cir. 2004); *see also* Elizabeth Robinson Martin, Note, *"Too Famous to Live Long!": The Anticybersquatting Consumer Protection Act Sets its Sights to Eliminate Cybersquatter Opportunistic Claims on Domain Names*, 31 ST. MARY'S L.J. 797, 808-810 (2000).

23 *E.g.*, Panavision Int'l v. Toeppen, 141 F.3d 1316 (9th Cir. 1998)

24 15 U.S.C. § 1115(d).

25 *See* H.R. Rep. No. 106-412, 106th Cong., 1st Sess. 6 (1999).

26 "Traffics in" refers to transactions that include, but are not limited to, sales, purchases, loans, pledges, licenses, exchanges of currency, and any other transfer for consideration or receipt in exchange for consideration. 15 U.S.C. § 1125(d)(1)(E).

27 In making this determination, the sole focus is on the senior user's trademark and the registrant's domain name. *See* Northern Light Tech., Inc. v. Northern Lights Club, 236 F.3d 57, 66 (1st Cir. 2001).

28 *Id*. § 1125(d)(1)(A).

29 *Id*. § 1125(d)(1)(A)(i).

30 *Id*. § 1125(d)(1)(B)(i).

31 Coca-Cola Co. v. Purdy, 382 F.3d 774 (8th Cir. 2004).

32 People for the Ethical Treatment of Animals v. Doughney, 263 F.3d 359 (4th Cir. 2001).

33 Sporty's Farm LLC v. Sportsman's Market, Inc., 202 F.3d 489 (2d Cir. 2000).

34 *See, e.g.,* TMI, Inc. v. Maxwell, 368 F.3d 433 (5th Cir. 2004)(noncommercial gripesite set up by defendant to complain about how he was treated during a home purchase demonstrated no bad faith intent to profit did not violate the anti-dilution or the ACPA or result in trademark dilution); Lucas Nursery & Landscaping v. Grosse, 2004 WL 403213 (6th Cir. 2004)(defendant not liable for ACPA violation due to noncommercial gripesite incorporating plaintiff's trademark in the domain name used for criticizing a landscaping company for inferior lawn care services).

35 15 U.S.C. § 1125(d)(1)(C).

36 *See* Uniform Domain Name Dispute Resolution Policy of the Internet Corporation for the Assigned Names and Numbers, available at: http://www.icann.org/udrp/udrp-policy-24oct99.htm (last visited May 15, 2007).

[37] Restatement of Torts § 629. The tort is closely related to, though distinct from, the torts of defamation and unfair competition. *See* Aetna Cas. & Sur. Co v. Centennial Ins. Co, 838 F.2d 346 (9th Cir. 1988); Dairy Stores, Inc. v. Sentinel Pub. Co., 516 A2d 220 (N.J. 1986).

[38] 15 U.S.C. § 1125(a).

[39] *See, e.g.,* Gucci Am., Inc. v. Duty Free Apparel, Ltd., 277 F. Supp.2d 269 (S.D.N.Y. 2003); Flotech, Inc. v. E.I. Du Pont de Nemours Co., 627 F.Supp. 358 (D. Mass. 1985); Hurlbut v. Gulf Atlantic Life Ins. Co., 749 S.W.2d 762 (Tex. 1987).

[40] *See, e.g.,* Bose Corp. v. Consumers Union of the U.S. Inc, 692 F.2d 189 (1st Cir. 1982); Collier County Pub. Co. v. Chapman, 318 So.2d 492 (Fla. Ct. App. 1975).

[41] *E.g.*, Satellite Financial Planning Corp v. First National Bank, 633 F.Supp. 386 (D. Del. 1986); *see also* Restatement (Second) of Torts §§ 632, 633.

[42] *See, e.g.*, Redco Corp. v. CBS, Inc, 758 F.2d 970 (3d Cir. 1985); Direct Import Buyer's Ass'n v. KSL, Inc., 572 P.2d 692 (Utah 1977).

[43] *See* U.S. Healthcare, Inc. v. Blue Cross of Greater Philadelphia, 898 F.2d 914 (3d Cir. 1990).

[44] *See* Groden v. Random House, 61 F.3d 1045 (2d Cir. 1995).

[45] *E.g.*, Hofmann Co. v. E.I. Du Pont de Nemours & Co, 248 Cal. Rptr. 384 (Cal. Ct. App. 1988).

[46] U.S. CONST. amend. 1. *See* Lovell v. Griffin, 303 U.S. 444, 450 (1938)(the right to free speech is "among the fundamental personal rights and liberties which are protected by the Fourteenth Amendment from invasion by state action").

[47] Near v. Minnesota, 283 U.S. 697, 708 (1931)("Liberty of speech ... is ... not an absolute right, and the State may punish its abuse.").

[48] *See* Chaplinsky v. New Hampshire, 315 U.S. 568 (1942)(defamation); Roth v. United States, 354 U.S. 476 (1957)(obscenity).

[49] *See* Taubman Co. v. Webfeats, 319 F.3d 770,774 (6th Cir. 2003); Boslely Med. Inst., Inc. v. Kremer, 403 F.3d 672, 674 (9th Cir. 2005).

[50] *See* Thornhill v. Alabama, 310 U.S. 88 (1940), where the Court struck down an Alabama state statute prohibiting picketing businesses. Although not directly addressing "commercial speech," the case supports the position that speech about issues of public interest or controversy are to be considered noncommercial speech. *See also* Valentine v. Chrestensen, 316 U.S. 52 (1942), holding that the addition of statements in protest of government action did not remove a "handbill" from the status of "commercial advertising."

[51] *See* Florida Bar v. Went For It, Inc., 515 U.S. 618, 623 (1995). *See also* Mattel, Inc. v. MCA Records, Inc., 296 F.3d 894, 900 (9th Cir. 2002).

[52] 15 U.S.C. §§ 1114(1)(a) & 1125(a)(1).

[53] *See* United We Stand Am., Inc. v. United We Stand Am., N.Y., Inc., 128 F.3d 86, 89-90 (2d Cir. 1997). *See also* People for the Ethical Treatment of Animals v. Doughney, 263 F.3d 359, 365 (4th Cir. 2001) concluding that although Doughney did not actually sell or advertise goods or services on his website, he needed to "only have prevented users from obtaining or using PETA's goods or services, or need only have connected the website to other's goods or services" to result in a violation of the Lanham Act. *See also* Taubman Co. v. Webfeats, 319 F.3d 770,775 (6th Cir. 2003) concluding that a website with links to for profit websites violated the Lanham Act.

[54] 15 U.S.C. §1125(c)(4).

[55] 15 U.S. C. §1125(d)(1)(B)(i)(IV).

[56] *See* Central Hudson Gas & Elec. Corp v. Public Serv. Comm'n of N.Y., 447 U.S. 557, 563 (1980), where the Court stated that regulation of commercial speech is subject only to intermediate scrutiny.

[57] *See* Bosley Med. Inst. v. Kremer, 403 F.3d 672, 677 (9th Cir. 2005)

[58] In CPC Int'l, Inc. v. Skippy Inc., 214 F.3d 456 (4th Cir. 2000), the Fourth Circuit Court of Appeals vacated an injunction directing the defendants to remove content from their website that was critical of the plaintiff. Explained the court: "[J]ust because speech is critical of a corporation and its business practices is not a sufficient reason to enjoin the speech." *Id*. at 458.

[59] 378 F.3d 1002 (9th Cir. 2004).

[60] *Id*. at 1006.

[61] *Id*.

[62] *See also* Taubman Co. v. Webfeats, 319 F.3d 770 (6th Cir. 2003)(finding no commercial use due to linking).

[63] *See* Bosley Medical Institute v. Kremer, 403 F.3d 672, 678 (9th Cir. 2005) where defendant's website contained no commercial links but instead contained links to a discussion group, which in turn contained advertising.

[64] *See id.*

[65] *See* Panavision Int'l, L.P. v. Toeppen, 945 F. Supp. 1296, 1303 (C.D. Cal. 1996)(stating that "[r]egistration of a trade[mark] as a domain name, without more, is not a commercial use of the trademark ... ." *See also* Lockheed Martin Corp. v. Network Solutions, Inc., 985 F. Supp. 949 (C.D. Cal. 1997) stating that "NSI's acceptance of a domain name for registration is not a commercial use within the meaning of the Trademark Dilution Act."

[66] *See* Panavision Int'l, L.P. v. Toeppen, 141 F.3d 1316, 1325 (9th Cir. 1998) the court holding that the defendant's "commercial use was his attempt to sell the trademarks themselves." Similarly, in Intermatic Inc, v. Toeppen, 947 F. Supp. 1227 (N.D. Ill. 1996) the district court held that defendant's "intention to arbitrage the 'intermatic.com' domain name constitute[d] a commercial use." *See also* Harrison v. Microfinancial, Inc., 74 U.S.P.Q.2d (BNA) 1848, 1851 (D. Mass. 2005).

[67] *See* People for the Ethical Treatment of Animals v. Doughney, 263 F.3d 359, 365 (4th Cir. 2001) concluding that although Doughney did not actually sell or advertise goods or services on his website, he needed to only have prevented users from obtaining or using PETA's goods or services. *Id*.

[68] *See id.* at 679. *See also* L.L. Bean, Inc. v. Drake Publishers, Inc. 811 F.2d 26, 33 (1st Cir. 1987); Ford Motor Co. v. 2600 Enters., 177 F. Supp 2d 661, 664 (E.D. Mich. 2001).

[69] *See supra* notes 11-13 and accompanying text.

[70] *See* Taubman v. Webfeats, 319 F.3d 770 (6th Cir. 2003)(discussing whether a gripesite is commercial use in commerce).

[71] *See supra* note 12 and accompanying text.

[72] *See supra* notes 21-22 and accompanying text.

[73] *See supra* note 14-20 and accompanying text.

[74] *See supra* note 72 and accompanying text.

[75] *See supra* note 16 and accompanying text.

[76] Once again, whether Flora's use of the trademarks amounts to commercial use is at issue. For sake of further consideration of the dilution claim, we will assume that it constitutes use in commerce.

[77] *See* Board of Directors of Sapphire Bay Condominium West v. Simpson, 129 Fed.Appx. 711 (3d Cir. 2005)(gripesite enjoined due to dilution as defendant intended to cause financial harm by disparaging plaintiff). Although Wahl might also argue that Flora's use of its mark is likely to cause dilution by blurring, such a claim depends on demonstrating a likelihood that the gripesite weakens the connection in consumers' minds between the mark and Wahl's service. Here, where the target is Wahl itself, the probable effect is just the opposite.

[78] *See supra* notes 21-22 and accompanying text.

[79] *See supra* notes 23-37 and accompanying text.

[80] *See, e.g.*, Fairbanks Capital Corp. v. Kenney, 303 F. Supp.2d 583, 595 (D. Md. 2003); Crown Pontiac, Inc. v. Ballock, 287 F. Supp.2d 1256, 1258 (N.D. Ala. 2003); Rohr-Gurnee Motors, Inc. v. Patterson, 71 U.S.P.Q.2d (BNA) 1216, 1220 (N.D. Ill. 2004).

[81] *See supra* note 35 and accompanying text.

[82] Taubman Co. v. Webfeats, 319 F.3d at 773.

[83] *See supra* notes 38-46 and accompanying text.

[84] 319 F.3d 770 (6th Cir. 2003).

[85] *Accord* Mayflower Transit, LLC v. Prince, 314 F. Supp.2d 362 (D.N.J. 2004)(rejecting claims for violation of the ACPA and for commercial disparagement due to defendant's use of plaintiff's mark in domain names of noncommercial gripesites critical of plaintiff).

[86] 115 F. Supp.2d 1108 (D. Minn. 2000).

[87] *See id.* at 1119-20.

[88] *See* Coca-Cola Co. v. Purdy, 382 F.3d 774 (8th Cir. 2004)(holding that an anti-abortion website that linked to other sites that solicited funds through donations or sale of goods was not protected by the First Amendment).

[89] *See* CPC Int'l, Inc. v. Skippy Inc., 214 F.3d 456 (4th Cir. 2000)(overturning an injunction ordering defendant to remove critical content from a website).

[90] 360 F. Supp.2d 768 (E.D. Va. 2004).

[91] *Id.*; *see also* Toronto-Dominion Bank v. Karpachev, 188 F. Supp.2d 110 (D. Mass. 2002)(finding that defendant violated the ACPA by registering domain names containing misspellings of plaintiff's trademark for use on gripesites).

[92] For a website featuring a compilation of links to various gripesites criticizing just about any product or service one can imagine, see Webgripesites.com at http://www.webgripesites.com (last visited May 14, 2007).

[93] For additional analyses of the trademark law aspects of consumer gripesites and domain names, *see* W. Scott Creasman, *Free Speech and "Sucking"—When is the Use of a Trademark in a Domain Name Fair?*, 95 TRADEMARK REP. 1034 (2005); Jonathan L. Schwartz, *Making the Consumer Watchdog's Bark as Strong as its Gripe: Complaint Sites and the Changing Dynamic of the Fair Use Defense*, 16 ALB. L.J. SCI. & TECH. 59 (2006); Yas Raouf, Note, Lamparello v. Falwell & Bosley Medical v. Kremer: *Undercutting the Applicability of Initial Interest Confusion to Trademark-In-Domain-Name Gripe Sites*, 21 BERKELEY TECH. L.J. 445 (2006); Tresa Baldas, *Trademark Lawsuits: The Price of Online Griping*,NAT'L L.J. (Dec. 2, 2004).

THE EVOLUTION OF CROCS, INC.: WILL CROCS FACE EXTINCTION?

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CASE DESCRIPTION

The primary subject matter of this case concerns the four "Ps" of marketing—product, price, place, and promotion. Secondary issues examined include entrepreneurship and business strategy. The case has a difficulty level three, appropriate for junior level courses. The case is designed to be taught in one class hour and is expected to require one hour of outside preparation by students.

CASE SYNOPSIS

Crocs, Inc. was founded in 2002 by three avid boaters who began a small company to make shoes specifically designed for boating. The owners were surprised by their own success; Crocs rapidly moved from a boating shoe to a fashion statement. After taking the company public in 2006, Crocs has come under increasing shareholder pressure to diversify. The fear was that Crocs limited product line was a "one trick pony" and as soon as consumer fashion tastes changed, Crocs sales would quickly decline. Crocs has responded to this pressure by moving beyond shoes to increase the variety of its product line, but in doing so the firm has encountered entrenched competitors that have fought back against Crocs' market encroachment. Management is well aware that competition and shifting consumer tastes could make Crocs extinct. These threats will drive Crocs to further hone its product, place, pricing, and promotion decisions. Exactly how Crocs will manage this, however, remains to be seen.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

As with many successful new products, Crocs attracted competitors producing and selling similar footwear at lower prices. Crocs must examine the current competitive situation and adjust its marketing strategy in a way that (1) continues to define Crocs as a premium brand and justify its relatively high prices and/r (2) diversify into new markets that are less price competitive.

Instructors may want to use the following questions to begin the student discussion:

1. **From a marketing perspective, evaluate Crocs brand name.**

Students will probably agree that Crocs brand name reminds people of the special material, croslite. Having a name similar to its materials can have both advantages and disadvantages. At the beginning when fewer competitors are producing the same product, this brand name is unique and differentiates the brand more easily. But with the growth of the market segment, more competitors using the same or similar materials will enter the market. By that time, the Crocs brand may be used as a generic term to refer to any product with a similar design. Instructors may ask students to recall such historical events, Students will likely mention that Xerox is a generic term for a photocopy, aspirin is a generic term for pain killers, Coke is a generic term of for cola drinks, and Kleenex is a generic term for tissue.

2. **Does Crocs have a well-defined target market? What are the pros and cons of having a less than clear target market?**

Instructors can encourage students to segment customers based on age, gender, profession, and/or usage of the products. They will find Crocs has expanded its target market from athletic youth and gardeners to a broader group of consumers who would wear Crocs on different occasions. An recent example to include here is Nike. Nike has recently begun to reorganize its marketing focus based on sport rather than on product. For example, rather than having a line of shoes, a separate line of knee pads, and a third line for headbands, Nike has organized these products by sport, basketball in this case, in an effort to capture a larger share of each customer's dollars rather than simply more customer share (as counted by the number of discrete individuals buying a Nike product).

The advantage of having a less defined target market is there is no stereotyping thus reducing the possibility that potential customers may be discouraged from trying the product unless they meet some preconceived demogaphics. The disadvantage of less defined target market is that less focused (more dispersed) marketing campaigns can be more costly.

3. **Crocs has adopted a distribution model that allows retailers to order as few as 24 pairss of shoes rather than running the risk of retailers having too many shoes in inventory and subsequently offering price incentives. Instructors might ask students to evaluate the pros and cons of this distribution mode. .**

To begin, ask students: is a clearance sale always a bad thing? Think about those customers who are categorized as “laggers”—those who will start using certain products only after everyone else is using them. Those customers tend to be price conscious and can be attracted to the brand if there are occasional clearance sales. Although clearance sales reduce margins per product sold, overall revenue may increase as a result of increasing volume.

A firm with a history of offering discounts faces a double-edged sword. Inventory management is assisted when a quick change like a price discount can clear out excess inventory. This is particularly important as new product lines are introduced while a firm still has a large inventory of product lines that run the risk of obsolescence as the new product model is rolled out. On the other hand, firms with histories of price discounts run the risk that consumers will wait for a clearance sale rather than pay full price, thus dampening demand when prices (and margins) are at their peak.

4. How does Croc’s product life cycle dictate responses in the firm’s marketing strategy?

This case presents an opportunity to examine several aspects of a firm’s marketing strategy and consider how this strategy is related to the product life cycle. After successful creation and introduction of a new brand and several years of rapid growth in sales with limited spending on advertising, Crocs is facing two particularly strong challenges. First, lower-priced imitators have entered the market and are capturing sales that, prior to market entry, would have likely been realized by Crocs. Second, the markets into which Crocs is currently expanding (such as athletic gear) is dominated by strong incumbents such as Nike, Reebok, and Under Armour. Crocs has responded by expanding positioning its product lines as fresh alternatives to these established products. Of course, Nike, Reebok, Under Armour, and similar competitors are not standing still—they are also finding ways to innovate and introduce fresh products thus potentially neutralizing Crocs efforts to enter such established markets.

After the class explores each marketing strategy avenue and realizes that each has its own pitfalls, the instructor can make the following point: *The only truly sustainable competitive advantage is the ability to create new competitive advantages.*

ANALYSIS OF STRATEGIC ISSUES AT BEWARI.COM: A B2B CASE STUDY IN THE MIDDLE EAST

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CASE DESCRIPTION

The main subject of this case is B2B e-commerce in the Middle East. Secondary issues examined are: strategic factors facing the company examined in the case study; the B2B business model; privacy and security issues of e-commerce; and new business strategies for B2B.

This case has a difficulty level of four and is best utilized in a senior level Strategic Management / E-Marketing course. Depending upon the depth of analysis, the case can be taught in three to six hours and requires a preparation time of three to six hours.

CASE SYNOPSIS

The introduction of Internet use and the resulting growth in e-commerce has changed the service industry in the 21st century. These factors have led to changes in online transactions and have introduced new, Internet-only services companies, forcing traditional service institutions to quickly develop and implement an e-commerce strategy.

The current case analyzes strategic issues surrounding e-business at Bewari, a B2B company established in June 2000 that allows companies in the Arabian Gulf region to buy and sell goods and services online. Bewari is a hypothetical company. At the request of the real company's management, its name is kept confidential since Bewari did not want to disclose its operations to its competitors. This case study is chosen since the Arabian Gulf region is unique in terms of culture, tradition, business practices, human and organizational values compared to those in developed economies. Most of the economies in the region are oil-rich. Business development practices in one economy in a particular sector are rapidly imitated by businesses in the neighboring economies in the region. The economies in the region form a major trade bloc of major importance to neighboring European and Asian economies.

