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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.

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

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

Inge Nickerson, Barry University
Charles Rarick, Purdue University, Calumet

CASES

WHEN CHANCE TURNS TO DISASTER: PARTS A, B, AND C

Barry Armandi, SUNY @ Old Westbury (deceased)
Herbert Sherman, Long Island University - Brooklyn Campus
Daniel J. Rowley, University of Northern Colorado

CASE DESCRIPTION

This is a field-based disguised case which describes how an instructor's replacement for the last four weeks for three courses encountered plagiarism with two group case term papers and how he and the administration dealt with the situation. In Part A, Professor Reynolds is asked to replace Professor Chance for the last four weeks of the semester after Professor Chance missed two weeks of three Business Strategy courses. He develops a new course outline which he presents to the class only to find that certain students object to the new outline given the fact that it does not factor in previously graded work. In Part B Professor Reynolds stays with the current outline and assigned student groups cases from their text to present to the class and then required a group case term paper. In examining two of the papers, he noticed that they had been verbatim copied from the instructor's manual. Professor Reynolds consulted with the Dean and they then informed the Provost that these students would be withdrawn from this course and allowed to retake the course without penalty. Students freely admitted that they had copied from the instructor's manual, which was earlier given to them by Professor Chance. In Part C Professor Chance is confronted by the Provost about the situation and ends up storming out of the Provost's office refusing to resign.

The case is designed to be taught in one class period (may vary from sixty minutes to one hundred minutes, depending upon the course structure and the instructional approach employed [see instructor's note] and is expected to require between six to ten hours of outside preparation by students (again, depending upon instructor's choice of class preparation method).

CASE SYNOPSIS

Derived from observation and field interviews, this two-part case describes how Professor Reynolds dealt with substituting for Professor Chance, a professor who seemed to have not been working out well with his classes. In Part A the students were complaining to Dr. Reynolds that much of their work was not being graded, and, if the work was graded, it was being graded too harshly-- at a graduate student level. Professor Reynolds unilaterally decided that the best *approach in the remaining four weeks of class would be to cover the course basics, and grade students not based upon past work (although those who received grades of B or better would receive extra credit) but upon four criteria: Mini-case Analysis (25%), Group Case Presentation (25%) and Group Case Report (50%). This decision did not go over well with some of the members of each class who had submitted work to Dr. Chance and now would not be considered as part of their grade unless they received a B or better (this would be used as extra credit).*

Part B begins with Reynolds explaining to his students that it would be difficult for him to use Dr. Chance's grading of their work given Dr. Chance's seemingly inconsistent grading of their work. Reynolds then discussed with the Provost his new course outline and how he would handle prior course work and the Provost approved of Reynolds's resolution. After sitting through student presentations and reading student group papers, Professor Reynolds realized that two groups' of the groups' papers were verbatim copies of the instructor's manual. The Dean and Professor Reynolds interviewed the students individually who were involved in the plagiarism. Students clearly admitted to the plagiarism, however, the students indicated that Professor Chance gave them his instructor's manual for assistance. Reynolds and the Dean wondered if the students could be held accountable for their actions even though a faculty member was an unknowing "accomplice?"

In Part C the Dean and Professor Reynolds decided that the students who plagiarized would be withdrawn from the course without penalty since plagiarism was inexcusable, regardless of Chance's actions. The Provost then met with Dr. Chance who confirmed that he had leant the students his instructor's manual. The Provost asked for Chance's resignation and the case ends with Chance refusing to resign and storming out of the Provost's office.

PART A

Introduction

"Houston, we have a problem!" Professor Reynolds may not have uttered those exact words to himself, but he certainly thought them as he perused the two plagiarized group case term papers from his Business Strategy classes. The case analyses he perused were professionally done and identical to what was in the instructor's manual of the textbook. This would seem to be an open and shut case, but there was far more here than meets the eye - far more than anyone could ever imagine.

In the Beginning …

It was bright and early Monday morning and Professor Reynolds sat in his office preparing an accreditation report for the Dean of the School of Business of Central State College. The phone rang, and he answered "Dr. Reynolds." "Bob, we have a problem," said Jen Thomas, secretary to the Dean of the School of Business at Caladon University, a local private college where Professor

Reynolds sometimes worked as an adjunct. "Oh, hi, Jen, what's the problem?" asked Reynolds. Jen continued "Well, remember that full-time person we hired, Dr. Chance, to teach those Policy courses you sometimes teach for us? Things aren't working out. He has been out for the last two weeks, claiming he is not feeling well. In that time, about fifty of his seventy students came over and complained. Their complaints were: that he was absent most of the time; he didn't cover a lot of material; they didn't use the book, which had cost them around $180; he only graded about 50% of the midterms and out of that only 20% got grades; on another assignment, he only gave about 10% of the class feedback and grades; and some students said he was grading them using graduate standards, but they are only undergraduates. They even showed the Dean and me an email indicating that he was using those standards. It's a mess and we have only four weeks left in the semester; less than 1/4 of the class time left!"

Reynolds said "What a shame! What can I do to help?" Jen quickly came back with a request, "Dean Barrett was wondering and hoping that you might be able to take over Dr. Chance's courses?" "You mean for the next few classes until he gets well" Reynolds responded. "No, for the rest of the semester, and perhaps even next semester. We are really stuck. Anything you can do would be better than what has been going on." replied Jen. Reynolds thought a moment and asked about class schedules, which didn't conflict with his own teaching schedule at Central. Dr. Reynolds had three courses of his own and luckily was not teaching an overload; he normally taught four courses. "OK, Jen," replied Reynolds. "I'll check with my Dean, but I don't envision a problem as long as this is a temporary fix and an emergency." "Great! Dr. Barrett would like to see you tomorrow, Tuesday, for lunch. I'll have the book and instructor's manual as well as any other material you may need. Also, we'll prepare any transparencies, slides, or copies. Whatever you need, we'll get it done ASAP," said Jen.

Reynolds Meets Barrett

The next day Reynolds met Dr. Barrett and Jen for lunch. They recounted in far greater detail what Jen had told Reynolds over the phone the previous day. Barrett was very appreciative and told Reynolds that Dr. Chance would never teach in his school again. He also informed Reynolds that besides the academic complaints, there were charges of sexual harassment from a female student and racial discrimination by two black students against Dr. Chance. Barrett felt that anything Reynolds would do now, with only four weeks left in the semester, would be better that what had been previously done.

Preparing for the Takeover

The weekend came and Reynolds started to review the material. Having a background in the area of strategy and policy, he recognized the approach used by Dr. Chance. Although Reynolds preferred to use a simulation, Dr. Chance used the typical case approach. Reynolds had just completed a policy book with two of his colleagues and his text used a similar approach. Reynolds knew the assigned text for these new classes well and also knew that the cases in the book were comprehensive and were typical policy cases about various organizations such as Apple Computer, United Airlines, Enron and other high profile companies. He checked his computer, and the overheads they prepared for the book were still there. He looked at the calendar and decided to work backwards from the final exam date to the next class on Monday. "Not much time," he muttered. He continued speaking out loud, "Let's see. It would be unfair to give them an exam, so I'll have to use the last day for them to hand in reports. They'll have to do group presentations of a comprehensive case (each of the three classes had an enrollment of around 25 students), so that will take at least four classes for the day classes; two for the evening class. That only leaves me with four classes for the day classes or two nights for the evening class to present the students with some material. Since I don't know what they do know, I'll give them some introductory material and then move on to external environment and internal environment analyses. Then, I'll put it altogether for them in an overall SWOT analysis. I should also have them do a mini-case at the end of one chapter. So let's see what I have." Reynolds constructed the following grade point distribution:

Mini-case Analysis	25%
Group Case Presentation	25%
Group Case Report	50%

Under the circumstances, he felt that these requirements were fair. He prepared his lecture notes and printed out the transparencies. He was ready for Monday's classes.

Reynolds Meets the Classes

There were three classes in undergraduate strategic management and policy: two in the day and one at night. The day classes met at 9 and 11 AM Mondays and Wednesdays for one hour and forty minutes. The evening class met at 6 PM on Mondays for three hours and twenty minutes. The students had been told via emails and phone calls over the weekend by Jen that a new professor would be in to cover the courses for the next four weeks until the end of the semester and that he would be grading them.

In each of the classes, Dr. Reynolds introduced himself and asked the students to tell him about what went on previously. He said this would be the only time that he would ask since they had limited time and allot of material to cover. The students recited a litany of complaints most of which Reynolds had heard from Jen and Dr. Barrett. Other complaints were that Dr. Chance liked females more than males and was kinder to them in class. After hearing the students' comments, Reynolds proceeded to explain to the class the requirements for the remainder of the semester, writing his grade distribution on the board. He explained the mini-case analyses and the comprehensive cases from the book. Over the weekend, he identified the cases he wanted the class to do in their presentations. He found out that Dr. Chance had constructed groups, but they did not contain the same number of students. He discovered that in each of the classes some groups had three students, while others had six. When asked about group formation, the students responded, "Dr. Chance let us do it ourselves." The students had met in their groups many times during the semester, always in class.

Some students raised the issue of previous work that had been done. Some had their work graded. Others had some feedback--but no grades. Others never received their work back, and others felt that they were not given the chance that other students had to revise and resubmit their work. Reynolds indicated for those who had grades on work from Dr. Chance, if the grade was a B or better, they would receive extra credit. He explained that he didn't have copies of the cases, didn't know about Dr. Chance's expectations or grading scheme, and didn't know about deadlines, revisions, or other qualitative feedback given by Dr. Chance. Some students protested and started to literally cry. All of their hard work was for nothing.

Reynolds felt his stomach tie in knots. He did not expect such a response from the students and really had not prepared for such an outcry. How can he deal with the students' needs for fair treatment balanced by what Reynolds perceived as a 'botched' job by Dr. Chance. What was Reynolds to do now?

WHEN CHANCE TURNS TO DISASTER: PART B

Dr. Reynolds sympathized and asked the students to understand how difficult, if not impossible, it was to evaluate fairly the entire class' performance, given such little information and obvious problems caused by Dr. Chance's inconsistent grading of their prior work. A large majority of students understood and told the other students that this was better than what they had before and that they were finally going to learn something. Afterwards, some students came to Reynolds and said that they were not in a group. All of them were Asian students. Reynolds asked how this could have happened. He was told that "Dr. Chance had a policy that if you showed up late for class, you had to work alone and not in a group." Reynolds assigned these students to other groups.

The Conversation with the Provost

The next day, Tuesday, Reynolds received a call from Barrett, who asked him to call the Provost to discuss compensation (under these special circumstances the Provost was trying to obtain permission from the College's V.P. for Finance for full adjunct pay for Dr. Reynolds rather than the traditional pro-rated compensation rate) and to give the Provost a briefing on the feedback from the classes. Reynolds called immediately. The Provost thanked him for helping, told him he was going to get his full pay, even though there was only a month left in the semester, and asked how the classes went. Reynolds explained the issues that had arisen in class and how he handled them. He told the Provost of his requirements and grading. He then mentioned the problem of previous work. He wanted the Provost to know that he may hear from some unhappy students. The Provost said he would have Dr. Chance grade all the work and give the grades to Reynolds. Reynolds said that Dr. Chance's grading may open up a can of worms, since some students felt they were unfairly graded, others felt that their grades were too low, and others felt that they were not given the chance that other students had to revise and resubmit their work. Reynolds told the Provost that there were only a handful of students who complained, and for those he would give extra credit for grades of B or better, that the process of Chance's continued grading of papers would be too cumbersome and perhaps not timely. The Provost agreed and went along with Reynolds' suggestions.

Lectures and Presentations

Over the course of the next two weeks, Reynolds lectured on introductory material, external and internal analyses, and culminated with a comprehensive SWOT analysis. He showed the class how to do an overall problem identification and analysis and how to quantify a SWOT analysis. He introduced theories from Michael Porter and Miles and Snow, as well as other strategy theorists. During his presentation, he referred to examples of corporations and small businesses. A number of students came to him after class and said they had learned more in those four weeks of classes then the previous twelve weeks of classes held by Dr. Chance.

The case presentations, scheduled for the last four sessions of the day classes, and the last two sessions of the evening class, went well. Reynolds had reviewed the cases before each class and checked the instructor's manual. Two of the presentations in different classes and on different cases looked familiar, but he didn't think much of it at the time.

When the semester ended and Reynolds had collected the group case reports, he settled in his office and started to read and grade them. He came to the reports of those presentations that previously seemed familiar to him. After reading them he became curious. They were professionally done and their analyses looked too good for undergraduates--especially since students made a continued point of complaining that they really had not learned much at all from their previous instructor. Becoming increasingly suspicious, he checked the instructor's manual. In both cases, the reports were identical to the analysis in the manual, even down to the typos! He sat back, and shook his head in disbelief and frustration.

Reynolds knew that these were not normal conditions, and there were numerous mitigating circumstances. He had substituted for a professor who, for whatever reason, seemed both incompetent and incapable of finishing the instruction of his classes. This was the capstone course, the final course that students took in business to graduate and to integrate their business education, and, clearly, it had been bungled from day one. Students had done prior work, and that work would no longer count towards a grade in the course. Dr. Chance had even been accused of favoritism and sexual harassment.

"What do I do now? Fail them, given the circumstances? Bring them up on charges? Just let it go? I need to be both fair and equitable, yet I cannot let plagiarism go without some form of punishment or at least acknowledgement." Reynolds had to do something, but what would do, at this point, escaped him.

Reynolds went to the Dean Barrett and explained the situation. The Dean was stunned after reviewing the evidence. He suggested that they call the groups in and see each member individually. After the questioning, the students waited in a separate room. Reynolds concurred with the suggested solution and the groups were notified.

During the meetings, the students readily admitted that they had used the instructor's manual. However, when questioned how they acquired the manual, the groups unanimously indicated that Dr. Chance gave them the manual. It seemed that the students had gone to ask him about doing a case analysis and report and asked if he had some examples. Being a new professor at the school, the professor told them that he didn't. They pleaded with him to give them some help, and Chance had finally relented and told them to follow the guide in the instructor's manual and handed it to one student whom he considered to be responsible. The following week, the student gave the manual back to Chance and thanked him. Unbeknownst to him, the student had photocopied the entire manual, distributed copies out to his classmates, and, subsequently, this material was used in their reports (without footnoting or indicating the source of their information).

Dean Barrett and Dr. Reynolds had a tough decision to make. Students had clearly and admittedly plagiarizing material from an instructor's manual that they obtained from their instructor; could they be held accountable for their actions even though a faculty member was an unknowing "accomplice?"

WHEN CHANCE TURNS TO DISASTER: PART C

After meeting with each student, Barrett and Reynolds decided to officially withdraw each student from the course since plagiarism (regardless of Chance's involvement) in and of itself was inexcusable. Since the students needed this course for graduation, the withdrawal would mean that they would not graduate for another semester. Barrett and Reynolds figured this would be apt punishment for their actions. Under the circumstances and realizing that the alternatives could be failure or expulsion (either one would leave a permanent mark on their transcript), the students quite reluctantly agreed.

Barrett decided to also notify the Provost. The Provost stated that the resolution was appropriate. He informed Barrett that he would discuss the matter with Chance. Barrett said adamantly, "I don't want him back teaching in my school." The Provost assured him that he would handle it quickly and decisively.

The Provost met with Chance the next day and confronted him with the situation. At first, Chance hesitated but realized that he had made a mistake. Chance confessed but said, in his defense, that he was new to classroom teaching, and that he had spent the last few years doing one on one and Internet teaching. He normally showed students the manual so he wouldn't have to waste time explaining it. The Provost asked for his resignation. Chance refused, indicating that he had a two-year contract and that he expected the University to honor it.

The Provost told him he was going to contact the University lawyers and once it was in their hands, he could not help Dr. Chance. The stigma would follow him in the industry. Chance told him to go to hell and stormed out of the office. The Provost wondered what his next steps should be in light of Chance's refusal to resign.

INFORMATICA DE SISTEMAS, S.A. EARNOUT NEGOTIATION

Dennis Zocco,. The University of San Diego

CASE DESCRIPTION

The primary subject matter of this case concerns the cross-cultural negotiation of an earnout agreement between Denshi Global Holdings, a publicly-traded Japanese company, and Informatica de Sistemas, S.A,.(IDS) a private Spanish company that Denshi is seeking to acquire. Secondary issues examined include (1) the added dimension of complexity involved in cross-cultural negotiations, 2) the issue of a valuation gap that frequently is an issue of contention between the buyer and seller in an acquisition, (3) the structure of an earnout agreement to bridge the valuation gap and to resolve the issue of which party will take on the risk of that value based on whether or not future performance exists, (4) the psychological (and emotional) elements involved in an owner giving up his company or taking on new owners, and (5) the self-interest motivations of the parties that often enter into negotiations in either a direct or subtle manner. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in three class hours and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

Javier Portilla, a Spanish academic turned scientist/entrepreneur, received the magic phone call. Denshi Global Holdings, a publicly-traded Japanese company whose growth strategy is the acquisition of global technology companies, wants to acquire Javier's private company, Informatica de Sistemas, S.A.(IDS). The due diligence and negotiations between the two companies proceeded at a fast pace to the present impasse. Javier and Katsumi Shimura, the Denshi negotiation, disagree on the value of IDS, resulting in a "valuation gap" of €67.5 million (¥10,987; $107.1 million USD). To resolve this issue, Katsumi has proposed an "earnout agreement" with payment by Denshi to Javier of all or a portion of the "valuation gap" based on IDS performance in the future. Denshi wants Javier to prove, through future performance based on the financial projections he presented during due diligence, that the added valuation he says exists really does exist. Javier and Katsumi are about to begin discussions to craft the elements of an earnout agreement that has value for both sides, with the added challenge of navigating the often tricky waters of cross-cultural negotiations.

DENSHI GLOBAL HOLDINGS

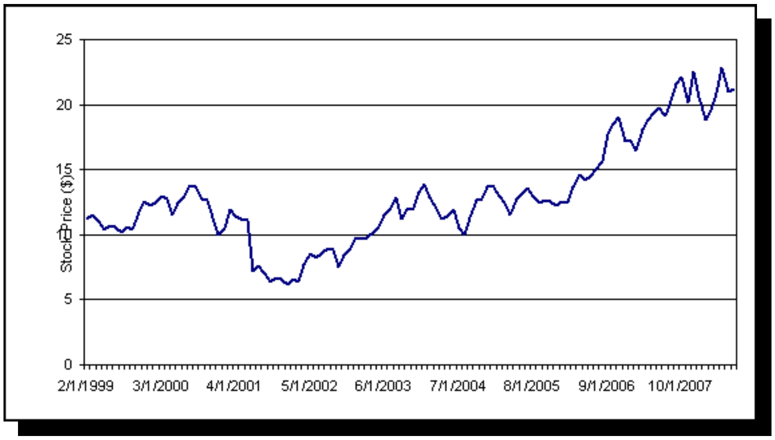
Denshi Global Holdings is a Japanese diversified holding company with a dynamic portfolio of subsidiaries spanning global software, information technology, computer science, and semiconductor technologies companies. Through its portfolio of twenty-eight companies, ranging in (U.S. dollar) revenues of $58 million to $360 million, the company takes advantage of valuable synergies among the holding company and portfolio companies to maximize revenue growth, internal development, and strategic acquisitions. In fiscal 2008, Denshi companies generated in excess of $1.85 billion in revenues with pre-tax profits of $237 million on a consolidated basis and projects fiscal 2009 revenues of $2.27 billion and pre-tax profits of $276 million.

Denshi implements its growth strategy through the acquisition of companies meeting the following criteria:

- attractive fundamentals, including annual revenue between $40 million and $200 million, EBITDA (earnings before interest, taxes, depreciation, and amortization) of at least $10 million, EBITDA margins of at least 10%, 3 years of profitability and positive free cash flow (cash flow from operations – net capital expenditures)
- modest capital requirements
- low cost of goods sold (gross margins in excess of 45%)
- high barriers to entry and switching costs
- operating in the software, information technology, computer science, or semiconductor technologies industries
- ability to sustain high rates of organic growth, where future growth is driven by steady demand that is not subject to above-normal volatility
- potential to grow faster than the markets they serve
- an international focus
- strong, highly motivated entrepreneurial management team
- potential for future growth through follow-on acquisitions within the same or an adjacent industry
- stable and long standing customer relationships
- deal size between $50 million and $500 million

Denshi has a global acquisition perspective, believing that global diversification of its portfolio companies reduces the volatility of the holding company's revenues and earnings, as well as the volatility of its stock price. Denshi stock, traded on NASDAQ, has performed well over the past eight years since the meltdown of technology stocks (Figure 1). Denshi had not been spared from the late 90's excess valuations and the subsequent descent into reality, but its global diversification strategy helped in maintaining more price stability than most NASDAQ stocks during the period. The current price of Denshi stock is \$22 with a P/E ratio of 25.3, a 31% premium over the average P/E for the S&P 500 companies.

Figure 1: Denshi Global Holdings Price History



IDS AND JAVIER PORTILLA

Javier Portilla was born in Madrid, Spain, in 1960. He received his undergraduate degree and Ph.D. from Complutense University in Madrid while there from 1978 to 1988. He served eight years on the faculty at the Universidad de Santiago de Compostela, Spain, as Professor of Applied Mathematics (Matemática Aplicada). In that position, he produced ground-breaking research in the area of load balancing, a technique to spread work between two or more computers, network links, CPUs, hard drives, or other resources, in order to get optimal resource utilization, throughput, or response time.

In 1996, Javier became Director of the university's Computer Science Institute where he extended his research in applied mathematics to grid computing, an optimizing technique for workloads which consist of many independent packets of work without data sharing requirements. His work went far beyond any that the field of computer science had ever seen. His research reports, published in the most prestigious academic journals, were eagerly awaited by both academicians and business information technology professionals. In 2000, Javier received Spain's prestigious Prince of Asturias Prize for Scientific Research for his landmark work in the "creation of revolutionary advances in applied mathematics for the benefit of mankind."

The Prince of Asturias Prize (*Premios Príncipe de Asturias*) for Scientific Research is awarded to "individuals, work groups or institutions whose discoveries or research represent a significant contribution to the progress of humanity in the fields of mathematics, physics, chemistry, biology, medicine, earth and space sciences, as well as their related technical aspects and technologies."

Eight Prince of Asturias prizes, established in 1981, are awarded each year covering categories such as arts, scientific research, sports, letters and humanities. The awards include a cash prize of €50,000 ($79,000) and a sculpture by Spanish artist Joan Miró representing and symbolizing the awards. They are named for Prince Felipe, heir to the Spanish crown, and are presented each fall in Oviedo, capital of the northern region of Asturias.

"I am deeply honored to receive this award," Javier said in his acceptance speech, "because it represents the quality of my education at Complutense University as well as the support of and collaboration with my colleagues. I would also like to thank my family members who have been so patient with me."

As a result of his ground-breaking work and the Prince of Asturias Prize, Javier's consulting services were in demand by many large companies. When he recognized the significant cost savings potential and commercial applications of his work, the entrepreneurial spirit within him came to the surface. He thanked the officials at his university for their support, resigned his position at the Institute, and formed his own company, Informatica de Sistemas, S.A. (IDS), in his home town of Madrid in June, 2002. With his reputation as the world's top computer scientist in the field of grid computing and his contacts within the Spanish business community acquired through his consulting services, he was able to secure initial contracts worth €14.6million in the first year of IDS.

While meeting heavy workload demands, Javier continued his research and built an efficient and productive infrastructure in his company by attracting top business executives from many European and U.S. companies. From initially providing grid computing consulting services, he quickly expanded into load balancing and computer cluster networking equipment. IDS revenue grew from its first year level of €14.6 million to its current 2008 level of €187.1 million, an average annual revenue growth rate of 53.0% over that period. Gross margins [(Revenue – Cost of Goods Sold)/Revenue] fluctuated in a range between 45% and 55%. Net margins [(Revenue – Cost of Goods Sold - Expenses)/Revenue] steadily increased over the years from 10% to its current level of 18%.

An audit of the IDS financials confirmed the summarized performance in Table 1.

Table 1: Informatica de Sistemas Summarized Financial Performance

Informatica de Sistemas, S.A. Company Performance (€ million; Actual. Audited)

	2002	2003	2004	2005	2006	2007	2008
Revenues	14.6	22.6	36.6	53.8	83.5	119.3	187.1
Gross Profit	6.6	10.2	17.7	26.9	43.4	60.9	91.7
Net Profit	1.6	2.4	4.4	6.9	12.6	20.4	33.7

THE OFFER

Kenji Ando, the head of Denshi Global Holdings' M&A Division, had contacted Javier six weeks ago to explore the potential for Denshi to acquire IDS. Javier was pleasantly surprised by the call, but he told Kenji he was reluctant to sell his company for several reasons. He had many goals to accomplish with IDS. Although Javier owns 90% of the company (the company has no outside investors or long-term debt), the employees own the other 10% and he was not sure whether an acquisition by a Japanese company would be in their best interests. He was also concerned that he was not able to determine the current value of the company with a high degree of accuracy and therefore could not be sure whether an offer would be fair or not. And finally, he was slightly uncomfortable allowing his Spanish company to be acquired by a non-Spanish company.

Kenji was not discouraged. He had encountered the same initial reluctance from the entrepreneurial owners of other global companies he had acquired for Denshi. Kenji was very simple in his explanation that as a portfolio company of Denshi, Javier would gain access to the greatest business and technology minds in the world through the scientists in the Denshi companies and the extensive network that Denshi has established in the science, business, and academic communities throughout the world. He would have access to technologies that would augment his own and allow him to achieve advances far beyond those he could achieve with IDS as a stand-alone company. Kenji assured Javier that IDS would continue to operate under his leadership and autonomy, as Denshi did not buy companies in which they would replace management or take an active management role. Great leadership is as important an asset as the technologies of the companies acquired by Denshi.

Kenji also explained to Javier that scientific methodologies can be applied to the valuation of companies, but the current value is based on future performance, and there is no scientific way of accurately seeing the business future. So any valuation would be subjective, but based on sound business valuation techniques and assumptions.

Kenji made a compelling case to Javier. Over the next month, Javier visited the headquarters of Denshi, spoke with the top executives of the holding company, and then visited several of the Denshi portfolio companies and spent time with their CEOs. From those meetings, he came away with a very positive view of Denshi, its people, and the benefits they provide to their portfolio companies. He learned that Denshi acquires companies with entrepreneurial management who produce solid financial performance, keeps management intact as long as they can, and provides management with an environment where performance can be enhanced. There have been no employee layoffs to cut costs. In fact, with all of the portfolio companies, employee count increased due to performance growth. After his visits, Javier was convinced that Denshi was the perfect acquirer, if all the terms could be agreed upon.

In response to a request by the Denshi acquisition team, IDS provided Denshi with the four-year financial forecast shown in Table 2.

Table 2: Informatica de Sistemas Projected Four-Year Performance										
Informatica de Sistemas, S.A. Company Performance (€ million; Forecast, Audited)										
	Q1 09	Q2 09	Q3 09	Q4 09	2009	Q1 10	Q2 10	Q3 10	Q4 10	2010
Revenues	72.6	72.6	72.6	72.6	290.3	110.3	110.3	110.3	110.3	441.2
Gross Profit	36.3	36.3	36.3	36.3	145.1	55.2	55.2	55.2	55.2	220.8
Net Profit	13	13	13	13	51.9	19.9	19.9	19.9	19.9	79.6
	Q1 11	Q2 11	Q3 11	Q4 11	2011	Q1 12	Q2 12	Q3 12	Q4 12	2012
Revenues	163.2	163.2	163.2	163.2	653.8	236.6	236.6	236.6	236.6	946.4
Gross Profit	81.6	81.6	81.6	81.6	326.5	118.3	118.3	118.3	118.3	473.2
Net Profit	29.4	29.4	29.4	29.4	117.8	42.5	42.5	42.5	42.5	170.1

After six weeks of due diligence, in which every aspect of IDS was examined by a Denshi due diligence team, with follow-up negotiations, Javier and Denshi had made significant progress on many issues of the acquisition but had encountered an impasse over the purchase price. The Denshi acquisitions team, under Kenji's direction, applied the earnings multiplier approach to valuing IDS, using the IDS 2008 net profit of €33.7 million as the basis to which an earnings multiplier would be applied. Based on the Denshi due diligence of IDS, Kenji offered to purchase IDS at five times the 2008 net income, or €168.7million (¥27,467at a €1 = ¥162.81 exchange rate or $267.7 million USD at a €1 = $1.587 exchange rate).

Javier was pleased with the offer, but wondered whether the valuation was appropriate. He asked his CFO, Yolanda Rodriquez, for her opinion of the valuation of IDS. She told Javier that, based on the IDS financial performance, past and projected, as well as its position in the industry, a multiplier of seven would be more appropriate than five.

Using an earnings multiplier of seven, Yolanda placed the value of IDS at €236.2 million (or ¥38,454; $374.8 million), a difference of €67.5 million (¥10,987; $107.1 million USD) from the IDS valuation provided by Denshi.

Javier then asked Yolanda if the earnings multiplier method is the most appropriate method of valuing IDS. Yolanda replied that although there are other methods, such as the discounted free cash flow, discounted earnings, discounted dividend valuation methods as well as the sales multiplier and book value methods, the earnings multiplier methodology used by Denshi had the most wide-spread application for valuing companies in mergers or acquisitions. One of the advantages is its wide-spread acceptance as a valid method. Other advantages are that it is easy to apply and uses current earnings and not a forecast of a financial metric, such as earnings, free cash flow, or dividends. She also explained that usually EBITDA (Earnings before Interest, Dividends, and Amortization) is used as the earnings metric. However, because IDS has no debt, and depreciation and amortization are an extremely small percentage of expenses, the bottom line earnings (before taxes) of IDS is an appropriate metric for the valuation. She added that since IDS does not pay a dividend, the discounted dividend valuation method could not be used.

Yolanda cautioned Javier that there are disadvantages to the earnings multiplier method. One is the somewhat subjective determination of the earnings multiplier which is designed to capture both the expected return and risk of future performance. Having access to multipliers used in the valuation of other comparable acquisitions reduces that subjectivity. Another disadvantage is that the earnings number may have to be adjusted for excessive executive compensation or if the past twelve months resulted in an abnormally high or low earnings performance. Adjustments to the earnings figure used in the earnings multiplier method would have to be made.

Considering both the advantages and disadvantages of the earnings multiplier method and the fact that Denshi provided three comparable acquisition valuations, Yolanda told Javier she was comfortable with its use in valuing IDS.

The valuation issue in the negotiations proved to be the most contentious. To support Denshi's position that a multiplier of five would be most appropriate for IDS, Kenji presented information (validated and accepted by Javier) on three very recent acquisitions in similar industries. The summarized information for those three companies is in Tables 3 (a,b,c).

Table 3(a). AkzeleRAM (ARAM) Financial Performance and Projections

AkzeleRAM (ARAM) is a German semiconductor company with corporate offices in Hanover. ARAM develops innovative products and technologies that accelerate storage applications and server appliances and performs real time compression of data during backup. It also produces a compression product that saves download time for the client and bandwidth costs for the server. Denshi acquired ARAM in 2008 at six times 2007 net profit.

	All figures in euros (€)											
AkzeleRAM	2002(a)	2003(a)	2004(a)	2005(a)	2006(a)	2007(a)	2008(e)	2008(a)	2009(e)	2010(e)	2011(e)	2012(e)
Revenues	14	23.5	35.3	59	92	142.6	196.4	206.7	279.1	376.8	508.7	686.7
Gross Profit	5.7	11.3	17.7	30.7	46.9	69.9	99.3	101.3	136.8	184.6	249.3	336.5
Net Profit	1.9	3.1	5.3	10	16.6	21.4	29.5	28.8	47.4	64.1	86.5	116.7
FCF	1.7	2.6	3.9	5.8	8.8	13.2	18.6	18.2	29.6	44.4	66.6	99.9
"Earnout Amount" Earned (%)								92%				

Table 3(b). Migratek Financial Performance and Projections

Migratek, a Brazilian technology company with headquarters in São Paulo, designs and markets a complete line of access solutions, enabling service providers to offer small and medium enterprises and institutional customers traditional and advanced data and telephony services over their existing networks. Denshi acquired Migratek in 2008 at eight times 2007 net profit.

	All figures in Brazilian Real (R$)											
Migratek	**2002(a)**	**2003(a)**	**2004(a)**	**2005(a)**	**2006(a)**	**2007(a)**	**2008(e)**	**2008(a)**	**2009(e)**	**2010(e)**	**2011(e)**	**2012(e)**
Revenues	16.2	24.5	37.3	55.2	80.5	114.3	142.6	156.7	219.3	307	429.9	601.8
Gross Profit	9.2	13	21.2	33.1	45.1	72	92.3	97.1	131.6	184.2	257.9	361.1
Net Profit	1.3	4.2	5.2	9.9	12.9	25.2	29.1	31.3	43.9	61.4	86	120.4
FCF	2	6.5	8.1	15.4	20	36.5	46.1	48.6	68	95.2	133.3	186.6
"Earnout Amount" Earned (%)								100%				

Table 3(c). Spruce Financial Performance and Projections												
Spruce is a U.S. company located in Houston, Texas. Spruce develops new technologies to improve memory performance by creating innovative solutions that multiplies the amount of standard memory to be placed into existing systems without any modifications. The ARAM products circumvent the normal limitations set by the memory controller and provide cost-effective additions to high-capacity memory. Denshi acquired Spruce in 2008 at five times 2007 net profit.												
	All figures in United States Dollars ($)											
Spruce	**2002(a)**	**2003(a)**	**2004(a)**	**2005(a)**	**2006(a)**	**2007(a)**	**2008(e)**	**2008(a)**	**2009(e)**	**2010(e)**	**2011(e)**	**2012(e)**
Revenues	13.5	19.8	28.2	38.9	52.9	69.8	86	88.7	115.3	149.8	194.8	253.2
Gross Profit	6.1	9.5	14.1	20.2	27	34.2	42.6	43.4	56.5	73.4	95.4	124.1
Net Profit	1.4	2.4	3.7	5.8	9	12.6	15.6	16	20.7	27	35.1	45.6
FCF	1.2	1.7	2.4	3.4	4.7	6.6	9.1	9.3	13	18.2	25.4	35.6
"Earnout Amount" Earned (%)								100%				

Kenji's position was that the performance of IDS, relative to the performance of comparable companies recently acquired by Denshi, justifies using a multiplier of five. Furthermore, although the financial projections provided by IDS were very optimistic, they showed higher growth rates than the trend of recent past performance. Kenji saw significant risk in IDS achieving their very optimistic projections and that a slightly higher multiplier may be justified if the IDS performance projections were certain, but there was no way that performance can be assured.

Javier expressed confidence in achieving his projections. Therefore, his position was that the valuation of IDS should be seven times earnings resulting in a purchase price of €236.2 million, a difference of €67.5 million from the valuation supported by Denshi.

Although an impasse existed on the valuation of IDS, Kenji was very encouraged by the progress and momentum gained in the IDS negotiations, as was Javier. Among the issues agreed upon by both parties were:

- IDS is to remain a separate operating company, as all the Denshi companies are
- Javier is to have complete autonomy in running the company the board of IDS is to be controlled by Denshi
- Javier is to sign an employment agreement and non-compete agreement (compensation agreed, but time period to be negotiated)

The valuation issue remained unresolved but Kenji was optimistic. However, he then received a communication directly from the Denshi CEO informing him that he was needed immediately on another major acquisition, but that it was imperative that all efforts by the M&A Division be directed toward completing the IDS acquisition if possible. Kenji needed a replacement for himself, and he knew the best person to complete the negotiations.

KATSUMI SHIMURA

Katsumi Shimura had just finished dinner at the Wasabi Bistro in the Oriental Hotel in Singapore when she received the call from Kenji, her manager in the Denshi Global Holdings' M&A Division, assigning her to the Informatica de Sistemas, S.A. (IDS) negotiation. She was slightly apprehensive about jumping into a negotiation just to complete the final stage, but the circumstances dictated that someone had to bring the discussions to a conclusion. She was briefed by Kenji during the call as to the progress that has been made and those issues still to be agreed upon.

Katsumi does not know Javier Portilla, nor has she ever negotiated with a Spaniard. She considers this a great opportunity to gain experience negotiating with counterparts from European cultures. The description of Javier that Kenji has given her was short and sweet: *He's smart and he's tough.* When she heard that, Katsumi smiled and thought, *So am I.*

Katsumi Shimura (her American friends and business colleagues call her "Kat") received her college education in the United States, earning her undergraduate degree at California Institute of Technology (Cal Tech) where her areas of concentration were Applied Physics and Computer Science. After graduation, she worked for a few years in the Cal Tech Jet Propulsion Laboratory (JPL) in Pasadena while taking classes at UCLA to earn her MBA in 1999. Denshi Industries had their recruiting eye on Katsumi while she worked on a joint project between the JPL and one of Denshi's companies. Denshi hired her a month before she graduated from UCLA and put her into their Financial Rotation Program the Monday after graduation, where she worked in the Treasurer's Office for a year, then in Strategic Planning for a year, and finally in Mergers & Acquisitions, where she found her talent and interest.

Katsumi requested and was awarded a position with the Denshi Global Mergers & Acquisitions Division where she spent the first year researching financial statements of potential Denshi acquisitions. Then she was assigned to an acquisition negotiating team which had the responsibility of negotiating and structuring deals. At any given time in Denshi's M&A Division, there were at least six deal negotiations taking place. Some of them resulted in Denshi acquisitions, others did not.

Katsumi learned the key principles of successful negotiations from the more experienced negotiators - the study of the issues, the importance of understanding the other party's interests in the negotiation, the setting of optimistic goals, the development of a flexible negotiation strategy, the power of listening, the problem-solving nature of negotiations, the use of leverage and protection against the other side using it when they have it, the importance of crafting an agreement which provides value to both parties. The process of putting these negotiating principles into action fascinated Katsumi.

She rose to a lead negotiator status very quickly. She was assigned to the Far East, negotiating acquisitions of companies in Hong Kong, Taiwan, and Singapore. Her next assignment:

complete the negotiations for the acquisition of the Spanish technology company, Informatica de Sistemas, S.A.

THE LAST PHASE OF THE NEGOTIATIONS – THE EARNOUT AGREEMENT

As the negotiations had reached an impasse over the valuation issue, Katsumi thought of alternatives to bridge the "valuation gap" that existed between Denshi and IDS. She felt the best approach would be an earnout arrangement, which she has used successfully in the past. In situations where valuation gaps exist, the difference in valuation seemed to exist due to a difference in the risk each party perceived in IDS meeting its optimistic projections.

In an earnout arrangement, the buyer negotiates a plan with the seller in which the total purchase price is divided between a guaranteed payment (received by the seller at closing of the acquisition transaction but before the earnout period commences) and an earnout amount, which is a portion of the purchase price (additional to the guaranteed payment) paid only contingent upon the acquired company meeting predetermined and well-defined performance milestones. If all performance milestones are met, the performance-based portion of the purchase price is paid by the buyer and received by the seller. However, if milestones are missed, the buyer will pay either none of the earnout payment or a percentage of the payment based on the earnout structure. Earnout arrangements are also a means to induce key shareholders to remain with the acquired company after the sale as well as to motivate them to achieve aggressive performance milestones on which the earnout amount is based.

Denshi perceives risk in buying companies, such as IDS, at a price that includes the value embodied in aggressive projections, such as those provided by Javier. If IDS does not meet those projections, Denshi's purchase price will include value that does not exist. During the negotiations, Javier's position had been consistent in his belief that his four-year projections will be achieved. Katsumi believed that an earnout arrangement was the best approach to address this impasse.

The key elements of any earnout plan are:

- Earnout Amount. The earnout amount is that part of the purchase price that is based on performance. The "valuation gap", based on different perceptions of risk inherent in IDS meeting its projections, is €67.5 million (¥10,987; $107.1 million USD). The issue of the earnout amount is still open for negotiation, with the comparable companies (AkzeleRAM, Migratek, and Spruce) being used as a basis for determining whether the difference in the earnings multiplier (5 versus 7) can be narrowed. Both Katsumi and Javier are open to discussing that issue, potentially increasing the guaranteed payment and reducing the earnout amount, but both sides are committed to their positions and any movement on their multiplier position will likely be slight.

- Earnout Period. The time period within which performance milestones exist and earnout payments are made is a critical element in the earnout arrangement. All of the earnout periods associated with Denshi acquisitions have been from one to four years. Several factors are of importance to both sides:

  - the present value of the earnout payments
  - the risk of economic or business conditions, out of the control of IDS, influencing management's ability to earn the earnout amounts
  - the financial forecasts provided by Javier during the due diligence process are the company's best estimate of future performance, but they are just estimates and the farther into the future those performance estimates are, the more risk there is of actual performance not meeting those projections.
  - Denshi prefers a longer earnout period for three reasons. First, it provides a greater degree of risk transfer to IDS since it is their performance that is at risk. Second, it allows a longer period of performance incentive. And third, it decreases the present value of the stream of potential payments during the earnout period. Denshi's acquisition team used the current Denshi cost of capital of 10.5% to perform their present value analyses.
  - Javier, however, would rather have a shorter earnout period. IDS performance farther into the future is much more speculative and therefore adds more risk that Javier will not receive the full earnout amount. Javier also realizes that a shorter timeframe puts more pressure on him to perform in a shorter time frame. A shorter earnout period also reduces the time that Javier has an incentive to stay on as CEO of IDS reporting to Denshi. Javier may want to start a new venture, but cannot as long as he is CEO of a Denshi-owned IDS. Finally, a shorter earnout period rather than a longer one increases the present value of the stream of potential payments during the earnout period. For the discount rate used to determine the present value of future earnout payments, Javier has several options. He could use the weighted average marginal cost of capital for IDS, which is 12.3 percent or the required rate of return for an equity investment in a Denshi-owned IDS for the earnout period. The latter would be the sum of the current risk free rate (a proxy would be the yield on a treasury security of a similar maturity as the earnout period) and an equity risk premium, that is, the additional return required for taking on the added risk associated with IDS meeting its performance milestones during the earnout period.

- Earnout Performance Intervals. Denshi prefers to have earnout performance intervals on a quarterly basis. That is, IDS would have one or more performance milestones each quarter during the earnout period. If it meets those performance milestones, the earnout payment for that quarter will be paid. If it fails to meet the performance milestones, no earnout payment is made.

  As an example of this earnout structure, if an earnout period of two years is agreed upon and the earnout payments are equally distributed based on quarterly performance goals, each quarter (of eight quarters) would have 1/8 of the earnout amount payable on achievement of that quarter's performance goal. If a four-year earnout period is agreed upon, then each quarter (of sixteen quarters) would have 1/16 of the total earnout amount associated with it. Of course, the payments do not have to be equally distributed. More could be weighted toward the beginning or toward the end.

  The reason that Katsumi prefers quarterly intervals is that Denshi is a publicly-traded NASDAQ company for which quarterly performance is important in that it is measured against the analysts' estimates of quarterly and annual performance. Denshi acquires companies to enhance its quarterly performance. Therefore, establishing Denshi's portfolio companies' performance goals on a quarterly basis bring their performance incentives in line with Denshi's holding company quarterly performance goals.

  If an earnout agreement is necessary, Denshi normally has an earnout structure in which a performance milestone must be met in full for an earnout payment to be received. If the performance milestone is missed, no payment is received. On some occasions in the past, Katsumi has agreed to earnout agreements in which there is some graduated scale. In this structure, if the acquired company misses the performance milestone by some amount, then the earnout payment is reduced accordingly. There is a tight limit on the degree to which the performance milestone can be missed before no payment is made. Katsumi is given some discretion by the Denshi M&A Division for structuring earnout agreements in which over-performance on annual performance milestones can result in recovering lost quarterly earnout payments.

  At the beginning of the due diligence process, Javier provided Denshi with four years of projections on a quarterly basis. He indicated that he was much more comfortable with the annual performance numbers than with the quarterly projections. Quarterly performance is difficult to predict due to the contractual nature of the business. For that reason, IDS starts with annual projections and then divides the annual forecast equally among the four quarters of the year. The process is not perfect, but the IDS CFO expressed her belief that it is the safest type of forecast for IDS to use. Some consulting services contracts produce a regular stream of cash and earnings. But those contracts are of a fixed length and, when they expire, a few months or even quarters might elapse before another contract takes its place. Sometimes the contracts come in bunches producing a spike in revenue and earnings after a quarter or so of slow business. The same can be said regarding software sales, although they have proven over the years to be less volatile than consulting services.

Equipment purchases are the most difficult to predict on a quarter-to-quarter basis. Customers are large companies that have IT budgets that must be managed. Although IDS customers have proven to be very faithful to them, sometimes IDS have had to wait for those budgets to free up before purchases can be made. Maintenance contracts on equipment buffer that volatility somewhat. Javier is concerned about the potential for not receiving the entire earnout amount if the earnout performance intervals are quarterly instead of annually. IDS could perform well over the year but have quarterly performance uneven during the year and potentially lose earnout payments.

- Performance Milestones. The possible performance milestones associated with an earnout agreement are Revenue, Gross Profit, and Net Profit. Previously, Kenji and Javier have agreed that the projections provided by Javier during the due diligence phase would serve as the basis for the performance milestones. Discussions are still required to determine whether quarterly or annual projections or a combination of both projections would be the appropriate intervals for performance milestones.
- Earnout Payment Currency. Agreement has been reached that the denomination of the guaranteed payment will be euros. However, since the earnout payments will occur over some period in the future, the currency to be used for earnout payments was left to be decided by Katsumi and Javier as part of the earnout negotiation.

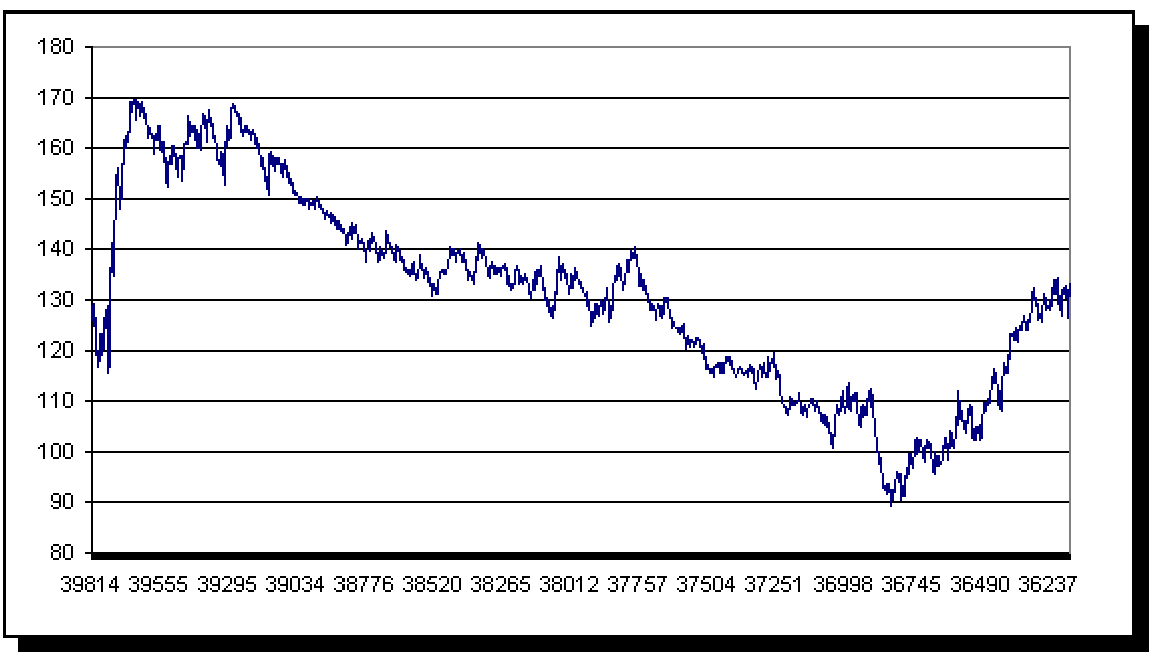
During the past ten years, the yen has shown periods of strength and weakness against the euro, as shown in Figure 2. During 2008, the yen appreciated 29.6 percent against the euro. Due to this significant appreciation of the yen against the euro and other currencies and its negative impact on Japanese exports coupled with a weakening Japanese economy, Denshi's Chief Economist is currently forecasting that the yen will again weaken against the euro (and other currencies) during 2009 and most likely beyond. If the agreement stipulates that the earnout payments are to be denominated in euros and if the yen depreciates against the euro as Denshi forecasts, then the euro-denominated earnout payment made during a performance interval would require Denshi to convert more yen into euros to make the payment than required under the current yen/euro exchange rate. The earnout payments would be more expensive for Denshi. A weakened yen against the euro would have no impact on Javier, as there would be no currency conversion necessary on the euro-denominated earnout payments received by him.

Of course, if the Denshi Chief Economist's forecast is wrong and the yen continues to appreciate against the euro during the earnout period, then Denshi would require fewer yen to convert into the euro-denominated earnout payments. In effect, the euro-denominated earnout payments would be less expensive for Denshi.

Conversely, if the earnout agreement had payments denominated in yen, then a stronger or weaker yen against the euro during the earnout period would have no financial impact on Denshi. Javier, however, would have to convert his yen-denominated earnout payments into euros. Therefore, a depreciation of the yen against the euro would decrease the euro-value of the payments to Javier. An appreciation of the yen against the euro would make the yen-denominated payments worth more on conversion of yen to euros.

Given the uncertainty of the future exchange rates between the yen and euro, if the earnout payments are denominated in yen, Javier would be exposed to exchange rate risk. If payments are denominated in euros, Denshi would be taking on that risk. The denomination of the earnout payments have yet to be determined.

Figure 2: Yen/Euro Exchange Rate History



- Employment Contract and Non-Compete Agreement Term. In addition to finalizing the acquisition agreement, Javier and Katsumi will need to negotiate the term of Javier's employment contract and non-compete agreement. Javier and the key members of his management and research teams agreed to the terms of employment agreements. The only issue left for negotiation is the length of Javier's employment contract. Javier will continue as the IDS CEO. Denshi normally has 2- to 4-year terms on its portfolio companies' CEO employment contracts. Javier also agreed that he would sign a Non-Compete Agreement (NCA) that would take effect immediately upon Javier leaving IDS, either when his employment agreement term expires or any time thereafter if he stays with Denshi beyond the term of his initial employment contract. Denshi made this criterion a requirement of the deal. However, Denshi is willing to negotiate on the term (length in years) of the NCA. These agreements usually have a term from 1 to 3 years. As part of the NCA, Javier agreed to include a clause which states that during his tenure as CEO of IDS while IDS is a portfolio company of Denshi, Javier will not start any other company. No other elements of either the employment contract of NCA are open for negotiation.

- Cross-Cultural Challenges. Katsumi understood from past experience, and past mistakes that a cross-cultural element of negotiations adds a critical new dimension to the process of coming to an agreement, and she will have to adjust her normal style of negotiating to take cultural differences between her and Javier into account. She knew that her experience with cross-cultural negotiations will be helpful to her in crafting an agreement that will be valuable to both parties, and the fact that she has never negotiated with a person from Spain will present an added challenge. She wondered what new challenges she will face from Javier's negotiating style.

  Javier's only experience with a Japanese negotiator was with Kenji over the past few months. In thinking about his upcoming negotiations, Javier pondered several questions: *Would Katsumi Shimura be the typical Japanese negotiator? She is educated in the United States, so maybe she has adopted part of an American style of negotiating. If she is as good as Kenji Ando said she is, is she preparing for the negotiations right now? How much does she know about me? Is she doing her homework on what to expect from a Spanish negotiator, just as I did my homework on other negotiating styles? What does the rest of the world think about the Spanish approach to negotiating? What would Katsumi Shimura expect me to be like?*

  In preparation for their negotiation, Javier and Katsumi researched their counterpart's cultural negotiating style. They read books and articles on cross-cultural negotiations and looked at the websites, www.cultureactive.com and www.executiveplanet.com, both excellent sites for information related to cross-cultural negotiations. The following is a summary of their findings from the www.executiveplanet.com site.

The Spanish Negotiating Style:

- Personal relationships are critical in the success of any negotiation with Spanish businessmen and businesswomen.
- Show respect to the Spanish business culture.
- Be extremely prepared.
- Hierarchy and status are very important in the Spanish business culture.
- Spanish decision-making is relatively slow compared to some other cultural styles.
- Spaniards in general have a great affinity for teamwork and for belonging to a group in both their professional and personal lives.
- Have patience.
- Remain flexible. Spaniards will seem to be making commitments as the negotiation progresses, but expect them to be soft commitments with the possibility of revisiting earlier issues on which commitments seem to be made.
- Spaniards are rather focused in their positions on issues. They do not change their minds easily, even with the introduction of new information.
- Spaniards often tend to hold information critical to the negotiations somewhat private.
- Expect the Spaniards to interrupt you while you are talking.
- As status is very important, be extremely careful about kidding or joking as you may inadvertently offend your counterpart, especially in front of subordinates.

The Japanese Negotiating Style:

- Business and personal connections and relationships are extremely important in Japan.
- Do not introduce new information in a way that surprises or casts doubts on the integrity of the information previously introduced by your Japanese counterpart.
- Frame the new information as a way of assisting you in understanding their markets.
- Japanese are very traditional, so the introduction of new concepts and ideas may take some time. There are generational differences in this timeline.
- Always maintain a high degree of professionalism.
- Japanese negotiate in teams, with the senior member of the team sitting in the middle and those of lesser rank on the sides.

- The pace of negotiating with Japanese can be slow, with much communication necessary to move toward an agreement.
- The word “Yes” said by a Japanese negotiator may not mean an affirmative agreement. It may simply mean “I understand.” Check for understanding before assuming you have an agreement on an issue.
- The Japanese are very thorough. They analyze each point made on each issue until they are comfortable that they understand every detail. This could be frustrating to those of other cultures.
- Japanese negotiators adhere strictly to their company policy. Adapt your strategy by understanding company policy.
- “Saving face” is extremely important, so make every effort to not embarrass your negotiator, especially if he/she has the highest status and subordinates are present.

Both Javier and Katsumi remembered one piece of advice that seemed to be common among everything they read about cross-cultural negotiations: *Any description of a culture-based negotiating style is a generalization and your negotiating counterpart may not fit a stereotype. So don’t be surprised if the person you are negotiating with breaks the cultural mold.*

The objective of the upcoming final stage of the Denshi/IDS negotiation between Javier Portilla and Katsumi Shimura is to explore the possibility of overcoming the “valuation gap” impasse through an earnout agreement and to agree on the term of Javier’s employment agreement with Denshi. The location of the negotiation: a private meeting room in the Hotel Baur au Lac, Zurich, Switzerland.

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Questions

1. What is the motivation of Javier, as an entrepreneur, to sell his company to Denshi?
2. What are the corporate objectives of Denshi in acquiring IDS?
3. What are the major negotiating challenges facing both Javier and Katsumi?
4. In what ways do cross-cultural negotiations differ from negotiations with someone from the same culture?
5. What is a "valuation gap" and why does one exist in the potential acquisition of IDS by Denshi?
6. What is the purpose of an earnout arrangement and how might it prove useful in the potential acquisition of IDS by Denshi?
7. Are there ways, other than an earnout arrangement, to bridge the "valuation gap"?
8. Explain the preferences and rationale of both Katsumi and Javier on the following earnout issues:
   a. Earnout Amount
   b. Earnout Term
   c. Earnout Performance Intervals
   d. Performance Milestones
   e. Earnout Payment Currency

9. How would you advise both Katsumi and Javier on preparing for their upcoming negotiation?

10. Is Katsumi justified in her position of preferring quarterly performance milestones?

11. Is Javier justified in preferring annual performance milestones?

12. What is the rationale for Javier's position that missing a performance milestone by a very slight amount, e.g., a few percentage points, would result in Javier losing the entire earnout payment for that performance interval? How would you counter if you were Katsumi?