Bewari has chosen to create and maintain the highest standard B2B customer service and trading facilities in the Middle East. The case shows that Bewari:

- *is an ideal partner for helping companies reach new markets in real time*
- *is agile enough to respond to fast changing market opportunities*

- *provides innovative online B2B services, enabling B2B firms to extend their reach and enhance their competitive standing, and integrates supply chain.*

Nevertheless, growing pains have ensued. From its inception, Bewari has given access to the resources and culture thought necessary to allow it to succeed. While Bewari was given the right resources and freedom to succeed, it was asked to do so within an organization incapable of producing the desired product. Bewari faces pressure from its stakeholders to improve performance and maximize synergies from recent alliances. In addition, decisions and options regarding Bewari must be taken into consideration as part of Bewari's overall strategy.

INSTRUCTORS' NOTES

STEPS COVERED IN STRATEGIC DECISION-MAKING PROCESS

Strategy Formulation								Strategy Implementation	Evaluation & Control
Performance	Strategic Posture	Corporate Governance	External Factors	Internal Factors	Strategic Factors	Review Objectives & Mission	Strategic Alternatives		
X	X	X	X	X	O			O	

O = Emphasized in Case X = Covered in Case

CASE OBJECTIVES

The purpose of the case is to engage the students to analyze the:

1. Customer profile of e-commerce customers
2. Strategic factors facing the company
3. B2B business model
4. Privacy issues in e-commerce
5. Security issues in e-commerce
6. New business strategies for B2B

SUGGESTED CLASSROOM APPROACHES TO THE CASE

1. We suggest the placement of this case in the first half of your Strategic Management/Internet Marketing/E-Marketing/International Marketing Strategy course or anywhere you do a segment on the Internet.
    - ♦ This case makes a nice package to discuss the B2B e-commerce business model.
    - ♦ We suggest that you have the students review the case
2. This is a very high interest case for the students.
3. If you want a team presentation we suggest the team be limited to three or four students. It worked well as a team presentation.
4. A typical team presentation of their strategic audit using PowerPoint may last about 45 minutes.
5. This case can be developed into an interesting lecture/case discussion package on the Internet.

In addition to the substantive learning objectives discussed above, the case would have students learn to develop formal oral presentations covering the following specific questions:

DISCUSSION QUESTIONS

1. What are the strengths and weaknesses of Bewari?
2. What are the opportunities and threats facing Bewari?
3. What are the strategic factors facing Bewari?
4. How do each of Porter's five forces impact on Bewari?
5. What will be the impact of cannibalizing of Bewari's customers by Bewari's associates and competitors?
6. What are the security and privacy issues in online e-commerce?
7. What are the supply chain management issues involved in B2B e-commerce?
8. How can the following issues facing Bewari's Management be effectively handled:
    - ♦ Maintain its systems and operations to share info and learning across Bewari's online expertise,
    - ♦ Convince buyers to change
    - ♦ Create trust in the minds of buyers and suppliers of B2B
    - ♦ Facilitate the acceptance of online transactions as legal by the courts
    - ♦ Increase internet penetration by buyers and suppliers

Further to the above set of questions,

9. Ask your students whether they transact via the Internet: This allows you to discuss with your students the advantages and disadvantages of online e-commerce.
10. Ask your students whether their parents transact via online B2B e-commerce.
11. Ask your students what services are offered online by B2B e-commerce firms.
12. Is B2B the future e-commerce of today?

STRATEGIC AUDIT PAPER

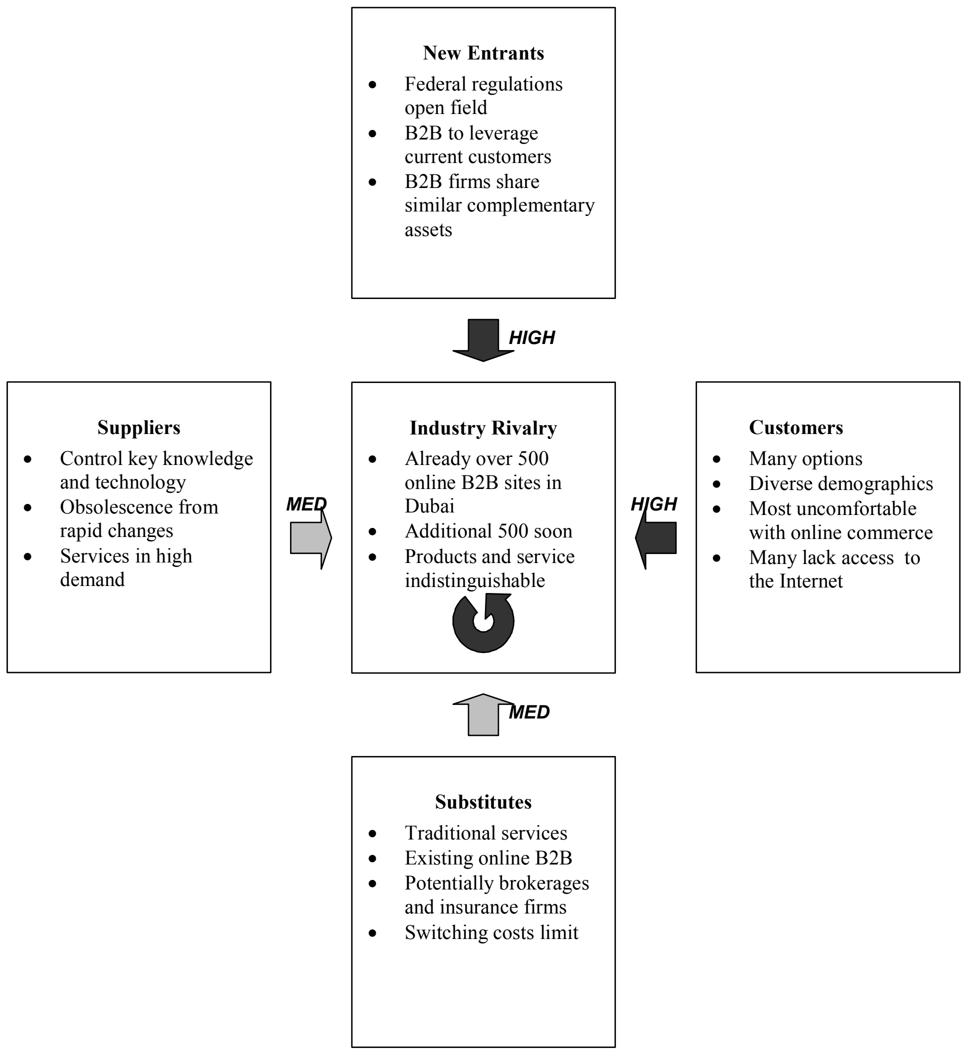
Bewari is owned by Bewari Management for B2B e-commerce. The teaching notes prepared by the case authors, cover in depth, the factors normally covered in a strategic audit, so we provide only Authors' Teaching Notes for this case.

General Framework

To begin the analysis, the case writing team has used two traditional corporate strategy frameworks, Porter's Five Forces and SWOT Analysis, which shed light on the viability of Bewari.com.

This Five Forces Analysis, though limited by its static nature, suggests that this industry is unattractive due to the high level of industry competition and high risk of new entrants. The case provides such evidence by stating the existence of over 500 online B2B e-businesses with more than 500 are predicted to be launched by the year 2007. In addition, the uncertain effects of suppliers and substitutes add further risk-potentially worsening the attractiveness of the crowded B2B online industry.

Porter's Five Forces



SWOT Analysis

Strengths	Weaknesses
• Financial resources of Bewari to build brand • Leading edge technology and partnerships • Fastest customer account growth among online B2B e-commerce	• Perceived value far below those of traditional B2B firms • Limitations from Bewari culture and difficulties
Opportunities	**Threats**
• First mover onto Internet among major B2B firms • Access to leading Internet companies • New markets through Dubai E-Government	• Increasing numbers of online B2B e-commerce firms • Market entry by other service institutions • Potential entry by major Internet portals (AOL, Yahoo)

The SWOT analysis for Bewari shows considerable strengths and opportunities that are nonetheless outweighed by the weaknesses and threats. Projecting the SWOT analysis into the future makes the weaknesses and threats even more significant as competition in this industry heightens.

Furthermore, B2B e-commerce faces the following challenges:

♦ **Change Management**

Buyers (end users) have been using their traditional or electronic procurement system for some time. They are happy with the results. Buyers are asking why they should change, and what value is added to their businesses by implementing changes. (For the instructor: This can be addressed by having a champion inside the buyer organization and work closely with him to make sure that he will get the full credit for the project success. Education and awareness can be created through different channels: seminars, road shows, workshops, participation in TV, Radio and Media programs which talks about benefits and values of e-commerce. Also share best practices and success stories. Undertake site visits to current buyers and suppliers to demonstrate benefits to others).

- **Trust (Security and Privacy)**

  Buyers and suppliers need to be sure that their transactions have a high level of security and privacy. In addition, they need to be aware of security features available in the application. The challenge is: how can trust be created in the minds of buyers and suppliers of B2B? (For the instructors: This can be addressed by again educating students about the security features and functionalities available in the e-commerce application and demonstrate how they can use them to maximize the benefits

- **Laws and regulation**

  Buyers and suppliers need to be sure that their transactions are accepted legally by the court and they need to be aware if there is any law which covers electronic transactions. The challenge is: how can these be ensured in the minds of buyers and suppliers? (For instructors: This can be addressed by again educating them that there are electronic transaction laws, explain the related articles if applicable to their business).

- **Infrastructure**

  Buyers and suppliers need to have an internet connection in order to start using any web- enabled e-commerce application. The challenge is how to increase internet penetration on the part of buyers and suppliers. (For instructors: On a country level it is very important, that the targeted countries have high level of internet penetration among the business sectors).

Strategic Factors (SF) (Based on Case Authors' SWOT Analysis)

SF 1 Financial resources of Bewari to build the Bewari brand
SF 2 Leading edge technology and partnerships
SF 3 Fastest customer account growth among online B2B e-commerce
SF 4 Perceived value far below traditional B2B firms
SF 5 Limitations from Bewari culture and difficulties
SF 6 First mover onto Internet among major B2B e-commerce providers
SF 8 Access to leading Internet companies through First USA
SF 9 Increasing numbers of online banks
SF 10 Market entry by other financial services institutions
SF 11 Potential entry by major Internet portals (AOL, Yahoo).

DISCUSSION POINTS

The case writers recommend that some combination of the following questions be used to begin discussing the issues presented in the case. Knowledge from both general and innovations frameworks shows clearly the answers to questions posed in the case.

1. Is there cannibalization in Bewari and its associates?

The analysis shows that Bewari must cannibalize its own customers in order to prevent the many other online B2B competitors from doing so. Unfortunately, the case demonstrates confusion at Bewari. Bewari management seems clearly to prefer a different target market. Their failure here can be seen earlier in the case, with Bewari.com having 2400+ member partners.

2. What strategy should Bewari take in the emerging B2B scenario?

Bewari has four primary options:

- Engage associates through JV
- Issue franchises
- Internal B2B acquisition
- Spin-off innovation

Only the second option viz., issuing franchises, rectifies concerns regarding culture and market perception. The analysis in the teaching notes supports this strategy.

3. What is the future of Bewari in the era of e-commerce?

The case shows Bewari capable of recognizing potential innovations, but unable to capitalize on them. Thus Bewari's best position in e-commerce may be to serve as an "Internet incubator" for B2B services products, which identifies, develops, and then spins off innovations. Each of our recommendations stems from the "elements" of a B2B business model analysis.

PHILIP MORRIS USA V. WILLIAMS: PUNITIVE DAMAGES, DUE PROCESS, AND THE U.S. SUPREME COURT

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CASE DESCRIPTION

The primary subject matter of this case is the impact of recent United States Supreme Court decisions regarding the application of the Due Process Clause in determining punitive damages awards. Specifically, this case looks at the most recent decision in Philip Morris USA v. Williams (2007) of three significant Supreme Court decisions regarding punitive damages awards.

The case looks at the two previous Court decisions regarding the criteria used in determining punitive damages awards and the effect of those decisions on the final decision in this trilogy. Given new appointments to the U. S. Supreme Court, the case provides an opportunity to examine the impact of those changes on this recent decision.

All three decisions raise questions about the commitment of firms to ethical and socially responsible behavior given the restrictions to the size of punishments that may be levied against them when their behavior is found to fall below the recognized standards of "acceptable."

This case would be appropriate for use in business law/legal environment of business, business marketing, or business ethics with a difficulty level of two or three depending on the course.

CASE SYNOPSIS

In Philip Morris USA v. Williams (2007), the United States Supreme Court decided that the Due Process Clause prohibits a state from using punitive damages awards to punish a defendant for injuries it inflicts upon non-parties, i.e. strangers to the litigation because such awards amount to a taking of property without due process, there being no fair notice of the severity of the penalty the state may impose (Philip Morris USA v. Williams, 2007). This decision is the third in the United

States Supreme Court's recent forays into the constitutionality of punitive damages awards, but the first punitive damages case decided by the Court since the retirement of Justice O'Connor and the death of Chief Justice Rehnquist, and the addition of Justice Alito and Chief Justice Roberts to the Court (Murray, 2007).

The purpose of this paper is to examine how Philip Morris USA v. Williams fits into the trilogy of punitive damages decisions issued by the United States Supreme Court, to assess the impact of the Chief Justice Roberts and Justice Alito's joining the majority decision, and to determine the reach of the Due Process Clause in restricting punitive damages awards (Hamdini, 2006).

Careful discussion of the case should enable the students to better understand (1) the use of punitive damages in legal decisions; (2) the concept of Due Process; (3) the possible implications of these decisions of corporate behavior; (4) the significance of the composition and creation of majorities on the United Supreme Court.

INSTRUCTORS' NOTES

Supplemental Documentation and Information

Some quotes and information provided in the court records and decisions that further describe and clarify the arguments made are found below.

Regarding Ms. Williams' personal claims of negligence and fraud:

> *Under 15 U.S.C. § 1334, the federally-imposed warning that appears on cigarette packages preempts all state regulation of the advertising and promotion of cigarettes that carry the warning. Further, in Cipollone v. Liggett Group, Inc., 505 U.S. 504, 524 (1992), the United States Supreme Court ruled that preemption extends to state common law claims, precluding plaintiff from pursuing a claim based on fraudulent concealment of information concerning smoking and health. Hence plaintiff pursued alternative claims for negligence and fraud.*

The trial court's reduction of the non-economic damages to $500,000.00 is based on Oregon statute:

> *ORS 18.560 provides in part: "(1) Except for claims subject to ORS 30.260 to 30.300 [the Oregon Tort Claims Act] and ORS chapter 656 [the Oregon Workers' Compensation Act], in any civil action seeking damages arising out of bodily injury, including emotional injury or distress, death or property damage of any one person including claims for loss of care, comfort, companionship and society and loss of*

consortium, the amount awarded for non-economic damages shall not exceed $500,000" (Williams v. Philip Morris Inc., 48 P.3d 824, 829 (2002)).

Oregon's Statute of Repose extinguishes claims for injuries that occur more than eight years after the product is purchased. ORS 30.905(1). Hence Plaintiff was required to prove that the cigarettes purchased by Williams after September 1, 1998, caused his cancer and death. (Williams v. Philip Morris Inc., 48 P.3d (2002), at 830).

Evidence provided of Mr. Williams exposure to the promotional message of Philip Morris and the tobacco industry included:

"When Williams' family urged him to stop smoking, he responded that what he had seen on television demonstrated that smoking did not cause cancer. When his son gave him articles on the subject, he responded by finding his own articles that countered the dangers of smoking. After his diagnosis, he told his wife that the 'cigarette people' had deceived him, that he had been betrayed, and that 'they were lying all of the time.") Furthermore, when his wife brought the Surgeon General's warning to his attention, he responded: "This is what the Surgeon General says, it is not what [the] tobacco company says" (Williams v. Philip Morris Inc., 48 P.3d , at 835).

Evidence that Philip Morris knew that cigarette smoking was related to a variety of illnesses contrary to the promotional message and strategy implemented by the company included:

In an internal memorandum, a Philip Morris vice president claimed "that it was necessary to 'provide some answers which will give smokers a psychological crutch and a self-rationale to continue smoking" (Williams v. Philip Morris Inc., 48 P. 3d, at 833).

"[T]here is evidence that defendant knew that smoking caused lung cancer and other diseases at the same time that it publicly claimed that the issue was unresolved. As early as 1958, three British scientists, meeting with scientists and tobacco executives, reported that industry representatives believed that smoking could lead to lung cancer. In 1961, defendant's director of research stated internally that 'carcinogens are found in practically every class of compounds in smoke' and that the best that the company could hope to do was to reduce their amounts. Later, defendant's internal memoranda made similar points, in some instances suggesting that the

company could not admit the facts publicly because of the probably adverse legal consequences" (Williams v. Philip Morris Inc., 48 P. 3d , at 838).

"The strongest statement of this fact may have been a presentation by a Philip Morris scientist in1972. In that presentation, he stated that the 'cigarette should be conceived not as a product but as a package. The product is nicotine[.]' He continued, 'think of the cigarette pack as a storage container for a day's supply of nicotine,' and 'think of the cigarette as a dispenser for a dose of nicotine.' Defendant spent considerable effort in the following years studying the best way to deliver the optimal dose of nicotine in each cigarette and to increase the effectiveness of the nicotine, resulting in the discovery of a number of ways of manipulating the material in cigarettes for that purpose without actually adding nicotine to it. Also, defendant carefully evaluated smoking cessation programs and technologies, concluding that alternative sources of nicotine, such as patches or gum, were ineffective in the absence of ongoing behavioral therapy. Because that therapy was expensive and time consuming, defendant thought it was unlikely that it would have a serious effect on the number of smokers. Defendant's public relations program of creating a controversy that would give smokers a 'crutch,' a reason to believe that there were serious doubts that tobacco was harmful, thus, would discourage them from making the significant effort that was necessary to stop smoking. The 'controversy' created by the tobacco industry was defendant's method of counteracting the information that otherwise suggested the harmfulness of cigarettes. Such an approach was aimed particularly at highly addicted smokers like Williams, who would search for any justification to continue smoking" (Williams v. Philip Morris Inc., 48 P. 3d , at 838).

"[Philip Morris] used the [Council on Tobacco Research] as a shield and as a source for expert witnesses at congressional hearings and in lawsuits against it rather than for research into the relationship between smoking and disease. The jury could have found on the record in this case that defendant specifically avoided testing with live animals and testing actual production cigarettes. On one occasion when defendant did test production cigarettes, the results were unfavorable, and it destroyed them. It is inferable from the record that tobacco industry lawyers, rather than scientists, set the general direction of the CTR's research program and that they did so for the purpose of protecting the industry's litigation position rather than to resolve scientific questions." Also, the jury could have found that the tobacco industry had a 'gentleman's agreement' not to conduct research beyond the scope of the CTR's efforts. Thus, to the degree that the defendant conducted animal testing that was relevant to the relationship between cigarette smoking and human disease,

it did so in a European laboratory and took precautions to ensure that the results of that research did not appear in its American records" (Williams v. Philip Morris Inc., 48 P.3d , at 839).

"Although a tobacco industry survey indicated that 85 percent of smokers wished that they had never started smoking, defendant concealed information that addictive effects of nicotine made it difficult for them to stop without significant assistance. The fraudulent statements from defendant and the rest of the industry reinforced those addictive effects by giving smokers a reason not to make the necessary effort to break the addiction. The jury could find on this record that defendant's public relations campaign had precisely the effect that defendant intended it to have and that it affected large numbers of tobacco consumers in Oregon other than Williams. It is also inferable from the evidence that defendant's products, used as defendant intended them to be used, together with other serious but non-fatal health problems with their attendant economic consequences." (Williams v. Philip Morris Inc., 48 P. 3d , at 839).

"[C]igarettes are relatively inexpensive to produce, and they provide a large profit margin. By maintaining a large population of smokers through fraudulent representations, defendant protected those profits. At the time of trial, defendant's new worth was over $17 billion, Its profit from cigarette sales in 1966, the year that Williams was diagnosed with lung cancer, was over $2 billion. In 1997, the year that Williams died and the most recent year for which figures were available at the time of trial, defendant's profit was $1.6 billion. (Williams v. Philip Morris Inc., 48 P. 3d , at 839).