13. Is some form of cumulative, additive, or catch-up provision justified in the earnout agreement?

14. Why is it important in an earnout agreement that the performance milestones are well-defined?

CON OR CON-STRUCTION?: THE CASE OF NYE CONTRACTING

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CASE DESCRIPTION

The primary subject matter for this case concerns the development of a communications strategy for a scenario where expectations have diverged between a contractor and a client concerning prior verbal and written agreements. Secondary issues include the ethical obligations of contractors to their clients, contractor expertise in bidding jobs, and effective communication between the contractor and the client. This case was designed for use in an undergraduate business communications course, but can also be easily adapted for use in an undergraduate business law or business ethics course. It could be taught in a 1½-hour session and is expected to require 2 hours of outside preparation by students.

CASE SYNOPSIS

Alex and Lauren Stewart, new to the Houston area, retained the services of a general contractor to make repairs to the home that they had just bought. Although they took great care in researching, specifying the work, and hiring Nye Contracting, they encountered problems from the start with the contractor, his various crews, interruptions and delays in the work schedule, and poor quality work. The last straw for the Stewarts was Nye's demand for additional money for materials to complete the job. He also threatened to place a lien on the Stewart's home until the additional money requirement was met. At this point, the Stewarts feel compelled to document their refusal to pay additional money to Nye and to hold Nye to the terms of their initial agreement, to clarify their position to his demands, to document the extent (percentage) of the work accomplished to date in order to calculate what percentage of the agreed-upon wages should be paid to date, to specify what jobs still need to be done, and to document the deterioration of their business relationship with Nye for possible legal action. Alternatively, however, the Stewarts are considering more positive communication in the hopes of convincing Nye to complete the job he agreed to perform initially and to maintain goodwill.

INTRODUCTION

The Benning Corporation bought John and Elise Montgomery's 8-year old, two-story, 5,000 square-foot Houston home in the upscale golf community of Pinehurst as a part of a relocation deal. The house stayed on the market for approximately three years, and because it was largely unoccupied during this time, regular maintenance was not performed leaving the house in need of many repairs.

After careful consideration of the improvements that it required, newcomers Alex and Lauren Stewart made a low-ball offer on the property which was accepted by The Benning Corporation. The Stewarts wasted no time in addressing two major problems with their brick veneer home. Non-structural, interior water damage had been caused by deterioration and rot of the caulking and exterior wood trim in and around the door frames and window casings, and doors. And the concrete floor in the attached garage had developed one large crack and several smaller ones due to the settling of the structure in the substrate soil. After setting a detailed scope of the work on these two projects (one for the exterior wood replacement, painting, and caulking and one for the garage floor), Lauren set about contacting contractors in the area, and after initial interviews and bids, and contacting references, selected Joe Nye Contracting for the two jobs to be performed simultaneously by his work crews under his direct supervision.

Prior to beginning work on the project and at Lauren's request, Mr. Nye had provided a signed copy of the scope of the project, the two-week time frame, and his estimate for the work, along with a copy of his liability insurance and licensure. He and his workers had signed a warranty and indemnification agreement required by the Stewart's prior to beginning the job on May 1. In addition, Nye had further agreed to be on-site to supervise his workers. The Stewarts were confident that they had done the necessary due diligence for the project and placed their trust in Mr. Nye for a quality job. And, as requested by Mr. Nye, they had paid a materials draw of 50%, the remaining 50% to be paid upon completion of the project.

The First Week

Mr. Nye and his work crews arrived on the property as scheduled on Monday, May 1, to begin work. Problems began almost immediately. Materials were not on site, instructions were not given to the crews whose primary language was Spanish, and Mr. Nye left, presumably to supervise work elsewhere. The Nye Contracting workers, left to their own devices, made half-hearted attempts to remove caulk, scrape paint, and chip out the cracks in the garage during the morning, but by the afternoon, had gathered in small and talkative groups in the backyard, on the patio, and in the driveway.

The next morning, Lauren approached Mr. Nye about the lack of materials on site, his lack of supervision the previous day, and his distracted workers. He responded that the workers had no need of materials yet in this first phase of the job, and apologized that another job had required his immediate attention the day before, but that he would be on site to supervise and direct his crews from now on, that these were individuals who had been with Nye Contracting only a short time and were unfamiliar with the company's work ethic. The next few days went better than the first: Mr. Nye supervised his workers (with only brief absences to obtain materials as needed) as they prepped word surfaces, replaced trim, caulked, and laboriously chipped out the cracks on the garage floor.

By Friday morning, the "house" crew was ready to begin painting, and the "garage" crew was still chipping. Mr. Nye had brought the necessary painting supplies for the job that morning, but told Lauren that he was unable to stay as he had problems at another job site which would take him away all day Friday and Saturday. He would, however, be back on site on Monday morning with additional materials for the garage floor. He then lined out the day's work with his crews, and left. When Lauren arrived home later that evening, she was appalled at the mess left in the driveway: paint cans left open, paint spatters on the pea gravel driveway, brushes unwashed with cans of solvent nearby, the garden hose uncoiled and white paint residue on the hose and spray attachment. Inside the garage, concrete debris and empty tubes of caulk and cans of paint, blue tape, hamburger wrappers, paper drinking cups, beer cans, and plastic littered the floor. Ladders were still set up in backyard, and more lunch litter was on the patio table. Lauren left the mess as it was, determined to talk to the crews on Saturday morning about cleaning up after themselves at the end of each day.

On Saturday morning, only three workers out of the entire "house" crew showed up; the "garage" crew did not show up at all. In halting Spanish, Lauren asked the workers to clean up after themselves and provided large trash bags for that purpose. The three workers complied willingly enough, and Lauren proceeded to walk around the house to look at the painting that had been done the day before. Some of the work had been neatly done, but she was again appalled to find that most of the work resembled the work of a five-year-old: white paint spatters and drips on the red brick veneer, drip marks on the window casings and doors, and uneven paint coverage on the trim and doors. In some cases the caulking, too, had not been smoothed, making a bumpy and uneven surface for the paint. Lauren called the crew's attention to the problems, and found herself supervising the three throughout the day so as to avoid additional mistakes. She resolved to discuss the situation with Mr. Nye the next week.

The Second Week

On Monday, neither Nye nor his crews showed up at all. Or Tuesday. Or Wednesday. Lauren's attempts to contact Mr. Nye by phone were unsuccessful although she left repeated messages.

On Thursday morning, a very apologetic Mr. Nye with two new work crews showed up on the Stewart's doorstep. He explained to Lauren that he had been having problems with the previous crews and had fired all but two of them, but that the new crews were prepared to finish the job as quickly and as efficiently as possible. He also apologized for the sloppy work that had been done and assured her that they would remove the white paint from the driveway and brick veneer and correct any problems to her satisfaction. He had also brought the epoxy filler for the garage floor so that the new "garage" crew could complete filling the cracks.

For the next two days, the crews worked diligently and cleaned up at the end of each day, even though Mr. Nye was not available to supervise them. For the most part, Lauren assumed that role to avoid further delays on the project. The crews attempted, unsuccessfully for the most part, to remove the paint residue from the brick veneer and to correct the sloppy caulking and painting errors of their predecessors. The "garage" crew had finished filling the cracks and sanding the lines, and had swept and cleaned the floor in preparation for the first coat of marine-grade epoxy primer and paint on Monday morning.

The Third Week

On Monday morning, Mr. Nye arrived early with his crews. While the crews were setting up, Mr. Nye explained to Lauren that he had miscalculated the materials expense in the original bid for the specified two-part epoxy paint and that he would need an additional $1,500 for materials to complete the project. Lauren explained to him that his bid earned him the job, and that as an experienced contractor, he should know the costs associated with construction projects. The epoxy paint was a fundamental requirement of the garage job from the outset. And further, that given the delays and problems with crews and the quality of the work, she didn't feel particularly inclined to continue to pay for his mistakes in terms of time or money. When she pressed Nye to explain exactly where he had miscalculated materials in the original bid, his response was vague, saying only that the epoxy paint had been much more expensive than he had originally thought. Lauren told him that she'd discuss the situation with Alex that evening and would get back with him the next day.

The following morning when Nye arrived on site, Lauren told him that she and Alex had agreed that they would hold him to the original bid for the work. Nye's face reddened with anger as he took a couple of steps towards Lauren, and with closed fists threatened to place a contractor's lien on the property until he was paid the additional amount. He promptly collected his crews and his materials and left the Stewart residence leaving the work on the house and garage uncompleted.

WE'D RATHER FIGHT THAN SWITCH: MUSIC INDUSTRY IN A TIME OF CHANGE

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CASE DESCRIPTION

The primary subject matter of this case concerns market changes experienced in the music industry with the advent of the Internet as a vehicle for distributing individual songs. The Internet, as a disruptive technology, spurred an upheaval of what had been a decades old business model for the creation and distribution of music. The music industry's desperate legal battle to preserve an out-moded distribution channel is discussed. Secondary issues examined include copyright protection for intellectual property and behavioral ethics for both individuals and companies. This case has a difficulty level appropriate for senior undergraduates and first-year graduate students (4 or 5). Appropriate courses for this case discussion include marketing management, channels of distribution and buyer behavior. The case is designed to be taught in 1.5 class hours and is expected to require 1.5 hours of outside preparation, not including supplemental readings, by students.

CASE SYNOPSIS

Imagine working in an industry that makes large profits with existing technology; an industry facing unprecedented change driven by shifting consumer demand facilitated by technological innovation. Instead of embracing change, your first strategy is to try banning the new technology. Your next strategy is to eliminate new competitors attempting to satisfy shifting consumer demand, using litigation to put them out of business. Your third strategy is to lobby for new laws restricting consumers from consuming your product in new ways. Your fourth strategy is to use technology to destroy your customers personal belongings and generally aggravate their lives. Finally, your coup de gras is to treat your customers as criminals and sue them for damages; a multi-billion industry settling for thousands of dollars in damages. This is an apt description of actions taken by the music recording industry and its trade association, Record Industry Association of America. Seeking to stave off innovation and squeeze as much profit from an out-moded production and distribution system, the music industry turned its collective back on their customers. They decided that they would rather "fight than switch!"

The music industry is been irrevocably changed by the Internet, but rather than embracing change to better satisfy their customers' needs the industry opted to continue to sell CDs. Music *consumer use of the internet and innovation has figuratively dragged the music industry into the 21st century. This case provides an overview of the changes occurring in the music industry over the last decade, allowing for the discussion of innovation's influence on distribution channels, and ethics in buyer and corporate behavior.*

INTRODUCTION

The game was on, with the Recording Industry Association of American (RIAA) using a full-court press. Tanya Andersen of Beaverton, Oregon, was accused of illegally downloading music files over the Internet (Ward, 2007). Ms. Andersen, a 42 year old mother of a 10 year old daughter, was allegedly downloading gangsta rap songs at 4:00 in the morning; a music genre she knew nothing about. When Ms. Andersen contacted the RIAA to report an error, she was informed that unless she paid a "$4,000-$5,000" settlement that "she would be ruined financially." (Ward, 2007, p. 14). Further, Ms. Andersen was advised to pay even though the person at the RIAA support center believed she was innocent of the alleged crime (Ward, 2007, p. 14). So aggressive was the RIAA in the pursuit of Ms. Andersen, the industry association attempted to contact her 10 year old daughter at school by "pretending to be her grandmother (Ward, p. 15 2007)." Clearly the RIAA had entered a new realm where being customer-focused took on a whole new meaning.

From the RIAA's perspective music downloading was the equivalent of illegal drug trafficking, where the focus was on prosecuting the user rather than taking out the distributor (Butler, 2007). According to RIAA senior vice president for communications, Jonathan Lamy, "We can identify the IP addresses associated with the user engaging in illegal activity, [and the Internet Service Provider] is able to match a specific IP address with the account holder (Ward, 2007, p. 15)." It is an open and shut, ironclad case with the RIAA taking the moral high ground; Lamy continued,

> *"Our companies have every right to protect their product, just as those who have been robbed have every right to claim damages for what was stolen from them. This process is simply a means to an end – that is communicating the message that illegal downloading has consequences and encouraging fans to turn to any one of the great legal ways to enjoy music." (Ward, 2007, p.15)*

THE INTERNET AND RECORD INDUSTRY BACKGROUND

The Internet has been characterized as a disruptive technology, changing the way in which companies do business across a variety of industries. Disruptive technologies work to undermine a successful business model, or product offering (Keller and Shanklin, 2007). It could be said that the Internet is a great leveler, allowing smaller firms to effectively compete against larger, market controlling firms; or, consumer markets to have a louder voice in how companies satisfy their needs.

Music is consumed equally by men and women all ages, 43 percent are under age 30 (see Exhibit 1). Eighty-five percent of music consumers purchase full length CDs, with a majority (79 percent) purchasing through retailers or record clubs (see Exhibit 1). As of 2006, just 16 percent of consumers report obtaining their music, legally, through the Internet or digital downloads.

Since 1999 the Internet has allowed consumers, mostly under age 30, to significantly alter their music consumption behavior. Some felt that illegal downloading grew in popularity as a "revolt against over-priced and inferior products (Fiely, 2003, p. 1)." The Internet is changing the music industry for good, turning a decades-long distribution model on its head. Exactly how much downloading is taking place, legal and illegal, and its growth or decline are open to debate depending on the data sources used. In 2003 it was estimated that over 60 million Americans were using file sharing services (Metz, 2004). It is thought that almost all of these users were illegally downloading music (Fiely, 2003).

Exhibit 1: 1997 to 2006 Market Demand and Music Consumer Profile

Industry Size	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Dollar Value (in millions)	$12.2	$13.7	$14.6	$14.3	$13.7	$12.6	$11.9	$12.3	$12.3	$11.5
	1997 to 2006 Consumer Profile of Music Consumption									
Format										
Full-length CDs	70.2	74.8	83.2	89.3	89.2	90.5	87.8	90.3	87	85.6
Full-length cassettes	18.2	14.8	8.0	4.9	3.4	2.4	2.2	1.7	1.1	0.8%
Singles (all types)	9.3	6.8	5.4	2.5	2.4	1.9	2.4	2.4	2.7	3.4
Music Videos/Video DVDs	0.6	1.0	0.9	0.8	1.1	0.7	0.6	1.0	0.7	1.1
DVD audio	N/A	N/A	N/A	N/A	1.1	1.3	2.7	1.7	0.8	1.3
Digital Download	N/A	N/A	N/A	N/A	0.2	0.5	1.3	0.9	5.7	6.7
SACD	N/A	N/A	N/A	N/A	N/A	N/A	0.5	0.8	1.2	0.0
Vinyl LPs	0.7	0.7	0.5	0.5	0.6	0.7	0.5	0.9	0.7	0.6
Age										
10-14	8.9	9.1	8.5	8.9	8.5	8.9	8.6	9.4	8.6	7.6
15-19	16.8	15.8	12.6	12.9	13.0	13.3	11.4	11.9	11.9	12.8%
20-24	13.8	12.2	12.6	12.5	12.2	11.5	10.0	9.2	12.7	9.8
25-29	11.7	11.4	10.5	10.6	10.9	9.4	10.9	10.0	12.1	12.7
30-34	11.0	11.4	10.1	9.8	10.3	10.8	10.1	10.4	11.3	10.2
35-39	11.6	12.6	10.4	10.6	10.2	9.8	11.2	10.7	8.8	10.6
40-44	8.8	8.3	9.3	9.6	10.3	9.9	10.0	10.9	9.2	9.0
45+	16.5	18.1	24.7	23.8	23.7	25.5	26.6	26.4	25.5	26.1

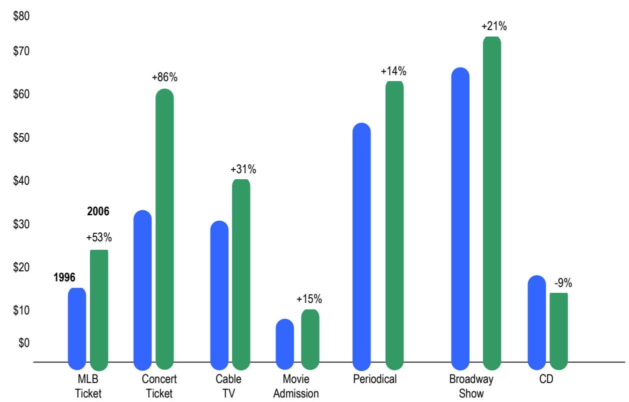
Exhibit 1: 1997 to 2006 Market Demand and Music Consumer Profile										
Industry Size	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Dollar Value (in millions)	$12.2	$13.7	$14.6	$14.3	$13.7	$12.6	$11.9	$12.3	$12.3	$11.5
	1997 to 2006 Consumer Profile of Music Consumption									
Channel										
Record Store	51.8	50.8	44.5	42.4	42.5	36.8	33.2	32.5	39.4	35.4
Other Store	31.9	34.4	38.3	40.8	42.4	50.7	52.8	53.8	32.0	32.7%
Record Club	11.6	9.0	7.9	7.6	6.1	4.0	4.1	4.4	8.5	10.5
TV, Newspaper, Magazine Ad	2.7	2.9	2.5	2.4	3.0	2.0	1.5	1.7	2.4	2.4
Internet	0.3	1.1	2.4	3.2	2.9	3.4	5.0	5.9	8.2	9.1
Digital Download	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	6.0	6.8
Concert	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1.6	2.7	2.0
Gender										
Female	51.4	51.3	49.7	49.4	51.2	50.6	50.9	50.5	48.2	49.6
Male	48.6	48.7	50.3	50.6	48.8	49.4	49.1	49.5	51.8	50.4%

Data based on telephone survey of past month music buyers. For 2006, the reliability of the data among 1,200+ past-month music buyers is +/- 2.8% at a 95% confidence level. With respect to genre, consumers were asked to classify their music purchases.
Source: Recording Industry Association of America, 2008, www.riaa.com.

Since the beginning of production and marketing music, major labels sought out musicians for exclusive recording contracts with a focus on producing and distributing CDs that would generate large profits. Throughout the 70s, 80s and 90s the recording industry experienced consolidation. The big five recording companies, including Sony, EMI, and BMG, controlled the talent and as a result what consumers would listen to. Music was either consumed via the radio or on physical CD-ROMs. Despite consumer dissatisfaction, the RIAA asserted that CDs were a better music value than ever when compared to other forms of entertainment (see Exhibit 2), the average list price of a CD dropped almost 31 percent between 1983 and 2006 (RIAA, 2007).

The Internet changed everything as young people investigated the excitement and freedom of music downloading. First, they converted personal music libraries to digital formats to create their own CD mixes; a behavior no different than making tape recordings of music on vinyl albums. Then, Napster was created in 1999. It was the original peer-to-peer (P2P) network that allowed users to share files over the Internet. An instant success, the P2P network concept burned through the marketplace like wildfire. The music industry claimed that illegal downloading was responsible for the loss of $4.3 billion in worldwide revenue each year (Sorkin, 2003). Consumers felt that being "ripped off" by overpriced CDs justified their illegal downloading activities (Dvorak, 2004).

Exhibit 2: Entertainment Cost Comparisons 1996 - 2006



Source: The CD: A Better Value than Ever, 2008, The Recording Industry of America Association, www.riaa.com.

Data compiled by the RIAA showed an increase in physical CD sales until 2000, with revenue peaking at $13.2 billion. Since 2000, unit sales of CDs declined by 35 percent, with revenue declining by 31 percent (see Exhibit 3). Between 2004 and 2006, sales of "legal" music downloads increased 379 percent to $878 million (see Exhibit 3). As far as the RIAA was concerned, illegal music downloading was responsible for the dramatic decline in CD sales (Gross, 2004). Terry McBride, CEO of the Nettwerk Music Group, questioned the music industry assumptions citing the following reasons for CD sales decline: 1) competition from other entertainment, 2) replacement cycle for music is over – digital doesn't scratch, 3) consumers prefer the great songs without the filler, 4) mass merchant retailers carry lower inventory due to narrow product assortment, consisting of only the "hits." (McBride, 2006, p. 4)

THE MUSIC INDUSTRY TAKES ACTION

The current industry distribution and revenue model was predicated on using radio for listener trial; then, consumers could buy CDs to own the music. Many consumers felt that being forced to buy complete CDs at an average price of $15.00 for one or two songs was much too expensive. Thus, they turned to downloading off the Internet. The music industry viewed all downloading the same, illegal! The RIAA fought desperately to save the traditional CD revenue and distribution system. To coin the tagline of the old Lucky Strike cigarettes, the music industry would rather "fight than switch."

EXHIBIT 3

2006 YEAR-END SHIPMENT STATISTICS

Physical		1996	1997	1998	1999	2000	2001	2002	%Change 2001-2002	2003	%Change 2002-2003	2004	%Change 2003-2004	2005	%Change 2004-2005	2006	%Change 2005-2006
(Units Shipped)	CD	778.9	753.1	847	938.9	942.5	881.9	803.3	-8.90%	746	-7.10%	767	2.80%	705.4	-8.00%	614.9	-12.80%
(Dollar Value)		9,934.70	9,915.10	11,416.00	12,816.30	13,214.50	12,909.40	12,044.10	-6.70%	11,232.90	-6.70%	11,446.50	1.90%	10,520.20	-8.10%	9,162.90	-12.90%
	Total Units	**1137.2**	**1063.4**	**1123.9**	**1160.6**	**1079.2**	**968.5**	**859.7**	**-11.20%**	**789.4**	**-7.10%**	**814.1**	**2%**	**748.7**	**-8%**	**642.6**	**-14.20%**
	Total Viaue	**12,533.80**	**12236.8**	**13711.2**	**14584.7**	**14323.7**	**13740.9**	**12614.2**	**-8.20%**	**11854.4**	**-6%**	**12154.7**	**2.50%**	**11195**	**-7.90%**	**9651.4**	**-13.80%**
Digital																	
	Download Single	–	–	–	–	–	–	–	–	–	–	139.4	N/A	366.9	163.30%	586.4	59.80%
		–	–	–	–	–	–	–	–	–	–	138	N/A	363.3	163.30%	580.6	59.80%
	Dowlad Album	–	–	–	–	–	–	–	–	–	–	4.6	N/A	13.6	198.50%	27.6	103.30%
		–	–	–	–	–	–	–	–	–	–	45.5	N/A	135.7	198.50%	275.9	103.30%
	Kiosk	–	–	–	–	–	–	–	–	–	–	–	–	0.7	N/A	1.4	89.50%
		–	–	–	–	–	–	–	–	–	–	–	–	1	N/A	1.9	96.20%
	Music Video	–	–	–	–	–	–	–	–	–	–	–	–	1.9	N/A	9.9	434.30%
		–	–	–	–	–	–	–	–	–	–	–	–	3.7	N/A	19.7	434.20%
	Total Units	–	–	–	–	–	–	–	–	–	–	**143.9**	N/A	**383.1**	**166.20%**	**625.3**	**63.20%**
	Total Value	–	–	–	–	–	–	–	–	–	–	**183.4**	N/A	**503.6**	**174.50%**	**878**	**74.40%**
Total Digital & Physical																	
	Total Units	**1137.2**	**1063.4**	**1123.9**	**1160.6**	**1079.2**	**968.5**	**859.7**	**-11.20%**	**798.4**	**-7.10%**	**958**	**20%**	**1301.8**	**35.90%**	**1583.2**	**21.60%**
	Total Value	**12533.8**	**12236.8**	**13711.2**	**14584.7**	**14323.7**	**13740.9**	**12614.2**	**-8.20%**	**11854.4**	**-6%**	**12338.1**	**4.10%**	**12269.5**	**0.60%**	**11510.2**	**-6.20%**

Retail value of shipments at recommended or estimated list price.

Source: Recording Industry Association of America, 2008, www.riaa.com.

File Sharing and MP3 Players.

Starting in 1999 the RIAA took two significant legal actions. The music industry attempted to squash Diamond Multimedia's Rio PMP300 digital music device, contending that the device "intended to encourage music piracy." (Null, 1999, p. 14) RIAA lost this legal battle; Judge Diarmuid F. O'Scannlian disagreed with the industry's contention, stating that the "…Rio's operation is entirely consistent with the act's main purpose – the facilitation of personal use." (Guglielmo, 1999, p. 24). Though not a complete loss for the RIAA, Diamond Multimedia agreed to endorse the industry's Secure Digital Music Initiative for later generation MP3 players (Guglielmo, 1999). Almost immediately a plethora of MP3 players appeared on the market.

Not ready to abandon their litigation strategy, the RIAA next turned their sights on Napster, the founding and leading P2P network. Napster streamlined the MP3 file sharing process by providing directories of music available on the user network (Sutin and Josel, 2000). Actual music files resided on the hard drives of network users. The courts agreed with the music industry that Napster helped to facilitate and encourage music piracy by providing music content directories. This was the RIAA's first legal success. The publicity generated over this case helped raise American music consumer awareness for alternatives to the "old" CD. Napster had a few hundred thousand users when it was shut down in 2000 (Dvorak, 2004), a far cry from the 60 million music downloaders by 2003

The speed of technology always moves faster than the speed of legality. While the RIAA was celebrating its victory over music piracy, Napster was replaced by other P2P networks. Providers such as Kazaa and Grokster quickly established themselves as dominant market alternatives for downloading music off the Internet. The RIAA swung into action, but success was not in the cards. While the RIAA tried to hold these new P2P networks responsible for the illegal music downloads as they did Napster, a change in the network structure made legal liability much more difficult to prove. Initial legal action against Kazaa was not successful leading Kazaa to file an anti-trust lawsuit against the RIAA and other industry trade groups (Gruenwedel, 2003). So, the RIAA came up with a new strategy.

Ground zero: College Campuses.

For the first time in recent history an industry decided to go after its own customers, and not in a positive way. The RIAA embarked upon a strategy of taking people who had downloaded music illegally over the Internet to court. The RIAA was successful in shutting down private music sharing systems on four college campuses (Ahrens, 2003). Four students from four different universities were found guilty of maintaining illegal music sharing networks similar to Napster. The settlement required each student to pay up to $17,000 to the recording labels and prohibited them from using the Internet for music related activities. Again, the publicity surrounding this action created more interest in the subject of music downloading. Some publicity was helpful to the RIAA in that similar networks at other colleges were shutdown voluntarily by their owners.

Outside of universities, though, tracking down consumers was proving to be difficult. In what appeared to be a broad ranging "strategy of last resort," the music industry sued Internet service providers to give up names of music downloaders. Internet intelligence companies would release into networks a digital copy of a target song provided by the RIAA. Spider software was then used to "crawl" through shared folders on users' hard drives to search for the target song. Once found, the IP address would be obtained for that computer. Internet Service Providers (ISP) were then contacted by the RIAA with demands for names and addresses associated with the IP address (Levy, Juarez, McClure, Bailey and Williams, 2003). Some ISPs cooperated out of fear, others, such as Verizon, fought back with their own lawsuits (Tavani and Grodzinsky, 2005). A recent ruling by the Canadian Federal Court blocked music industry demands for ISPs to reveal the identities music downloaders, ruling that music downloading "for personal use was not illegal" and "found insufficient evidence that file sharers are infringing on Canadian copyright law (Dickie, 2004, p, 50)." The RIAA's strategy had some success, but clearly not the overwhelming "knock-out" blow they hoped to deliver to illegal downloaders.

Legislative Action.

At the same time consumers were being threatened with legal action, the RIAA was actively lobbying Congress to pass legislation strengthening laws against the creation and distribution of digital copies of copyrighted material. The Induce Act was legislation pushed by the RIAA that "would create a new civil cause of action for simply 'inducing' a copyright violation." (Shapiro, 2004, p. 10) This act was "secretly" drafted in Congressional committee, but when reaching the light of day generated strong objections from the technology and content communities. Had the legislation passed it could have severely hindered technological innovation in many related industries.

Fighting Fire with Fire.

As the legal strategy against music downloading bogged down the music industry decided to fight fire with fire. Software solutions were used to provide decoy files to downloaders. While the files looked like regular music tracks, when played they either produced random noise or "gotcha" scoldings exhorting downloaders to buy music, not steal it! (Chartand, 2004). The major record labels also quietly began research into software programs that would actually disable the computers and Internet connections of music downloaders. While never fully implemented, these were of questionable legality (Sorkin, 2005). Sony developed a software program and distributed it on newly released CDs of a number of popular recording artists. When these CDs were placed in the CD-ROM drive of a computer, a hidden program inserted itself in the Windows operating system unbeknownst to the user. There it sat, disguised from virus checking software, observing and reporting on everything a person was doing with that computer. This provided Sony with information on individual consumer music consumption behavior. If the software was discovered and removed, it would disable the computer's CD-ROM drive. Further, a number of computer viruses were able to take advantage of this system back door to attack individual computers. Needless to say, this resulted in a public relations and legal nightmare for Sony music. Sony eventually lost the legal battle and agreed to a $5.75 million settlement with 41 states and the District of Columbia (Ben-Yehuda, Brandle, Garrity and Nagy, 2007).

Broadening the Pursuit of Consumers.

The music industry next turned their lawyers loose on consumers, other than college students; some were guilty of illegal downloading and others, like Tanya Andersen, were not. Since September of 2003 thousands of music consumers received letters from the RIAA seeking restitution for illegal downloading or faced the threat of being dragged into court (Holland, 2005). In response, many music lovers agreed to out-of-court settlements out of fear or due to lack of resources to fight the RIAA. Others, such Tanya Andersen fought the lawsuits (Holland, 2005). Some being sued, such as David Greubel, had received support for their lawsuits from music companies (Butler, 2006). While the RIAA had some success with this strategy, they have also had failures. Many cases against individuals have been dismissed, and in at least one instance the RIAA had to pay one aggrieved defendant $68,000 for legal fees after dismissal of the case (Brandle, Bruno, Butler and Koranteng, 2007).

This desperation strategy, while achieving moral victories and small sums of monetary restitution, had a much larger cost in terms of negative publicity. Not to be deterred, the time had come for the industry to turn its sights back to what had become the "hotbed" of music downloading: college students (Booth, 2003). Over 5,000 students at dozens of colleges and universities received pre-lawsuit letters for illegal music downloading activities from the RIAA (RIAA, 2008a). The RIAA also initiated a campaign to assist schools and universities in educating students about the legalities and ethics of music downloading (RIAA, 2008b).

Legal victories and threats aside, many music downloaders still did not perceive legal action by the music industry to be a major threat to their own activities. The pervasiveness of music downloading lent a measure of security to consumers who felt that the music industry did not have the resources to find and prosecute millions of people in this country (Fiely, 2003). Music downloading was proving to be a gray area, both ethically and legally. Lending to this lack of clarity was the difference between those consumers who were downloading music for their own, personal use versus those who were starting a business to make a profit versus those who were sharing, not selling, their music with others. Further, if asked, consumers would tell you that their music downloading, while wanting portability, was a form of variety seeking, allowing them to try music from new bands before buying a single song.

MARKETPLACE ALTERNATIVES FOR MUSIC DOWNLOADING

While the music industry fought to protect an increasingly out-dated distribution system, players outside of the industry took advantage of the opportunity and provided solutions for consumers' music needs. The first to enter the market was Apple Computers (Swett and Kasler, 2003). They had recently introduced the iPod mp3 player, and moved quickly to establish a presence in the music downloading market with the new iTunes software. Apple became a dominant force in the industry by providing economical, legal access to individual songs and CDs. Songs could be downloaded for 99 cents, with complete CDs costing only $9.99. Aside from economical, iTunes was also the easiest and most convenient music downloading software on the market. Consumers flocked to iTunes, which also helped to sell many iPods.

Apple wasn't the only new player to the market. America Online offered their subscribers its own version of music downloading software for Windows computers (Sanders, 2004). Yahoo became an instant player with the purchase of MusicMatch (London, 2004). And, Microsoft eventually jumped into the market with their own downloading service (Microsoft, 2004). First to market, however, worked well for Apple as they amassed a 70 percent market share. The 100 millionth song download from iTunes was achieved just over one year from Apple's entry into the market (Evangelista, 2004).

Interestingly, Wal-Mart jumped into the music downloading business (Alexander, 2003, Evangelista, 2003). They made deals with the major record labels to sell songs for 88 cents, and

CDs for $8.44. It was difficult to argue with Wal-Mart since 14 percent of all physical CDs sold, worldwide, were through their stores (Alexander, 2003). Some country musicians were signed for exclusive releases of their most recent hits through the Wal-Mart music store. Wal-Mart would be a force to be reckoned with.

It was not surprising that the players were mostly computer firms and Internet providers due to the synergies between music downloading, the Internet and computer technology. The Internet also provided lesser known artists the opportunity to bypass the record labels completely and reach consumers directly through sites such as Garageband.com (www.garageband.com). Conspicuously absent, however, were the major recording labels.

Rather than develop their own music download alternatives, major record labels licensed their material to Apple and other intermediaries for distribution, and, continued to seek legal resolution or software solutions to the illegal downloading problem. While thinking this might be a match made in heaven, it wasn't all smooth running. Apple's success in the marketplace lead to earning large revenues, and major record labels wanted a larger slice Apple's pie (Graham, 2005). Claiming that Apple was using copyrighted music simply to sell iPods, the industry wanted to increase prices on music downloads to Apple's customers. The record labels already received 70 cents of every 99 cent download, but they wanted more. Specifically, they tried to pressure Apple into charging a $1.49 for popular songs; less popular songs could stay at 99 cents. The major record labels threatened to boycott iTunes over this issue (Brown, 2005). Apple resisted, contending that any move above the 99 cent price point would encourage consumers to engage in illegal downloading. Market size is power, something the music industry was desperately trying to hold onto. As an aside, the musicians who created the songs received approximately 4.5 cents in royalties for every song downloaded (Duhigg, 2006).

The Pandora's box of online music distribution had been opened, and try as they might the industry was having a difficult time closing it.

WHERE TO FROM HERE?

So, what to do about illegal music downloading? The music industry continued to sue customers engaged in illegal music downloading, which was clearly justified from a legal perspective. Since the first days of litigation involving distributors and consumers, the music industry had developed a multipronged approach to the problem. They continued to work with law enforcement to curtail the illegal replication and distribution of counterfeit CDs. The RIAA had developed and stepped up a campaign to assist educators and parents to educate young people as to the ethics and legality of music downloading. Efforts continued to craft legislation seeking to restrict the copying and distribution of music digitally. This directly involved efforts to modify existing FAIR USE laws to be more favorable to the music industry's position, potentially at the expense of consumer rights and needs (Tarr, 2005).

The industry had begun efforts to develop their own digital distribution channels, and continued to have conflicts over digital rights management with existing channel intermediaries such as Apple's iTunes and satellite radio providers. This had created tension, spurring Steve Jobs of Apple to publicly call for offering music without anti-piracy software (Gibbs, 2007). It is Jobs contention that this type of activity is fragmenting the digital music market, slowing market development. With satellite radio, the music industry wanted changes to music broadcasting and receivers to restrict "time-shifted" listening by consumers (Palenchar, 2005).

The music industry received an abrupt wake-up call from the marketplace, perhaps the victim of a disruptive technology called the Internet. Were they a victim of their own malaise and greed? Industries are in constant transition and their health and survival depends on how they deal with new technology.

Had the major recording labels waited too long and ceded their position as channel captains to new players in the market? What will the future hold for continued changes in consumer music purchase and consumption behavior? Did the industry understand the monumental change in distribution that had taken place? Where do they go from here?

Mitch Bainwol, President of RIAA, feels that "…we come together as a community—not just the labels begging for fairness, but all of us who care about the integrity of creative property—to demand comparable payment for music regardless of the consumer choice of platforms." (Bainwol, 2006, p. 4)

Terry McBride, CEO of Nettwerk Music Group, feels that, the "…RIAA's litigation policy has no upside. It is destroying our ability to monetize the P2P market by chasing music fans even further underground. It is hypocritical because we have shared music for decades…It undermines the importance of these file sharers. They represent behavioral marketing at its best and as such should be embraced, not sued." (McBride, 2006, p. 4)

CASE QUESTIONS:

1. Why do people listen to music? What are the benefits associated with listening to music?

2. Why do people download music? What benefits do they seek with music downloading?

3. How has music consumption behavior changed over the last ten years?

4, What would a channel map look like for the original, or pre-digital age, model of recorded music distribution?

5. How would the channel map for the distribution of recorded music change as a result of technological innovation? How would you classify the innovations that changed the music distribution channel?

6. Do you see channel conflict taking place in the evolution of the distribution of recorded music?

7. How much is the recording industry losing? What is the profit margin on digital downloads for the recording industry? Apple Computer?

8. What options did the RIAA and the major recording companies have for dealing with the marketplace changes?

9. Did the industry react the right way? How might they have reacted differently?

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COOPERATIVE GUATEMALA, LLC: "AN EXAMINATION OF A GUATEMALAN COOPERATIVE'S STRATEGIC DEVELOPMENT"

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CASE DESCRIPTION

The primary subject matter of this case concerns the development of strategy for confronting barriers to growth facing a small fishing Cooperative in rural Guatemala. The core issues include coming up with ways to evaluate past performance and to evaluate future options. The backdrop for these issues consists of identifying competitive advantages through diversification into identified new businesses. While this case is based on an actual, real set of circumstances, people and organizations; specific names of people, towns and the Cooperatives have been changed for proprietary reasons.

The case lends itself to student project assignments with respect to developing a strategy for "Cooperative Guatemala". Proposed solutions should follow for determining which ventures to accept with particular attention paid to the cultural implications. Furthermore, students should determine the viability of entering various markets based on incomplete information and the lack of full-time general management as identified in the case.

The case has a difficulty level appropriate for a senior course at the undergraduate level or at the graduate level. The case is designated to be taught in 1.5 class hours and is expected to require 2-3 hours of outside preparation by students.

CASE SYNOPSIS

This case explores the establishment and growth of homogenous Cooperatives in a stunted market and some challenges facing diversification of Cooperatives in rural Guatemala. Specific concerns of this case center on the development of strategy for confronting barriers to growth facing a small fishing Cooperative in rural Guatemala, with the added challenges of both strategic and operational decisions being determined solely by the Cooperative's board of directors. The cooperative faces some significant challenges including overcoming lack of education, culturally related decision-making stigmas, and poor organizational structure. These challenges fall within the context of attempting to find competitive advantages through diversification into identified new *businesses. Stemming from a search for assistance, the Cooperative eventually was assigned a US Peace Corps volunteer, the viewpoint from whom this case was developed, to assist the Cooperative in providing business administration skills, such as strategy development along with financial and operational control mechanisms, and help improve profitability. A major task of the case is to develop a framework within which the Cooperative can evaluate business opportunities it should pursue.*

INTRODUCTION

In the Spring of 2005, fresh from a re-election to a second term (2 years), Juan Perez faced some rather perplexing issues as President of the Cooperative Guatemala, an integrated-services fishing cooperative in the tiny city of Isla Bonita, Guatemala. No one in the Cooperative was stepping up to take over management of the hardware store, and Francisco, current store manager, had given his two weeks notice. The idea was proposed to hire an outside manager to try his hand at turning the hardware store's burgeoning credit deficit and lagging sales into a once-more profitable venture. With that proposal dismissed, almost as half-heartedly as it was suggested, Juan had to either find someone to run the hardware store, or step into the position himself.

A mason and artisan fisherman by trade, he had no direct knowledge of running a traditional business, but Juan was one of the few Coop members who had actually finished high school. After all, this could be the perfect opportunity to try and put into practice all the training he had been receiving from Rodrigo, a Peace Corps volunteer assigned to Cooperative Guatemala for nearly a year-and-a-half. This could be his chance to prove to the other members that management controls could indeed be implemented, and that it may even improve the profitability of the business.

He knew, however, should he step into the position, he would only be able to do it for a few months before the Cooperative would need to find a long-term competent manager. Marlin season was approaching, and he would not be able to split his time between his main jobs (Juan was the year-round manager of the local marlin hatchery, funded by AGEXPRONT, Agencia de Exportacion de Productos Non Tradicionales, as a way for industrial exporters to "give back" to society. Marlin eggs were captured and incubated for re-release into the ocean between late July and early December. Besides, as President, he already had enough on his plate without having to be responsible for the actual day-to-day business management. Therefore, when every other member of the Cooperative had openly declined the position at the hardware store, Juan took his boldest step to date and assumed the manager role.

The first thing Juan wanted to do, in part stemming from advice from Rodrigo, was to give some thought to more than just the short-term. Rodrigo suggested that Juan think about the vision of what the Cooperative might be capable of achieving and what might it look like in the future. After some discussions the two of them came up with some thoughts as outlined in Table 1.

Table 1: Strategic Vision	
Vision:	Be the example of cooperative success through diversified businesses and overall community contribution.
Mission:	Provide distribution channels and diversification options for Cooperative members and grow distinct core competencies in the fishing, construction and tourism industries.
Values:	The discussion here did not come to any conclusions as the past had indicated differences on this dimension. It was agreed for the time being to table this and come back to it later.
Short term goals:	
	* Diversify Cooperative into alternative services, including tourism.
	* Develop core competency
	* Build relationships with NGOs and Government Institutions to increase likelihood of consideration for grants and projects through better visibility.
Long term goals:	
	* Job creation and profit sharing for Members
	* Own a hotel on the island of Isla Bonita
	* Open to other ideas

BACKGROUND SETTING

Isla Bonita

Isla Bonita, a quaint fishing village along the Guatemalan coast, lies roughly one-hundred fifty miles away from the capital, Guatemala City. The latest census indicates a population of about 3,500, but even with a regular flow of trade and tourism traffic, one finds it difficult to imagine more than 1,000 live anywhere near the center of town. About an hour on a local bus will carry one the 30 miles to the Municipality of Mega Ciudad, the nearest thing to a city the region has. There, 40,000 to 50,000 people converge daily to buy and sell at the open-air markets, run errands in the municipal offices and change busses for the capital or the border. Known in the region mostly for its beautiful landscape and tourism, Isla Bonita is near a national preserve, and is home to a unique ecosystem of endangered habitat and sea wildlife. The nearest post office lies one town inland in El Sabanilla. Mail is still distributed by a local courier who walks the 8 kilometers to fetch it every morning. Electricity did not arrive to Isla Bonita until 1985, and no cable or telephone lines have been installed to date.

Due to its distance from the capital, and relative isolation, Isla Bonita has long been a spot for wealthy business people and government officials from the Capital to build their vacation homes. These wealthy homeowners, or Chaleteros as they are called, have formed a dichotomy of social and economic equity in the community, yet the community would be remiss without the jobs created for "guardians" of the Chaleteros' properties. There seems, thus, to have long existed a stratification of society whereby the wealthy were served and their lands tended by the local Lisenos. Shortly after the Chaleteros began to make Isla Bonita their second home, they took an interest in the social problems of the town and general lack of financial resources. There exists a rich history of community projects initiated, promoted and even funded by the Chaleteros.

HISTORY

Cooperative Guatemala

The Integrated Fishing Cooperative, Cooperative Guatemala R.L., did not find its humble roots in Hardware Stores, and fishnets. In fact, it did not even begin in the small fishing village of Isla Bonita. It was started in the mid-1980s by a group of would-be farmers in nearby San Cristobal and transient workers from neighboring Isla Bonita. When the farming cooperative hit hard times in the mid-80s, the members from Isla Bonita brought the idea home, kept the name and applied themselves to what they knew best, fishing. By law, the minimum number required for active status of a cooperative is twenty. Given initially sufficient numbers, the members in Isla Bonita divided their efforts to buy and sell seafood from the members in town and distribute it in the outlying regions. Unfortunately for Cooperative Guatemala, and the community, cooperatives began facing declining support from the government in the late 80's, and members began to disband and return to their separate lives. Not until 1995 would the Cooperative resurface with renewed vigor.

Cooperative Isla Bonita

Close to twenty years before the original Cooperative Guatemala, the Cooperative Isla Bonita was formed in 1968 by thirty-five fishermen in Isla Bonita, funded in part by the Government (several chaleteros were also government officials) in conjunction with foreigners interested in helping the Guatemalan fishing industry improve. The remaining funds were raised by the fishermen themselves through individual contributions. It was a booming time in the economy, and the Ministry of Agriculture poured money into the formation of industrial fishing cooperatives, giving them complete outfits of boats, nets, and other equipment along with the formation of a Federation to help govern themselves. The cooperative proved quite a lucrative venture over the ensuing years and created a stable economy in Isla Bonita along with substantial wealth. Unfortunately, the wealth was clearly not equitably distributed among associates, and in due time the leaders of the cooperative could be identified solely by their own social status and possessions. By the mid-80s, there were signs of elite leadership entrenchment and many factions began severing the bonds of membership in "The Big Cooperative", as the locals called it.

It was only a matter of time before Cooperative Isla Bonita would lose its monopoly on the local market as the owners' children began to reach member age. Nevertheless, with a good economy and a wide-open fish market, not to mention the lack of any sign of scarcity in the ocean, the cooperative members hoarded their prosperity and refused to let even their own family members join the ranks and dilute the earnings. It surprised no one, then, that when Cooperative Guatemala resurfaced in the mid-90s, the call for members was answered primarily by the bitter descendents of The Big Cooperative, chomping at the bit to show up their fathers.

Initially, no tangible rivalry existed between these two cooperatives, since Cooperative Guatemala did not have the resources to invest in any substantial industrial fishing equipment. However, increasingly less supply was being brought in by those large aging trawlers. The members of Cooperative Guatemala quickly saw that the glory days of the past, noted by limitless supply and demand in the industrial fishing market, were numbered.

ECONOMIC EXTERNALITIES

EFIS Isla Bonita (Social Investment Fund Entity – Isla Bonita)

By 1999, Cooperative Guatemala was 23 members strong and rapidly growing its own local fish market beyond the cramped little thatch-roof hut they were using as a headquarters. The members began to look around for expansion opportunities. In the fall of 2001, then Board President Carlos Mata, while on a routine visit to the INACOP (National Institute of Cooperatives – Government entity in charge of auditing and regulating Cooperatives) offices in Barberena, ran into a long-time friend of the Cooperative and Senator for the department of Southern Lights (to which Isla Bonita pertains), Rodrigo Cortez. Carlos was pleasantly surprised to hear of a new investment fund offered by a government organization. The Social Investment Fund (FIS), offered a 3 year contract to invest Q300,000 (the relevant conversion rate was US $1=Q7.90. Q indicates the Guatemalan currency, the Quetzal.) in Cooperatives looking to expand into non-traditional businesses and provide more employment opportunities to members. Excited about the news, Carlos immediately came back to the Cooperative and began motivating the associates, convincing the Board of Directors and filling out the necessary paperwork to begin the project.

The purpose of this investment (besides political party influence) was to promote income-generating projects and emphasize the importance of savings and profit re-investment for the healthy future of a business. The money was to be imparted in full to the Cooperative and kept in a new account created by FIS which would monitor the outflow of cash. Any amount taken from the account would be charged 3.5% interest per month. This "interest" was rolled into a separate account (Cooperative Guatemala chose a non-interest bearing checking account) where it was to remain for the duration of the 3 years, proving to FIS that the Co-op was diligent in paying the loan back. There were also measures taken to ensure the cooperative was dutifully re-investing at least

10% of the profits into expansion. At the end of the 3 years, however, this money would be added to the sum of the loan and "given" back to the Cooperative in it's entirety as a grant. Until this time, Cooperative Guatemala's only venture was buying and selling fish on the local market. From the FIS project sprang the construction of a Hardware Store and General Store as new business units built alongside their current fishing operations. This expansion also doubled as the Cooperative Headquarters. FIS assigned a Supervisor who helped Cooperative Guatemala with a feasibility study that indicated the market/profit potential of these two additional businesses. The supervisor's main role after the inception of the projects, however, was to monitor their progress and give the Cooperative members training sessions once-a-month regarding general management practices, accounting, market analysis and the general marketing of their products and Cooperative.

Razon Para Quedarse (A Reason to Stay – RPQ)

In 1990, a former German industrial fisherman and government labor lobbyist, John Q Doelander, stumbled upon Isla Bonita while looking for a beach a friend recommended. John jokes that from the first day, watching the fishermen row in from the sea in wooden boats, he knew there was much improvement potential in Isla Bonita. John's week-long stay turned into a year, then two, and before long he was calling in favors from friends back in Germany to help improve the artisan fisherman situation in Guatemala. He was dismayed by the mass exit of youth toward urban areas, the dwindling popularity and practice of artisan fishing which first attracted him to the relaxed yet hard-working community, and the lack of basic infrastructure already widely available in his native Germany for nearly twenty years. Now fourteen years later, John manages an NGO he helped found which built a solid Artisan Fisherman Network around the idea of giving local fishermen, and the artisan fishing industry, "A Reason to Stay".

RPQ began in Isla Bonita by funding the start-up of a new fishing association, Homegrown Ventures. Commonly referred to as a cooperative, Homegrown Ventures is alive and well in Isla Bonita. But John soon learned that his real impact would come in advocacy for all artisan fishing groups, and striving to provide solid business and project management training for other groups that would organize themselves.

From 2000-2005, John and his highly educated staff of fishing and legislative professionals unified over 50 different groups of fishermen across the country. In 32 cases, they actually had to help create the legal entities by which these groups would be known. Seeing this diligent effort to provide advocacy for a still strong cultural and economic sector of the country, the Guatemalan government arranged an agreement with RPQ and the German government to provide training in Business Administration for the fishermen. They also built a technical school for training in new fishing practices, where all groups would be owners and participants in the curriculum.

The members of Cooperative Guatemala participated in the launching of this Fishermen's Network. In addition, Juan, Cooperative Guatemala's Board President, and Jose Sanches, another

Board member, served as Secretary and Regional Coordinator respectively for the coordination of the South Coast Region. In their respective capacities, they were able to participate in a 9 month training program focusing on Administrative and Leadership training, culminating with technical training in the planning and financing of Tilapia and Shrimp farms. Cooperative Guatemala gained quite a reputation among the member organizations of the Fishermen's Network as having a successful cooperative and capable leadership, and often was elevated by RPQ leadership as the example for other Cooperatives to ascribe to.

PEACE CORPS VOLUNTEER

Rodrigo was sent to Isla Bonita by the US Peace Corps through a solicitation via INACOP by the Cooperative Guatemala Cooperative for a technical advisor in Business Administration. He made the following observations regarding his impression of the Cooperative.

> *"When I arrived in Isla Bonita, and Cooperative Guatemala, it was like being transported back 30 years in time. Very little there is done on a schedule, at least not what the industrial world would call a schedule, and there seemed to be very little, if any, structure to the organization and delegation of work. I found no real, by real I mean valid, registers of the Cooperative's cash flow, and soon learned the Treasurer had the equivalent of an eighth-grade education. In fact, of the 23 members of Cooperative Guatemala, only three finished high school and only one had pursued a technical degree. The remainder had between a third and sixth-grade education, and three members were illiterate. I realized it was going to be an interesting two years when I asked to see some financial information and was handed "the notebook", a hardly legible manuscript of presumably ALL transactions flowing into, out of, or owed to the Cooperative for the previous 3 years. At that moment, someone arrived at the hardware store. A call went out, "They need you at the Hardware store!" As Martino begrudgingly returned from his thirty-minute gossip session at the other end of the Co-op's "headquarters" (widely recognized as the local gossip mill), he diligently responded to the customer, and went back about his business – lounging till someone else bothered him. No receipt was written, no note taken in inventory, no planning to be done; and the purchase, bought on credit, was written in Martino's notebook to be tallied at the end of the month and added to the growing Q40,000 in accounts receivable that had accumulated since he had taken charge six months prior."*

As time progressed, the gravity of the situation became obvious, and Rodrigo began to recommend some much-needed reformation of business processes. Training was given on teamwork, planning, the role of the Board of Directors, and general accounting principles. For all the work put into this training, very little evidence was shown that anyone actually tried to put it into action. This was largely due to the high rate of turnover in the three businesses. About every three months, or whenever the current Co-op member in charge got tired, there would be a rotation, and someone completely new would take over day-to-day operation. Were these people given full autonomy, it may have been effective, but the Board of Directors was constantly charged with the role of finding new managers and governing the overall management of the Cooperative themselves. With no stipend for doing so, and professions of their own, Rodrigo noticed the Board was at odds over how to best manage the Cooperative. He also noted that the largest problem in the Cooperative was a lack of leadership. Culturally, to make a decision meant ownership and full responsibility of any consequences resulting from that decision. This inevitably created a stigma within the Board where no one wanted to be held liable for any decision leading to failure. Adding to the layers of cultural fabric was an undercurrent of mistrust for outsiders. It became apparent after months of goading, that Rodrigo was not getting very far with the recommendation to bring in outside management help. In fact, this same mistrust seemed to be applied to him and nearly every recommendation he made to improve the cooperative's organizational structure.

CHAIRMAN'S DILEMMA

Despite their troubles, Juan and the Board managed to stay afloat during the EFIS project. He knew if they could manage the fund wisely for another five months, the cooperative would receive a cash injection of almost Q250,000. He had finally begun to trust and listen to Rodrigo's advice regarding project planning. Now that he was in the Hardware Store, he intended to find out just how profitable it could be, and what strategy the Co-op should take to make it grow. In light of that, he and the Board began discussing how the Co-op should proceed over the next four months while the EFIS project was liquidated, and where they would invest for the coming year. He sat back in his chair after outlining the potential options. He knew his training and the cooperative's competencies suggested some certain projects, but they all had justifiable logic for investment, and he wanted to pursue the Co-op's vision of diversification.

NEW INITIATIVES TO CONSIDER

Fish Farm (Aquaculture)

As predicted by many in the fishing industry, the sea began to give up less and less of her supply. By 2003, the aggregate catch in Guatemala was just above 75% of the level five years prior, and over 50% less than in the heydays of the 1980s. However, worldwide, the demand for seafood as an alternative nutrient source had increased, fueled by research showing the tri-glycerides in fish as a healthy substitute for more traditional amino acid sources. With over-fishing prevalent in nearly all parts of the world, governments were looking at fish farming as a serious alternative to industrial fishing to supply the growing demand. Wildly successful in Mexico and Asia, countries like Japan, Spain and Taiwan (all with above average fish consumption per capita) were looking to invest in the application of this alternative source in other developing countries.

Recognizing this development, RPQ began to focus its attention on the artisan fishing groups it represented as potential recipients of potentially large investments in infrastructure spilling over from the partnerships the government was garnering for increased fish production. Who better to cultivate fish than those who make their livelihoods understanding how fish behave? As the last part of their Business Administration training, a nine-month series from August 2003 to May 2004, RPQ arranged for professors from San Carlos University to give intense courses on the process of raising fresh-water shrimp and tilapia in man-made pools or ponds. Representatives from Cooperative Guatemala were Board President Juan Perez and Board member Jose Sanchez. The member-cooperative representatives spent three final days traveling to different projects and participating in classes at the San Carlos University's shrimp hatching facility. Well-equipped with the basics of aquiculture production, RPQ sent the members back to their cooperatives with the promise to help any member cooperative interested with the process of writing grant proposals to the government for their own project seed money.

In February of 2005, the Ministry of Agriculture announced a US $6 million agreement with the Taiwan Government to promote tilapia farm projects specifically targeted for cooperatives. This news came only months after the completion of the RPQ training, and Juan and Jose were anxious to try their hand at this great new opportunity. They went to work promoting the idea within the cooperative and looking for a piece of land where the project could be carried out. Only weeks later, they called a general meeting of the associates to present what they had to offer. Jose had spoken with his sister, whose husband was working in the United States and had left a large tract of partially excavated land in his hometown of Otra Ciudad, about 8 kilometers from Isla Bonita. It seems the brother-in-law had intended to begin his own fish farm, but times were difficult and the project was stuck half done. He was willing to rent the land to Cooperative Guatemala for only Q20,000 per year and they'd have rights to use the diesel pump already on the property (these can run upwards of Q100,000 to purchase and install). All it would take was some preparation work to finish excavating the ponds and the seed money to buy the tilapia.

The only competition foreseeable would be the response by Homegrown Ventures. Homegrown Ventures was already in its second year of production in a 3 acre Tilapia farm that the government had helped them establish. Though the first year was predominantly a failure, the leadership was intent to make this project successful, and they were well along the learning curve. Many wondered if Homegrown Ventures could sustain the growth they had been experiencing, however, as they diversified into small-volume gasoline sales on the island, and intermediary fish distribution to the capital using a refrigeration truck donated in the original founding of the Association.