From *State Farm Mutual Automobile Ins. Co. v. Campbell*:

"The wealth of a defendant cannot justify an otherwise unconstitutional punitive damages award."(State Farm Mutual Automobile Ins. Co. v. Campbell, 538 U.S. at 427).

The Court also disparaged the use of criminal sanctions to benchmark a punitive damages award, because they establish only the seriousness with which the State views wrongful conduct, and have far less utility in gauging the dollar amount of a punitive damages award. The court explained: "Great care must be taken to avoid use of the civil process to assess criminal penalties that can be imposed only after the heightened protections of a criminal trial have been observed, including, of course its higher standards of proof. Punitive damages are not a substitute for the *criminal process, and the remote possibility of a criminal sanction does not automatically sustain a punitive damages award" (State Farm Mutual Automobile Ins. Co. v. Campbell, 538 U.S. at 428).*

From *Williams v. Philip Morris Inc*., 193 Ore. App. 527, 557-563 (2004):

"Defendant [Philip Morris] sold a product that it knew would cause death or serious injury to its customers when they used it as defendant intended them to use it. Despite that knowledge, defendant, together with the rest of the tobacco industry, engaged in an extensive campaign to convince smokers that the issue of cigarette safety was unresolved. It insisted that more research was necessary at the very time that it was carefully avoiding doing the very research for which it called, although it had an extensive program of research into other issues. Rather, it used its research to determine the optimum dose of nicotine in each cigarette, knowing or, but publicly denying, nicotine's highly addictive properties. Defendant also knew that, because of those addictive properties, it would be difficult for smokers to quit smoking, and it relied on its fraudulent message to discourage them from doing so. The result, as defendant hoped, was that addicted smokers remained addicted, and purchased more it its product. In short, defendant used fraudulent means to continue a highly profitable business knowing that, as a result, it would cause death and injury to large numbers of Oregonians"(557-8).

[T]he jury in assessing the amount of punitive damages was entitled to draw reasonable inferences as to the number of smokers in Oregon who had been defrauded during the past decades and would be affected by the future by defendant's conduct, if that conduct were not deterred. Based on the evidence before it, and, particularly, the pervasiveness of defendant's advertising scheme in Oregon, it would have been reasonable for the jury to infer that at least 100 members of the Oregon public had been mislead. Such a conservative calculation of compensatory damages based on William's actual damages and the potential magnitude of damages to the public thus would cause the ratio between compensatory and punitive damages, whatever it is, to fall within State Farm's 4 to 1 boundary (559)

Parrott lists "five criteria for determining the range of punitive damages that a rational juror would be entitled to award: (1) the statutory and common-law facts that allow an award for the claim at issue; (2) the state interests that the award would serve; (3) the degree of reprehensibility of the defendant's conduct; (4) the disparity between the award and the actual or potential harm inflicted; and (5) the civil and criminal sanctions provided for similar misconduct" (546-7).

From *Williams v. Philip Morris, Inc*., 340 Ore:

> *"Using harm to others as part of the ratio may have been correct under the plurality opinion in [TXO]. However, it no longer appear to be permissible (if it ever was) to factor in that consideration. Although Campbell held that similar acts could bear on reprehensibility . . . , it now appears that harm to others should not be considered as part of the ratio guidepost. . . . [W]e conclude that the ratio guidepost considers only harm to the plaintiff"(60-61).*
>
> *The Court also recognized that the wealth of Philip Morris was wrongfully used by the Oregon Court of Appeals in upholding the punitive damages award. The Court stated: "Wealth 'cannot justify an otherwise unconstitutional punitive damages award.' (cit. omitted) If a punitive damages award is grossly excessive under Gore and Campbell, then the defendant's wealth will not make it constitutional. In short, wealth is not a fourth Gore guidepost. However, Campbell did not otherwise remove wealth from the punitive damage equation, as Philip Morris asserts. A jury still may levy a higher punitive damage award against a wealthy defendant, as long as the final punitive damage award does not exceed the constitutional limits established by the three Gore guideposts" (62).*
>
> *The Oregon Court of Appeals viewed the purpose of the Oregon sanctions as providing notice that sanctions could be imposed. The Oregon Supreme Court differed, concluding the purpose of the Oregon sanctions was to provide a comparable legislative guide for an appropriate sanction and to give notice to wrongdoers of the penalties that can be imposed for certain conduct (57).*
>
> *Given the language in Campbell disparaging the utility of criminal penalties in gauging punitive damages awards, it is doubtful the United States Supreme Court would agree with the Utah Supreme Court's analogy to the criminal penalty for manslaughter (60). Related to this in State Farm Mutual Automobile Ins. Co. v. Campbell, 538 U.S: "Punitive damages are not a substitute for the criminal process, and the remote possibility of a criminal sanction does not automatically sustain a punitive damages award" (428). Because the United States Supreme Court declined to consider whether the punitive damages were excessive, it did not address this particular issue.*
>
> *"In summary, Philip Morris, with others, engaged in a massive, continuous, near-half-century scheme to defraud the plaintiff and many others, even when Philip Morris always had reason to suspect – and for two or more decades absolutely knew*

> *– that the scheme was damaging the health of a very large group of Oregonians – the smoking public – and was killing a number of that group. Under such extreme and outrageous circumstances, we conclude that the jury's $79 million punitive damage award against Philip Morris comported with due process, as we understand that standard to relate to punitive damage awards. It follows that the Court of Appeals correctly held that the trial court should have entered judgment against Philip Morris for the full amount of the jury's punitive damage award." (62-63)*

In the Supreme Court Decision, *Philip Morris USA v. Williams*, 127 S. Ct. 1057, 1060, 1062 (2007), the following conclusions can be found:

> *"We have said that it may be appropriate to consider the reasonableness of a punitive damages award in light of the potential harm the defendant's conduct could have caused. But we have made clear that the potential harm at issue was harm potentially caused the plaintiff."*
>
> *The United States Supreme Court did not consider whether punitive damages awarded were excessive, "[b]ecause the application of this standard may lead to the need for a new trial, or a change in the level of the punitive damages award" (1065).*

QUESTIONS FOR DISCUSSION

1. What would be the likely result had the case been brought under the theories of product liability?

A plaintiff suing based on product liability will usually allege one or more of the following theories: negligence, strict liability or breach of warranty.

Negligence

In order to prevail on the tort of negligence, the plaintiff would have to prove 4 elements:

1) that the defendants owed a duty of care to the plaintiff
2) that the defendant breached the duty
3) that there as a causal connection between the breach and plaintiff's injury
4) that the plaintiff suffered injury

Should the plaintiff be successful in proving all four elements, thus presenting a prima facie case, the burden shifts to the defendant for the assertion of defenses. Common defenses to negligence are contributory negligence by the plaintiff and assumption of risk. The plaintiff in this case brought an action in negligence and fraud on behalf of her deceased husband. As to the issue of negligence, the court determined that the deceased was also negligent by 50%, and therefore declined to award punitive damages on the basis of negligence.

It may be argued that the Philip Morris had a duty to warn of the dangers of smoking tobacco. According to the Court, studies in early 1950s showed that cigarette tar could cause cancer in mice and that there were correlations between smoking and lung cancer. The ordinary consumer would be reasonable to expect that the tobacco industry had a duty to warn of the dangers. However, despite the studies, the defendant took actions to diminish concerns about tobacco and alluded to the premise that the studies were unclear as to the causal connection.

The Federal Cigarette Labeling and Advertising Act of 1965 required a warning to appear on each package of cigarettes, thus confirming the duty owed. And the placement of the warning would likely defeat a plaintiff's claim that the duty was breached. The failure to prove elements (1) and (2) would not shift the burden to the defendant.

Even if the plaintiff is successful in proving all four elements of negligence the likely result would have been in favor of the defendant. After the 1965 Act, the defendant could rightfully asset the defense of assumption of the risk. This is a valid defense against negligence when the plaintiff is aware of a danger and voluntarily assumes the risk of the danger, in this case by using or being affected by those who use tobacco products.

The plaintiff's husband began smoking in the early 1950s, prior to the requirement of any warning. However, he continued to smoke for at least 40 more year, clearly after the warnings were required and the hazards of smoking were more commonly known. While it is true that he made numerous attempts to quit smoking at the urging of his family he remained unsuccessful. Plaintiff's husband therein assumed any risk of the forewarn ailments.

Strict liability

Strict liability, applied in limited situations, is liability without fault. Regardless of behavior, the defendant could be found liable for damages. Traditionally, the concept of strict liability has been applied in cases involving abnormally dangerous activities such as manufacturing explosives, dangerous animals and product liability.

According to Section 402A of the Restatement (Second) of Torts, there are six conditions that must be met in order to prevail: (i)the product must be defective when the defendant sells it,(ii) the defendant must normally engage in the business of selling it, (iii)it must be unreasonably dangerous to the user,(iv) the plaintiff must suffer damages, (v)the condition must cause the damages and (vi)the product must not have been substantially changed from the time the product was sold to the time of the plaintiff's injury.

The plaintiff would most likely lose on the issue of strict liability. The plaintiff must first show that tobacco is defective and unreasonably dangerous. However, the question before the court would be whether the manufactured cigarettes or the tobacco itself was the unreasonably dangerous element. The American Law Institute debated this issue and now includes a comment that would protect the defendant from being responsible under the theory of strict liability. In short it provides that good tobacco is not unreasonably dangerous merely because the effects of smoking may be harmful."

To find a tobacco company responsible under the theory of strict liability would be akin to holding knife manufacturers responsible for sharp knives or farmers liable for the sale of whole milk leading to heart disease.

Warranty

Warranties arise in the sale of goods in two manners, expressed and implied. According to the Uniform Commercial Code (UCC) section 2-313, an express warranty may be created by any affirmation of fact or promise or description. Unlike an earlier case, Pritchard v. Liggett & Myers Tobacco, wherein the defendants produced advertising that made specific references to the safety of their cigarettes, the facts do not support such findings in Williams. Although the facts in the case indicate that the defendant's husband thought he heard television commercials diminish the danger of smoking, there was no clear references to statements made by Philip Morris regarding the safety of their products. Therefore, the defendant would most likely be successful in asserting that no express warranty existed (Pritchard v. Ligget & Meyers Tobacco Co., 370 F.2d 95, 3d Cir.M., 1966).

An Implied Warranty of Merchantability is created in every sale by a merchant under UCC section 2-314. To be merchantable, according to the code , the goods must be "reasonably fit for the ordinary purposes for which such goods are used." In Green v. American Tobacco Co, the plaintiff alleged a breach of implied warranty however the court found no breach due to a lack of forseeability of harm of the product. When considering a product such as tobacco, which is not manufactured, one would most likely revisit the analysis used in determining "unreasonably dangerous" under a strict liability cause of action. In other words, are the cigarettes unmerchantable because of the manner of manufacture? Or is tobacco itself unmerchantable simply because of its hazardous effects? (Green v. American Tobacco Co., 304 f.2d.70, 5th Cir., 1962)

2. Why deception or fraud was selected as a theory in Williams?

The plaintiff prevailed under the theory of fraud because the elements of fraud were present. More specifically, the plaintiff showed (a) a misrepresentation of material facts (b) an intent to induce another to rely on the misrepresentation (c) justifiable reliance by the plaintiff and (d) the misrepresentation caused the injury of the plaintiff.

a. Misrepresentation of material facts. The Oregon Court of Appeals found that the defendant and other tobacco companies created doubt about the health hazards of smoking, knowing that no such controversy existed. As stated above, as early as the 1950s studies show a link of smoking to lung cancer (Williams v. Phillip Morris Inc., 48 P.3d, at 830).
b. Intent to induce. Philip Morris and other tobacco firms employed a public relations firm to reduce the perception of the dangers of cigarette smoke and later adopted a "common front" that denied the linkage between smoking and cancer in the 1950s and 1960s.
c. Justifiable reliance. Arguably the plaintiff was justified in relying on the actions and statements of the defendant. The US Army provided cigarettes and encouraged smoking. The deceased and the plaintiff most likely had a high level of trust in their country and Armed Forces specifically in the era in which the deceased served. They also relied on the defendant so much so that at the time of diagnosis the deceased "expressed a feeling of betrayal."
d. Injury to the plaintiff. The deceased was established as having been caused by over 40 years of cigarette smoking.

3. Discuss the general rules of taxability of personal injury awards.

Section 104 of the Internal Revenue Code exempts from gross income certain amounts received for personal physical injuries or sickness and includes damages received by suit or a settlement (Code §104(a)(2)). The regulations clarify the source of the damages to include "[a]n amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution" (Reg. §1.104-1(c)). The Omnibus Budget Reconciliation Act of 1989 (OBRA), amended section 104(a) by adding the sentence "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness" (Pub. L. 101-239, <u>sec. 7641(a) </u>, 103 Stat. 2106, 2379). It should be noted however, that the Supreme Court held in *O'Gilvie v. United States* that paragraph (2) of section 104 also exempted punitive damages received incident to a *physical injury* award "because they are an element of damages not designed to compensate ... victims" (519 U.S. 79 (1996), 117 S Ct 452 Affirming, CA-10, 95-2 USTC ¶50,508.). The Court accepted the government's position that "such damages were not "received ... on account of" the personal injuries, but rather were awarded "on account of" a defendant's reprehensible conduct and the jury's need to punish and to deter it" (519 U.S. 79 (1996), 117 S Ct 452 Affirming, CA-10, 95-2 USTC ¶50,508.). Currently, the only exception to the judicial requirement that punitive damages be included in gross income is in the case of proceeds received pursuant to a civil "wrongful death action", where applicable State law existing on September 13, 1995, and ignoring subsequent modifications, limits recoveries so awarded to punitive damages (Code §104(c)).

The Small Business Job Protection Bill of 1996 amended section 104 by limiting the exclusion from gross income to amounts received solely from 'physical' injuries and punitive damages awards arising under a "wrongful death action" as described above (Pub. L. 104-188). Amounts received prior to the effective date of this Bill (August 20, 1996) were exempt from gross income even if received on account of a ***non***physical injury such as age discrimination as long as it qualified as a *personal* injury. Section 104 specifically excludes emotional distress from the definition of physical injury or physical sickness. However, the exclusion does not apply to amounts received in recovery of previously paid medical costs. Also, damages for emotional distress and other nonphysical injuries or sickness remain excludable to the extent attributable to a physical injury or sickness (Code Sec. 104(a)). Legal fees paid out of a personal injury settlement are includable in gross income if the award amount is also properly included in gross income (*J.W. Banks*, S Ct, 2005-1 USTC ¶50,155, at ¶6662.515).

4. Under the current statutory scheme of section 104, how would Mayola Williams be taxed on the compensatory and punitive damages in the *Williams* case?

Jesse Williams' widow would be able to exclude from gross income all of the compensatory damages she received under the settlement agreement with Phillip Morris regardless of the characterization of each of the underlying components supporting the damage award. As long as all of those components are *on account of* a personal physical injury the entire proceeds of the award will be exempt from taxation. This would include lost wages, pain and suffering, medical costs and any other damages deemed compensatory and not punitive in nature. The Supreme Court clarified the meaning of "on account of personal injuries" by illustrating the computation of a typical personal injury settlement in *Commissioner v. Schleier*:

> Assume that a taxpayer is in an automobile accident, is injured, and as a result of that injury suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision. If the taxpayer settles a resulting lawsuit for $30,000 (and if the taxpayer has not previously deducted her medical expenses, see §104(a), the entire $30,000 would be excludable under §104(a)(2). The medical expenses for injuries arising out of the accident clearly constitute damages received "on account of personal injuries." Similarly, the portion of the settlement intended to compensate for pain and suffering constitutes damages "on account of personal injury." Finally, the recovery for lost wages is also excludable as being "on account of personal injuries," as long as the lost wages resulted from time in which the taxpayer was out of work as a result of her injuries. . . . The critical point this hypothetical illustrates is that each element of the settlement is recoverable not simply because the taxpayer received a tort settlement, but rather because each element of the settlement satisfies the requirement set forth in §104(a)(2) (and in all of the other subsections of §104 that the damages were received "on account of personal injuries or sickness" (Commissioner v. Schleier, 515 U.S. 323, 336-337 (1995).

Since the Williams settlement included a $32 million dollar punitive damage award, this amount would be includable in gross income under the present statutory scheme and in the light of *O'Gilvie supra*. Punitive damages represent an element of recovery not "on account of personal injuries or sickness" according to the Supreme Court. Similar to the instant case, *O'Gilvie* involved a settlement received by the Petitioner husband and two children of Betty O'Gilvie who died from toxic shock syndrome stemming from the use of a defective product. Rejecting the "but for" reasoning proffered by the Petitioner, the Court opined that Congress could not have intended that any and all damages received under a personal injury claim be exempt from gross income. Indeed, the "but for" argument would, by necessity, include all amounts so received since the settlement would never have materialized "but for" the injury. Given this ruling, it would appear that Mrs. Williams would be compelled to include the $32 million dollar punitive damages in gross income in the year received.

5. Does the *Williams'* Court linking of punitive damages to compensatory damages provide an opportunity to challenge the constitutionality of Section 104's disparate treatment of physical damage awards and punitive damage awards or, render all

damages including punitive damages awarded on account of personal physical injuries nontaxable?

Challenging the constitutionality of any Internal Revenue Code provision is an ominous task to say the least. Notwithstanding, Marrita Murphy made such a challenge in the United States Court of Appeals for the D.C. Circuit in the case *Murphy v. Commissioner* (460 F3d 79 (D.C. Cir. 2006)). The plaintiff in this case had succeeded in an action against her employer for retaliation over her whistle-blower activity and was awarded compensatory damages for emotional distress and injury to her professional reputation. The award was includable in gross income under section 104(a)(2) since it was not made "by reason of or because of" a personal physical injury (*Murphy v. Commissioner,* quoting *O'Gilvie v. United States*, 519 U.S. 79, 82 (1996)). Amazingly, the court initially ruled that section 104 was unconstitutional in that it purported to tax something that was not income within the meaning of the Sixteenth Amendment. In so arguing, the court reasoned that "not all receipts of money are income" if the receipts are not "received "in lieu of" something normally taxed as income" (*Murphy v. Commissioner, at 83).* Indeed, the court made clear that the Sixteenth Amendment regulating Congress' power to tax was not as expansive as the Government would believe:

At the outset, we reject the Government's breathtakingly expansive claim of congressional power under the Sixteenth Amendment --upon which it founds the more far-reaching arguments it advances here. The Sixteenth Amendment simply does not authorize the Congress to tax as "incomes" every sort of revenue a taxpayer may receive.

After presenting an analysis of the Sixteenth Amendment and a detailed history of the taxation of personal injury damage awards, the court concluded that Congress could not tax a recovery of human capital because it lies outside the scope of Congress' taxing authority. The court easily adopted the human capital argument advanced by Murphy. Noting "The long history of . . . holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital" *(Murphy* (quoting *Glenshaw Glass*, 348 U.S. at 432 n.8), the court concluded that "insofar as §104(a)(2) permits the taxation of compensation for a personal injury, which compensation is unrelated to lost wages or earnings, that provision is unconstitutional" (*Murphy v. Commissioner,* 460 F3d 79 (D.C. Cir. 2006)).

Unfortunately, the court vacated its ruling in *Murphy* on its own motion and reheard the case after the Government petitioned for rehearing *en banc*, arguing that, even without the *income* label, the constitution permits its taxing because it is neither a direct tax nor is it imposed without uniformity. On rehearing, the court held that a tax on damages received for non-physical personal injuries were in the form of an excise and not a direct tax requiring apportionment under Article 1, Section 9 of the U.S. Constitution. (Murphy v.

Commissioner, 460 F3d 79, 05-5139 (D.C. Cir. 2007), Affirming DC D.C., 2005-1 USTC ¶50,237).

There are two requirements in the U.S. Constitution that limit the imposition of taxes. Article 1, Section 8 states that "all duties, imposts and excises shall be uniform throughout the United States" and Article 1, Section 9 states that "No capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken."

Although Murphy was a circuit court opinion it demonstrates the reluctance of the judiciary to restrict the taxing authority of Congress. In considering whether punitive damages are beyond the reach of Congress' taxing authority consider the footnote in the famed Glenshaw Glass case:

> The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property . . .. Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes (Glenshaw Glass, 348 U.S. at 432 n.8.)

With the recent holding of Murphy coupled with the Glenshaw Glass footnote, it seems unlikely that sufficient sway can be made in the court regarding the constitutionality of taxing punitive damage awards. The best argument that could be advanced in light of Williams is found in the dissenting opinion of Justice Scalia in the *O'Gilvie* case:

The Court greatly understates the connection between an award of punitive damages and the personal injury complained of, describing it as nothing more than "but-for" causality, *ante*, at 3. It seems to me that the personal injury is as proximate a cause of the punitive damages as it is of the compensatory damages; in both cases it is the *reason* the damages are awarded. That is *why* punitive damages are called *damages.* To be sure, punitive damages require intentional, blameworthy conduct, which can be said to be a coequal reason they are awarded. But negligent (or intentional) conduct occupies the same role of coequal causality with regard to compensatory damages. Both types of damages are "received on account of" the personal injury (519 U.S. 79, 1996, Scalia, J., dissenting).

But this argument has been made moot by the passage of The Small Business Job Protection Bill of 1996, which specifically added the "other than" language in section 104 regarding punitive damages (Pub. L. 104-188). However, it has been held that State law controls in the determination of whether damages are noncompensatory or punitive (See *Bagley v. Commissioner*, 105 T.C. 396, 417 (1995), affd. 121 F.3d 393 (8th Cir. 1997)).

Much of the argument surrounding the taxation of damages is largely semantics. If a state were to draft legislation that classified punitive damages as compensatory and on account of a personal injury, it may create a sufficient argument in light of *Williams* to sustain a challenge.

With the addition of Justice Alito and Chief Justice Roberts to the high court the constitutionality of taxing any damage award arising out of a physical personal injury may be worth revisiting. This is especially so in light of the language in the *State Farm* case regarding punitive damage limits: "in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process" (*State Farm Mutual Automobile Ins. Co. v. Campbell*, 538 U.S. 408, 425, 2002). By limiting punitive damages to such a small multiplier of the compensatory amount an argument can be advanced that such damages no longer operate in a sufficiently noncompensatory way to be indistinguishable for tax purposes. Indeed, the Committee report supporting the change to section 104 in The Small Business Job Protection Bill of 1996 noted the following: "Punitive damages are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering. Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income" H.R. No 104-586, House Ways and Means Committee (May 23, 1996). The "windfall" intended to be the distinguishing feature of taxability has been largely emasculated by the *Williams* and *State Farm* courts.

In the case of Philip Morris USA v. Williams, there were three damages awarded by the jury:

$21,485 of economic damages
$800,000 of non-economic damages
$79,000,000 of punitive damages

6. In keeping with Generally Accepted Accounting Principles,

a. what amounts would Philip Morris need to recognize in their financial statements,

b. when should they recognize these amounts, and

c. how would these amounts be classified in their financial statements (Income Statement, Balance Sheet, and Statement of Cash Flows)?

The economic and non-economic damages were not contested by Philip Morris, so these amounts should have been recognized in the accounting period in which the verdict was returned by recording an expense on the Income Statement and recording a liability on the Balance Sheet. The cash outflow would be recognized when the actual payment was made, at which time the cash balance would be reduced and the liability would be removed from the Balance Sheet. A cash outflow from operating activities would be shown on the Cash Flow Statement during the accounting period in which the cash payment was made.

In terms of the punitive damages, during the time periods that the court case was under review or under appeal, Philip Morris should have accrued a contingent liability according to Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FASB, 1975), if the following conditions were met:

- the loss was *probable* and
- the amount of the loss was reasonably *estimable*.

One could argue that the amount of the loss from the punitive damages was estimable, since a specific dollar amount had been determined by the jury. However, the degree of likelihood that the entire $79 million would eventually be paid out by Philip Morris would have been subject to debate, given the appeals process. The degree of probability of an unfavorable outcome (from Philip Morris' perspective) would determine the need to accrue the contingent liability. If this liability were accrued, it would result in recording an expense on the Income Statement and a liability on the Balance Sheet in the period that the judgment was entered against Philip Morris. If Philip Morris management concluded, in consultation with counsel and its auditors, that an unfavorable outcome was possible but not probablye, or that the amount of the loss could not be reasonably estimated, then accrual would be inappropriate, but a disclosure in the notes to the financial statements should be made. The disclosure should indicate the nature of the contingency and give an estimate of the possible loss or range of loss, or state that such an estimate cannot be made (FASB, 1975).

7. In your opinion, would the amount of the punitive damages meet the criteria of an *extraordinary item* in terms of how it would be shown in the Income Statement?

According to Accounting Principles Board (APB) Opinion no. 30, *Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* (APB, 1973), a loss should be shown as extraordinary only if it is both unusual in nature and infrequent in occurrence for the environment in which the enterprise operates. Given the nature of the tobacco industry, the well-known harms caused by the products produced by this industry, and the frequency of law suits against companies in this industry brought by people sustaining these harms, it is not likely that the punitive damages would qualify as an extraordinary loss. Such a loss would more likely be viewed as a normal cost of being in the business of producing cigarettes.

8. Which of Philip Morris' key financial ratios would have been impacted by recognition of the punitive damages and in what direction? (Assume that the cash flows are unaffected at this point in time.)

Recognition of the punitive damages would have reduced Net Income, and increased Liabilities (thereby reducing Net Worth). The following key ratios would be affected in the direction indicated:

Profit Margin – DOWN
Earnings Per Share (EPS) – DOWN
Price Earnings (PE) – UP (assuming no immediate affect on the stock price)
Interest Coverage – DOWN
Current Ratio – DOWN (assuming that the liability is classified as current; otherwise, no effect)
Quick Ratio – DOWN (assuming that the liability is classified as current; otherwise, no effect)
Debt to Equity - UP
Asset Turnover – no effect
Inventory Turnover – no effect
Days Sales Outstanding – no effect

To summarize, measures of profitability and interest coverage would be negatively impacted by the reduced Net Income. Financial leverage, a measure of risk, would be higher due to the higher liability. Indicators of operating efficiency would be unaffected.

9. If the amount of the punitive damages had been maintained at $79 million and recognized in 2006, would this amount have been material to Altria Group, Inc., the parent company of Philip Morris, USA?

An expense and corresponding liability in the amount of $79 million would represent approximately .08 percent (i.e., .0008) of the 2006 Net Sales, and would have reduced Net Income by less than .7 percent. Net Income for the Altria Group, Inc., in 2006 was approximately $12,022 million. Total current liabilities as of year-end 2006 were $25,427 million and total assets were $104,270 million. Thus, a $79 million award is not likely to have been considered material in terms of its dollar impact on the financial statements or financial ratios of the corporation. (Source of company financial data per Lexis/Nexis Company Dossier for Altria Group, Inc.)

10. In teaching promotional strategies and ethics, there is often a distinction made between sales puffery and misrepresentation. Are those distinctions as clear as they once were given the position of the court regarding the Due Process Clause?

Sales puffery can be defined as

> Exaggerated statements about the performance of products or services (Weitz, Casselberry, and Tanner, 2001)

Misrepresentation can be defined as:

> A legal cause if action on which an injured party seeks damages. It arises when a salesperson makes erroneous statements or makes false promises regarding a products characteristics and capabilities (Futrell, 2007).

The distinction between the two has been based on the presentation of false facts (misrepresentation) versus the use of exaggerated opinions (sales puffery) in order to sell products and services. While misrepresentation has typically been viewed as a legal cause of action, sales puffery has not. The recent decision of the Court make the two less easily differentiated.

Pragmatically, the Supreme Court's decisions have in many ways reduced the threat of a charge of misrepresentation to that of sales puffery. The requirement that only those victims represented in the courtroom can be included in determining the punishment of misrepresenting or misleading a consumer of a product makes each complaint almost indistinguishable from individual charges of sales puffery. While the charges may be different conceptually, the process of seeking compensatory and punitive damage awards will in the future be treated as if they are individual acts rather than comprehensive strategies affecting more than the "people in the courtroom."

11. Given the recent findings regarding the application of punitive damage awards, what is the likely impact on the behavior of organizations? Specifically, will socially responsible behavior be encouraged or discouraged by the Court's position?

Socially responsible behavior will more greatly depend on the values of specific organizations. The threat of punitive damages used as a deterrent to unethical behavior is significantly lessened by the Court's rulings. The limits to amount of punitive damages as well as the limitations to how a single party's injuries can be generalized to a greater population as the basis for assessing punitive damages severely limits the power of courts to control or impose behavior on an organization that is not positively disposed to that behavior. In fact, the punitive damages awards as limited by the Court's decisions might redefine those awards as a "cost of doing business" rather a punishment for doing business unethically and irresponsibly.

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HDTV DIVISION OF GLOBAL ELECTRONICS, INC.

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CASE DESCRIPTION

The primary objective of this case is to describe realistic capital budgeting issues within a large organization. The case illustrates ways that staff inside a corporate finance department (and in related departments) position themselves in the capital planning process. The case also stresses steps that a large firm can take to leverage its size to gain the maximum benefit of investment projects. Further,, the case demonstrates sensitivity analyses in the capital budgeting process, and the resulting internal rates of return.

We suggest the case be used to follow the related case "HDTV Systems", which shows the firm as a medium-sized enterprise and its capital budgeting issues before becoming a division of Global Electronics. This case should be used for students who have been exposed to capital budgeting in a prior course, either undergraduate or graduate. Class time should not exceed two hours, with approximately four hours of student preparation time.

CASE SYNOPSIS

This case involves a need for a decision regarding a large capital expenditure. Students will find that capital planning involves not only the use of accepted capital budgeting techniques, but also a considerable impact based on staff viewpoints that reflect their particular department's biases. Also explicitly presented are multiple levels of investment worth based on alternative, realistic assumptions. Students can verify IRR and payback calculations using Excel, and they will see that capital budgeting involves fragile forecasts and biases that managers bring to the analytical process.

INSTRUCTORS' NOTES

Teaching Suggestions

This case is primarily intended to demonstrate the nature of capital budgeting within a multinational firm. Instructors can emphasize both advantages and disadvantages that large firms possess. For example, although large firms may have strong negotiating power with regard to external purchasing, and advantages through synergy with other divisions, there is uncertainty about quality and reliability of parts purchased from outside suppliers. As specific divisions compete for funding, staff may overestimate the projected performance of their division's projects and receive funding. Other divisions that more objectively develop their capital requests may not be funded because they appear less worthy. The case provides an opportunity to consider the effects of capital rationing.

Also, the instructor may want to stress that the involvement in capital planning by a large number of people may be an asset or a liability. While it will be useful to obtain a number of inputs into the process, it may also cause capital planning to drag on beyond the ideal time for introduction of a new product before the firm's competition beats them to the market.

In order to demonstrate that large firms may also use weak capital budgeting methods, Global also uses Payback Period. Instructors can use Global's environment in which divisions compete for capital, and then focus on the impact of capital rationing.

The case uses a number of financial management personnel at both the division and corporate levels. Instructors can use the interactions between these people to demonstrate real-life capital budgeting processes, as well as the divergent opinions expressed by the staff. Additionally, the challenging nature of forecasting is displayed within the case.

The case demonstrates the difficulty of generating above average IRRs in a highly competitive market. One way to achieve higher return on projects is to include a product "enhancer" like the television stand which will be a source of additional cash flow. Instructors may also want to stress the issue of timing of equipment changes to accommodate product modifications in an industry characterized by rapidly changing technology.

Instructors may wish to emphasize the realistic assumption of a decline in product price over time in the electronics industry. Further, the case shows the IRR on the project moving around with different assumptions about inputs such as product pricing and investment cost savings when combined with the cost associated with capital requests from other divisions. The case also brings in the possibility of accepting a project which does not meet the customary criteria, but holds a "protect position" benefit in which the company maintains its presence in the market.

A committee of staff from various departments within Global Electronics is introduced with the assignment of improving the firm's overall capital expenditure process, as well as pinning down the merits of the Ultra High Definition TV project. One person recommends the stand as a closely aligned TV product that could make a difference for the sucess of the primary product, encouraging students to look for creative ways to present a firm's products to the marketplace. Also, the case provides explicit differences of opinion about the merits of the project when viewed by individuals with differing stakes in the capital budgeting process; included are staff in engineering, procurement, marketing, plant management, and capital planning. In this way, instructors can enhance interest in capital budgeting processes for students with majors other than finance, and at the same time emphasize the importance of company departments outside of corporate finance to students majoring in finance.

Additionally, the quantitative analysis in the Exhibit includes various IRR results under different assumptions about product pricing, quantity sold, and purchase price savings. Instructors may want to emphasize these factors which lead to various rates of return.

DISCUSSION QUESTIONS

1. **Identify some aspects of the capital budgeting process that you believe large, multinational firms might deal with successfully, as well as other aspects of the process that large firms might perform poorly, if at all.**

    The various divisions of Global could engage in in-fighting for capital, and overstate their analysis in favor of their own favored projects. The issue is divisional objectivity and appropriate desire for growth for the benefit of shareholders versus excessive optimism. We would expect a large organization to use generally accepted capital budgeting analytical procedures, and we would expect large firms to develop a more reliable cost of capital. Also, large firms might be expected to conduct better market analysis in developing new product ideas and the associated revenue and cost projections.

2. **Identify and discuss inputs to the IRR calculation that were varied in the case in order to assess the sensitivity of the IRR calculations. Can you identify additional inputs that could be adjusted in order to help management understand the uncertainty inherent in the UHDTV project?**

    The case uses a 4% annual price drop, lower unit demand in the later years, and a 10% vendor discount on the production equipment. Some additional examples include varying production cost levels, and shorter or longer cash flow generation periods than the eight years used in the Exhibit.

3. **Using the net cash flows in the Exhibit, verify the accuracy of the 11.9% and 13.2% IRRs shown.**

    These can be verified with a calculator or Excel.

4. **How did the pilot committee members contribute to a more comprehensive, enterprise level view of the UHDTV project?**

    Marketing suggested a stand to be packaged with the UHDTV. Design Engineering pointed out that the stand did not adequately utilize company engineering talent, and it was outside existing competencies across products and use of equipment. Procurement voiced opposition to low cost foreign vendors, although this opposition could probably be overcome by evaluating vendor capabilities more closely. Operations Management strongly supported making as many component parts as possible within the company. Specifically, the case states that plant capacity for in-house production is available, and in-house costs are believed to be lower than out-sourcing. There should be a benefit to the informed, collective judgment by bringing these department leaders together on this project, and for the company's capital budgeting process in general.

5. What is the appropriate capital budgeting decision when an asset's IRR only marginally clears the cost of capital?

The analysis should include calculations based on various assumptions to gain an appreciation of the sensitivity of the IRR result to the level of the inputs. Also, an investment can be analyzed to see if the expected value of the IRR, developed through a probability distribution of possible IRRs, exceeds the cost of capital. Realistically, actual results of accepted projects will be above or below the expected value. Also, an investment with marginal return could be justified on the basis of "protect position" in which value is seen in maintaining the company's presence in the marketplace. Additionally, a divisional cost of capital could be developed by using a beta within the cost of equity drawn from firms that make only or primarily the division's products.

6. Using the stand/TV combination, the IRR increased to a range between 14% and 16.3%. Can the firm depend on this return range, when consumers could simply buy a stand separately?

The much higher IRRs with the addition of the stand seem unreasonable. Perhaps the revenue, cost and volume assumptions are excessively optimistic. If consumers perceive a purchasing advantage from the inclusion of the stand (and perhaps the more exact match with the television in terms of color and style of an included stand), then the combination will probably be accepted in the product market.

7. What steps can Global Electronics take to reduce the divisional cost of capital faced by the HDTV division? Evaluate the results of (1) raising capital in the debt and equity proportions currently used, (2) increasing the proportion of debt, and (3) increasing the proportion of equity.

The middle of the road approach would be continuing the current capital mix and may be desirable. If the company can safely meet the debt service of additional borrowings, the weighted average cost of capital will decline because of the tax deductibility of interest expense. The use of additional equity in the mix will raise the weighted average cost of capital because the cost of equity is above the cost of debt.

8. Discuss the advantages and disadvantages of building a new plant for the potential UHDTV project, including the fact that excess plant capacity currently exists within Global Electronics.

This is a key issue in the case. The company faces the choice of high capital requirements associated with an efficient, new production facility, or higher product manufacturing costs if the company has excess capacity within existing facilities. A new production facility is under consideration for the UHDTV project.

9. What can be predicted about the future dividend policy of Global Electronics, if its other divisions have similar financial performance and capital requirements as HDTV Division?

The combination of weak profitability and large capital requirements suggests that Global's future dividend policy will lean toward high retention of net income.

10. Ms. Cunningham initially calculated a 10% IRR, and then in a subsequent round, she found an IRR of 13.5%. Explain how these and possibly additional IRR calculations under different assumptions can be collectively considered in an assessment of the risk of the UHDTV project.

Through the use of sensitivity analysis, a distribution of IRRs can be developed by calculations under different cash flow assumptions, with an estimated probability for each outcome. An expected value for IRR can thus be determined, as well as standard deviation to measure risk.

11. Discuss the importance of management and marketing staff identifying worthy future projects given the depreciation expense of a potentially disappointing UHDTV project.

Failed capital projects may require write off of assets no longer useful, and identification of new, financially viable projects hold the potential to offset the consequences of abandonment. However, through reworking the fixed assets, potential exists for their use in the production of other products. Close monitoring on a regular basis will help minimize losses; follow-up analysis of project performance leading to possible abandonment can avoid continuing, excessive losses.

12. Develop some specific incentive mechanisms and penalties that can be put in place that would be sufficiently effective in ensuring that divisional managers maintain realism in capital budgeting projections.

One possibility would be to rank divisions based on realized returns from prior capital expenditures. Divisions with weak capital expenditure performance should be scrutinized very closely to help ensure future results.

OPERATIONAL IMPROVEMENT PROJECT MANAGEMENT: CATEGORIZATION AND SELECTION

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CASE DESCRIPTION

The field of project management is experiencing a burgeoning amount of growth in its applications. Companies apply innovative management methodologies such as project management in order to achieve rapid and continuous improvements in their operations. Selecting an appropriate set of operational improvement projects out of a potential pool of projects is a difficult task. How can companies select an optimum portfolio of projects?

The primary subject matter of this case study is concerned with objective evaluation of candidate projects that will address corporate business objectives based on a quantitative method. Projects can be objectively evaluated based on a quantitative method such as Six-sigma, which is defined as "a disciplined, data-driven approach and methodology for eliminating defects in any process, from manufacturing to transactional and from product to service" (www.isixsigma.com). The secondary subject matter for this case study is the project selection based on more a qualitative or abstract method utilizing the mapping process. The balancing act between quantitative methods and qualitative methods is highlighted in this case study.

This case study is appropriate for senior level undergraduate students and/or graduate level students while taking an operations management course. The case is designed to be used in conjunction with two to three hours of in-class preparation followed by approximately four hours of outside classroom analysis, discussion, and report write-up. In-class topics can include project selection models, project categorization criteria, and the project portfolio process.

CASE SYNOPSIS

This case describes a systematic way of categorizing, evaluating, and selecting projects using information from a leading automotive electronics component manufacturer. The projects discussed in this case study are based on real life projects. However, the company name, project names and financial numbers are modified in order to protect the company's identity.