Hotel/Tourism Project

In December of 2004, the newly formed Local Tourism Committee (LTC) was invited to Guatemala City to participate at the National Fair in the Tourism Expo promoted by INGUAT (National Tourism Institute – Government entity). Given an expo space and some general promotional material, LTC brought home the 2nd place prize among the nation's tourism spots for best promotion by a local committee. Since then, tourism had spiked in the town, and there was a definite rise in community awareness that perhaps Isla Bonita's near dormant tourism industry was about to be reborn.

Throughout the late 80s and early 90s, Isla Bonita was the destination for nearly 25,000 tourists annually, with nearly half of those coming during the Holy Week as city dwellers sought the refuge of beach life and hot weather. It was said that Lisenos worked the rest of the year just to make it back to Holy Week, where they would often gross enough income to pay off any outstanding debts. That was before the great fire of 1998. A few children playing with leftover bottle rockets from New Year's celebrations caught the thatch roof of a local store on fire. In that time, the whole community built their homes with thatch roofs because it was much cooler, in the 100 degree weather, than the more fire-retardant sheets being used in the cities. Unfortunately, thatch roofs are extremely flammable, and the townspeople could only stand by in despair as the store fire spread to encompass nearly 50% of downtown Isla Bonita. It just happened to be the side of town where 3 major hotels were located. In one fateful night, over 100 rooms were burned to the ground, crippling Isla Bonita hopes of handling any substantial off-peak tourism.

After that event, Cooperative Guatemala quietly bid its time watching the tourism industry in town, waiting for the right time to try its hand at the hotel industry. Starting in 2003, three new hotels had been constructed, and with them, a renewed tourism industry in Isla Bonita. With Juan Carlos and Victor Castillo, two associates of Cooperative Guatemala, at the helm of the newly formed and apparently successful LTC, perhaps it was the right time for Cooperative Guatemala to invest in the hotel its associates had long dreamed of putting their name on. Ester Lopez, former project manager for RPQ, informed Juan and the Board that a friend of hers in the Ministry of Economy was promoting tourism projects. INGUAT, too, was on the march to substantiate Gautemala as the new Costa Rica of Central America for tourists looking for natural beauty plus the rich culture of Guatemala's 21 different indigenous groups. Every week another promotion was being announced for Guatemalans to take advantage of this growing industry. The most recent was a US $3 million investment fund aimed at Local Tourism Committees and Cooperatives with formal ideas for how to attract and service tourists to their communities.

Though no plans had been drawn up, Ester assured Juan that as soon as they decided to invest in a hotel, she would put them in touch with an architect friend of hers at the University of San Carlos. They would be able to get a student to come to Isla Bonita for free to do a feasibility study and draw up the plans for the student's thesis. With the close of the EFIS project nearing, Juan knew they would have a little over Q200,000 of their own money to invest. The tourism industry was beginning to look like the answer to their woes, especially if they could partner with LTC and heavily promote the city.

Gasoline Station

The Cooperative Isla Bonita has owned a Gas station in Grecia, a nearby town, since 1991. It is the first, and only, full service gasoline and diesel station servicing the region, with the next nearest station being 16 miles away at the crossroads of the main international highway. This business move for a time proved quite lucrative for the Cooperative. Unfortunately, they have since let the station become run down and have not maintained good relationships with suppliers. They often string along their creditors for months at a time on payments because they have used the station to subsidize the losses of their 3 shrimp trawlers.

For years the two Cooperatives, Cooperative Guatemala and Isla Bonita, had not enjoyed a good working relationship, despite family ties, due to an unfortunate incident whereby Juan, acting on orders from his job as Manager of the Marlin hatchery, served The Big Cooperative with a court order to stop fishing without TEDs (Marlin Escape Devices). Juan had convinced several then-board members, including Martino Valenzuela, a captain of one of Cooperative Isla Bonita's trawlers and secretary of Cooperative Guatemala, to sign the document, saying it was simply a note for a meeting with the Cooperative. Outraged, Cooperative Isla Bonita cut off all business dealings with Cooperative Guatemala, as the Cooperative as a whole was implicated in the backing and enforcement of this costly court order.

Now four years later, Cooperative Isla Bonita found itself significantly overextended financially. Some of its members had convinced their sons, Board Members for Cooperative Guatemala, to lend a hand and help relax the tensions between the two entities. Fresh off the sale of Cooperative Guatemala's fish market stall in Guatemala City for nearly Q200,000, the treasurer and secretary of Cooperative Guatemala went secretly to the office of Cooperative Isla Bonita and signed over a check for Q150,000 in a Gentleman's agreement. The Cooperative would pay Cooperative Guatemala 5% interest on this short-term loan and repay the full amount no later than December 2004. No documents were drawn, and no minutes were kept of that meeting. Only the copy of the check, once it was deposited in the bank, served as proof that the transaction had ever taken place. The Cooperative Isla Bonita then miraculously began offering Cooperative Guatemala an option as intermediary for the resale of its shrimp capture, and it seemed the good will had, indeed, been restored.

Unfortunately, for Cooperative Guatemala, the Cooperative Isla Bonita still faces hard times. It has consistently denied full payment of the loan, and refuses to agree to put the agreement in writing. However, the cooperative has entertained one interesting proposal, put forth by Juan and the Board in March of 2005, as an alternative method of repayment. Juan proposed the handing over of the Gas Station and its 30 car parking lot (occupancy is charged by the day) to Cooperative Guatemala for a period of 2 years with an option to purchase after said time, to amortize the loan owed to Cooperative Guatemala. The deal is on the table for the Cooperative Isla Bonita to review, and there appears a good chance for approval. The Gas Station, if properly managed, could mean an additional two job opportunities for Cooperative Guatemala and a monthly income over Q8,000 from day one. The money from the EFIS project would serve to make improvements on the general appearance of the Station and make the deposit for the first month's gasoline delivery.

BOARD OF DIRECTORS – COOPERATIVE GUATEMALA

Juan Perez, 42, President, High School Education. Professional artisan fisherman, journeyman mason, serves as Secretary of a regional board of advisors coordinating the collective efforts of artisan fishing groups. Currently in his 3rd year, re-elected as President. Manager of Local marlin hatchery – incubating marlin and releasing them to the wild from July to December.

Francisco Garcia, 40, Vice President, High School Education. Professional mechanic for shrimp trawler and artisan fisherman, coordinated distribution efforts in the capital when the cooperative owned a market stall. Has served as past-president and also as manager of all three business units. Currently working in masonry and deep-see fishing.

Carlos Mata, 48, Secretary. Grade-school education, artisan fisherman and intermediary distributor. Currently serves as manager of Hardware store and has previously served as manager of the fish market.

Antonio Vargas, 50, Treasurer. High School education, Entrepreneur. Owns several small business ventures in the town, has served as Chairman of Town Council for 9 years and is one of the most influential townspeople, his opinion highly respected. No formal financial training.

Jose Sanches, 49, Member. Post-high school trade-school degree in Business, Cattle farmer, Entrepreneur. Lives in a neighboring town to Isla Bonita where he owns a Cattle and produce farm, serves on the Town Council and is a generally well-respected and influential individual in the region. Very well-connected. Currently serves as President of "The Fishermen Network"

2 Additional Committees – 3 Members Each:

Education Committee – in charge of organizing educational opportunities for the cooperative members and ensuring that each member understands the principles of Cooperativism and their role(s) as members of the Cooperative.

Oversight Committee – Responsible for overseeing the financial and organizational matters of the cooperative. This committee exists to provide objective analysis of the work being carried out by the Board of Directors, a system of checks and balances.

SECONDARY BOARD OF DIRECTORS– EFIS –

* Carlos Mata – President
* Sonia Ramirez – Secretary
* Ernesto Acuna – Treasurer
* Jessica Coto – Vocal 1
* Johana Carmen – Vocal 2

Three functional Committees – 3 members each:

* Credit Committee
* Marketing Committee
* Oversight Committee

DISCUSSION QUESTIONS

1. What major problems can you identify (internal and external) that have influenced the Cooperative's current economic position and strategy? Would you characterize their position as weak or strong? Defend your position.

2. What is the Board's role regarding the direction of the Cooperative? Consider the following:

   * How are the three current business units managed and what role does the Board play?
   * Should the Board look outside the Cooperative for a GM to manage these units and head up the expansion? If so, what qualifications are important, and how should that person be compensated?
   * What are the pros and cons inherent in promoting someone from within the cooperative to be General Manager?

3. What strategic planning methods, if any, have been used by the members of Cooperative Guatemala thus far? How should Rodrigo suggest they move forward? Highlight the planning limitations facing the Board of Directors.

4. Of the projects mentioned, list the benefits and constraints in a manner which would clearly identify which of the projects would be most feasible with respect to the Cooperative given time, money and knowledge boundaries. As a consultant, how would you advise the Cooperative to proceed?

5. Evaluate the concept of proposing a merger between Cooperative Guatemala, Cooperative Isla Bonita and Homegrown Ventures

WARREN E. BUFFETT AND BERKSHIRE HATHAWAY, INC.

Todd A. Finkle, Gonzaga University

ABSTRACT

The case discusses the history and background of one of the most successful entrepreneurs, Warren E. Buffett, and the company that he built, Berkshire Hathaway, Inc. The investment genius of Buffett who is affectionately called the "Oracle of Omaha" is examined. The progressions of Buffett's entrepreneurial endeavors are followed from his youth, college, Wall Street, investment partnership, and Berkshire Hathaway. The case discusses Buffett's keys to success, including his value system, and investment philosophy. Students are required to analyze the entrepreneurial personality of Buffett as well as perform a financial analysis on the company. Students are required to make recommendations on what Berkshire should do next in this fragile economy, which Buffett characterized as a recession.

The case gives an in-depth analysis of the background, personality, and history of Warren E. Buffett. Buffett's childhood and psychological makeup are discussed as well as the various influences in his life. The case is especially interesting because it follows the path of one of the most successful entrepreneurs of all time. Students have the ability to follow the life of one of the richest people in the world. The case also gives an overview of the stages that Berkshire Hathaway goes through leading up to 2008. Financial statements are provided so the students can perform financial ratio analysis and evaluate the company's financial disposition. The current economic crisis facing the U.S. is evaluated. Students are required to evaluate Buffett's investment philosophy and make recommendations as to what moves the company should make.

INTRODUCTION

It was Thursday, November 20, 2008 and Warren E. Buffett, 77 years old, was about to bite into his favorite meal at his favorite restaurant, a New York strip steak at Gorat's Steakhouse in Omaha, Nebraska. As he chomped down on the steak, he gleefully sloshed down the food with a cool, refreshing cherry coke. Buffett, fondly called the "Oracle from Omaha", had accomplished what few people on earth had done. He built one of the most successful companies of all time with a market capitalization of over $227 billion. As Chairman and Chief Executive Officer of Berkshire Hathaway, Inc., he had become the richest man in the world with a net worth of over $62 billion.[1]

From his humble beginnings in Omaha, Nebraska, Buffett had built a dynasty over four decades by buying out-of-favor stocks and businesses whose management he deemed superior.[2]

If you were an investor in 1956 and gave Buffett $10,000 to invest, today it would be worth more than $500 million.[3] Exhibits 1-5 show Berkshire Hathaway's portfolio of businesses.

Exhibit : List of Companies that Warren Buffett owned as of 9/30/2008

No	Company	No	Company
1	Acme Brick Company	27	International Dairy Queen, Inc.
2	Applied Underwriters	28	Iscar Metalworking Companies
3	Ben Bridge Jeweler	29	Johns Manville
4	Benjamin Moore & Co.	30	Jordan's Furniture
5	Berkshire Hathaway Group	31	Justin Brands
6	Berkshire Hathaway Homestates Companies	32	Larson-Juhl
7	BoatU.S.	33	Marmon Holdings, Inc.
8	Borsheims Fine Jewelry	34	McLane Company
9	Buffalo NEWS, Buffalo NY	35	Medical Protective
10	Business Wire	36	MidAmerican Energy Holdings Company
11	Central States Indemnity Company	37	MiTek Inc.
12	Clayton Homes	38	National Indemnity Company
13	CORT Business Services	39	Nebraska Furniture Mart
14	CTB Inc.	40	NetJets®
15	Fechheimer Brothers Company	41	The Pampered Chef®
16	FlightSafety	42	Precision Steel Warehouse, Inc.
17	Forest River	43	RC Willey Home Furnishings
18	Fruit of the Loom®	44	Scott Fetzer Companies
19	Garan Incorporated	45	See's Candies
20	ateway Underwriters Agency	46	Shaw Industries
21	GEICO Auto Insurance	47	Star Furniture
22	General Re	48	TTI, Inc.
23	Helzberg Diamonds	49	United States Liability Insurance Group
24	H.H. Brown Shoe Group	50	Wesco Financial Corporation
25	HomeServices of America, a subsidiary of	51	XTRA Corporation
26	MidAmerican Energy Holdings Company		

Source: Links to Berkshire Hathaway Subsidiaries: http://www.berkshirehathaway.com/subs/sublinks.html, Accessed December 3, 2008

Exhibit 2 – List of other companies that Warren Buffett has a stock position in and the amount of stock and its current value 9/30/2008

No	Ticker	Company	Industry	Shares	Value ($1000)	% Weighting
1	WFC	Wells Fargo & Company	Banks	290,407,668	10,899,000	15.59%
2	KO	Coca-Cola Company	Food & Beverage	200,000,000	10,576,000	15.13%
3	AXP	American Express Company	Financial Services	151,610,700	5,371,570	7.69%
4	KFT	Kraft Foods Inc.	Food & Beverage	138,272,500	4,528,420	6.48%
5	PG	The Procter & Gamble Company	Personal & Household Goods	105,847,000	7,376,480	10.55%
6	COP	ConocoPhillips	Oil & Gas Producers	83,955,800	6,149,760	8.80%
7	USB	U.S. Bancorp	Banks	72,937,126	2,627,190	3.76%
8	BNI	Burlington Northern Santa Fe Corp.	Industrial Goods & Services	63,785,418	5,895,690	8.44%
9	JNJ	Johnson & Johnson	Pharmaceuticals & Biotechnology	61,754,448	4,278,350	6.12%
10	MCO	Moody's Corp.	Industrial Goods & Services	48,000,000	1,632,000	2.34%
11	WMT	Wal-Mart Stores Inc.	Retail	19,944,300	1,194,460	1.71%
12	KMX	CarMax Inc.	Retail	18,444,100	258,217	0.37%
13	USG	USG Corp.	Construction & Materials	17,072,192	437,048	0.63%
14	BUD	Anheuser-Busch Companies Inc.	Food & Beverage	13,845,000	898,264	1.29%
15	CMCSK	Comcast Corp. Special	Media	12,000,000	236,640	0.34%
16	UNP	Union Pacific Corp.	Industrial Goods & Services	8,906,000	633,751	0.91%
17	GE	General Electric Company.	Industrial Goods & Services	7,777,900	198,336	0.28%
18	NKE	NIKE Inc.	Personal & Household Goods	7,641,000	511,183	0.73%
19	MTB	M&T Bank Corp.	Banks	6,715,060	599,319	0.86%
20	LOW	Lowe's Companies Inc.	Retail	6,500,000	153,985	0.22%
21	UNH	United Heal Group Inc.	Health Care Equipment & Services	6,379,900	161,986	0.23%
22	WSC	Wesco Financial Corp	Insurance	5,703,087	2,036,000	2.91%
23	IR	Ingersoll-Rand Company Ltd.	Industrial Goods & Services	5,636,600	175,674	0.25%
24	COST	Costco Wholesale Corp.	Retail	5,254,000	341,142	0.49%
25	NRG	NRG Energy Inc.	Electricity	5,000,000	123,750	0.18%
26	BAC	Bank of America Corp.	Banks	5,000,000	175,000	0.25%
27	WLP	WellPoint Inc.	Health Care Equipment & Services	4,777,300	223,424	0.32%
28	SNY	SanofiAventis	Pharmaceuticals & Biotechnology	3,903,933	128,323	0.18%
29	HD	The Home Depot Inc.	Retail	3,700,000	95,793	0.14%
30	GCI	Gannett Co. Inc.	Media	3,447,600	58,299	0.08%
31	IRM	Iron Mountain Inc.	Industrial Goods & Services	3,372,200	82,315	0.12%
32	STI	SunTrust Bank Inc.	Banks	3,204,600	144,175	0.21%
33	ETN	Eaton Corp.	Industrial Goods & Services	2,908,700	163,411	0.23%
34	TMK	Torchmark Corp.	Insurance	2,823,879	168,869	0.24%
35	WBC	WABCO Holding Inc.	Automobiles & Parts	2,700,000	95,958	0.14%

Exhibit 2 – List of other companies that Warren Buffett has a stock position in and the amount of stock and its current value 9/30/2008						
No	Ticker	Company	Industry	Shares	Value ($1000)	% Weighting
36	NSC	Norfolk Southern Corp.	Industrial Goods & Services	1,933,000	127,984	0.18%
37	WPO	The Washington Post Company	Media	1,727,765	961,951	1.38%
38	CDCO.OB	Comdisco Holding Co. Inc.	Industrial Goods & Services	1,538,377	14,630	0.02%
39	GSK	GlaxoSmithKline Plc.	Pharmaceuticals & Biotechnology	1,510,500	65,646	0.09%
40	UPS	United Parcel Services Inc	Industrial Goods & Services	1,429,200	89,882	0.13%
Source: Gurufocus.com: http://www.gurufocus.com/holdings.php?GuruName=Warren+Buffett						

Exhibit 3: Berkshire Hathaway's Portfolio: Numbers of Shares 9/30/2008

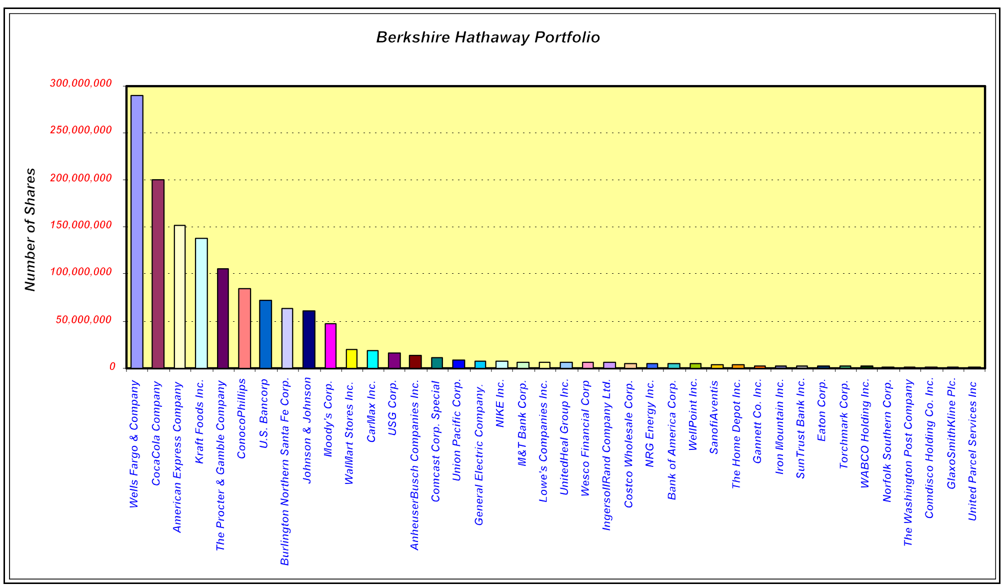


Exhibit 4: Berkshire Hathaway's portfolio: Current Value of Investees 9/30/2008

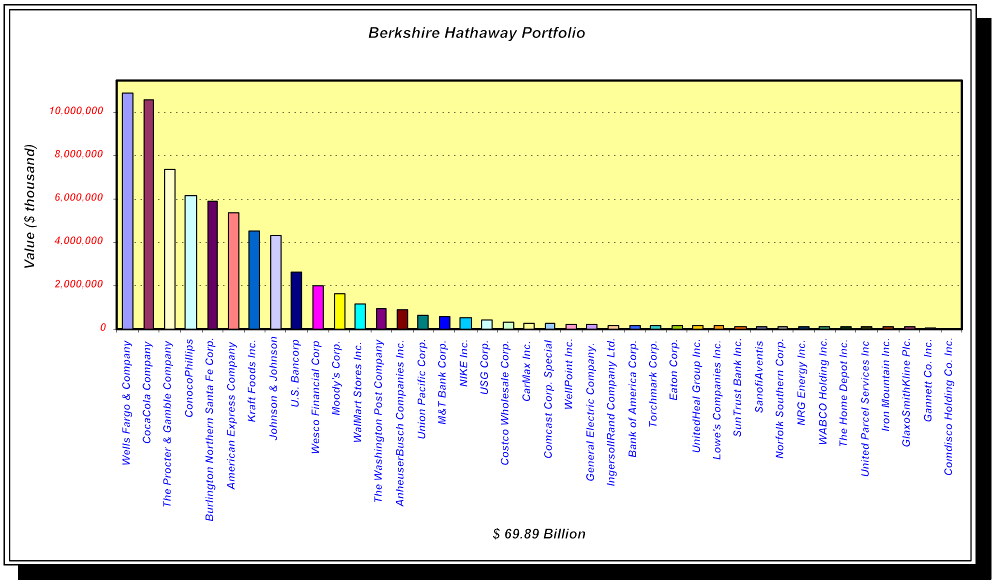
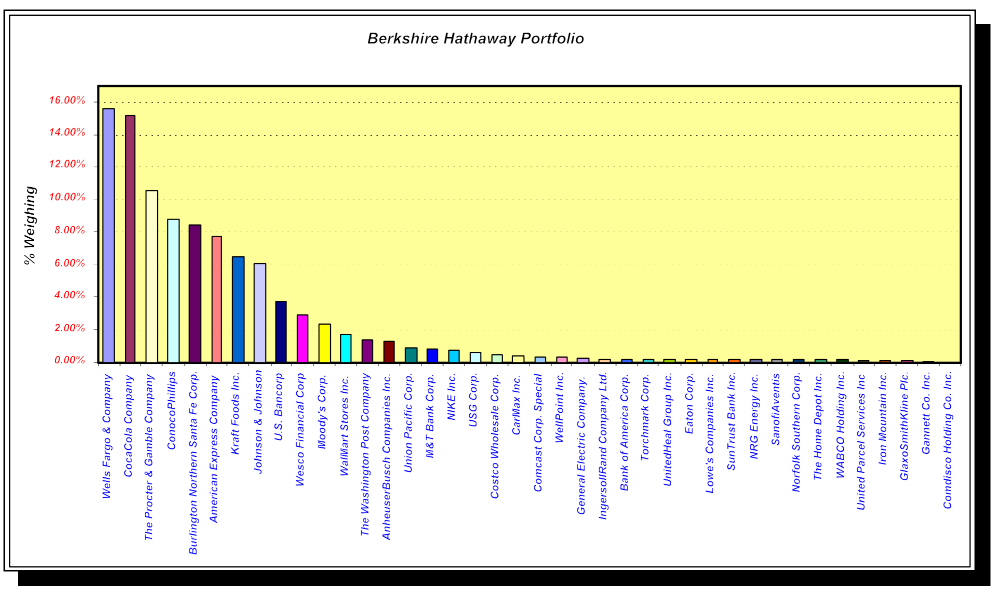


Exhibit 5: Berkshire Hathaway's portfolio: % weighting 9/30/2008



Despite Buffett's personal and professional successes, his company was still faced with one of the toughest economic environments since World War II. The stock market was currently in a bear market. On November 20, 2008, Berkshire's stock price was down 48% from its high of

$148,300 on December 6, 2007. This was surprising given that Berkshire Hathaway had advanced 17 out of the past 20 years and Buffett's stock had beaten the S&P 500 index on average 21% versus 10% since 1965. Exhibits 6-11 show the performance of Berkshire's stock price through the years.

Exhibit 6: Comparison of the Performance of Berkshire's stock versus the S&P 500: 1965-2007

Years	In per-share book value of Berkshire (1)	In S&P 500 with dividends included (2)	Relative results (1)-(2)
1965	23.8	10.0	13.8
1966	20.3	(11.7)	32.0
1967	11.0	30.9	(19.9)
1968	19.0	11.0	8.0
1969	16.2	(8.4)	24.6
1970	12.0	3.9	8.1
1971	16.4	14.6	1.8
1972	21.7	18.9	2.8
1973	4.7	(14.8)	19.5
1974	5.5	(26.4)	31.9
1975	21.9	37.2	(15.3)
1976	59.3	23.6	35.7
1977	31.9	(7.4)	39.3
1978	24.0	6.4	17.6
1979	35.7	18.2	17.5
1980	19.3	32.3	(13.0)
1981	31.4	(5.0)	36.4
1982	40.0	21.4	18.6
1983	32.3	22.4	9.9
1984	13.6	6.1	7.5
1985	48.2	31.6	16.6
1986	26.1	18.6	7.5
1987	19.5	5.1	14.4
1988	20.1	16.6	3.5
1989	44.4	31.7	12.7
1990	7.4	(3.1)	10.5
1991	39.6	30.5	9.1
1992	20.3	7.6	12.7
1993	14.3	10.1	4.2

Exhibit 6: Comparison of the Performance of Berkshire's stock versus the S&P 500: 1965-2007			
Years	In per-share book value of Berkshire (1)	In S&P 500 with dividends included (2)	Relative results (1)-(2)
1994	13.9	1.3	12.6
1995	43.1	37.6	5.5
1996	31.8	23.0	8.8
1997	34.1	33.4	0.7
1998	48.3	28.6	19.7
1999	0.5	21.0	(20.5)
2000	6.5	(9.1)	15.6
2001	(6.2)	(11.9)	5.7
2002	10.0	(21.1)	31.1
2003	21.0	28.7	(7.7)
2004	10.5	10.9	(0.4)
2005	6.4	4.9	1.5
2006	18.4	15.8	2.6
2007	11.0	5.5	5.5
Compounded Annual Gain - 1965-2007	21.1	10.3	10.8
Overall Gain - 1964-2007	400,863	6,840	
Source: *Berkshire Hathaway's 2007 Annual Report*: http://www.Berkshirehathaway.com/letters/2007ltr.pdf Accessed June 30, 2008.			