This case study describes seven different project proposals that were presented to the company's management staff for evaluation and selection. Five projects are to be selected which *will be sponsored by the plant's top management. The projects come from multiple disciplines and department areas and are affecting the overall company performance. The company's performance is judged on their performance in reference to the following areas: scrap cost, first time quality, operational effectiveness, and assembly plant returns. The candidate projects are evaluated using both numeric and non-numeric project selection models to determine where the management team for this automotive electronics manufacturer should allocate and focus their efforts for the upcoming year. Several teams composed of personnel that have been trained in Six-sigma methodologies are available to begin addressing these issues immediately and will be supported by current trainees in these problem solving methodologies.*

INSTRUCTORS' NOTES

1. **For financially distressed companies, project selection based on financial analysis such as the Net Present Value (NPV) and payback period may receive higher priority. NPV of free cash flows is calculated using 8% discount rate. Project payback period are in the unit of years. Projects are ranked based on NPV as follows:**

	Y0	Y1	Y2	Y3	Y4	Y5	Y6	**Y7**	Payback	**NPV**	**RANK**
1.Surface Mount Component	-1500	500	500	500	400				3	**76.44**	**2**
2.Surface Mount Misfiring	-1000	400	300	300	200				3	**11.78**	**7**
3.FinalTestFailure	-300	200	200						2	**52.46**	**6**
4.Surface Mount Terminal	-800	300	300	300	120				3	**56.79**	**4**
5.Leak Test Failure	-500	110	110	110	110	110	110	110	5	**67.32**	**3**
6.EnergySaving	-150	40	40	40	40	40	40	40	4	**53.94**	**5**
7.CaseDefect	-200	-200	-200	-200	100	200	400	600	7	**89.22**	**1**

2. **As a quantitative approach, the weighted scoring method can be used. This method is an objective method in that it overcomes possible bias of a decision maker. In this case, the model uses four different criteria to evaluate the proposed projects. Depending on current performances, numeric scores of 1 to 5 are assigned to each criterion. These numeric scores and performance ranges for each criterion can be generated by the cognizant and experienced personnel**.

SCORE	5	4	3	2	1
SCRAP	> $20K	$15K - $20K	$10K – $14K	$5K - $9K	< $5K
FIRST TIME QUALITY (% Good)	< 97.5%	97.5% - 97.9%	98.0% - 98.9%	99.0% - 99.4%	> 99.5%
OPERATIONAL EFFECTIVENESS (hrs)	> 10	8 – 10	5 – 7	3 – 4	< 3
ASSEMBLY RETURNS (Qty)	> = 5	4	3	2	< = 1

The next step involves applying a weight to each performance metric. Typically, these weights are determined by the organization's decision making team members. Numeric weights reflect the relative importance of each of the individual performance criterion. Below, the weights applied to each criterion are shown with greater weight being allocated to a factor, which the decision makers decide as more critical. For this example, scrap cost was given the highest weight of 0.5 due to its biggest impact on the quality performance.

QUALITY CRITERIA AND WEIGHTS										
	0.50		0.15		0.10		0.25			
	SCRAP		FIRST TIME QUALITY		OPERATIONAL EFFECTIVENESS		ASSEMBLY RETURNS			
Project Proposal	Score	Weighted	Score	Weighted	Score	Weighted	Score	Weighted	TOTAL	RANK
1. Surface Mount Component	5	2.50	4	.060	4	0.40	4	1.00	4.50	1
2. Surface Mount Misfiring	4	2.00	3	0.45	3	.030	1	0.25	3.00	3
3. Final Test Failure	1	0.50	5	0.75	3	0.30	1	0.25	1080	6
4. Surface Mount Terminal	2	1.00	5	0.75	3	0.30	2	0.50	2055	4
5. Leak Test Failure	2	1.00	5	0.75	4	0.40	5	1.25	3.40	2
6. Energy Saving	1	0.50	1	0.15	1	0.10	1	0.25	1.00	7
7. Case Defect	1	0.50	4	0.50	1	0.10	3	0.75	1.95	5

The results of the weighted scoring method are shown above. The top ranked proposal based on weighted scoring method is "*Surface Mount Component*." Two main drivers of this project receiving the highest rank are scrap-cost and assembly-plant-returns due to their higher weights. Because of the relatively lower weights assigned to first-time-quality and operational-effectiveness, "*Final Test Failure*" is ranked at 6th place even with the high scores on the other two criteria.

Although weights are provided in this case, instructors can generate a new set of weights by involving students as well. A typical example, I provide in my class is analyzing what issues are important for choosing a MBA program. Let's say a local college students are deciding where to pursue their MBA degree. Through a brain storming, four issues are identified as important issues to consider: cost, distance, brand name and quality. Create a table with identified issues on the first column and on the first row as follows:

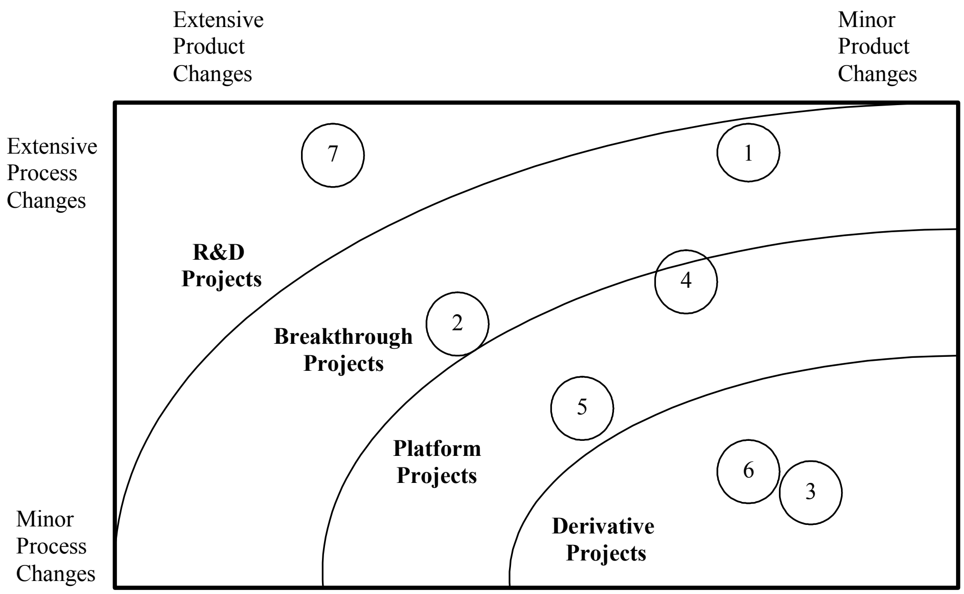
	Cost	Distance	Brand name	Quality
Cost	1	2	3	4
Distance	5	6	7	8
Brand name	9	10	11	12
Quality	13	14	15	16

Suppose a total of twenty students are deciding on relative importance (weights) of these four issues. Diagonal cells (cells 1,6,11 and 16) do not require voting as they represent same issues. For the upper triangular cells (2, 3, 4, 7, 8 and 12), have the students vote (by raising hand) whether they consider "row" issue is more important than "column" issue. For example, cell 2 compares "cost (row)" and "distance (column)" and say 15 students thought "cost" was more important than "distance." Record voting counts (15 for cell 2) and keep voting until all upper triangular cells are filled. Lower triangular cells (5, 9, 10, 13, 14 and 15) do not require voting as they are complementary to upper triangular cells. For example, cell 5 is 20 (total number of students) – cell 2, and cell 9 is 20 – cell 3. Once all cell values are filled (other than diagonal), sum each row values (shown as "Row total" below). Divide each "Row total" by "Grand total" to obtain weights.

	Cost	Distance	Brand name	Quality	Row total	Weight
Cost	-----	15	18	16	49	0.408
Distance	5	-----	12	8	25	0.208
Brand name	2	8	-----	7	17	0.142
Quality	4	12	13	-----	29	0.242
Grand total					120	

3. **There are numerous criteria which can be used to categorize the projects (i.e., financial impact, existing capability, synergy with other projects, company image, employee moral, involved risk, potential learning, etc.). Using "amount of product change" and "amount of process change" can be one of such criteria. Based on candidate project descriptions provided, students are expected to map (categorize) the projects. Based on students' interpretation, a project can be categorized somewhat differently (i.e., "Platform" instead of "Derivative"). However, it should not be categorized too**

differently (i.e., “R&D” instead of “Derivative”). Our interpretation of proposed project descriptions is given below.



Instructors can elaborate on this concept by using different set of criteria as the axes for the map. For example, “Net Present Value (NPV)” and “Rate of Return (ROR)” can be more appropriate and interesting choices for an organization that is focusing on a greater financial return. How about “Probability for FDA approval” and “”Return on Investment (ROI)” for a biomedical development company? Further, different names for categories can be selected instead of the ones used for this case.

4. From above analyses, the following table summarizes proposed projects.

A “Sacred Cow” proposal (i.e., one favored by the top management; in this case, *Final Test Failure*) can be selected when a non-numeric approach is used to rank the projects. Since the “boss” suggests the project, the team might pre-conclude that this is the best project to select. Charles Garcia needs to be careful that he does not offer any favoritism towards a certain project during the review phase.

	Category	NPV ($1,000)	Cost ($1,000)	Quality Weighted Score
1. Surface Mount Component	Breakthrough	76.44	1,500	4.50
2. Surface Mount Misfiring	Breakthrough	11.78	1,000	3.00
3. Final Test Failure	Derivative	52.46	300	1.80
4. Surface Mount Terminal	Platform	56.79	800	2.55
5. Leak Test Failure	Platform	67.32	500	3.40
6. Energy Saving	Derivative	53.94	150	1.00
7. Case Defect	R&D	89.22	800	1.95

As a mature manufacturing operation, AEG – San Antonio may want to focus more towards Derivative and Platform projects. Breakthrough and R&D projects might require too much change from existing system and capability, which may involve more risk taking. While, "Case Defect" project has the highest NPV, it is a R&D project and thus not recommended. The "Surface Mount Case" project ranks highest on the "Quality Weight Score" and second in NPV. Although it is categorized as a Breakthrough requiring a lot of change from existing status, such high ranks on the other two criteria would justify this project.

Using the project map, comparing a project from one category to projects from other categories should be discouraged. A project should be compared with other projects in the same category. For example, our mapping process (based on "product change" and "process change") yielded four different categories. A Derivative project requires less amount of risk and requires less amount of change from existing capabilities. This will favor a Derivative project over projects from other categories.

Based on analyses from above, the following five projects are recommended. These projects will cost a total of $3,250,000, leaving $250,000 (about 7% of total budget) as the contingency fund. Total NPV for these five projects is $306,950.

Project Name	Category	NPV ($1,000)	Cost ($1,000)	Quality Weighted Score
1. Surface Mount Component	Breakthrough	76.44	1,500	4.50
5. Leak Test Failure	Platform	67.32	500	3.40
4. Surface Mount Terminal	Platform	56.79	800	2.55
3. Final Test Failure	Derivative	52.46	300	1.80
6. Energy Saving	Derivative	53.94	150	1.00

BUSINESS ETHICS, BUS 3333: COMMUNITY ORGANIZING RURAL NEBRASKA CASE

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Stephanie Metts, Southeastern Oklahoma State University

CASE DESCRIPTION

This case focuses on the business ethics topic of corporate governance in a nonprofit organization with issues involving conflicts of interest, organizational politics, and lack of internal controls. Secondary issues focus on accounting problems associated with accounting controls of the organization. The case has a difficulty level appropriate for an undergraduate junior level Business Ethics or Accounting course. It is designed to be taught in one to two class periods with the requirement of three to six hours of outside preparation by students.

CASE SYNOPSIS

Unlike Dragnet, the detective show, more than the names of the innocent have been altered in this case based on facts, people, and events from a real nonprofit organization. The facts and events came to light when the organization's respective state auditors issued findings from a compliance audit. While nonprofit organizations may receive funds for promoting social welfare as in this case, the ethical and business issues are common to ethical dilemmas, business structure and related business issues for all business organization forms.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

The three questions included with the case are very general in nature to allow the instructor flexibility in teaching the case. Suggested teaching approaches include assigning teams to evaluate an aspect of the case, setting up team competitions to find multiple issues, asking student to prepare a SWOT analysis of the ethical issues, using the case as a summative learning tool for a business ethics class, and using case for an essay final exam.

The instructor may choose to focus on actions of individuals, on organizational issues, on general and internal controls, or on accounting issues. Student teams could assume the role of consultants or specialists and provide a report or list of recommendations to management on one or more kinds of issues.

POSSIBLE SOLUTIONS

The following solutions represent some of the key issues involved in the case. Other solutions to the case may be possible as well.

Issues with corporate governance

Conflicts of interest policy

Jefferson, the Executive Director of CORN appointed five members to the CORN Board.

Solution:

President or CEO should be involved in the board member recruitment process but the selection should not be under his or her control.

President's appointees also serve as the Executive Committee which possesses the powers to change charters, negotiate loans, approve purchases, fire or hire, and to approve bonuses.

Solution:

No subgroup should possess the power of the full board. Either there is a violation of the organization's incorporating documents or there are flaws in those documents. The former is more likely given the governmental oversight of this organization.

The full Board of Directors manages the organization and has the legal and ethical obligations to do so.

The organization should adopt a formal code of conduct or ethics that detail conflict of interest policies and procedures as they apply to senior management, officers, and the board.

Organizational failure:

Organizational failure occurs by Jefferson appointing the members to the Executive Committee.

Solution:

More restrictions should be placed on the Executive Committee in terms of defining the committee's authority.

Organizational failure also occurred because the Board of Directors responsibilities were not clearly followed to implement financial oversight.

Solution:

The Board should meet on a regular basis and thoroughly review a complete set of the organization's financial statements.

Subjective conflicts of interest

Jefferson appointed James Whitecloud and others to the Corn Board of Directors and the Executive Committee. Whitecloud recommended his former teacher Dr. Karney to the Board.

Solution:

Jefferson should not make appointment to the Board of Directors. The Board has the responsibility to manage an organization. The Board delegates that responsibility to the Chief Executive Officer not the other way around.

James Whitecloud, a member of the Corn Board of Directors and the Executive Committee socializes with Jefferson and Adam Jackson on the golf course. A conflict is present because every member of the Board of Directors is responsible for directing, supervising, and placing limitations on the Executive Director. Mr. Whitecloud's independence in regards to evaluating the performance of both Jefferson and Adam Jackson can be questioned given the fact that they have been seen socializing.

Solution:

The conduct of both Jefferson and Jackson may be called into question with the current Executive Committee powers. Their actions could be viewed as political tactics of ingratiation, associating with the influential, and even creating obligations. While not necessarily illegal, these types of actions can be viewed as unethical. The organization might adopt a formal code of conduct or ethics that detail conflict of interest policies and procedures as they apply to senior management, officers, and the board.

Establishing favorable relationships:

This occurred when the Executive Director of CORN, Jefferson, appointed Lucas Wilson to the position of accountant even though Wilson was not educated in nor had any experience in accounting.

Creating obligations/Associating with the influential:

This occurred when Jefferson hired Ms. Sarah Adams for the public relations position as a "favor" to the Nebraska Senator realizing it could lead to favorable political treatment in the future.

Solution:

The promotion and hiring of both people appear to be questionable and may be in violation of Equal Opportunity Laws if other candidates were overlooked for these positions. The organization should adopt hiring procedures and a formal code of conduct or ethics that detail conflict of interest policies and procedures as they apply to senior management, officers, and the board.

ISSUES IN GENERAL OR INTERNAL CONTROLS AND IN ACCOUNTING:

Lack or inadequate general business controls:

Employees were given corporate credit cards and supporting documents were not required for payment of receipts.

Solution:

Safeguarding assets, such as the disbursement of cash for business expenses, is a basic internal control issue for any business. Employees should only be given access to corporate credit cards for necessary travel expenses. All other expenses should be paid for by the employee and reimbursed from the organization after sufficient documentation is provided. There should be a review process to insure that receipts are submitted for every purchase.

Mr. Wilson lacked accounting experience and the related knowledge of internal control procedures. As Chief Executive Officer, Mr. Jefferson had an obligation to protect the organization's assets and establish general and internal controls to that end.

Solution:

Hire an accountant or a person who has experience in working with nonprofit organizations.

Solution:

Computerize accounting

Solution:

Change to an accrual basis of accounting

Solution:

Establish Internal Control by ensuring all transactions have adequate documentation, ensuring all transactions and are properly authorized, and ensuring all transactions proper recording of information in proper amounts, accounts, and period.

Auditor's list of problems:

The year-end adjusting entries for accounts receivable and payable were not made. The problem is this resulted in unrecorded revenues and liabilities and thus misrepresentation of the financial statements.

Solution:

Organizational internal controls should specify these. Close attention to detail should be paid to ensure that these adjusting entries are made prior to year-end.

The notes payable and the related assets were not included in liabilities and assets, but rather were incorrectly listed as miscellaneous expenses or lease expenses. The problem is this resulted in unrecorded liabilities and assets misrepresenting the financial statements.

Solution:

Again closer attention to detail should be made to ensure expenses and assets are recorded in the proper accounts.

A multimillion dollar bond issue, for which CORN is the fiscal agent, was not included in the records. The problem is this resulted in understated liabilities and revenue and thus the misrepresentation of financial statements.

Solution:

Closer attention to detail should be made to ensure all liabilities and revenues are properly recorded.

CORN operated on a cash basis. Payroll records have been improperly maintained at net amounts. The problem is that such a practice misstates employer payroll taxes and withholding for employee retirement, insurance, and other withholding amounts.

Solution:

Implement an accrual basis of accounting as well as a computerized accounting system.

The auditors point to a lack of general ledger to organize the accounting records. Their recommendation is to use this structured accounting process.

Solution:

Implement a computerized accounting system and an accrual basis of accounting to ensure that all accounting records are complete and that revenues and expenses are properly matched.

The Executive Committee has the ability to act on the Board's behalf. However, no minutes could be found to document actions taken by the Executive Committee. The auditors are concerned that the Board may not have sufficient financial information (see other notes) to adequately exercise its oversight authority. The full Board of Directors should consider changes to significantly limit the authority of the Executive Committee, but then this committee has the same powers as the full board.

Solution:

Additional restrictions in regards to the authority of the Executive Committee and the responsibility of the Board of Directors should be clearly defined and implemented. The Board of Directors should be supplied with a complete set of financial statements and meet on a monthly basis to review those statements for completeness and accuracy.

The intercompany receivables and payables between CORN and CARD were not recorded.

Solution:

Intercompany accounts should be reconciled monthly.

The records for CARD indicated that CARD funds were used to pay CORN bond obligations.

Solution:

CARD and CORN were separate entities. From a legal, accounting, and ethical standpoint this action should not have occurred. Each organization should be held responsible for its obligations. It is highly unlikely that CARD would be a guarantor on debts of CORN.

The note payments for CORN did not match supporting documents and most paid invoices were not defaced. If the invoices are not defaced upon payment, duplicate payments may be made.

Solution:

Payment should be made using the original invoices and the invoice should be defaced and marked with the date it was paid and with the check number it was paid with.

Credit cards for the organization had been issued in Jefferson's name. In examining the credit card receipts, \$17,433.21 were questionable as expenses for CORN. These questionable items included travel and lodging expenses, meals, office supplies, clothing, gifts, books, antiques, and some unidentified. All directors have corporate credit cards and are supposed to submit receipts prior to CORN's payment.

Solution:

Corporate credit cards should only be supplied to employees for necessary travel expenses. All other expenses should be paid for by the employee and reimbursed after adequate documentation is provided.

The payments to taxing authorities were made late.

Solution:

Install a computerized accounting system to track when payments are due to prevent untimely filing of tax payments.

Four of five nutrition program reports were submitted late.

Solution:

Find the reason for the late submissions. Was it due to human or internal control error? If it was human error then educate, penalize or replace the human. If the late submission was a system error install a computerized accounting system to track when reports are due to prevent untimely filing of reports.

RASCAL-MILDEW, INC.: A CASE OF THE INVENTORY HOT POTATO

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CASE DESCRIPTION

The primary subject matter of this case is Inventory Management in a high tech company with a very short product life cycle due to continual product improvements. Rascal-Mildew Inc. went from one of the best managed companies in the U.K. to a company that ultimately succumbed to competitive forces, lead by severe inventory problems. The case has a difficulty level of undergraduate seniors in Operations Management or Auditing and/or graduate level MBA Operations Management or MACC Cost Accounting and/or Auditing programs. The case is designed to be taught in one class (one hour and fifteen minutes), assuming cases are presented in groups of four students, with a fifteen minute presentation per group and fifteen minutes wrap up by the instructor. Student workload should be expected to be eight hours per group or roughly two hours per group participant at the undergraduate level. Workload should increase to ten to twelve group hours at the graduate level.