Exhibit 7: Berkshire Hathaway, Inc. Class A Stock Price 1990-December 12, 2008

Exhibit 8: Berkshire's Performance vs. S&P 500 1965-2007

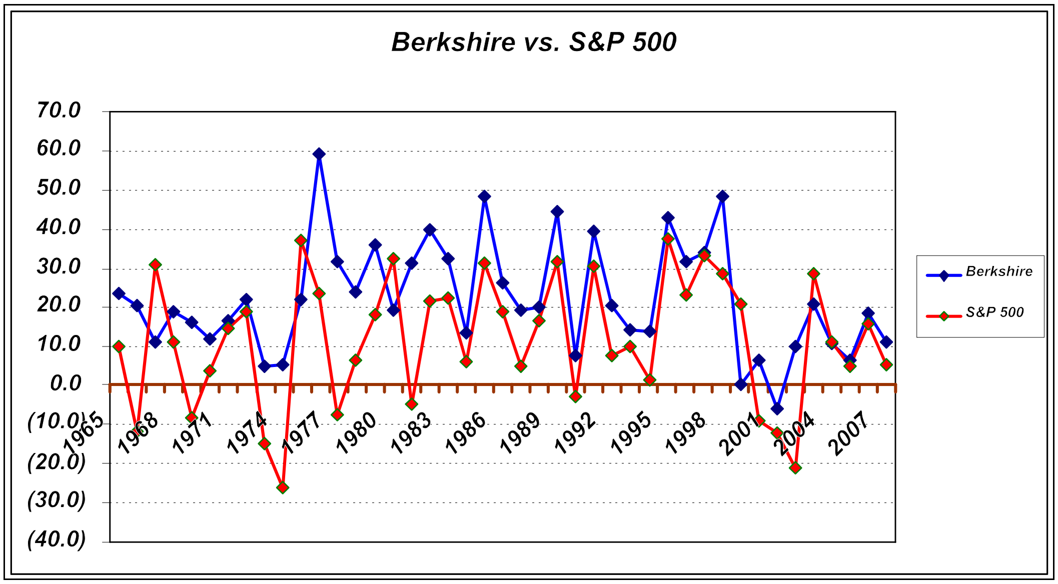


Exhibit 9: Berkshire's Performance vs. S&P 500 1965-2007

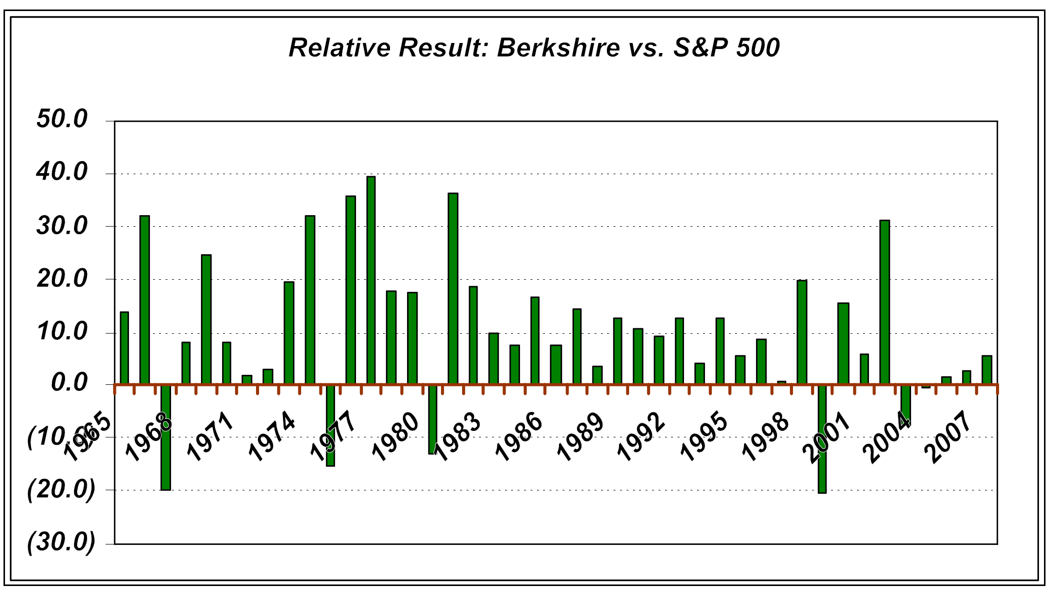


Exhibit 10: Compounded Annual Gain of Berkshire's Stock from 1969-2007

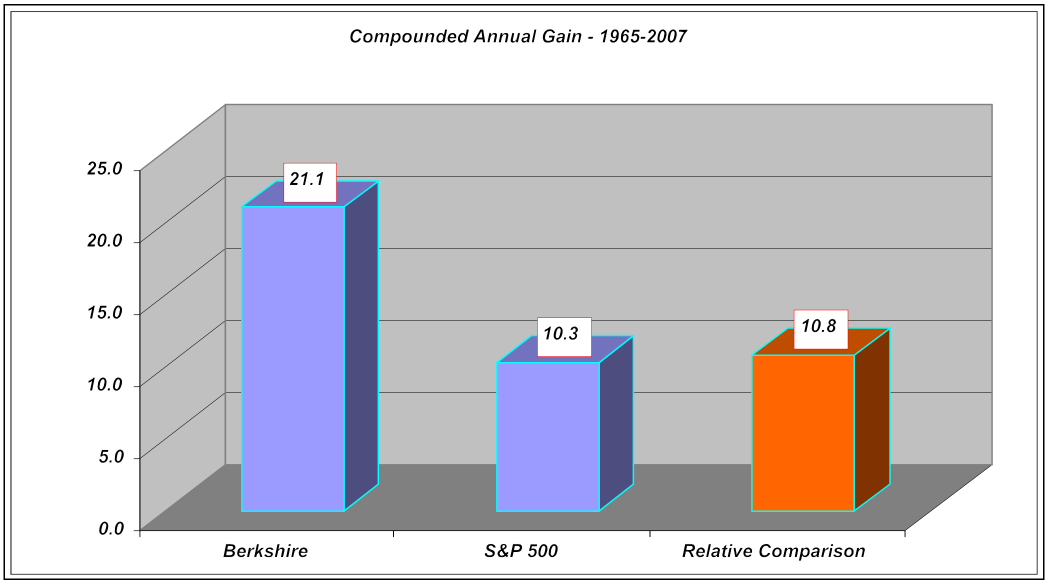
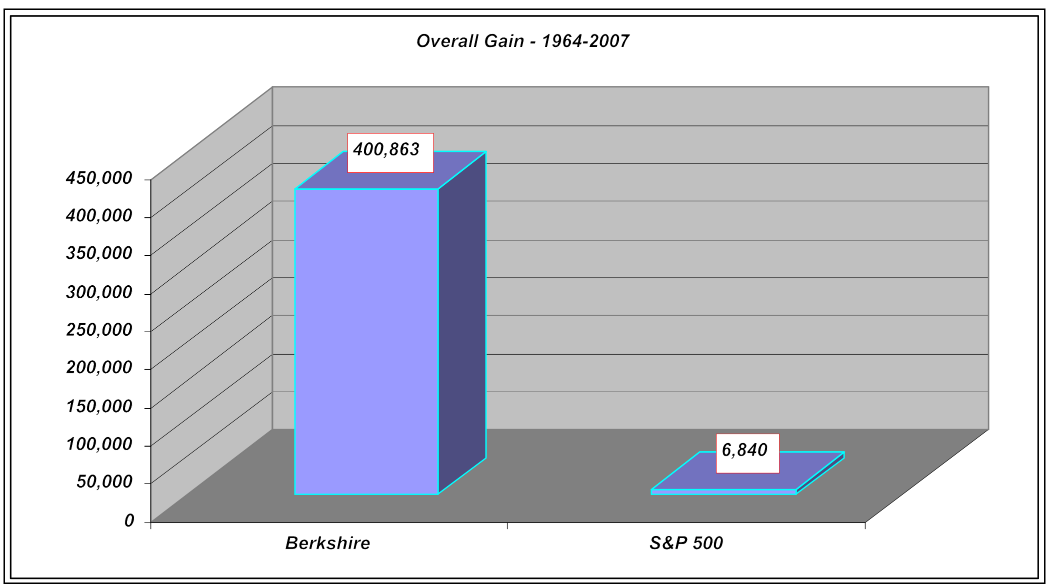


Exhibit 11: Overall Gain Berkshire's Stock versus the S&P 500 Index 1965-2007



Buffett stated that even though the numbers do not state it, the U.S. is in a deep long-lasting recession.[4] The economy was dealing with a triple whammy; a drop off in consumer spending, the housing bust, and the subprime financial disaster (over leveraged firms, which eventually led to the collapse of Bear Stearns, the first Wall Street investment bank since the Great Depression). These crises, combined with higher gas and food prices, fewer jobs, and personal income not keeping pace with inflation, all had Buffett concerned. Despite this, Buffett was optimistic. In a recent interview he stated, "We may not be better in five months, but I know we will be better off in five years".[5]

Buffett typically excelled during downturns in the economy. His investment philosophy of value investing entailed buying undervalued assets when others were selling. Buffett used his entrepreneurial mindset and skills to seek out undervalued companies. Buffett wondered how Berkshire would handle this recession.

WARREN E. BUFFETT

Warren Buffett was one of three children born to Howard and Leila Buffett in the heart of the Midwest in Omaha, Nebraska in 1930 during the Great Depression. His family had roots in the United States dating back to the 1600's. Buffett's great grandfather started a grocery store in 1869 in downtown Omaha. Buffett and the future Vice Chairman of Berkshire Hathaway, Charlie Munger, would later go on to work in the grocery store.

Entrepreneurship flourished in the Buffett household. Not only did Buffett's father own his own stock brokerage called Buffett-Falk & Company, but he also sold diamonds on the side to hedge for inflation.[6] Buffett's youth was also influenced by his mother's family who owned their own print shop. But it was Buffett's great grandfather's grocery store that had a major impact on Buffett's future. He was paid $2.00 a day for 12 hours of work doing manual labor, which included sweeping floors and unloading trucks. It was here that Buffett decided that he did not want to do manual labor for the rest of his life.

This exposure to entrepreneurship from all of these family members rubbed off on Buffett at a young age. The first few cents Buffett earned came from selling chewing gum. And from the day he started selling, at age six, he showed an unyielding attitude toward his customers that revealed his later style. Buffett stated, "I remember a woman saying, I will take one stick of Juicy Fruit. I said, we do not break up packs of gum, I mean, I have got my principles." Making a sale was tempting, but not tempting enough. If he sold one stick to her, he would have four sticks left to sell, not worth the work or the risk. He made two cents profit per pack. [7]

After this venture, Buffett began purchasing six packs of coke from his grandfather's store for 25 cents and sold individual bottles for 5 cents.[8] He also began to learn about investments from his father's library and had a paper route.

For Buffett's 10th birthday, his father took him to New York. A scene from the stock exchange dining room captured his imagination. According to Buffett, "We had lunch with At Mol, a member of the stock exchange. After lunch, a guy came along with a tray that had all these different kinds of tobacco leaves on it. He made up a cigar for Mr. Mol, who picked out the leaves that he wanted. I thought: It does not get any better than this." Buffett had zero interest in smoking a cigar, but he saw what hiring a man for such a frivolous purpose implied. It meant that, even while most of the country was still mired in the Depression, the cigar man's employer, the stock exchange, was making a great deal of money. That day, a vision of his future was planted. He wanted money. Buffett stated, "It could make me independent. Then I could do what I wanted to do with my life. And the biggest thing I wanted to do was work for myself." [9]

At age 11, he purchased three shares of Cities Service for $38. He later sold it for $40, only to watch it increase in value to $200.[10] This was one of the first lessons that Buffett learned about patience in investing.

By age 13, Buffett filed his first tax form with the Internal Revenue Service (IRS). On the tax form he deducted his bicycle as a $35 expense. At age 14, he purchased 40 acres of land from his father for $1,200, which he rented out.

By the time Buffett was in junior high school his father moved the family to Washington D.C. because he was elected to Congress. While in Washington, Buffett continued his serial entrepreneurial endeavors. He started a pinball and peanut vending machine business called the Wilson-Coin-Operated Machine Company. At age 15, Buffett and a partner named Don Daly, purchased a pinball machine for $25 and placed it in a barber shop. They split the proceeds 50/50 with the owner. They were so successful that they purchased five more machines and eventually had sales of $200 a month.[11] Buffett also made $175 a month from his two paper routes. Additionally, he made money by going to golf courses and gathering lost golf balls, cleaning them, and then reselling them to golfers.

Another entrepreneurial venture in high school was with Don Daly, a high school friend. It involved purchasing a 1928 Rolls Royce for $350, fixing it up, and renting it out for $35 a day.[12] At age 16, Buffett graduated from high school 16th in his class of 350 at Woodrow Wilson High School.[13] After high school, Buffett sold the Wilson-Coin-Operated Machine Company for $1,200 and had savings of $6,000, which he used for college.

Buffett was not keen on going to college, but his father pushed him to attend the Wharton School of Business at the University of Pennsylvania. He spent two years there and complained that he was bored and more interested in the practical applications of the business world. So Buffett transferred to the University of Nebraska at Lincoln. He graduated with a Bachelor of Science degree from the University of Nebraska at Lincoln in 1950 at the age of 19 while working full-time.

Buffett then applied to the Harvard Business School, but was rejected because they thought he was too young. After reading the *Intelligent Investor* (1949) by Benjamin Graham, he decided that he wanted to study under Graham at Columbia Business School. He applied, was accepted, and studied under Graham and another famous investor, David Dodd, for one year. He earned a Master of Science degree and was one of Graham's prized students.

It was under Graham that Buffett learned his investment philosophy. He was exposed to Graham's two famous books, *Security Analysis* (1934) and *The Intelligent Investor* (1949). After graduation, Buffett told Graham that he would work for his firm for no pay. Unfortunately, Graham turned him down saying that he undervalued himself.

As a result, Buffett moved back to Omaha and worked as a stockbroker for his father's investment firm Buffett-Faulk and Company from 1951-1954. During this period, he was keeping in close contact with Graham and making investment recommendations to him.

Graham eventually hired Buffett at his firm called the Graham-Newman Corporation, from 1954-1956. At age 24, Buffet was making $12,000 a year at Graham's firm on Wall Street.

Over the next two years Buffett learned as much as possible from Graham. During those years, Buffett learned about arbitrage. In 1956, Graham retired and Buffett moved back to Omaha where he started his own investment partnership.

BUFFETT AND HIS PARTNERSHIPS

At age 26, Buffett made the decision that he wanted to be an entrepreneur again. Buffett knew that he was not a corporate man and envisioned working for himself. He had amassed savings of over $140,000 from his two years of working on Wall Street. Over the years, he had been approached by several family members for financial advice. As a result, he decided to create an investment partnership called Buffett Partnership, Limited.

According to Buffett, "I will run it like I run my own money. I will take part of the profits and losses but I will not tell you what I am doing". The partnership was created with Buffet as the general partner with seven limited partners. Buffett contributed only $100 and seven friends and family members contributed $105,000. His office was located in a three story Dutch colonial home that he purchased for $31,500 in 1957. The house was adjacent to a busy street and had a handball court inside. Buffett had no office and ran things from a tiny sitting-room off his bedroom with no secretary and no calculator.[14]

That summer Buffett garnered his first outside investor, Homer Dodge, a physics professor and president of Norwich University in Vermont. Dodge wanted to invest in the partnership because he heard of Buffett's talent from Benjamin Graham. Dodge drove 1,500 miles to give $120,000 of his family's savings to Buffett. In 1983, when Dodge died, his investment with Buffett was tens of millions of dollars.[15]

At age 27, Buffett had three partnerships. At 28, he had five partnerships. By the time Buffett was 30 years old he had seven partnerships worth over $7 million of which $1 million was his. In 1962 Buffett also began buying shares of a textile manufacturer named Berkshire Hathaway, Inc. located in New Bedford, Massachusetts.

In 1965, Buffett's Partnership received a check for $300,000 from one of the great businessmen of his times, Laurence Tisch, with a very simple note "include me in". Tisch described Buffett as one of the greatest investors of his generation.[16] By 1965, Buffett controlled Berkshire

Hathaway, Inc. which had a stock price of $18.00.[17] In 1966, Buffett became chairman of the company.

In 1969, Buffett decided to liquidate his partnership. He transferred all of the assets from his partnership into shares of Berkshire Hathaway, Inc. and gave the partners their shares. Buffett was now going to use Berkshire as a holding company to purchase other companies and investments. At the end of its life of 13 years, the partnership was worth $100 million. The Partnership returned an average annual return of 30%.[18]

BERKSHIRE HATHAWAY, INC.

In 1970, Buffett was now the Chairman of Berkshire Hathaway, a public company. This was when he began to write his famous annual letter to shareholders. The annual shareholder letters would be his signature as he discussed the firm's strategies, entrepreneurial pursuits, investment decisions and philosophies, state of the industry and economy, and more importantly the mistakes the firm made. Shareholders were always excited about the letters as they used this literature as vital learning tools. To this day, shareholders and investors use Buffett's shareholder letters as learning tools about business and investments.

In the early years, Berkshire Hathaway, Inc. entered into the insurance industry acquiring such companies like Geico and National Indemnity Insurance Company. The main business activity for Berkshire was the property and casualty insurance conducted on both a direct and reinsurance basis. Buffett liked the insurance industry because it gave Berkshire free cash flow to invest in the advance of the payout of any claims.

From 1965 to 1985 the company purchased companies like See's Candies, *The Washington Post*, and Nebraska Furniture Mart. By 1985, the stock price of Berkshire had grown to $1,000 a share. In the 1990s the company began purchasing investments in Coca-Cola, Gillette, Anheuser-Busch, ConocoPhillips, General Electric, Johnson & Johnson, Kraft Foods, Wal-Mart, etc.
Unfortunately, things were not as good for Berkshire Hathaway, the textile manufacturer. The company was shut down in 1985 due to increased competition. However, Buffett continued to keep the name of the company, Berkshire Hathaway, Inc.

More recently, the company has been expanding internationally. In 2006, it purchased 80% of Iscar Metalworking Companies based out of Israel that does business in 60 different countries.

In 2008, Berkshire was a conglomerate holding company located in Omaha, Nebraska that owned companies and subsidiaries, engaged in a number of diverse business activities. The company had over 223,000 employees however its corporate headquarters in Omaha had only 12 employees and office space of 3,500 square feet. Berkshire's Vice-Chairman was Charlie Munger, a childhood friend who attended the same grade school as Buffett. The company owned over 70 companies and had shares in great companies like American Express, Wells-Fargo, Coca-Cola, Kraft, Burlington

Northern Santa Fe, Dairy Queen International, Wal-Mart Stores, Inc., Procter & Gamble, Washington Post Company, Wells Fargo & Company, and other public companies.

Berkshire had two classes of stock; Class A, which was the highest priced stock listed on the New York Stock Exchange. The company also released a class B share. Berkshire's stocks never split as Buffett's investment philosophy was to reinvest the dividends. Berkshire's financial statements can be seen in Exhibits 12-15.

Exhibit 12: Berkshire Hathaway Balance Sheet 2004 – 2008 (2nd qtr)					
				(in million dollars)	
	2008 Q2	2007	2006	2005	2004
Assets					
Cash and Short Term Investments	31,159	44,329	43,743	44,660	43,427
Total Receivables, Net	0	0	0	0	0
Prepaid Expenses	0	0	0	0	0
Property/Plant/Equipment, Total – Net	43,708	36,190	33,342	7,500	6,516
Goodwill, Net	33,524	32,862	32,238	23,644	23,012
Intangibles, Net	0	0	0	0	0
Long Term Investments	109,408	106,570	89,845	83,505	79,569
Insurance Receivables	30,008	13,157	12,881	12,397	11,291
Note Receivable - Long Term	0	12,359	11,498	11,087	9,175
Other Long Term Assets, Total	3,739	3,987	1,964	2,875	4,376
Other Assets, Total	26,246	23,706	22,926	12,657	11,508
Total Assets	**277,792**	**273,160**	**248,437**	**198,325**	**188,874**
Liabilities and Shareholders' Equity					
Accounts Payable	0	0	0	0	0
Payable/Accrued	21,236	19,646	19,890	8,699	7,500
Accrued Expenses	0	0	0	0	0
Policy Liabilities	72,844	70,575	62,208	62,371	64,384
Notes Payable/Short Term Debt	0	0	0	0	0
Current Port. of LT Debt/Capital Leases	0	0	0	0	0
Other Current Liabilities, Total	16,821	18,825	19,170	12,252	12,247
Total Long Term Debt	36,235	33,826	32,605	14,451	8,837
Deferred Income Tax	0	0	0	0	0
Minority Interest	4,230	2,668	2,262	816	758
Other Liabilities, Total	8,432	6,887	3,883	8,252	9,248

Exhibit 12: Berkshire Hathaway Balance Sheet 2004 – 2008 (2nd qtr)					
					(in million dollars)
	2008 Q2	2007	2006	2005	2004
Total Liabilities	**159,798**	**152,427**	**140,018**	**106,841**	**102,974**
Redeemable Preferred Stock	0	0	0	0	0
Preferred Stock - Non Redeemable, Net	0	0	0	0	0
Common Stock	8	8	8	8	8
Additional Paid-In Capital	27,132	26,952	26,522	26,399	26,268
Retained Earnings (Accumulated Deficit)	75,973	72,153	58,912	47,717	39,189
Other Equity, Total	14,881	21,620	22,977	17,360	20,435
Total Equity	**117,994**	**120,733**	**108,419**	**91,484**	**85,900**
Total Liabilities & Shareholders' Equity	**277,792**	**273,160**	**248,437**	**198,325**	**188,874**
Total Common Shares Outstanding	1.55	1.55	1.54	1.54	1.54
Total Preferred Shares Outstanding	0	0	0	0	0
Source: http://moneycentral.msn.com/investor/invsub/results/statemnt.aspx?Symbol=US:BRK.A&lstStatement=Balance&stmtView=Ann. Accessed December 3, 2008.					

Exhibit 13: Berkshire Hathaway Income Statement 2004 – 2008 (2nd qtr)					
(in million dollars)					
	2008 Q2	2007	2006	2005	2004
Total Premiums Earned	6,231	31,783	23,964	21,997	21,085
Net Investment Income	246	5,598	1,811	6,196	1,636
Realized Gains (Losses)	0	0	0	0	0
Other Revenue, Total	23,616	80,864	72,764	53,470	51,661
Total Revenue	30,093	118,245	98,539	81,663	74,382
Losses, Benefits, and Adjustments, Total	5,671	28,409	20,126	21,944	19,534
Amortization Of Policy Acquisition Costs	0	0	0	0	0
Gross Profit	24,422	89,836	78,413	59,719	54,848
Selling/General/Administrative Expenses, Total	2,049	7,098	5,932	5,328	4,989
Depreciation/Amortization	0	0	0	0	0
Interest Expense (Income), Net Operating	493	1,910	1,724	723	721
Unusual Expense (Income)	0	0	0	0	0
Other Operating Expenses, Total	17,409	60,667	53,979	41,400	38,439

Exhibit 13: Berkshire Hathaway Income Statement 2004 – 2008 (2nd qtr)					
(in million dollars)					
	2008 Q2	2007	2006	2005	2004
Operating Income	4,471	20,161	16,778	12,268	10,699
Interest Income (Expense), Net Non-Operating	0	0	0	523	237
Gain (Loss) on Sale of Assets	0	0	0	0	0
Other, Net	0	0	0	0	0
Income Before Tax	4,471	20,161	16,778	12,791	10,936
Income Tax – Total	1,443	6,594	5,505	4,159	3,569
Income After Tax	3,028	13,567	11,273	8,632	7,367
Minority Interest	-148	-354	-258	-104	-59
Equity In Affiliates	0	0	0	0	0
U.S. GAAP Adjustment	0	0	0	0	0
Net Income Before Extra. Items	2,880	13,213	11,015	8,528	7,308
Total Extraordinary Items	0	0	0	0	0
Net Income	2,880	13,213	11,015	8,528	7,308
Source: http://moneycentral.msn.com/investor/invsub/results/statemnt.aspx?Symbol=US%3aBRK.A. Accessed December 3, 2008.					

Exhibit 14: Berkshire Hathaway Cash Flow 2004 – 2008 (2nd qtr)					
(in million dollars)					
	2008 Q2	2007	2006	2005	2004
Net Income/Starting Line	0	13213	11015	8528	7308
Depreciation/Depletion	0	2407	2066	982	941
Amortization	0	0	0	0	0
Non-Cash Items	0	354	258	104	0
Changes in Working Capital	4991	-3424	-3144	-168	-938
Cash from Operating Activities	4991	12550	10195	9446	7311
Capital Expenditures	-2538	-5373	-4571	-2195	-1278
Other Investing Cash Flow Items, Total	-16886	-8055	-9506	-11646	1593
Cash from Investing Activities	-19424	-13428	-14077	-13841	315
Financing Cash Flow Items	-31	387	84	188	166

Exhibit 14: Berkshire Hathaway Cash Flow 2004 – 2008 (2nd qtr)					
(in million dollars)					
	2008 Q2	2007	2006	2005	2004
Total Cash Dividends Paid	0	0	0	0	0
Issuance (Retirement) of Stock, Net	0	0	0	0	0
Issuance (Retirement) of Debt, Net	1287	979	2406	5563	-322
Cash from Financing Activities	1256	1366	2490	5751	-156
Foreign Exchange Effects	7	98	117	-123	0
Net Change in Cash	-13.17	586	-1275	1233	7470
Net Cash - Beginning Balance	44329	43743	45018	43427	35957
Net Cash - Ending Balance	31159	44329	43743	44660	43427
Cash Taxes Paid	2921	5895	4959	2695	2674
Source:http://moneycentral.msn.com/investor/invsub/results/statemnt.aspx?Symbol=US:BRK.A&lstStatement=CashFlow&stmtView=Ann. Accessed December 3, 2008					

Exhibit 15a: Berkshire Hathaway Income Statement & Balance Sheet 10 Year Summaries 12/98-12/07						
Income Statement - 10 Year Summary (in Millions)						
	Sales	EBIT	Depreciation	Total Net Income	EPS	Tax Rate (%)
12/07	0.0	20,161.0	2,407.0	13,213.0	8,547.95	32.71
12/06	0.0	16,778.0	2,066.0	11,015.0	7,144.2	32.81
12/05	0.0	12,791.0	982.0	8,528.0	5,538.45	32.52
12/04	0.0	10,936.0	941.0	7,308.0	4,752.49	32.64
12/03	0.0	12,020.0	829.0	8,151.0	5,308.68	31.66
12/02	0.0	6,359.0	679.0	4,286.0	2,795.3	32.38
12/01	0.0	1,438.0	1,517.0	795.0	520.55	41.03
12/00	0.0	5,587.0	1,712.0	3,328.0	2,185.26	36.12
12/99	0.0	2,450.0	1,165.0	1,557.0	1,024.54	34.78
12/98	0.0	4,314.0	376.0	2,830.0	2,261.54	33.77

Exhibit 15b: Berkshire Hathaway Income Statement & Balance Sheet 10 Year Summaries 12/98-12/07				
Balance Sheet - 10 Year Summary (in Millions)				
	Current Assets	Current Liabilities	Long Term Debt	Shares Outstanding
12/07	273,160.0	152,427.0	33,826.0	1.5 Mil
12/06	248,437.0	140,018.0	32,605.0	1.5 Mil
12/05	198,325.0	106,841.0	14,451.0	1.5 Mil
12/04	188,874.0	102,974.0	8,837.0	1.5 Mil
12/03	180,559.0	102,963.0	9,119.0	1.5 Mil
12/02	169,544.0	105,507.0	9,288.0	1.5 Mil
12/01	162,752.0	104,802.0	12,504.0	1.5 Mil
12/00	135,792.0	74,068.0	2,663.0	1.5 Mil
12/99	131,416.0	73,655.0	2,465.0	1.5 Mil
12/98	122,237.0	64,834.0	2,385.0	1.5 Mil
Source: http://moneycentral.msn.com/investor/invsub/results/statemnt.aspx?Symbol=US:BRK.A&lstStatement=10YearSummary&stmtView=Ann. Accessed December 3, 2008.				

BUFFETT'S INVESTMENT PHILOSOPHY

Warren Buffett followed a value investment strategy similar to Benjamin Graham. His investment strategy consisted of discipline, patience, and value that consistently outperformed the market. Buffett's moves were mirrored by thousands of investors throughout the world. It was not uncommon to see double digit increases in stock prices of companies after Buffett's investments were made public. Berkshire acquired great businesses that traded at a discount to their intrinsic value and he held them for a long time.

Buffett stated, "We want businesses to be ones (a) that we can understand; (b) with favorable long-term prospects; (c) operated by honest and competent people; and (d) available at a very attractive price".[19] Buffett stated, "*Success in investing does not correlate with I.Q. once you are above the level of 25*. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing".[20] Buffett and Munger never hired any consultants to help them.

Buffett stated, "I do not want to buy into any business that I am sure of. It probably is not going to offer any credible returns. Why should something that is essentially a cinch offer you 40% a year? We do not have huge returns in mind, but what we do have in mind is never losing anything".[21]

Buffett followed the value investing methodology where one purchased stocks that are undervalued by the marketplace. The problem with this methodology is that there is no one best universal way to value a company. Valuing companies is different depending on the industry and stage of growth. Valuing companies was a competitive advantage that Buffett brought to Berkshire. He seemed to have the magical touch when valuing companies. It was not uncommon for Buffett to follow a company's management team and performance over a number of years before he would invest in a company.

At the 2008 Berkshire Hathaway Shareholder's Meeting, Buffett stated that business education was highly overvalued. He stated that he did not believe in the Efficient Market Hypothesis, which was taught at most business schools. Buffett stated that these schools have you taking all of these different classes, when all you really need to know to become a successful investor is two courses: (1) A course on how to value companies and (2) A course on human behavior in the markets.

VALUE INVESTING

According to Buffett, "The two most important essays ever written on investments were written by Benjamin Graham in his book, *Intelligent Investor* in Chapter 8 on the attitude towards stock market fluctuations and Chapter 20 on the margin of safety. I have no idea what the stock market is going to do. It is something that I never think about at all. But I am looking for the stock to go down so I can buy it on sale. I want the stocks to go down, way down so I can make better buys.[22]

Buffett only invested in businesses that he understood, and he always insisted on a margin of safety. The margin of safety was when an investor only purchased securities when the market price was significantly below its intrinsic value. In other words, when the market price was significantly below your estimation of the intrinsic value, the difference was the margin of safety. This difference allowed an investment to be made with minimal downside risk.[23]

Buffett combined Graham's investment philosophy with his own by answering the following issues related to a potential investment:

- ♦ Is the business easy to understand and analyze? Buffett only liked businesses that he could understand. Buffett stated that if he was teaching a course on valuation, his final exam to the students would be to value an Internet company. If the student answered the question, he or she would receive an F.
- ♦ Is the company in an industry with good economics, i.e., not an industry competing on price? Does the company have a consumer monopoly within their industry (e.g., Gillette, Coke, Dairy Queen, etc.)? Coca-Cola and Gillette have what Buffett calls a moat, where the resources necessary to overcome the brands are enormous.
- ♦ How old is the company? Buffett liked to look at a 10 year track record of financial statements. He also liked to compare the company with other firms within their industry.
- ♦ Buffett preferred firms that did not require a great deal of capital. The business should not have high maintenance cost of operations, high capital expenditure or investment cash outflow. This was not the same as investing to expand capacity. For example, in

1972, Berkshire bought See's Candies, who had a $4 million pre-tax profit for $25 million. Buffett stated that Berkshire never hired a consultant; their idea was to go out and buy a box of candy and see if they like it. Buffett purchased the company with the idea that Berkshire could raise the prices of the candy without investing a great deal in capital. That formula worked. Today the company has a net profit of $60 million a year.

- ♦ Does the company have a high Return on Equity (ROE)? Buffett preferred 15%, but was willing to go lower depending on the economic conditions.
- ♦ Was the company's debt-to-equity ratio low enough for the company to pay its debt obligations? Can it repay debt in years when earnings are lower than average?
- ♦ Does the company have a quality, ethical management team that had passion? For example, in 1983 Buffett purchased the Nebraska Furniture Mart. At the time it was the largest furniture store in the U.S. Buffett purchased the company from the founder, Rose Blumkin (also called Mrs. B), with a handshake and $55 million. Blumkin came to the U.S. from Russia in 1917 with $66 and no knowledge of English. She learned English from her five year old daughter and in 1937 she started her store in the basement of her husband's pawn shop in Omaha. After the acquisition, Blumkin had enough money to retire, but she continued to work because of the passion she had for her business. Blumkin's motto was to be honest and sell cheap.
- ♦ Is the company free to adjust prices for inflation and still maintain profitability?
- ♦ Will the value added by retaining earnings lead to an increase in the stock market value of the company?
- ♦ Did the company have consistent strong free cash flow to maintain its current operations? Did the company retain earnings for growth and what is management's track record on those investments?[24] [25]
- ♦ Is the stock undervalued by at least 25%? Is the intrinsic value of the company 25% less than the market value of the company?

Buffett stated that he would talk to CEOs in an industry and ask them, if you wanted to invest in one company in your industry who would it be and why? This methodology allowed him to learn about the leaders in each industry.

There was no magical test to determine the value of a company, but Buffett appeared to have a good handle on the various tactics he used to help him value companies.

BUFFETT'S KEYS TO SUCCESS

Buffett has been described by many as a genius, brilliant with numbers, photographic memory, honest, loyal, frugal, smart, rich, etc. Peter Buffett, Buffett's youngest of three, stated that his dad had the most integrity and was the most honest man that he had ever met.

Buffett was not an ostentatious man. He lived in the same house in Omaha that he purchased in 1957 for $31,500 and drove a Lincoln Town Car with license plates that said THRIFTY. A few years ago he auctioned off the car on e-Bay. Buffett stated, "My suits are old, my wallet's old, my car's old and I've lived in the same house since 1957, so I hang on to things".[26]

In a recent talk to University of Florida students Buffett stated, "There is no difference between you and me: We all go to McDonald's…better yet Dairy Queen, we all live in cool houses in the summer and warm houses in the winter. Our lives are not that different. You will get decent medical care if something happens to you and so will I. The only difference is that I travel around on this little plane and that is the only difference. If you leave this aside, what can I do that you cannot do? I get to work in a job that I love and I think you are out of your mind for taking jobs you do not love. Take a job that if you were independent wealthy you would do. If you think you are going to be a lot happier with 2x instead of x, you are probably making a big mistake. Find something you like, you will get in trouble if you think that making 10x or 20x will make you happy because then you will do things you should not do like cut corners. Do something you enjoy and be associated with people you like. If I could make $100 million dollars with some guy that made my stomach churn I would say no. It is like marrying for money, which if you are already rich, is crazy". [27]

Buffett did not believe in high CEO pay. He consistently spoke out about the abuses of management in relation to pay and stock options. Since 1980, Buffett made $100,000 a year, which he stated was more than enough to live on. He never cashed in a share of Berkshire stock for personal use. Exhibit 16 showed some of Buffett's more famous quotes.

Forever a student, Warren Buffett stated that if you want to become a successful investor you need to read all of the time. In 1965 he wrote, "We derive no comfort because important people, vocal people, or great numbers of people agree with us. Nor do we derive comfort if they do not. A public opinion poll is no substitute for thought. When you find a situation you understand, where the facts are ascertainable and clear, then act, whether the action is conventional or unconventional and regardless of whether others agree or disagree. When you are dead sure of something and are armed with all the facts, then everyone else's advice is only confusing and time-consuming". [28]

Buffett stated that we like to buy businesses at reasonable prices. He also stated that the secret to making money was to avoid making mistakes and bet big, but seldom. Buffett kept his investments secret until the publication of the Berkshire Hathaway's Annual Report or until he was required by the Securities and Exchange Commission to disclose his transactions.

A Wall Street money manager with First Manhattan Co. in New York reported to his wife after a lunch with Buffett "I think I just met the smartest investor in the country". Phil Carret, an investor, called Buffett "the smartest man in the U.S." Sequoia Fund's Bill Ruane dubbed Buffett "the smartest guy in the country". Former GE CEO Jack Welch called Buffett "the smartest guy in any room". Executive Jet CEO Rich Santulli said, *"There is not a person in the world that is smarter than Warren Buffett*".[29]

Exhibit 16: Warren Buffet Quotes

- "Shares are not mere pieces of paper. They represent part ownership of a business. So, when contemplating an investment, think like a prospective owner."
- "All there is to investing is picking good stocks at good times and staying with them as long as they remain good companies."
- "Look at market fluctuations as your friend rather than your enemy. Profit from folly rather than participate in it."
- "If, when making a stock investment, you're not considering holding it at least ten years, don't waste more than ten minutes considering it."
- “A public-opinion poll is no substitute for thought.”
- “Of the billionaires I have known, money just brings out the basic traits in them. If they were jerks before they had money, they are simply jerks with a billion dollars.”
- “It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently.”
- “I always knew I was going to be rich. I don't think I ever doubted it for a minute.”
- “What good is money? It buys time and flexibility to do what you want (work how you want). But, it doesn’t really make a huge difference in other things.”
- “It's better to hang out with people better than you. Pick out associates whose behavior is better than yours and you'll drift in that direction.”
- “The business schools reward difficult complex behavior more than simple behavior, but simple behavior is more effective.”
- “Our favorite holding period is forever.”
- "Price is what you pay. Value is what you get.”
- “Risk comes from not knowing what you're doing.”
- “There seems to be some perverse human characteristic that likes to make easy things difficult.”
- “Time is the friend of the wonderful company, the enemy of the mediocre.”
- “We enjoy the process far more than the proceeds.”
- "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.”
- “When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact.” “Why not invest your assets in the companies you really like? As Mae West said, "Too much of a good thing can be wonderful.”
- “You only have to do a very few things right in your life so long as you don't do too many things wrong.” “Your premium brand had better be delivering something special, or it's not going to get the business.”

- “Wide diversification is only required when investors do not understand what they are doing.”
- "I don't look to jump over 7-foot bars: I look around for 1-foot bars that I can step over.”
- “If past history was all there was to the game, the richest people would be librarians.”

Source: Warren Buffett Quotes. http://www.brainyquote.com/quotes/authors/w/warren_buffett.html. Accessed December 3, 2008.

Buffett disliked schedules, meetings, company rituals, and managing people. His office was in a simple building called Kiewit Plaza for over 30 years.

Buffett had an incredible high level of integrity (e.g., he mouthed no threats and never participated in hostile takeovers). Buffett considered character the most important ingredient of a hire, but he also wanted someone who was intelligent with a high level of energy. Other characteristics he admired were generosity; people that gave credit to other people even if they did the work, people that had strong leadership capabilities, and people that were not greedy. Buffett also believed in the philosophy that if you admire someone, you should behave like them.

Buffett was also a debt adverse person and had a strong dislike for being in debt. Buffett had two rules that he considered rich seekers must learn: Rule no 1: never lose money. Rule no 2: never forget rule no 1.[30]

One of the keys to Buffett and Berkshire’s success was the interest free leverage from the insurance premiums the company received. For example, Geico customers would pay their premiums and then Berkshire was free to use the money for other investments, such as the acquisition of successful companies like See’s Candies or Nebraska Furniture Mart. Of course, Geico would have to pay claims, but until then, they were free to use the cash on other investments.

BUFFETT AND CHARITY

What made Buffett especially happy was giving most of his fortune to the Bill & Melinda Gates Foundation and four other philanthropies.[31] More than 99% of the monetary proceeds and 100% of the human proceeds of his life were to be returned to society. Buffett stated, “I want my trustees to swing for the fence on a few projects that do not have natural funding constituencies, but that are important to society. I tell them that if they start giving half a million to this hospital and a million to that college, I will come back and haunt them”.[32]

Buffett also stated that his children would not inherit a significant proportion of his wealth and that his great fortune would not be transferred from one generation to the next. Buffett stated, “I want to give my kids just enough so that they would feel that they could do anything, but not so much that they would feel like doing nothing. I do not have a problem with guilt about money. The way I see it is that my money represents an enormous number of claim checks on society. It is like I have these little pieces of paper that I can turn into consumption. If I wanted to, I could hire 10,000 people to do nothing but paint my picture every day for the rest of my life. And the GNP would go up. But the utility of the product would be zilch, and I would be keeping those 10,000 people from doing AIDS research, or teaching, or nursing. I do not do that though. I do not use very many of those claim checks. There is nothing material I want very much. And I am going to give virtually all of those claim checks to charity when my wife and I die".[33]

Buffett always felt best when he was giving and helping others. Buffett's value system was a major reason why he was so successful. Every year for the past several years Buffett invited approximately 15 universities and colleges from all over the world to his corporate headquarters. He shared his thoughts on business and more importantly his lessons on how to live your life. Buffett donated one class A share to each school to cover their expenses.

Buffett also auctioned off a lunch with himself every year on eBay. He gave the proceeds to Glide Foundation, a non-profit organization in San Francisco that helped the homeless and poor. This past year a Chinese investment fund manager won the bidding at $2.1 million.

Buffett stated that he was the luckiest person in the world because he loved what he did for a living and was surrounded by people that loved him. When he was recently asked in an interview about the key to happiness, Buffett made no mention of money or any materialistic things, but mentioned the importance of surrounding yourself with people that love you.

Buffett's value system stressed the importance of being honest and forthright; something his father had taught him. His honesty was legendary. Buffett always stated that it was better to make less profit if it meant doing it honestly rather than questionably. As a result, it was not uncommon for leading investors and media to contact Buffett first to get his opinion on critical issues. People knew that when Buffett spoke, they got an honest, intelligent, and forthright answer.

ECONOMIC ENVIRONMENT

In late 2008, the U.S. economy was muddled with a drop off in consumer spending, the housing bust, and the subprime financial disaster. At the heart of the economic mess was one of the biggest financial disasters in the history of the U.S., the housing bust and the subprime mortgage collapse. The U.S. was in the worst housing correction since the Great Depression. By 2009, the average net worth of households headed by homeowners age 45 to 54 will be almost 25% less than it was in 2004.[34]

The factor that led up to the housing bust that began in 2006 was the U.S. recession from 2001-2003. To stimulate the economy, the former Chairman of the Federal Reserve, Alan Greenspan, dropped the Federal funds rate to 1%, making it easier for people to borrow money at a very cheap rate. The lowering of interest rates, compounded with little regulations, and greed within the financial industry, created a housing boom.

New innovations along with low interest rates allowed consumers easy access to funding to purchase real estate. Buyers were allowed to purchase real estate with no money down without lenders checking employment records or their ability to pay their debt obligations. The easy access to capital created a housing boom. Some areas of the country (e.g., California, Florida, Arizona, Nevada, etc.) saw their housing values increase in double digits for several years.

This level of growth was not sustainable and eventually led to the collapse of the housing industry. People borrowed money to purchase houses with adjustable rate mortgages (ARMs) with the hope that the values of real estate would continue to go up. Unfortunately, that gamble came to an end in 2006 when prices started to fall and people could not refinance their ARMs due to falling home values.

According to the latest S&P/Case-Schiller Index, the most respected U.S. housing index indicator, the average U.S. home price dropped 21% from its peak in the second quarter 2006 to September 2008. On a year-to-year basis, the average home in the U.S. dropped 16.6% from September 2007 to September 2008. Some areas of the country have been hit especially hard. Phoenix, Las Vegas, Miami, Los Angeles and San Francisco saw their average home prices decline 39%, 38%, 36%, 33%, and 33% from their highs in mid 2006 and were still dropping.

The collapse in housing values cost U.S. homeowners $4 trillion in lost equity. Many analysts have estimated that home values could drop another 10-20% before the crisis is over. Some analysts also state that just because the housing crisis bottoms, does not necessarily mean that price appreciation will come back any time soon.

According to Bill Gross, CEO of Pimco Investments, "The housing market is going down because quite simply, they went up too much and were financed with excessive debt. The housing bubble was well inflated by low interest rates, easy, and in some cases fraudulent credit, a lack of federal and state regulation, and a gullible public who read the history books for the past half century and knew full well that home prices never, ever go down. Not much of an enigma there. No riddle to be solved it would seem. It was simply a fairy tale too good to be true. Yet housing, unlike other asset classes, carries with it an aura more like a bad dream than a fairy tale. That is because it is the most levered asset class and the one held by more "investor" citizens than any other. U.S. homes are market valued at over 20 trillion dollars with nearly half of the value supported by mortgage finance of one sort or another. At first blush that appears to be reasonably levered, but at the margin, homes purchased in 2004 and beyond are now at risk of turning upside down – negative equity – and there are some 25 million or so of those. The "upsidedownness" in many cases results in foreclosures, or outright abandonment and most certainly serves as an example of what not to do for millions of twenty-somethings or new citizens choosing between homeownership and renting. PIMCO estimates a total of 5 trillion dollars of mortgage loans are in risky asset categories and that nearly 1 trillion dollars of cumulative losses will finally mark the gravestone of this housing bubble. The problem with writing off 1 trillion dollars from the finance industry's cumulative balance sheet is that if not matched by capital raising, it necessitates a sale of assets, a reduction in lending or both that in turn begins to affect economic growth, creating what Mohamed El-Erian fears as a "negative feedback loop".[35]

"I worry a lot about what's happening in housing," Martin Feldstein, Professor of Economics at Harvard University and President Emeritus of the National Bureau of Economic Research. Feldstein stated, "The number of negative-equity homes is exploding. Housing prices will continue to go down, driven by the large oversupply of houses and the increasing number of foreclosures".[36]

In an interview on August 22, 2008 on CNBC Buffett was quoted, "The economy continues to be in a recession, by my definition, and will continue to be for at least several more months. The ripples of the credit crunch are continuing to cause problems in financial businesses and the economy. We found out that Wall Street has been kind of a nudist beach. You always find out who has been swimming naked when the tide goes out. We found out that Wall Street has been kind of a nudist beach. I am confident the country will be doing better five years from now, but the economy could be worse five months from now. The economy is in a recession because most Americans are not doing as well today as before. The technical definition of a recession most economists use is two consecutive quarters of negative growth in the country's gross domestic product. The current economic struggles in the U.S. create investment opportunities, and my phone is ringing more lately than it was three months ago. However, many of those calls have come from desperate people and did not represent good investment opportunities" (Funk, 2008).[37]

BUFFETT'S NEXT MOVE

As Buffett finished his Buster Bar at Dairy Queen his second wife, Astrid Menks, (Buffett's first wife, Susie, passed away in 2004) asked him a few questions, "Warren, Berkshire Hathaway's stock price is down 48% this year and you keep telling me that we are in a recession. I am very concerned about the economy. I have never seen it this bad before. What are you going to do next, Warren? Buffett thought to himself, this was the worst economic period of his investment career. He pondered about what his next moves should be.

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TALENT MANAGEMENT AT THE ADV CORPORATION

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CASE DESCRIPTION

The primary subject matter of this case is that of talent management – the attraction, on-boarding, development, retention, and re-deployment (or counseling out) of professional and managerial employees while optimizing individual and organizational performance. Discussion questions range from the specific situation ADV faces to issues of whether or not one should join a high level task force responsible for making recommendations to the CEO. The case requires significant analysis and generates useful discussion on many talent management issues including the need for targeted employee value propositions in four countries (Germany, India, UK, and US) to be able to attract, develop, and retain professional level talent. Secondary issues include the work climate at ADV and the questionable senior management support for task force recommendations. Case difficulty is 3 to 6 (junior to second year graduate, depending on issues raised and depth of analysis and discussion). The case is designed to be taught in a management, organizational behavior, or human resource management course requiring from 50-90 minutes of class time and 2-3 hours of pre-class preparation.

CASE SYNOPSIS

ADV is a $3.5 billion multinational corporation that is struggling to attract and retain professional and managerial level talent in four country markets (Germany, India, UK, and the US). You have been asked to join a task force to make recommendations to the CEO and Board on how ADV should invest an ***incremental*** *$13 million in talent selection and development for the next fiscal year. The case provides retention and job openings data by country along with a discussion of talent management issues from several perspectives: the Board's views on investing in talent management, the CEO's charge for the task force, the soon-to-depart Global Head of HR's analysis of current and past talent management practices including why she is leaving, and extensive comments from your mentor detailing how ADV has attended to or ignored talent management issues in the past. Information provided indicates that prospective employees' value different work attributes than employees two years later, and that these attributes vary by country (e.g., level of compensation, work-life balance, development opportunities, location, job impact, empowerment, quality management, etc.). Financial information is provided on the expected costs of projects and activities associated with recruiting, training, developing, and communicating the ADV talent management approach to prospective and current employees. Four guidelines for talent management are embedded in the case* *dialogue: (1) avoid mismatch costs through careful 'make' versus 'buy' decisions at each level in each country, (2) reduce financial and labor market risks by developing shorter forecasts of talent needs and using a portfolio approach, (3) ensure payback in employee development practices through targeted development and retention, and (4) balance employee interests and career moves with those of ADV, including re-deployment and counseling out.*

TALENT MANAGEMENT AT THE ADV CORPORATION

You have been asked to become a member of the Talent Management Task Force (TMTF). Talent management is not your area of expertise, you have little 'extra' time for this, and the stakes seem to be high. TMTF is to make recommendations to the CEO and Board on how ADV should invest an incremental $13 million in talent selection and development for the next fiscal year. No commitment has been made beyond the next year, but insiders think that comparable funds will be made available for several years.

You have decided to learn a bit more before you agree to join TMTF. What follows is what you have been able to learn regarding the reasons for TMTF by asking around (including your boss), a meeting with Pat (Head of Global HR), and a lengthy discussion with your mentor, who reports directly to the CEO and attends Board meetings.

From Your Mentor: CEO and Board Level Interest

The need to invest significant additional resources over the next several years is based on what is viewed by some Board members as an impending leadership crisis. There are several factors that suggest that ADV may be heading for that crisis. The minutes from the last Board meeting provided the following summary of Board member conversations which were being led by ADV's Head of Global HR.

- ♦ Retirements over the next five to ten years, led by the Baby Boomers, is of immediate concern. "By the year 2015, a majority of today's senior leaders will be eligible to retire or will have retired. At the same time, corporate growth plans suggest the need to hire leaders into as many new positions as we currently have. Since the generation that follows the Boomers has 20%-25% fewer people, perpetuating past ways of developing leadership talent will not result in a sufficient supply, nor are the past ways of developing leaders likely to the 'right' ways in the future."

- ♦ Decline of Loyalty and Organizational Commitment. "The present generation of new leaders and professionals is expected to change jobs from 7 to 10 times in their career. While job changes can be developmental and within the firm, they sometimes result in a loss of talent for the organization. Turnover in mid-to-senior level leadership positions has been high in some regions."

- ♦ Loss of Knowledge and Social Capital. "More retirements and turnover translate into a loss of the company specific knowledge along with each departing executives' social capital and contact network. Much of ADV's business rests on loyal relationships with customers, clients, suppliers, and buyers. Many high potential women are leaving ADV just before advancement into senior positions due to quality of life and child rearing issues – causing a large drain on our social capital with some stakeholders."

- ♦ Increasing Technical and Global Complexity. The advances in technology and globalization have made it impossible to conceive of leadership talent in non-technical and non-global terms, requiring more time and developmental assignments to develop leadership talent that is technically and globally savvy.

These Board observations and trends make it imperative for TMTF to be able to make recommendations that will, when effectively executed, lead to the successful identification and nurturing of the talent in ADV ranks, and to the successful attraction of new talent to fill key leadership roles over the next 3-7 years. To highlight the importance of talent management, one Board member shared the following statistics at the last Board meeting: (1) Top performing companies source more CEOs internally than other companies (85% to 68%); (2) they source more VP-level talent internally (74% vs. 59%); (3) they are more consistently able to attract the external talent they want (95% vs. 59%); and (4) nearly all reported ongoing gaps in their leadership talent pool (97%).

The CEO went on to state that talent management is a top priority for us. He stated, "We want to have the reputation with our employees, customers, and investors as one of the top companies in our industry in terms of leadership talent. That means that we attract, develop, and retain the best men and women in each region – delivering value to all through excellent decisions, caring and respectful treatment of people, and a high quality of life for all employees."

From Your Boss: ADV Business Situation

ADV had revenues of over $3.5B last year, with profits of $358 million. The workforce includes 8,800 employees, 430 of which are considered middle and upper level management and/or senior professionals. ADV operates in 9 countries/regions including Australia, Canada, China, France, Germany, India, Japan, UK, and the United States. While still somewhat US-centric, 44% of revenues are generated, and 38% of the mid-to-senior level leadership positions are held, in Germany, India, and the UK. Less than 15% of revenues and about 20% of ADV mid and senior level leaders are in the remaining 5 countries.

Talent management at ADV involves the attraction, development, and retention of people who are among the top 430, or viewed as having potential to be advanced to that level within 3 years (approximately 400 more are unofficially viewed as 'high potential'). The total compensation and benefits for these top 810 leaders/senior professionals is over $165 million annually (excluding the compensation of the top 20 executives). The number of professionals/leaders and their compensation/benefits have been increasing at approximately 4-5%/year. This is already in the budget for next year.

From Pat, Head of Global HR: ADV's Talent Management

The objective of a quality talent management program is to ensure the organization can attract, develop, and retain the top talent necessary for sustainable success in the global market place – success with customers, employees and investors. This is done, in part, when the organization's leaders are able to meet their personal goals while directly and meaningfully contributing to the organization's goals. ADV recognizes its need to manage its employee value proposition to enhance the quality of its leadership talent. The attributes of this value proposition are intended to provide a competitive advantage for the organization so as to both attract and gain the retention of its leaders and senior professionals. Components of talent management that are used to deliver ADV's value proposition include:

- a fair and open recruitment and selection process
- compensation and benefits that are slightly above industry-by-country averages
- opportunities for training/development
- accurate and useful performance appraisals
- on-the-job support such as apprenticing, coaching, and mentoring
- job assignments that match the employee's interests, developmental needs, and career aspirations, and
- a quality of life that reflects and possibly exceeds local standards

While the elements of ADV's talent management efforts are espoused by senior leadership, the programs and practices within ADV for talent management are not well established (often with little accountability), not well executed, and not targeted to individuals or regions to gain maximum return on the dollars invested.

From Your Mentor: Inside View of TM at ADV

Your mentor had a lengthy interview with Pat, the Head of Global HR, and learned that Pat was leaving in three weeks – not for a better salary offer. Pat was leaving to join a smaller company ($2.4B in revenue) that Pat believed had its senior leaders highly committed and personally involved in the processes of attracting, developing, and retaining leadership talent.

Your mentor recalls Pat making the following 'comments' during the interview. "ADV has no consistent recruiting process or recruiting message across regions, functions, or lines of business. I've tried to get our country and functional leaders to commit to a formal recruiting process – I was stonewalled. The situation is made worse by not having a clear strategy on the kinds and level of the people we want to hire. Sometimes we go after the 'best and brightest' college graduates with the idea of fast tracking them, other times we focus on industry hires with 8-15 years of work experience. And the recruiting budget for mid and senior level hires has been flat for 2 years at $1 million for mid-levels and $2 million for senior levels. Needless to say, but I'll say it any way, the recruiting, development, and retention issues vary significantly for college hires versus senior level industry hires. Because we do not have a strong pipeline for senior positions, we currently have many vacancies and not enough senior-level recruiting budget to fill them."

Pat continued, "Starting pay and benefits are locally determined, even when someone is likely to be rotated or transferred to a different region within a year. Pay raises are rewards for past performance -- relatively little of the salary pool is ever targeted to reward a person's potential or their being identified as 'high potential'. Training and development (T&D) are generally available, but not strategically attended. Most employees view our T&D policies as a plus. The $1.4 million spent on mid and senior level T&D last year could yield better returns. People go to what they want, when they want. Other than a 3-day New Hire Program and tuition reimbursement for part-time MBA courses, little is uniform. Some companies commit to a certain number of professional development days per year for each employee – we have not. Most people attend a program lasting a few days once every 3-5 years and do web-based or CD/DVD training at their desks 10-20 hours a year. This level of in-residence and computer-based training is inadequate to develop a high potential talent pool of future leaders. The accountability for the success or failure of professional development programs is weak with the regional HR units acknowledging that they are doing a mediocre job of it; senior management has not been involved."

In discussing ADV's performance appraisal system, Pat noted, "There is no direct accountability via the performance management process for managers developing their direct reports. 360-degree feedback is still relatively new, and rarely used outside the US. It is occasionally used in training programs. The leadership competencies identified in performance appraisals and 360's are not directly linked to succession planning, promotions, or hiring leaders from outside the company. I've tried to push this point with the regional leaders – they balk at any formal succession planning or 'anointing' people as 'high potential'. Promotion from within varies greatly by region – as does the identification and notification of high potential employees."

As an aside, Pat noted that, "ADV is piloting an apprentice process in Japan for high potentials – early responses are promising with higher retention rates and more individuals being identified as having leadership potential. Mentoring is still ad hoc, we have no formal structure or processes around it. Most new hires are informed that mentoring is valued here, yet we do nothing special to connect them with a mentor. Executive coaching is new to ADV – maybe 10 people have had a coach. Developmental assignments are common, but not always presented as part of a leadership developmental plan. We – or should I say the firm -- could do so much more here if developmental assignments were part of a formal career management program."

Attraction and Retention Drivers by Regional Geography

Pat shared with your mentor some research that was going to be sent to TMTF members. ADV had participated in a study that examined what employees want from potential employers or their current employer. The results varied by geographic region. This data may help the TMTF answer two nagging questions:

- ♦ How can you best attract future leaders?
- ♦ How can you best gain the commitment of those that you want – so as to retain the best?

The following arrived via email from your mentor.