CASE SYNOPSIS

The case presents students with a combination of quantitative and qualitative aspects of Inventory Management. The products' high tech nature and unusual short life cycle should have made inventory management a serious priority in the company. The company lacked any detailed sales plan that could be driven down to specific product configurations for manufacturing to produce. This lead to the Manufacturing organization building what it thought would sell due to the Sale organization's reluctance to accept Inventory level and mix responsibility. Students should examine the role of the Sales organization in forecasting sales and inventory levels and tie this information to product life cycle.

At the same time, Manufacturing was combating increased automation to reduce direct labor costs leading to excess capacity. This was evidenced by the Labor Efficiency report. Manufacturing management's response was to increase efficiency by building more inventory, instead of laying off direct labor. In addition, during this time a Manufacturing Resource Planning (MRPII) implementation was underway throughout the organization. Students should be able to pick up the change in the WIP aging, indicating a much better priority planning process than pre-MRP times.

Further complications can be examined related to the audit-client relationship. This aspect could be explored at the graduate level so students can better understand the "political" nature of the audit relationship. The circumstances could also be examined in a post Sarbanes-Oxley environment where students understand how the audit-client relationship may be different. Lastly, the student is faced with the reality of considerable excess and obsolete inventory and how to financially cope with the effects of writing it off the books.

This case was prepared solely to provide material for class discussion. The author did not intend to illustrate either effective or ineffective handling of a managerial situation. The author has disguised all names and other identifying company information to protect confidentiality.

INSTRUCTORS' NOTES

Teaching Objectives

Inventory represents one of the largest assets for many companies and one of the worst managed. Students need to be exposed to both the quantitative aspects of inventory management, such as JIT, ERP, and EOQ, but the qualitative aspects can be more difficult to understand.

The Sales forecast is the most important plan in an organization. For a manufacturing company, the Sales forecast must be in sufficient detail for Manufacturing to translate those requirements into physical products. Therefore it is not sufficient for the Sales forecast to be equal to last years' sales plus 10%. Manufacturing must know which products are going to be obsolete, which will be increasing and decreasing in sales, and which will require new manufacturing methods in production. Rascal-Mildew Inc. did not produce a detailed sales plan, driven down to the product level and instructors should expect students to identify that deficiency and provide recommendations.

Typically, one organization is responsible for this level of detail and that is the Sales organization. From the case dialog, it is clear Sales only wanted to sell product and therefore the Manufacturing organization became both the custodial agent responsible for inventory and Sales forecasting organization by default.

Over-producing product with a very short life cycle can result in serious financial consequences for any company. As inventory levels began to build, it became evident to both internal and external accountants there were problems. Accounting rules state that inventory must be valued at the lower of cost or market. Therefore, as inventory continued to build and not be sold and newer, faster products were produced, all the inventory that was more than one year old was essentially obsolete and could not be sold – not even for cost. This fact required Nick to write down a substantial value of inventory to zero – a negative Income Statement effect.

ISSUES FOR EXAMINATION

Immediate Issue(s)

Nick's initial dilemma is dealing with the issue of what organization(s) is/are responsible for Inventory. While Inventory valuation remains the domain of the Finance organization, the responsibility for appropriate levels of inventory for raw material, work-in-process, finished goods, off-lease equipment and orders shipped, unbilled remain unanswered.

Basic Issue(s)

Inventory responsibility and accountability, Demand Planning and Forecasting, Scheduling, Product Life cycle as it affects Inventory Planning, Audit issues and the Audit relationship**.** Students should be expected to research Inventory responsibility and accountability from an organizational perspective. A good source of information is the American Production and Inventory Control Society (APICS) website at www.apics.org. Additional sources of information should be Sarbanes-Oxley related and instructors are free to choose their favorite sites.

Suggested Student Assignment

There are a number of aspects that should be examined in this case and equal weight should be considered. Please read Disclaimer before proceeding as this note identifies the actual company. It should be stressed that students do not spend time trying to find financial statements related to Racal-Milgo Inc., Racal-Datacom, or Racal Electronics Ltd. Existing support financial data should provide an adequate basis for both quantitative and qualitative evaluation. Following are the areas that should compose the student perspective and response.

- **How did Rascal-Mildew get to this point?**

  There are a number of issues the student should be exploring including the following:

  - **Lack of responsibility and accountability for overall Inventory levels.**

    Typically, the sales organization is responsible for the level of inventory in an organization. Sales typically will set a desired customer service level, expressed in stock-outs. A 95% customer service level would suggest 5% of the time, a company will not be able to fill a specific order immediately. As the desired customer service level increases, say to 99%, the level of inventory required will increase geometrically.

♦ **Failure to establish a given customer service level related to product availability.**

Sales wants all orders filled immediately but due to financial, capacity and other organizational constraints, a 100% customer service level is not possible. Failure to set any specific rate and track it to performance, leads the Manufacturing organization to make whatever it thinks will sell and in quantities that maximize production facilities and reduces cost per unit. Unfortunately, if you produce the wrong products in the wrong quantities, you are left with high levels of inventory that customers do not want.

c. **Poor priority planning as evidenced by the Aged Work-in Process report.**

Students should identify a significant change in the Manufacturing WIP aging report from 1985 to 1986. This change is the result of the implementation of the MRPII system which helps Manufacturing Management better prioritize what to work on. There is still a problem with Engineering WIP and although the overall number is relative low, it represents yet another symptom of poor priority planning and the possible effects of changing engineering designs as the product is being produced.

d. **Product commoditization – as modems increased in speed and reduced in size, the product life cycle became shorter and shorter. As a result, investment in inventory should have been less. More attention could have been paid to reducing lot sizes in production.**

Students should be able to relate product life cycle concepts from their Marketing class to any high tech product such as the popular iPod. Customers that purchased the initial iPod were stunned to learn the next generation iPod came with a video screen and came double the capacity of their units purchased just six months ago. Apple initially handled that problem poorly but then began to give its existing customers a rebate for the upgraded models. Of course, this result came at significantly reduced margins for Apple.

e. **Students should examine both Overtime and the Efficiency Reports for revealing trends.**

Manufacturing management is seeing the negative effects of the Efficiency report with a low occurring in P5. Students should be able to make the case that Manufacturing management is now becoming more effective with their use of D/L but all they are really doing is building more inventory. More inventory growth means the possibility of greater excess and obsolete inventory in the near future, but it makes Manufacturing management look good. Students can also examine the OT Report and note a reduction in OT. Again, the connection here is unless the OT is utilized for current product that ships in the Period, it is usually wasted in building unnecessary inventory. Another possible explanation for the OT is reworking the product on the shop floor from one configuration to another in order to meet actual customer demand. These costs are very expensive and result in many cases from the lack of any detailed sales forecast and MRPII system. Anytime students see “RE” in front of a work, it typically implies doing something over again and this is no exception. The only way for Manufacturing Management to stay ahead of customer demand is to partially build product and then hope they guess correctly. If not, then they have to spend labor to reconfigure product.

f. **What should Rascal-Mildew do regarding the current Excess and Obsolete analysis yielding a $65mm write off?**

This is probably the easiest answer and the most difficult answer for students. The easy answer is to follow GAAP and write off the $65mm and from a textbook perspective, this is correct. In the real world, there are huge consequences for this action. For the CFO, it would likely be the last entry written as S/he is escorted out the door. It is likely the blood-letting will not end with just the CFO. Indeed, all the senior management is culpable and responsible for the problems. Therefore, the best initial alternative would be for Nick to let the auditors do their job and require Rascal-Mildew Inc. to properly state the value of their inventory. Unfortunately, even the auditors have some culpability in allowing the problem to build over a number of years, only to get past the point of anyone’s ability to financially manage the problem to a successful conclusion. The auditor’s culpability rests in the fact that the ongoing large consulting engagement at Rascal-Mildew Inc. presented a probable conflict of interest and diminished auditor independence. Students should contrast the change in rules related to auditor independence and consulting engagements.

g. **What can Rascal-Mildew do to better manage Inventory in the future?**

Expect recommendations related to a group planning function whose output should be a time phased, product level detailed production plan. The plan will need to assume a given customer service level, implying some stock-outs. This document should be tested to see if capacity is available to produce the plan in terms of labor, materials, capacity, skill requirements, cash needs, and so on. Students should insist on examining current practices of maintaining a residual balance for modems coming "off-lease" and these should not be carried on the books with value. This policy will have immediate effects going forward, assuming the existing values are written off.

h. What was/should be the Auditor's role?

Students need to understand the relationship of the external auditor to the company and the concept of independence. The problem did not happen overnight, but it would appear the Auditors continued to work with management so the problem would be "managed" over time.

DISCUSSION QUESTIONS FOR USE IN CLASS

1. Who should be in charge of the levels of Inventory in this or any company?

This can be a complicated question. Inventory levels are certainly a function of the service level a company wishes to provide its customers. The decision of an appropriate service level should be a senior management team responsibility. Many factors need to be considered such as manufacturing capacity, inventory storage facilities, product life cycle, technical and functional obsolescence, competition, and the financial impact with special regard to cash.

2. What should Nick's role be in this process?

Clearly as one of three company Controllers, he has a certain level of responsibility to bring the issue to senior management.

3. How might the audit partners conduct themselves in a post Sarbanes-Oxley environment?

While this case is not related to "accounting", students can better understand the impact Sarbanes-Oxley has had in many public companies.

4. How would the successful implementation an ERP system affect inventory planning?

Students should be responding that MRPII, is a subset of an ERP system. MRPII provides a priority planning system for order fulfillment. In addition, the implementation process rationalizes the need for sales forecasting at a detail level sufficient for Manufacturing Management to turn into a Production Plan.

Case Analysis

This case demonstrated how one of the best managed UK companies was ill prepared to deal with the rapid change of technology and how those changes demanded a pragmatic approach to Inventory Management.

Inventory problems were evident based on the company's turnover ratio which was about 1 to 1 when Nick first began at Rascal-Mildew Inc. As a new person, Nick's initial concerns were to get a better understanding of his job and how the company operated before voicing such serious concerns to senior management. His boss, Fernando Lopez was apparently aware of the Inventory problems judging from his reaction to the E&O analysis and also his prior conversations with both audit partners.

Senior Manufacturing management appears to have been focused more on getting product out the door, rather than concerned with the growing inventory levels. Ray Bucci positioned manufacturing's responsibility as "custodial" and this is not by coincidence. Intuitively, he believes that responsibility should be driven from a detailed sales plan, at the product level. Given the strong personality of Ken Matty, the Sales V.P., and the apparent lack of involvement from the President, Ed Blottner, Ray was not in a political position to take on that fight.

The auditors should have dealt with the problem in prior year audits but there were a number of mitigating issues here. First, C&L had a very close relationship with Rascal-Mildew's senior management team. This case pre-dates Sarbanes-Oxley and given the large concurrent consulting engagement that was being conducted, C&L's independence was likely compromised. If the product were stable and not prone to numerous engineering changes and technology advancements, the company could have worked down the excess inventory over time as the pervious audit partner had tried to do.

Disclaimer

The actual name of the case company is Racal-Milgo, Inc. a wholly owned subsidiary of Racal Electronics Ltd., a United Kingdom based company. Racal-Milgo, Inc. existed during the timeframes mentioned in the case history and no longer exists today. Students may or may not make that connection as the name of the company had changed in 1991 to Racal-Datacom although a Racal-Milgo Ltd. also existed concurrently in the United Kingdom. The History Section of the case write-up is derived from the websites listed in the Reference section and while many details are directly taken from these sources, any mentioned names have been changed. The author also worked at Racal-Milgo Inc. from 1981-1986 and had first hand information related to the case. Case details do not necessarily represent actual outcomes and/or behavior but illustrate several scenarios expressed during that time. All names related to employees have been changed to protect confidentiality.

REFERENCES

http://www.answers.com/topic/racal-datacom-inc?cat=biz-fin

http://www.referenceforbusiness.com/history2/78/RACAL-ELECTRONICS-PLC.html

PURAC ENVIRO-FILTER COMPANY

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CASE DESCRIPTION

The primary subject matter of this case is the pricing of consumer goods in International Markets. Secondary issues include price discrimination by small firms in foreign markets; product differentiation in international markets; branding and price discrimination. This case has a difficulty level of 3-4 and is targeted at business students in a first course in international business or international marketing. The case can be used either as a functional case on pricing in the international environment, or as a study in exporting. One hour of class time should be sufficient to handle the case discussion and students should budget 2-3 hours of time for case preparation.

CASE SYNOPSIS

The PURAC Enviro-Filter Company is a small manufacturer of air filters located in southern Florida, USA. Diana Page, the firm's marketing manager is in the process of determining her target price for the upcoming year for their most profitable product, the F-18 filter. Just as she was finalizing her recommendation, one of her salespeople approached her with the possibility of entering into a contract for a distributor branded sale to Russia. This would be a new market for her company. The price offered by the Russian mass merchandiser is much lower than that charged for branded PURAC filters in the domestic market. This new market opportunity complicates Diana's decision process. She must decide at what price to offer her goods for sale at home, and consider the relative advantages of the new offer presented by the foreign market proposal. She must decide the probably effect of these additional sales on the firm's profitability and what conditions to negotiate with the Russian company if PURAC decides to accept their offer.

INSTRUCTORS' NOTES

Case Summary

Diana Page, marketing manager for PURAC Enviro-Filter Company, is in the midst of determining her pricing strategy for the F-18 filter for the coming year. She must perform certain calculations, for which all numbers are indicated in the text of the case to determine break even at the various possible prices and the profit maximizing price for the firm. Her first task is to fill in a table of cost and revenue figures for the sale of branded F-18 filters in the U.S. market and determine the optimal profit maximizing price for the firm. Then she must further analyze the effect of a proposed sale of additional filters in the Russian market as dealer branded filters. The additional sales are, of course, at a much lower price than would be possible in the home market and forces the students to explore the idea of marginal cost pricing utilizing price discrimination between this new market and her core market at home.

The case provides an opportunity for the student to apply knowledge of price discrimination in markets, and to explore some positive effects of international sales on the bottom line of the company.

The case is entirely fictional and was written to assist students in understanding some of the complexities of international marketing, branded vs. unbranded products, and price discrimination between markets.

Earlier versions of this case were published:

In the 2006 Proceedings of the Society for Marketing Advances: Richard J. Sjolander and David Eppright, "PURAC Filter Company: Pricing in the Face of Uncertainty," *Advances in Marketing: Linking Organizations and Custome*rs, William J. Kehoe and Linda K. Whitten, editors. Mobil, AL: Society for Marketing Advances, 2006, pp. 89-91, and

In the Fall, 2007 Proceedings of the Allied Academies: Richard J. Sjolander and David Eppright, "Purac-Enviro Filter Company: Pricing in the Face of Uncertainty: A Preliminary Analysis," *International Academy for Case Studies Proceedings,* 2007, pp.57-60.

CASE QUESTIONS

A. How would one characterize the nature of demand in the U. S. market? They discuss the market in terms of the four types of market demand structures (competitive, monopolistic competition, oligopoly, monopoly) and identify implications for PURAC Enviro-Filters in terms of the use of the various marketing mix variables in the market under each type of competitive situation. Please develop this analysis. Include in your discussion of each of the types of demand structures, as well as the various characteristics of the market for specialty filters that affect your decision as to the nature of the market (type of competitive environment

As there are four domestic competitors in the industry, this firm could be competing in either a monopolistic competition demand structure, or an oligopoly demand structure, judging strictly on the basis of numbers of competitors. It is clearly not a competitive market with only four firms controlling the entire market, and, at the same time this is far too many firms to consider the industry a monopoly.

Looking closer at the statements in the case, we note that the products being sold by the 4 firms are closely related, but can be assumed to be at least somewhat differentiated at the same time. The demand curve in this market, while downward sloping to the left, as expected, has a relatively inelastic range at the current price. This is especially noticeable if one considers lowering the price from the current optimal price of 7 dollars. This analysis should lead students to choose an oligopoly as the expected market structure, though many will probably choose monopolistic competition, too. The products may well be classified as heterogeneous shopping goods on the basis of the demand schedule slight differentiation among products; i.e., they are close substitutes but not perfect substitutes so demand cannot be perfectly elastic.

This firm would not be a monopoly, as there are other firms involved in the industry. Finally, it would not be involved in a perfect competition demand structure because the firm is experiencing profits. The firm is also setting its own price. In perfect competition, the firms are price-takers, not price-setters.

B. Recreate the table she calls her forecasting spreadsheet, calculating the missing data points. This information should prove critical in answering the questions faced by PURAC Enviro-Filters in terms of its decisions in its markets.

Table 2: Forecasting spreadsheet

Price in Dollars	UNITS	Variable Cost	Fixed Cost	Total Cost	Total Revenue	Break Even pt.	Profit
$4	3000000	$2.20	$5,300,000	11,900,000	$12,000,000	2944444	$100,000
$5	2000000	$2.20	$5,300,000	9,700,000	$10,000,000	1892857	$300,000
$6	1800000	$2.35	$5,300,000	9,530,000	$10,800,000	1452055	$1,270,000
$7	1600000	$2.50	$5,300,000	9,300,000	$11,200,000	1177778	$1,900,000
$8	1300000	$2.50	$5,300,000	8,550,000	$10,400,000	963636	$1,850,000
$9	900000	$2.90	$5,300,000	7,910,000	$8,100,000	868852	$190,000
$10	500000	$3.10	$5,300,000	6,850,000	$5,000,000	768116	$1,850,000

C. Why might Diana be interested in knowing the break-even quantities at the various proposed prices? What does this information tell her?

The break-even points show the volume that must be sold at each price to cover all fixed and variable cost. Exact sales can not be forecast. Thus, break-even gives us an idea of the minimum quantity that must be sold to not lose money.

D. What is the profit maximizing volume for PURAC Enviro-Filters to sell under its own brand name in the U. S.? At what price should they sell specialty filters, and what is the expected profit?

The profit maximizing volume for PURAC to sell under its own brand name in the U.S. market would be 1,600,000 units, at a price of 7 dollars per unit. This would generate an expected profit of $1,900,000.

E. Should PURAC Enviro-Filters try for the Russian sale? Back up your answer with analysis (meaning that specific numbers and reasoning should be shown).

Yes, PURAC should try for the Russian sale. This is the correct answer for several reasons.

First, the firm is already covering its fixed cost in the domestic market and can be assumed to produce the additional units in its current facility without incurring additional fixed cost.

Second, producing 200,000 additional units will allow PURAC to lower its current variable cost. Producing 200,000 additional units will make the total production equal to 1,800,000 units, a level which falls into the 2.35 dollar variable cost range, instead of the 2.50 dollar variable cost currently experienced. This means that for each of the 1,600,000 units sold in the U.S. market, the firm will lower its cost by 0.15 dollars per unit due to the Russian sales.

Third, the additional (marginal) cost of producing the additional 200,000 units will be the variable cost incurred = 2.35 dollars per unit plus the 0.50dollars per unit in additional shipping and insurance cost. 2.85 dollars per unit is much less than the proposed selling price of 3.25 dollars.

F. What would the bottom line effect be of the additional sales be on revenues, costs, and profits from the units sold by PURAC Enviro-Filters both under its own brand and the dealer brand in each country?

Table F-1
Additional profit on current output = (1,600,000 * 0.15) = $240,000 And Profit on Russian sales = ($3.25-$2.85) x 200,000 = $80,000 TOTAL CHANGE IN PROFIT $320,000

Table F-2
Alternately, students could compute Total Cost and Total Revenue to come up with the same final answer. Revenue on domestic sales =(1,600,000*7) = $11,200,000 (Increase) Additional Revenue = (200,000 * 3.25) = $650,000 Less Variable Cost = (1,800,000*2.35) = $4,230,000 Fixed Cost = $5,300,000 Equals Total Profit = $2,220,000 Less profit from only selling in the U.S. = $1,900,000 Incremental profit from Russian sales = $320,000

G. What sorts of guarantees would PURAC Enviro-Filters Company want from the retail chain purchasing the filters for sale in Russia? Please be specific as to the sorts of contractual arrangements PURAC might want from the Russian company that would make the eventual contract more attractive to the U.S. company and the reasoning behind your various suggestions.

The main guarantee that PURAC Enviro-Filter would like to receive from the retail chain purchasing the filters for sale in Russia would be that the buyer would not allow resale of these filters in the U.S. PURAC would not be able to price discriminate between the two countries if this were to happen. A second condition might be that the Russian company would not reveal the name of the manufacturer of the filters. A third condition could be that the Russian purchaser would only sell filters in the Russian market, or even in a certain area of that market.

H. What might lead the Russian buyer to offer to sign a contract for the filters in U.S. dollars instead of Russian rubles? Discuss how this affects the risks for each company.

There are many answers to this question – none of which appear in the text of the case. One common suggestion is that the Russian buyer sees this as leverage in extracting the extremely low price they are offering to pay for the filters. A second could be that they are aware that PURAC has not dealt internationally, and they see this as something they can offer to make the deal less risky for the American firm. You will note that these two potential answers are quite similar. They both revolve around reducing risk for the seller – something for which we would assume the buyer would want to be compensated.

KOHL'S DEPARTMENT STORE: FASTEST GROWING RETAILER IN 2007

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Cathleen Folker, University of Wisconsin-Parkside

CASE DESCRIPTION

The primary subject matter of this case concerns an overview of the U.S. retail industry and specifically addressing an in-depth view of the Kohl's Department Store strategy. This case is primarily based on secondary source information and is ideal as a leadoff case for business undergraduate students (level 4) to demonstrate their ability to interpret basic strategic planning concepts. The case was written to provide an opportunity for students to 1) apply Porter's Five Force Framework to analyze the impact of the competitive forces on industry attractiveness, 2) prepare a thorough SWOT analysis to assist in developing potential strategic options, and 3) practice evaluating an organization's strategy. The decision focus of the case centers on what strategy can sustain a competitive advantage given the high level of consolidation within the retail industry. The case is designed to be taught in 2 class hours and is expected to require 6 hours of outside preparation by students.

CASE SYNOPSIS

The retail industry is in a state of flux, marked by a high-level of consolidation and new partnerships. The long-term trend of consolidation and intense competition for the mass market has been especially difficult for the traditional department stores as the popularity of the shopping mall declines while big-box discounters and specialty stores become more attractive alternatives. Amidst the recent restructuring arises the need to transform the competitive landscape; executing a well defined corporate strategy will be a key factor in determining which retailers will stay on top.

Making headlines with its aggressive five-year growth strategy, Kohl's Department Store continues to capture the attention of the public and investors alike. After years of retail consolidation, how does Kohl's manage aggressive department store expansion? Will the Classic American Family be able to "expect ***great*** *things" from Kohl's ten years from now or will the department store overextend itself and relapse into stagnant sales growth?*

INSTRUCTORS' NOTES

Overview

The U.S. retail industry is once again in a transition state surrounded by mergers and on-going consolidation activity. The traditional department store may soon find itself wedged between low-end discounters and high-end retailers while struggling to revitalize itself as the preferred one-stop shopping destination. With consumers more educated, time-conscious and value-oriented, discount stores, specialty shops, and on-line shopping have become increasingly popular retail channels replacing the old fashioned enclosed shopping mall. In order to encourage sales growth and survive, department stores must offer merchandise that is valued and distinctive while meeting customer service expectations. Focusing on differentiation will separate their stores apart from other shopping destinations in a highly competitive industry.

Based in the Midwest, Kohl's Department Store has expanded to operating 834 stores across 46 states since 1962. The family-oriented store maintains its core concepts of brands, value and convenience for the middle-income family by offering competitively priced apparel and home product/houseware merchandise. The retailer strives to exceed the expectations of women aged 35 to 44 with children which represents a 6.1% share of retail sales totaling $4.7 trillion in 2006.

Central to the Kohl's strategy is providing exclusive and private labeled merchandise that competes primarily with mid-tier retailers. In effort to increase same-store sales figures and attract new customers, Kohl's will continue implementing feasible department extensions that will differentiate itself in effort to become the preferred, one-stop shopping destination. The "Only At Kohl's" and "Expect Great Things" marketing jingles are backed by the retailer's mission statement: "To be the leading family-focused, value-oriented specialty department store offering quality exclusive and national brand merchandise to the customer in an environment that is convenient, friendly and exciting."

To further enhance the shopping experience, the retailer will apply its three-prong prototype approach to new store locations and redesign existing locations to make the shopping experience more enjoyable. New locations will primarily be located in suburban neighborhoods where Kohl's core target segment resides. The free-standing stores offer easy access, ample parking, and a race track floor plan with centralized checkouts for the convenience of its core customer, "her." The interior redesign efforts include remodeling restrooms and service counters, widening isles, adding additional directional signs and larger fitting rooms with lounge areas. By 2010, Kohl's plans to operate 1,200 locations by opening 100 stores annually, making it the nation's fastest growing retailer.

Recommendations for Using the Case

The focus of the Kohl's Department Store Case Study is twofold: first, an overview of the U.S. retail industry and second, a more in-depth view of the Kohl's Department Store strategy. This case is primarily based on secondary source information and is ideal as a leadoff case for business undergraduate students to demonstrate their ability to interpret basic strategic planning concepts. The case was written to provide an opportunity for students to 1) apply Porter's Five Force Framework to analyze the impact of the competitive forces on industry attractiveness, 2) prepare a thorough SWOT analysis to assist in developing potential strategic options, and 3) practice evaluating an organization's strategy. The decision focus of the case centers on what strategy can sustain a competitive advantage given the high level of consolidation within the retail industry.

The Kohl's case study can be used effectively for a written or an oral assignment. Students who complete the case assignment questions prior to class should be well prepared to contribute insightful responses to classroom discussion. The case questions and answers are not intended as a complete set of options or responses but rather as a vehicle to demonstrate strategic thinking and to strengthen practical application of strategic analysis tools. The questions were designed for the purpose of getting students off on the right foot in understanding basic strategic concepts and how to think strategically about a company. The case contains a wealth of information regarding the current state of the retail industry as a whole, including economic factors which influence purchasing decisions. Student familiarity with discount stores, specialty stores, and shopping malls will aid in their comfort level, ability to identify competitive issues, and generation of feasible alternatives.

Building a competitive strategy is about devising and executing a plan that will differentiate one's organization from its rivals by offering customers a unique service and/or merchandise as a way to effectively compete. In preparing for class discussion and/or a written case study, students should be asked to identify and develop potential strategies that take advantage of industry opportunities while building on the strengths of the Kohl's Corporation. As alternative solutions unfold, encourage students to evaluate each alternative and prepare a defense for the chosen path forward. Short-term and long-term goals for achieving the recommended course of action should be clearly defined and include timeframes for completion. When applicable, assigning responsibilities to functional areas within an organization will simulate accountability in executing the chosen strategy.

TEACHING OUTLINE AND ASSIGNMENT QUESTIONS

1. **How has the U.S. retail industry changed over the past three decades? Apply Porter's Five Forces Framework to describe the current state of the industry. What are the leading economic factors influencing the retail industry?**

The U.S. retail landscape has undergone significant change over recent decades. The downtown stores of the 1970s lost market share to more centralized shopping mall structures which offered a variety of selections under one roof. Following the rise of home development in less urban areas, shopping malls were typically located in suburban neighborhoods. During the 1980s, the malls began losing favor to more economical shopping destinations, the manufacturer outlets, which competed on price and offered an array of discount bargains during economic slowdowns. These outlets continued to benefit as more retailers strived to serve the value-oriented consumer. Retail outlet centers and large discount stores began popping-up while high-end retailers in downtown districts remodeled and formed downtown shopping destinations to attract clientele. Revitalizing locations however was not enough to combat the growth of strip malls, increase in catalog sales and growing popularity of on-line shopping as a result of the Internet in the 1990s. Today, closings and consolidations are commonplace since competition has stiffened; consumers have multi-line retail channels to suit their needs.

Porter's Five Forces Framework can be applied to the retail industry to provide an understanding of the current competitive state and a solid basis for students to begin formulating strategic suggestions. As a $4.7 trillion industry in 2006, retailers need to be conscious of the environment in which they operate to be better equipped to respond to industry change. Porter's Framework is one analytical tool that can be utilized by students to make an industry assessment which considers the impact of the power of customers, power of suppliers, threat of new entrants, threat of substitute products/services, and jockeying for position among current competitors.

Power of customers

Although more product differentiation reduces buyer power, consumers are more sophisticated, time-conscious and price sensitive which suggests more buyer power. If consumers can't find what they want at an acceptable price, they will shop elsewhere. Additionally, shopping has been coined "An American Pastime," especially for youth, singles, and empty nesters which typically have more disposable income. Basic necessities in both apparel and housewares can be purchased at any number of shopping destinations.

Power of suppliers

As the number of department store retailers continues to decline through acquisitions and consolidation, merchandise suppliers are also losing foothold. Fewer department stores which are capable of placing large merchandise orders exist, intensifying competition for suppliers. Additionally, as retailers continue striving to differentiate their brands, vendors who fail to design and deliver unique merchandise that meet the consumers' demands will likely struggle. Competition among suppliers has heightened as the number of retail chains continue to consolidate; fewer opportunities are available to land exclusive brand agreements. Department stores ultimately decide which lines of merchandise fit their product mix selection.

Threat of new entrants

Historically, barriers to entry have been low in the retail segment. Numerous retail shopping destinations have popped-up as U.S. citizens continue to prosper. However, department stores in particular have been on a downswing in popularity as large discounters and specialty stores gain the spot light. With the increase use of the Internet, those seeking convenience have turned to cyber shopping as an alternative. Today department stores are faced with increasing threats of consolidation and acquisitions, making the likelihood of new entrants a relatively low threat.

Many surviving corporations are restructuring their operations to become more competitive. Retailers are looking to 1) maximize economies of scale, 2) transfer knowledge and share best practices among locations, and 3) strengthen their leveraging position as powerful buyers. Larger budgets are being allocated to national advertising and marketing campaigns to draw consumers inside, making it more difficult for smaller organizations to compete. Additionally investments in distribution centers for store replenishment and direct-to-consumer processing and building new store locations or upgrading existing sites have become commonplace. Barriers to entry for retailers have clearly risen.

Threat of substitute products

The general public no longer sews its own clothing as done in former generations indicating few substitutions for apparel. Although "hand-me-downs" are still common, especially among pre-school and grade school aged children, the threat of substitution for apparel and home products is relatively low. Interestingly though, resale shopping (purchasing gently used clothing) and rummage sale shopping for unique housewares and children's toys have become popular trends. Often sighted in women's magazines are articles that feature how to transform "another's trash" into your own treasure as recycling and environmental awareness programs continue to capture the public's attention.

Jockeying for position

Competition among retailers is high. Consumers have an endless choice of shopping destinations to meet their fancy. Mid-tier department stores as mall anchors such as Sears and JC Penney are on the decline whereas specialty stores located in lifestyle centers are rising in popularity. Some analysts believe department stores are being wedged between the high-end retailers and the low end discounters and warehouse clubs which cater to customers seeking value deals. Whether destinations are discount stores, specialty shops, town centers, or the Internet, consumers have the flexibility to shop when and where they please. Today's consumer tends to be more price and time-conscious, forcing retailers to adjust their strategies to meet consumer demands if they are to survive. Furthermore, brand-building of larger, national chains provides retailers an advantage over smaller, independent or regional companies who just don't have the financial means to advertise as effectively. As fewer firms increase their size and power, competitive advantages for these companies are a likely result.

Consumer spending is directly related to economic factors which influence discretionary income. With a weaker U.S. dollar, one's purchasing power is challenged especially during present times when financial pressures from rising interest rates, higher costs of health care, and escalating energy and fuel costs are so prevalent. These factors indicate a slower economy since consumers tend to tighten their purse strings in order to cover the basic necessities. Discount retailers are impacted more severely than high-end retailers since their target market has less discretionary income for apparel and houseware purchases to begin with. Likewise, with only modest levels of income growth, a somewhat stagnant job market, and a declining housing market, consumer spending habits tend to reflect the uncertainty of the times.

2. What would a SWOT Analysis for Kohl's Department Store entail?

Internal Analysis

Strengths

- ♦ Publicly traded organization and favorable financial performance permits store expansion and opportunities to invest in new markets
- ♦ Solid reputation for offering quality merchandise at fair prices
- ♦ Exclusive and private label merchandise provides highly valued product differentiation
- ♦ Ownership of nine distribution centers and one e-commerce fulfillment center

- Emotional tie to serving the "Classic American Family" through financial contributions, scholarships, community service, and merchandise fundraisers for schools, hospitals, and non-profit organizations
- Dedication to product extensions of popular apparel brands into home collections lines
- Free-standing structure and race track floor layout offers customer convenience, locks-out competitors, and minimizes premium property expenses
- Ability to operate on a national level enhances efficiencies, reduces advertising expenses, attracts professional talent, and generates greater leverage with suppliers

Ideas to build on strengths

- Experiment with offering a café in prototype stores
- Expand merchandise selection to offer gourmet food stuffs and related packaged gifts
- Solicit employees and families to showcase in an in-store, back-to-school fashion show

Weaknesses

- Lack of services offered such as salon, eyecare, photography, and custom decorating
- Website primarily features "basic" products, thus limits access to exclusive merchandise
- Limited prime real estate locations for new suburban, stand-alone store locations
- Fifty percent of merchandise mix is "basics" which can be purchased at discount stores
- Reliance on domestic market

Ideas to minimize weaknesses

- Expand website to include broader range of merchandise mix and offer in-store pick-up for on-line orders
- Occupy mall anchor locations with spin-off business that offers family-oriented services
- Open stores in new markets such as in Puerto Rico, Canada, and Mexico

External Analysis

Opportunities

- ♦ Consumers have become more sophisticated, time-conscious, and price sensitive
- ♦ Internet sales are rising fourfold faster than traditional retail formats
- ♦ Media coverage on sour mergers, unfavorable reactions to change, and competitor strategic plans provide insight to industry-wide trends and pre-emptive strike ideas
- ♦ Reorganization efforts provide a time-factor edge in the short-term; lag in competitor profitability typically results
- ♦ Duplication of stores in close proximity as a result of mergers may lead to closings and an overall reduction in number of shopping destinations
- ♦ Consolidation aids growth strategies for controlling firms, providing learning curve and economies of scale benefits
- ♦ Rise in spending habits during the back-to-school shopping season
- ♦ Favorable trade relations as a result of Agreement on Textiles and Clothing Act quotas

Ideas to investigate or take advantage of opportunities

- ♦ Develop a centralized, corporate training center for new hires, professional development, and rollout of new organization-wide support functions/activities (inventory management systems, computer system upgrades, employee benefit registration)
- ♦ Research manufacturing opportunities for large volume items overseas such as the "basics" and search for unique apparel styles to be introduced to U.S. as exclusive brands
- ♦ Employ interns to assist with website development ideas and implementation

Threats

- ♦ Industry consolidation results in fewer firms gaining both strength and leveraging power
- ♦ Stagnant product lines drive consumers to specialty stores and high-end merchants
- ♦ Competition from discounters and specialty stores contribute to a 50% decline in multi-line or department store retailer's revenue
- ♦ Financial pressure as a result of rising energy costs, inflation, and interest rates impacts discretionary spending
- ♦ Decline in popularity of shopping malls affects department stores as mall anchors

Ideas to minimize or overcome threats

- ♦ Employ a task force to research and evaluate stand-alone store locations for acquisition and/or building of new structures
- ♦ Solicit customer feedback on merchandise mix, store upgrades, and customer service
- ♦ Set organization-wide goals to reduce inefficiencies and implement cost-cutting incentives/continuous improvement programs to ensure best value is passed onto customers

3. What are the key components of Kohl's strategy as of 2007?

Students should have little difficulty identifying the key components of Kohl's business strategy. The following outlines the highlights presented:

Expand the number of stores by 20% annually: Credited as the nation's fastest growing retailer, operating 834 stores spanning across 46 states; Aggressive five-year growth plan to operate 1200 stores by 2010, opening new stores at the rate of 100 locations annually

Locate new stores primarily in suburban neighborhoods: Suburban stores represent 93% of new store openings and offer location convenience for Kohl's target market, the middle-income family; Free-standing stores offer easy access, ample parking, and locks-out competitors; Innovative store design follows three-prone prototype model to serve a variety of markets

Customer service: The "3E" quality standard of exceeding customers' expectations (every store, every customer, every time) is an internal measure of employee dedication; Shopping with ease is enhanced by Kohl's website and on-line ordering capabilities, private-label credit card, various denomination gift cards, and life event gift registry opportunities; On-going feedback is solicited to increase customer loyalty and attract newcomers; Race track layout is consistent among locations providing quick access to departments and central checkouts for customer convenience; Reasonable return policy

Attract new customers: Two new segments Kohl's is targeting include the independent taste segment and the self-focused explorer, both non-family oriented women groups (4.5% and 3.1% market share opportunity respectively); Fashion has become equally as important to the merchandise mix as the basics; Launching exclusive "Only at Kohl's" merchandise and private-label apparel are central focal points

Enhance remerchandising efforts: Kohl's continues to emphasize its exclusive and private label brands while downplaying national brands; Successful product lines are researched and considered for product extensions into home collections while the cosmetic and accessory departments continuously evolve; High profile names are being used to develop, launch and promote merchandise such as skateboard icon Tony Hawk, high-profile apparel designer Vera Wang, and television personality Christina Saralegui; Good-better-best strategy categorizes lifestyle segments and identifies product gaps in merchandise offerings; Visual merchandising demonstrates fashion coordination ideas

Redesign and upgrade facilities: Exterior has a more contemporary look, featuring large display windows and earth-toned marble accents as part of the building; Customers directly benefit from wider aisles, additional directional signs, and improved lighting throughout the stores; Relaxed atmosphere is enhanced by an increase in size and in the number of fitting rooms, lounge areas with entertainment and comfortable seating, and newly remodeled restrooms and customer service areas

Reduce operating expenses: Expansion into the development and manufacture of its own private labels; Efficiency in advertising and promotional campaigns along with providing economies of scale from volume discounts as a national chain; Race track layouts and centralized checkouts offer efficiency for vendors and customers; Isolated store locations minimize premiums otherwise invested in real estate and additional costs associated with mall locations such as security and maintenance

Continue to be a leader in the community: Kohl's Cares for Kids Program raises funds through corporate contributions, provides scholarships, and sells fundraiser merchandise for schools, hospitals, and non-profits; Corporation encourages employees to take an active role in their communities by volunteering their time; in 2006, 57 thousand hours were volunteered for charitable events and partnerships formed between Kohl's and 143 hospitals; Kohl's is blazing trails by promoting green power; it aims to convert 75% of its California's store locations to solar power by close of 2008

4. Assess Kohl's financial performance during fiscal years 2002-2006. Do you think Kohl's will be able to sustain its growth goals?

Review of financial statements is an essential component of any company and industry comparison analysis. To evaluate Kohl's financial situation, refer to the data provided in Exhibits 8 and 9 of the case to reveal a number of interesting statistics including:

Kohl’s store expansion

a. Kohl’s has opened 360 new store locations during the past four years.
b. The number of new store openings has been steady but not at the 20% growth rate Kohl’s strives to maintain on an annual basis. Beginning with 2003 through 2006, the number of stores added to the Kohl’s operation each year was 85, 95, 95 and 85 which represents an 18.6%, 17.5%, 14.9%, and 11.6% percent increase respectively.
c. Number of stores has risen from 457 in 2002 to 817 in 2006, a compound annual growth rate (CAGR) of 77.8%.

Compound annual growth rate (CAGR) can be applied to more than just operating data. The formula for CAGR is: [(ending amount / beginning amount) $^{(1/\text{number of years})}$ - 1], and then multiply by 100 to illustrate as a percentage. Application of CAGR will yield the following Kohl’s statistics:

a. Net sales have risen from $9,120 million in 2002 to $15,554 million in 2006, a CAGR of 11.3%.

b. Gross margin has risen from $3,139 million in 2002 to $5,654 million in 2006, a CAGR of 12.5%.

c. Net income has risen from $601 million in 2002 to $1,109 million in 2006, a CAGR of 13.0%.

d. Earnings per share have risen from $1.75 in 2002 to $3.31 in 2006, a CAGR of 13.6%.

Profitability ratios

a. Kohl's and its primary competitors in softline merchandise have gross profit margins well above the industry standard of 28.3%. Gross profit margin (gross profit as a percentage of sales) for Kohl’s in 2006 is 36.35% ($15,554/$5,654).

b. Both operating margin and net profit margins are almost two-fold above industry standards. Operating profit margin (operating income as a percentage of sales) for Kohl’s in 2006 is 11.67% ($1,815/$15,554). Net profit margin (net income as a percentage sales) for Kohl’s in 2006 is 7.13% ($1,109/$15,554).

c. Return on assets (ROA) measures the amount of net income that is generated by every dollar invested in company assets. The higher the ROA, the more profitable the company. Kohl's ROA is 10.33 whereas the industry standard is 8.01. Similarly, Kohl's return on investment (ROI) at 15.26 is well above industry standard of 11.91.

Other ratios of interest may include:

a. Kohl's has plenty of short-term liquidity, with a current ratio of 1.77 whereas the industry standard is 1.18. The current ratio indicates that Kohl's is well positioned to pay its maturing obligations and meet unexpected needs for cash in the short-term.

b. Long-term debt to equity ratio is .19 which is relatively low in comparison to industry standard of .49 and key competitors.

Students will realize that Kohl's strategy is yielding acceptable financial performance.

5. What obstacles may Kohl's encounter with its aggressive five-year growth strategy?

Often organizations are consumed by the desire to grow their business which can negatively impact their ability to remain profitable and can result in deviations from the organization's strategy. Kohl's has maintained its desire to grow in store locations by 20% annually and has also demonstrated the desire to broaden its product mix as evidenced by the increased focus on exclusive and private label merchandise offerings. Typically, department stores tend to expand by offering new services, extending product lines, and making acquisitions to reach growth goals. This can be dangerous when Management's actions are not in alignment with the corporate strategy. Trade-offs to growth exist and are to be considered when students evaluate strategic options available. Compromises taken to pursue growth goals can dilute an organization's competitive advantage yielding a loss in focus. Revenue may increase temporarily but not necessarily in relation to profits.

With Kohl's aggressive store expansion plans, the organization may face a number of obstacles including:

- Real estate opportunities and premium prices for prime locations
- Hiring personnel, training and retaining professionals at a sustainable rate
- Impact of consolidation on department store landscape
- Rise of Internet shopping
- Threat of discount stores offering better quality or name brand merchandise
- Lack of adequate infrastructure to support growth

- Dilution of brand reputation

6. As the newest member of the Kohl's Executive Committee, what recommendations would you make to sustain company growth and profitability?

Students should be encouraged to develop strategic recommendations for Kohl's by identifying reasonable options based on the case information and current industry events, evaluating alternatives, and developing short-term and long-term goals to achieve their chosen strategy. The following list provides a starting point for discussion on alternative strategies available:

- Branch out into Canada, Mexico, and U.S. Commonwealth of Puerto Rico
- Employ vertical integration such as purchasing its own fleet of trucks for transportation
- Develop partnerships with international suppliers and manufacturers
- Provide internships for apparel and jewelry designers to assist with rollout of new lines
- Open store locations at outlet shopping centers for overrun merchandise and promotion of exclusive brand merchandise
- Add in-store cafes or coffee shops to prototype locations
- Acquire Mom and Pop businesses which design unique hardline merchandise
- Occupy and/or transform mall anchor locations into stores with specialized services such as eyecare, photography, and beauty salons
- Develop marketing campaign and expand product offerings to include segment catering specifically to college-bound students for dormitory living
- Encourage charitable contributions by holding promotional events that offer customers who donate gently worn Kohl's brand merchandise additional, in-store savings on new merchandise

Stay on course

EPILOGUE

New challenges surround retail department stores during an era of rapid consolidation and new partnerships in the industry. As consumers lean towards other retail channels, department stores will need to revamp their strategic plans to remain competitive. As presented in the case, Federated, JC Penney, and Kohl's are expanding their domestic presence either through acquisition or building new store locations. Although this will present new opportunities to attract customers and gain market share, saturating the market with an influx of store locations is not enough. To be competitive, these retailers will need to develop a solid report with their core target market, the middle-income family, and offer desirable merchandise and customer service levels that exceed customer expectations. Kohl's will continue to broaden its exclusive and private label brands to differentiate itself. With department store chains becoming fewer in number and larger in size, differentiation will be key to survival.

SOUTHEAST SPORTING GOODS: APPLICATION OF INFORMATION SYSTEM PURCHASING PRINCIPLES

Renae Clark, Henderson State University
Todd Green, Weyerhaeuser Company
Paul Robertson, University of Texas-Brownsville & Texas Southmost College
Alan Wright, Henderson State University

CASE DESCRIPTION

The primary subject matter of this case concerns information systems. Secondary issues to be examined include identification of technology issues for a small business and the design of a new system. The case, when used for a RFI and RFP exercise, has a difficulty level of five. The case is designed to be taught in three class hours and is expected to take approximately fifteen hours of outside student preparation.

CASE SYNOPSIS

The company president, to whom Eric reports, gives him his first assignment, "You've got a budget of $230,000 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 or PDAs to enter orders directly from customers. Make a list of what we need in the way of hardware and software. Include everything –"

Students are presented with a business scenario in which they need to have a new information system installed for a small company where a recent graduate has just started working. Students are asked to review the scenario, create an organizational overview to be used as part of a Request for Information (RFI), create a functionality list for a new information system, create an internal memo to justify the expenditure on the new system, and outline what the possible responses to a Request for Proposals (RFP) might be. Included in the instructor's note are guidelines for the use of RFIs and RFPs, complete directions for an assignment, and a completed response. Graduates in the Information Systems area or with MBAs are expected to have an immediate impact on their new company. Many times the graduate is in a newly created position with little guidance from a mentor or more experienced worker. This is especially true for small and medium sized corporations, the very ones that are creating the most new jobs. This case and instructor's note fills *a specific void in the field of applying information systems education. Although aimed at small business situations, the knowledge gained through this exercise is equally or more important to graduates who take jobs in government and non-profit agencies or supplying those offices.*

INSTRUCTORS' NOTES

Case Overview

A new graduate is expected to "hit the ground running" with his first job. The company desperately needs to have a new information system installed. He has been hired by a small company that has fallen behind in the technology field. The current situation is presented as a typical small business that has been doing things in an informal and unsystematic method for several years. The technology is a patch-work quilt of hardware and software systems.

Students are asked to review the scenario, create an organizational overview to be used as part of an RFI, create a functionality list for a new information system, create an internal memo to justify the expenditure on the new system, and outline what the possible responses to an RFP might be.

Recommended Teaching Approach

This case has been used to reinforce the concept of a structured approach to information system development/acquisition for a graduate course taken by Master of Business Administration (MBA) students. While all MBA students are exposed to problem solving, this case is designed to have them apply their problem solving skills to getting a new information system for the company. This case forces the student to follow some of the System Development Life Cycle (SDLC) concepts to solve their problem.

A general instructional approach should include a review of the SDLC, general problem solving skills, and the principles for preparing RFIs and RFPs. This discussion should take approximately three in-class hours. The instructor should give examples of the SDLC steps, general problem solving skills, and well written RFIs and RFPs. A description of the SDLC can be found in *Essentials of System Analysis & Design* (Valacich, George, and Hoffer, 2006). A sample of a possible handout regarding RFIs and RFPs is attached.

Projects are graded primarily for content. Successful students present well-written documents that show the student understands there is a relationship between the organization of the company, its desired system outcomes and the requirements for the system. The successful student includes components that address today's IT issues, such as networking, security, virus protection, etc.

Reference

Valacich, J. S., J. F. George, and J. A. Hoffer (2006). *Essentials of System Analysis & Design (3rd edition).* Upper Saddle River, NJ Pearson/Prentice Hall.

INSTRUCTIONS TO STUDENTS WHEN USING THE CASE AS A RFI/RFP EXERCISE

Using a Request for Information (RFI) and a Request for Proposal (RFP) as part of an organization's purchasing principles consider the Southeast case and generate the following:

Item 1. Create an organizational overview diagram with division descriptions to demonstrate the company structure that will be included in an organized description of the company *to be used as part of a Request for Information (RFI)* to gather information on what options are available. Do *not* develop an entire RFI, only the section on company information. Be sure you give adequate information for the readers to determine the number of employees in each area and the physical office location of each employee or that they do not have an office if that is the case. This information would be needed by someone responding to an information system RFI. (1 page)

Item 2. Create a list of required functionality for a new information system for this situation. Do NOT just repeat the information given in the case and handout, take the information and organize it, supplement it with details you feel have been left out and are necessary to gather the required information about a new system. This might include information Eric should have gathered at the VP meeting. Remember this is to be a list of functions the new system is capable of handling, *not hardware or software or networking equipment*. Again, you are creating *part of an RFI here*, *not* the entire document.

Remember that an RFI is often issued publicly and as a result, your competition may see it. Don't put information in the document that you do not want known or that would reflect negatively on the company. This should be a *very formal and professional document*. In many cases these documents are reviewed by attorneys. Search the Web for "Request for Information" for additional ideas. (1 to 2 pages)

Item 3. Create an internal company memo to the company president that outlines what the new information system should do, the benefits that are expected to be received (e.g. how will it help to increase revenues, lower costs, make the company more efficient, etc.). This document will be used to *justify* the decision to go ahead or not with the new proposed system. Will the system fit in the budget given by the president? Be sure to *justify* why you think these things will happen, preferably with concrete numbers to support your comments. You would need to come up with some reasonable figures to fit the situation. Eric could gain job security if he solves the company's problems and comes in under budget. (1 to 2 pages)

Item 4. What are the possible responses to a Request for Proposal (RFP); that is what types of proposals for a new system might you expect to get if you were to put an RFP out now? An example would be "No responses received, the company will need to design, purchase, create, and install the system with in-house staff." Describe at least two other options to an RFP. You should be able to answer this with three to four points, including the one mentioned here. (1 page)

Suggested RFI/RFP handout:

Request for Information

A Request for Information (RFI) is often used by government agencies and others, to gather information on differing options available regarding potential purchases. The ultimate goal might be to purchase advertising, products for resale, computer hardware, software, or services, basically anything. RFIs are used to gather information when the item or service being purchased is new to the purchaser or when there are frequent developments in the area and the purchaser wants to be sure it has the most up to date information on what is available. The information collected through this process is then used to develop the specifications for a Request for Proposal (RFP) or to perhaps delay or cancel the purchase process.

Request for Proposal

An RFP is used when a very structured purchasing process is desired. It is often desirable when what is being purchased is very complex, such as a complete information system for a business and very expensive. Request for proposals are also used in some situations because of a contractual requirement or a statutory requirement. An example of a contractual requirement would be when a large contract is awarded and the winner of the contract will be sub-contracting out a portion of the work, the sub-contracting may be required to be done through an RFP process to ensure it is a fair process. This is often the case when a company contracts with a governmental agency and wishes to sub-contract part of the work. Many governmental agencies are required by statutes to bid out purchases over a certain amount and if the amount is large enough, to do it through an RFP process. The goal behind the statutes is often to create a level playing field and avoid any appearance of nepotism or favoritism.

The RFP process often involves site visits to proposer's facilities, recommendations from other customers, and an elaborate ranking system to evaluate the information provided by the responder, collected during site visits, and received from other customers. While there does not appear to be a standard RFP format, they are usually very formal documents that have been reviewed by attorneys. Some standard categories of information typically requested are descriptive information, financial information, proposed plan for meeting the requirements, mitigation of critical risks, services guarantees, and pricing (Applegate, Austin, & McFarlan, 2003). Very often the pricing must be received in a sealed envelope to avoid pricing information getting released accidentally to other bidders and to prevent the process being tainted. Different industries will generally have their own categories based on the type of products they provide.

There are several possible responses to RFPs. One might be no response at all from outside vendors and the work will need to be completed using in-house staff. You might receive proposals to completely outsource a project. You might receive a proposal to partially out-source a project, that is part will be completed by outside consultants and part will need to be completed by your in-house staff. You might receive a proposal to have the work outsourced to multiple consultants working together.

Miscellaneous Benefits of RFIs and RFPs

One of the biggest benefits of using an RFI/RFP process is that it forces the creation of a well-defined description of what is desired from the proposer. Requests for information/requests for proposal that don't have good descriptions of what is desired often are not responded to because the potential responders cannot determine what exactly is wanted. To receive the best product/service possible using a RFP process, the desired functionality of the product or capabilities of the service provider must be well defined.

Keep in mind the benefits of using this formalized approach for purchasing increase when you are spending large amounts of someone else's money, particularly taxpayer funds or government funds. Any time you are in a position of responsibility for someone else's money, it is to your advantage to be able to prove you have spent it responsibly. Using an RFPs for purchases over a specified amount can help document that you made reasonable and responsible purchases with the funds you were entrusted with. You can read news articles practically every day about someone who is being accused of misspending public funds, corporate funds, or personal funds that were entrusted to them.

Additional Sources of Information on RFIs and RFPs

Here are a few web sites that I located with some information on RFIs and RFPs. Please remember that each of these sources presents different opinions and different business situations. Not all of the ideas are appropriate for every setting.

Some of them suggest putting in a monetary amount of how much you are willing to spend on the project. There are differing opinions in this area; if you put in a top limit, will bidders bid higher to spend the entire budget or not?

One of the important points made in these articles is the use of a standardized format being required of bidders to make the evaluation process easier. If you are part of the group evaluating responses, this can make your job much easier if it is a well thought out format.

www.library.yale.edu/consortia/techreq.html - These are guidelines for technical issues and provide some excellent things to consider when working in the high-tech data exchange area.

http://www.managementhelp.org/misc/smpl_rfq.htm - Sample RFP.
http://www.internetraining.com/6art2.htm - This one provides a sample format.
http://www.webdevelopersjournal.com/columns/writerfp.html - This is directed at those writing RFPs for a web site. It presents some ideas that government offices would disagree with, such as restricting who would be allowed to bid on the project, something you can do in a private company, but not always with public funds.
Another source for RFP examples is http://www.findrfp.com
Again, keep in mind that not all comments apply in all situations.

References

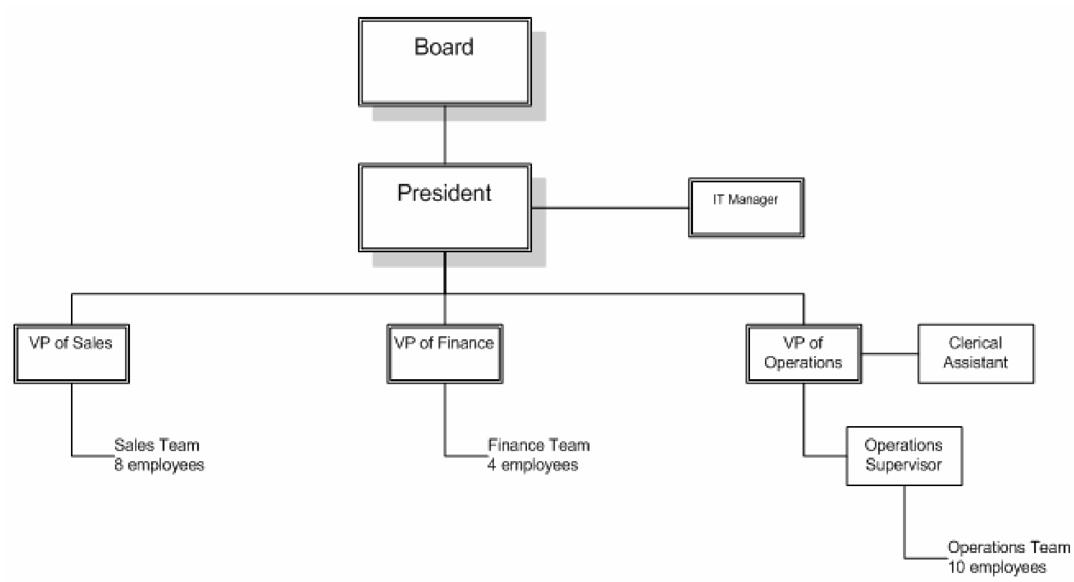
Applegate, L. M., B. D. Austin, & F. W. McFarlan (2003). *Corporate Information Strategy and Management, The Challenges of Managing in a Network* Economy (6^{th} edition). New York, NY McGraw-Hill/Irwin.

Valacich, J. S., J. F. George, and J. A. Hoffer (2006). *Essentials of System Analysis & Design (3^{rd} edition).* Upper Saddle River, NJ Pearson/Prentice Hall.

Sample solution:

Item 1 – SOUTHEAST SPORTING GOODS, INC. ORGANIZATIONAL OVERVIEW

Illustration 1



Southeast's home office executive staff includes the company president and three vice-presidents, one each for marketing, finance and operations. The president answers directly to the Board of Owners, and is responsible for maintaining organization between and integration of each department and its functions. The vice-president of marketing is responsible for an out-of-office sales force of eight representatives located throughout the southeastern United States. She is also in charge of sales catalog preparation and circulation, as well as for direct mail sales promotions. The vice-president of finance is responsible for Southeast's general ledger, accounts payable, accounts receivable, purchasing, and inventory accounts. She manages a staff of four accountants with one assigned to each finance function. The vice-president of operations is responsible for receipt and storage of shipments, the manufacturing process, and filling and shipping customer orders. He manages one clerical assistant and one operations supervisor along with ten employees assigned to various operating functions. The office area and plant and shipping departments are located in separate areas within the same facility.

Item 2 – LIST OF REQUIRED FUNCTIONALITY FOR NEW SYSTEM

The new system should comprise of components for each department. Forward and backward integration of these components is a necessity. The marketing department will need software and hardware capable of recording and communicating out-of-office sales. The system should also be able to design the company sales catalog. In addition, it should facilitate the catalog circulation and direct sales promotions. For the finance department, an accounting system should be capable of performing general ledger, accounts receivable, accounts payable, payroll, inventory functions, etc. The system designated for the operations department should be capable of recording and tracking receipt and storage of shipments. This component should also be integrated with the manufacturing process, and be capable of reporting progress throughout. In addition, it should facilitate the process of filling and shipping customer orders and provide all relevant paperwork. A word processor, spreadsheet, e-mail and calendaring system will be needed for clerical and supervisory duties.

Item 3 – INTERNAL COMPANY MEMO

To: President and Vice-Presidents
From: Eric Green
Subject: New Information System Justification

It has been shown that utilization of current IT systems can eliminate unnecessary costs and increase revenues and efficiency. The following is a list of benefits that Southeast will experience that will lead to increased revenues and lowered costs, if the proposed upgrade is accepted:

Operational process redesign – The new system will permit removal of unneeded steps in our line of operations and make data more available to others in the firm, connecting employees and information across departmental boundaries. The removal of the two unneeded steps out of the 10 step process will allow the line to operate 20 percent faster, thereby lowering production costs. Based on last years production costs associated with the line operations, this would be a cost savings of approximately $100,000 in the first year after implementation.

Improved organizational coordination – The proposed system will be used as the “cement” to join our different business units in an effective and lasting way. It would allow us to experiment with many structures in order to develop the most efficient way of conducting business. The proposed system will not only enable all departmental units to share information in real time, but it will also increase coordination between the firm and our clientele.

Improved worker collaboration – The new system promotes communication and information sharing across organizational boundaries. Employees can work together in teams without being in the same location.

Improved information use – Finally, the new system will provide us with an all-inclusive picture of Southeast’s dynamics that will lead to more effective and timely decisions.

Item 4 – POSSIBLE RESPONSES TO RFP

No response received, the company will need to design, purchase, create, and install the system with in-house staff. No response might be received due to the RFP laying out an unrealistic request or because the request is not doable by the companies considering responding to the RFP.

No response received, the company needs to go back to the drawing board and reconsider what is being asked for to make sure the requests are reasonable and possible.

A single company responds to the RFP with a proposal to outsource all functions through the one company.

Multiple companies band together and propose to outsource all functions through a collection of companies.