E-mail Message

Subject: Talent Management

Below are the results of a research study on employee value propositions along with some background information on our current talent management activities and plans. Table 1 presents the research study of what employees' value most from their employers by region. Table 2 is our current mid-to-senior level staffing, planned staffing, turnover rates, and cost comparisons by region. A summary of key costs and estimated costs for talent management activities follows in Table 3. This is based on our expenses over the past two years and some of Pat's planning documents for next year.

Value Proposition Research Study

The 'drivers' of Attraction and ***Retention*** are listed in rank order in Table 1, with "A" being the most important factor in attracting (and gaining the retention of) employees, "B" being the second most important, etc. 38 different 'drivers' were examined in the research. Only 15 were consistently top ranked. Note some significant differences between what people want to join, versus what they want to stay.

ADV's People Committee's Assessment of Our Value Proposition

Our People Committee (now disbanded) did a competitive assessment of our top 3 labor market competitors in each region. The numbers associated with each value proposition element in Table 1 are the People Committee's best estimate of where we stand relative to competitors in that region. "1" indicates a clear competitive advantage. "2" signifies a strong position but not the industry leader. "3" indicates that we have some positive reputation around this, but that its 'pulling' or 'staying' power is modest (at best). If no number is indicated, the Committee thinks that we have a **weak** position which is a competitive **disadvantage**.

Table 1. Value Proposition Factors to Attract and Increase Retention by Region				
(People Committee's competitive assessment in parentheses, 1 is best, blank is worst)*				
	Germany	**India**	**UK**	**US**
A – Attraction	Compensation	Future Career	Work-Life	Compensation
	(3)	Opportunities (2)	Balance	(3)
A – Retention	*Development*	*Manager*	*Respect*	*Job-Interests*
	Opportunities	*Quality (3)*	*(1)*	*Alignment*
B – Attraction	Collegial Work	Compensation	Future Career	Health
	Environment (2)	(3)	Opportunities	Benefits (2)
B – Retention	*Manager*	*People*	*Job-Interests*	*People*
	Quality (3)	*Management (3)*	*Alignment*	*Management (3)*
C – Attraction	Location (1)	Development	Compensation	Organizational
		Opportunities (2)	(3)	Stability (2)
C – Retention	*Respect (3)*	*Job Impact*	*Manager Quality*	*Respect (2)*
D – Attraction	Organizational	Organizational	Location	Work-Life
	Stability (2)	Stability (2)	(3)	Balance
D – Retention	*Recognition*	*Compensation*	*Senior Leader*	*Manager*
			Reputation (3)	*Quality (3)*
E – Attraction	Development	Job-Interests	Organizational	Future Career
	Opportunities	Alignment	Stability (2)	Opportunities
E – Retention	*Empowerment*	*Innovation*	*People*	*Development*
	(3)		*Management*	*Opportunities (2)*

Table 1. Value Proposition Factors to Attract and Increase Retention by Region
* The People Committee, which was comprised of 10 people (1/2 from HR), noted that the top two factors associated with the retention of women were work life balance and job-interests alignment in each region. The research study offered the following clarifying definitions: **Empowerment** – the level of involvement employees have in decisions that affect their job and career **Innovation** – the opportunity provided by the job to work on innovative, 'leading-edge' projects **Location** – the location of the jobs the organization offers **People Management** – the organization's reputation for managing people **Respect** – the amount of respect the organization shows its employees **Work-Life Balance** – the extent to which the job allows you to balance your work and your other interests

Table 2. Current Staffing, Shortfall, Turnover, and Cost Statistics for Mid-to-Senior Level Positions (Leaders and Senior Professionals)

	Germany	India	UK	US
Total Mid-Level Positions	34	59	40	128
Total Senior Level Positions	8	10	12	43
Open Mid-Level Positions	3	18	12	23
Open Senior Level Positions	1	4	2	6
Within 3 years:				
New Mid-Level Positions	21	68	11	25
New Senior Level Positions	5	23	2	4
Past 3 yrs Average Annual Turnover				
Mid-Level Positions	11%	23%	8%	14%
Senior Level Positions	10%	36%	10%	15%
Recruiting and Compensation Cost Factor (relative to US)	1.5	.65*	1.8	1.0

* We increased this cost factor in recruiting and compensation from .5 to .65 this year. While we observe some cost differences by region for other expenses, such as T&D programs, meetings, etc., we budget at the US rates. Instructors, facilities, lodging, and travel do not vary significantly by region in cost/person or program for the quality we require.

Table 3. Costs for Talent Management Activities for Mid-to-Senior Level Personnel	
Actual Costs/Year for Past 2 Years (includes travel and lodging)	
College recruiting within region:	$6,700/hire
College recruiting globally at top tier schools:	$11,300/hire
Industry recruiting without search firm:	$15,900/hire
Industry recruiting with search firm, mid-level:	$33,000/hire
Industry recruiting with search firm, senior-level:	$96,000/hire
Sponsoring MBA (tuition reimbursement program)	$40,000/person/pgm
Sponsoring EMBA and Full Time MBA/MS	$85,000/person/pgm
Sponsoring Top Tier University-Based Exec Ed Programs	$12,000/person/week
Executive Coaching (senior leaders only)	$20,000/person/year
Regional New Hire and Prof. Development Programs	$300/person/day
Global Leadership Development/Targeted Prof. Development Programs	$800/person/day
Global Developmental Assignments, Meetings, and Seminars	$600/person/day
Executive Committee Meetings (off site, global, 30 participants)	$240,000/meeting
Senior Staff Meetings (off site, global, 200+ participants)	$1.6 million/meeting
Regional Mid-to-Senior All Hands Meetings (40-150 participants)	$1.2 million/4 mtgs
HR Staff Increases to Attract and Serve Larger Talent Pool	$1.5 million/year
HR Initiatives that Focus on the Retention of Women	$.2 million/year
HR and T&D Related Communication and Marketing (non-employee)	$1.3 million/year
Estimated Costs for Talent Management Projects	
Revise and Validate Performance Management System, firm wide	$2.1 million
IT Budget for Distance Learning via CDs/DVDs/Web-Based	$1.5 million
Develop and Use 360-degree Assessment Internally	$ .2 million/year
Develop and Administer Formal Mentoring Program	$ .2 million/year
Develop/Deliver 'Leadership Academy' for Top Performers (8 days, 40 people/yr)	$ .5 million/year
Develop/Deliver Assessment Center to Identify High Potentials (60/year attend, 3-day assessment)	$.4 million/year
'High Potential' Career Management Program (100/yr, job assign., project work, leadership dev.)	$1.6 million/year
Incentive Compensation Pool to Reward High Potentials (top 20%)	$2 million/year
Structural Compensation Adjustment for High Potentials (300-400)	$3-5 million/year
Structural Compensation Adjustment for India (69 people)	$1.4 million/year
Involvement of Senior Leadership in High Potential Programs (mostly travel expenses)	$ .3 million/year
Consultants plus Senior Leadership Involvement to Develop a Succession Plan	$ .7 million

The Decision Situation

You begin to ponder….

- ♦ Should I join the task force?
- ♦ Is this work interesting enough to be of real value to company, or is it a passing fancy?
- ♦ Can developing an employee value proposition make a difference?
- ♦ Would it be best to have different value propositions in different businesses, or regions?
- ♦ How easy will it be for competitors to copy or surpass it?
- ♦ How would I invest the first year's TM budget – Recruiting? Training? Meetings and Communication? Projects?
- ♦ Even if we come up with a good strategy and recommendations, will our middle and senior level managers support it?

Assignment

Be prepared to discuss your 'pondering' thoughts based on the questions above in class with 4-5 others. Your group will be responsible for deciding whether or not, as a group, you would join the task force. You will be expected to defend your decision based on your interpretation and understanding of the situation as described in the case.

Table 1: EVP by Region for Attraction and Retention

List the top 3 attributes in rank order of their expected value in attracting and retaining the desired talent. Note in parentheses the desired ranking relative to competition in each region (see sample data for Germany below).

Region	***Attract***	***Retain***
Germany	Organizational Stability (1) Development Opportunities (2) People Management (2)	Respect (2) Empowerment (2) Manager Quality (2)
India		
UK		
US		

In words, the above chart is communicating the following: ADV's EVP to attract talent in Germany is based primarily on creating the perception of being a stable organization, then the development opportunities offered, and then their people management processes. ADV wants to be the industry leader with respect to organizational stability, and at least number 2 in the industry for their ability to attract talent based on the development opportunities offered and the people management processes they use. Since they do not currently hold these 'positions', investments are needed.

For retention, ADV's EVP is based foremost on respect, then empowerment and manager quality. ADV wants to be perceived as being number 2 or better relative to other firms in the industry on these attributes. Since they do not currently hold these 'positions', investments are needed.

Table 2: Investments in Talent Management (1st Year)

For each TM function, note all the actions you would take and the expected expense of these actions. Be prepared to justify your actions conceptually and analytically.

TM Function	*Program/Action for 1st Year*	*Estimated Cost*
Recruiting - Mid Level		
Recruiting - Senior Level		
Training & Development		
Communication/HR Staff		
Special Projects/Issues		

USE OF STAFF ATTORNEYS IN DEFENDING INSURANCE CASES: CAN AN ATTORNEY SERVE TWO MASTERS?

Joey Robertson, Sam Houston State University
Laura Sullivan, Sam Houston State University

CASE DESCRIPTION

This case deals with the issue of whether or not staff attorneys, employed by an insurance corporation, can legally or effectively represent an insured client in an insurance defense case. This case study will examine the practical and ethical issues involved in the case: Unauthorized Practice of Law Committee v. American Home Assur. Co., Inc., 261 S.W.3d 24 Tex.Sup. Ct. J. 590 (Tex. Mar 28, 2008)(American Home). The primary area of concern for this case is whether or not the interest of the insurance company and their insured are ever truly the same. Secondary issues in this case study will include an examination of whether or not the acts of a staff attorney constitute the acts of a corporation itself, and if they do – is this an unauthorized practice of law. An additional secondary issue is the idea that by the nature of his employment, a staff attorney's legal judgment may be influenced in that his employer controls the scope and depth of investigations, fees made available for discovery, expert testimony, and general guidelines the attorney must follow in pursuing the defense in trial.

This case is designed for use in an undergraduate business law/business ethics course, or graduate level course in management law. The various legal aspects emphasized in this case could be taught in one fifty-minute class. The assignment is expected to require approximately 1 to 2 hours of outside preparation time by the student.

CASE SYNOPSIS

Like many states, Texas has long struggled with the question of how many clients does an attorney, who has been hired by an insurer to defend an insured, have. Courts have tended to rule that these attorneys have two clients in the insurer and the insured, yet they owe an unqualified loyalty to the insured who has been sued. The Unauthorized Practice of Law Committee has sought to end or limit this practice based on concerns that a staff attorney, whose actions can be strictly controlled by his employer, will have an irreconcilable conflict of interest and be unable to give full allegiance to the insured.

In 2008 the Supreme Court of Texas reviewed a prior decision of the Court of Appeals for the Eleventh District of Texas. In American Home, the court was asked to determine if an insurance company's use of staff attorneys to defend cases filed against their insured resulted in the insurance company practicing law. If this did constitute the practice of law it would be a violation of Texas law. The Court ruled in part that the use of staff attorneys did not constitute unauthorized practice of law on the part of the insurance corporations. This case study will discuss that decision and attempt to determine if a staff attorney can avoid being improperly influenced by their nonattorney supervisors and those supervisors' duties of maximizing profit.

INTRODUCTION

In examining the tripartite relationship between an insurer, counsel provided by that insurer, and the insured to whom counsel is provided, it has long been accepted that insurers can provide legal counsel for their customers to aid in defending suits covered by the contractual agreement between the insured and the insurance company. Since the insurer has the duty to indemnify their insureds from losses covered by these insurance contracts, the insurance company is allowed to exert some level of control over retained defense attorneys. Much less settled is the idea that an insurance company can use staff attorneys, actual employees of the insurance firm, to defend these cases.

Currently only two states, Kentucky and North Carolina, prohibit staff attorneys from defending insures, while many other states do allow the practice. The concern of critics of this practice is primarily that through the control exerted by nonattorney officers and shareholders of the insurance company, the company itself is practicing law. In 2008 through their decision in the case of *Unauthorized Practice of Law Committee v. American Home Assur. Co., Inc.,* the Supreme Court of Texas addressed the issue of whether or not the use of staff attorneys constituted the unauthorized practice of law. Unfortunately as is often the case with decisions of the upper courts, the Court addressed only very specific questions, and left the major issues to be decided another time. Although the Court in this case determined that insurances companies engaged in the use of staff attorneys were not engaged in the unauthorized practice of law, they left on the table some much bigger issues. We will be looking at three of these issues. First we will look at whether or not the acts of a staff attorney constitute the acts of a corporation itself, and if they do – is this an unauthorized practice of law. We will go on to break this larger issue down into two sub issues: whether or not the interest of the insurance company and their insured are ever truly the same, and the proposition that by the nature of his employment, a staff attorney's legal judgment may be influenced to the point that he cannot fully live up to his duty to his insured client.

DO THE ACTS OF A STAFF ATTORNEY CONSTITUTE THE ACTS OF A CORPORATION ITSELF

In order to assist with the monitoring of the unauthorized practice of law in the State of Texas, the Unauthorized Practice of Law Committee (the Committee) was developed. The committee is responsible for the investigation and prosecution of individuals and entities involved in the unauthorized practice of law. Since its creation the Committee has sought to prevent insurance providers from using staff attorneys to defend cases against insured clients (insureds). The Committee has long argued that based on the level of control exerted over staff attorneys by nonattorney influences of the corporations, the acts of these staff attorneys amounts to no less than the acts of the corporations itself. The Committee has brought several suits related to this issue, but we will focus on the *American Home* case where the Committee sought to prevent American Home Assurance Company, Inc., and The Traveler's Indemnity Company, from using staff attorneys in the defense of suits against their insureds. After the trial court found in favor of the Committee the decision was reversed by the Court of Appeals before finding its way to the Texas Supreme Court (the Court). The Court ruled in part that the use of staff attorneys did not constitute the unauthorized practice of law.

In addressing *American Home* the Court attacks the issue by trying to determine if the insurance company is representing its own interest. The Court held that insurance corporations may use staff attorneys as long as the interests of the insurer and the insured are congruent. The Court believed that these interests would be congruent as long as there was no conflict of interest between the two. The Court in *American Home* found that there was nothing in the law which prevents insurers from contracting with private counsel to represent insureds. The Court also felt that the Penal Code provisions restricting the unauthorized practice of law did not apply to liability insurers' defense of their insureds. Liability insurance providers often have the right to exert total control over the defense of insureds based on contractual agreements. The Court held that there is little difference in the use of outside counsel and use of staff counsel. Based on this ruling insurance corporations may use staff attorneys to defend claims against insureds provided that the insurer's and insured's interests in the situation are congruent, and that staff attorneys must completely disclose to their insured clients their ties to the insurance provider.

As early as the 1930's the law has allowed liability insurance providers to provide staff attorneys to defend suits brought against their insured clients. As our unfortunate national history has shown us through slavery laws, past treatment of women and lack of employee rights, old laws are not always correct laws. Although the Court in *American Home*, ruled on behalf of the liability insurance providers we need to examine that decision and see if the Court got it right. As the Court in *American Home* was quick to point out, any analysis of this issue must begin by answering the question of whether or not the insurance counsel represents the insurer as well as the insured. The Court was hesitant to answer that question directly, but did provide some insight into determining the answer. The Court also made itself clear that it would not address the issue of what the law should be, only what the law is.

The practice of law in the State of Texas is governed in part by the State Bar Act (the Act), and the Texas Penal Code (The Code). The Act has since been recodified in the Government Code. The Act and The Code, as well as other aspects of the current law clearly allow a corporation to employ staff attorneys to represent the corporation itself, the corporation's officers, directors, employees, or shareholders. What is not allowed under current law is for a corporation to use staff attorneys in actions where it does not have a direct interest.

In the past insurers have used outside counsel or "captive firms". The members of these firms are not employees of the insurance corporation, but they work exclusively for the insurer having no outside clients. In *American Home* the Committee did not claim that an insurer engaged in the practice of law by hiring a private attorney to defend its insureds. Insurers clearly have a financial interest in covered suits against their insureds, but the issue we address here is whether or not the acts of a staff attorney constitute the acts of the corporation itself. Texas Law does allow corporations set up expressly for the purpose of offering legal services to do so, but it is clearly not the purpose of an insurance corporation. If it were determined that the actions of staff attorneys constituted the actions of the corporation, this would constitute an unauthorized practice of law in that it violates the requirements of the Act and sections of the Code restricting the unauthorized practice of law by corporations not set up expressly for the purpose of offering legal services.

As previously discussed these provisions do not prohibit all corporations from practicing law. There are certain corporations set up expressly for this purpose and they are in compliance. It is only when a corporation is set up for a different purpose, such as providing insurance, engages in the practice of law that unauthorized practice becomes an issue. In making its ruling in *American Home* the Court seemed to diverge from its own precedent. As the persuasive dissent by Justice Johnson points out, the Court has dealt with these issues before. In the earlier decision of *Hexter Title & Abstract Co. v. Grievance Committee, 179 S.W.2d 946 (Tex. 1944)* (*Hexter)*, the Court ruled that an insurance company had engaged in the unauthorized practice of law through the use of staff attorneys. The facts of that case were very different, but the Court's ruling and observations would seem to be applicable to *American Home*. As Justice Johnson noted in referring to *Hexster*, the only reason the insurers pursue this issue is because they want the economic benefit of having their staff attorneys represent individuals that are not corporate officers, employee, or shareholders – the purposes for which a corporation has historically been allowed to use staff attorneys.

Justice Johnson also noted that in the corporate environment, nonattorney officers often direct the work of the staff attorneys. He goes on to note that even if that direction were absent the result of using staff attorneys would still be the same. The staff attorney is acting as the agent of the corporation, and indeed his first loyalty is to the corporation. The Court in *Hexter* noted that due to these loyalties the actions of the staff attorney are the acts of the corporation. If one believes that the acts of an agent are the acts of his employer than it would stand to reason that the corporation using staff attorneys to defend insureds is engaged in the unauthorized practice of law. The staff attorneys are performing the tasks they were hired to perform on behalf of their employers. They take their direction from their corporate officers just as a junior attorney would take direction from a partner. The primary difference is that in an independent law firm, both parties are attorneys.

The regulations regarding the representation of a client do not concern themselves with profit. When a corporate entity is allowed to insert that criteria into the legal decision making process, we have moved from an attorney exercising his best legal judgment into an area of corporate decision making not bound by the rules of legal ethics. In can be argued that we have moved to a position where a corporation is allowed to practice law by proxy.

ARE THE INTERESTS OF THE INSURANCE COMPANY AND THEIR INSUREDS EVER TRULY THE SAME

The court in *American home* held that a liability insurer was not engaging in the practice of law by providing staff attorneys to defend claims against insureds if the interests of the insureds and the liability insurance company are congruent. The Court felt that in these instances a staff attorney's representation of the insured and representation of the insurer is indistinguishable. There are several issues which might cause the interests of the two parties to not be congruent. The most obvious occurrence is when there is a question as to the existence or limitations of coverage. This issue is well settled in the law. It was not a point of contention in *American Home*. The more compelling question is whether or not there is a lack of congruent interests based on the cost of a complete defense.

Supporters of the Court's decision in *American Home* point to the use of "captive firms", and argue that staff attorneys will serve the same purpose, but at an even lower cost. There are two errors with this argument. The first is that there is an inherent difference between the relationship of retained counsel bound by a contractual agreement and the relationship of a true employer and employee. Basic agency law tells us that the primary difference in a person being considered an independent contactor or an employee is the amount of control exerted over that individual by the employer. It is exactly the amount of control that makes the use of staff attorney employees troubling. Management decisions of large corporations are not driven by the same duties as attorneys.

In the world of accountants and attorneys there has always been a fundamental difficulty in the working relationship of legal counsel and auditors. The issues are based on the fundamental difference in the duty of confidentiality owed by attorneys and the duty of transparency of auditor CPA's. Similarly even a modest amount of common sense provides that there will undoubtedly be an ongoing struggle between the staff attorney's duty to provide his client with the best defense and pressure applied by that attorney's nonattorney supervisors to cut costs and maximize profits. It is the nature and very purpose of a corporate officer to pursue these goals and to apply pressure to their subordinates as necessary. As Justice Johnson stated in his dissent to *American Home* there is no reason to believe that staff attorneys will be immune from these pressures to keep costs low. If anything, one could argue that the declining economy will only increase those pressures. It is here that the second error comes into play from the statement that staff attorneys serve the same purpose as captive firms, but at even lower costs.

As previously mentioned, the rules governing the practice of law do not concern themselves with issues related to the minimizing of defense costs, and neither do the concerns of the insured customer of the corporation. Reducing costs as a means to increase profits are certainly a primary goal of the corporation itself, and it is here that the interests of the insurer make a radical departure from those of the insured. It is here – where we have a fundamental difference in interests related to the legal defense of these actions - that we might argue that the positions of the two entities, insurers and insureds, are never *truly* congruent. The parties may have similar interest, but their goals will never legitimately be the same. The insured wants to best defense possible; they want to avoid a judgment in excess of their coverage. The legitimate pursuit of the corporation is to minimize costs, and this is an important goal on behalf of the corporation and its shareholders. It is a goal much less comforting to the insured facing a judge and/or jury.

MIGHT A STAFF ATTORNEY'S LEGAL JUDGMENT BE INFLUENCED TO THE POINT THAT HE CANNOT FULLY LIVE UP TO HIS DUTY TO HIS INSURED CLIENT

Despite the ruling in *American home* there is clearly a fundamental difference in the position of an independent attorney retained by an insurance company and a staff attorney employed by that same company. For true private counsel the insurer is simply a client. While that client is a source of income, that client does not have complete control over the independent attorney. When you look at the situation of a staff attorney the circumstances are much different. The corporation, through its officers and directors, directly controls that attorney's salary, benefits, work environment and indeed their continued employment. Not only does this situation create additional pressures on the staff attorney, but you have to ask which competing interest he will or even should follow: does he provide the best defense he can for his insured client, or does he cut back on depositions, travel, experts and other expenses in order to fulfill his fiduciary duty to his employer? The court in *American Home* seems to recognize the existence of these problems, but balks at the lack of evidence that these issues have ever resulted in harm to an insured. Anyone who has ever worked in a corporate environment can step outside the legal theory and realize the outcome of these dilemmas. The attorney can subscribe to the highest ethical standards, but what are they to do in these trying economic times when their nonattorney officers are berating the staff for "unnecessary expenses". What may be unnecessary to an the executive is not necessarily unnecessary to an attorney, and in this situation the reality is that ultimately, the executives call the shots – and as an additional representative of the liability insurer, engages in the unauthorized practice of law. Complete control of the attorney's action is not even the bar that should be used to measure when the interests of the parties are not congruent. If a staff attorney is ever subject to pressures, which in any way influence his professional judgment and his relationship or representation of his insured client - that staff attorney has failed to meet his duties to that client.

CONCLUSION

In *American Home* the Court has ruled that a staff attorney will be able to avoid the pressures normally inflicted on personnel of a corporate environment to cut costs. Indeed there are likely many attorneys who can resist these pressures. Common sense and human nature dictate however that not everyone will be able to be so strong when their very employment may be on the line. In light of the current economic environment one has to ask what additional cost-cutting pressures may come to bear. In the theoretical world of law school we would like to believe that attorneys can resist outside pressure and abide by the interest of all clients. In the world of the decreasing value of the dollar, corrupt chief executive officers, and failing corporations, however, we should at least pause to analyze the decisions and reasoning of the court in *American Home*.

It should be clear that this ruling does little to address the legitimate concerns surrounding the use of staff attorneys to represent insureds. The law is clearly evolving, and only time will tell if the current economic environment will have an effect on how insurance companies balance their clients desire for the best defense with the companies own desires to maximize profits.

RESOURCES

Unauthorized Practice of Law Committee v. American Home Assur. Co., Inc., 261 S.W.3d 24, (2008)

PUBLIC FUNDS VERSUS PRIVATE ENDEAVORS: CATALOGS AND CONFLICT IN ALASKA

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CASE DESCRIPTION

The primary subject matter of this case concerns marketing. Secondary issues include finance, quantitative analysis, and public administration. The case has a level of difficulty of three to five, depending on the depth of analysis. The case is designed to be taught in 1.5 to 2.5 class hours and is expected to require 2-4 hours of outside preparation by students.

CASE SYNOPSIS

Rural Alaska Community Action Program, Inc. (RurAL CAP), an Alaskan nonprofit organization dedicated to serving the economic and welfare needs of rural Alaskans, particularly native Alaskans, launched a new catalog operation in 1993. The catalog had several purposes, one of which was to generate funds to support other social programs. In 1995, after two years of heavy losses and the investment of more than $600,000 of public money through Alaska State administered grant programs, controversy and uncertainty swirled about the contentious new venture. Investors in a private catalog operation, including a leading state politician, were very concerned about competing against a heavily subsidized operation that clearly did not have to make a profit. In addition to competing in the same markets, the two organizations competed for the talents and products of the same producers. RurAL CAP, Inc. argued that the losses were to be expected in a start-up operation, that they needed more time and money to become profitable and further claimed that they did not compete unfairly with private enterprise.

The Department of Community and Regional Affairs, the agency responsible administering the federally funded grant programs, was unsure of what to do. Besides the discomfort associated with giving taxpayer money to an organization that competed against private enterprise, they were concerned about whether the catalog operation represented a wise investment of public money. They wondered whether or not the catalog would ever be profitable, and hired a consultant (the author) to help answer this basic question.

This case can be used to raise and address a number of interesting issues appropriate to classes in public administration, marketing, finance, accounting, and entrepreneurship. In particular, it can be used to demonstrate the power of 'running the numbers.' The teaching note will emphasize marketing and financial issues, including break-even analysis.

INTRODUCTION

The Rural Alaska Community Action Program, or RurAL CAP, is a leading nonprofit organization in Alaska whose mission is "to protect and improve the quality of life for rural Alaskans through education, training, direct services, advocacy and strengthening rural people's ability to advocate for themselves." RurAL CAP began in 1965 as a consequence of the 1964 Economic Opportunity Act. In pursuing its mission it has started or otherwise managed well over a dozen statewide programs, including Head Start, weatherization assistance programs, information services, programs related to alcohol abuse, AmeriCorps, and a program to provide legal assistance to villages. By 1995 RurAL CAP's annual budget exceeded $8 million, and it had over 200 employees.

As a nonprofit social agency the majority of RurAL CAP's funds come from federal and state grants. However, RurAL CAP does obtain some funds from Rural Electric Enterprises (REE), a profitable wholly-owned subsidiary formed in 1987. REE grew out of an effort to import and sell cost saving, efficient, affordable heating sources to rural native Alaskans through rural product dealerships. The initial feasibility analysis was funded by a grant from the Department of Energy, and was initially supported by Community Service Block Grant funds. REE is a profitable operation that wholesales various energy saving products, including Toyostoves, to more than 60 dealers in the United States and Canada.

THE AURORA CATALOG EXPERIENCE-PLANNING

In February 1992 the Board of Directors of RurAL CAP gave the go-ahead to the staff to begin examining the feasibility of producing a catalog that would feature products made by rural, native Alaskans. As subsequently stated, the following were the goals/mission of the project:

1. *Develop income opportunities for Alaska natives that promote increased self-sufficiency;*
2. *Develop wider markets for Alaska native arts, crafts and products;*
3. *Create value for the subsistence way of life and distinct Alaska native cultures by providing accurate education and information about rural Alaska; and*
4. *To supply RurAL CAP with an unrestricted source of funds to help support other programs and activities.*

The executive director, accompanied by several board members, traveled to nine villages to discuss the project and to buy representative sample products. At this point it was made clear that artisans would be paid what they asked for their products - there would be no haggling or negotiations. Further, they were informed that goods would be purchased when it was convenient for the artists and producers. Rural residents showed overwhelming support for the project.

Throughout 1992 staff members began to become acquainted with the catalog industry. Based on discussions with representatives from other catalogs, such as the catalog operations of the World

Wildlife Fund and Robert Redford's *Sundanc*e catalog, RurAL CAP decided to hire an experienced, highly recommended catalog consulting firm from San Francisco to help in the analysis and planning of a catalog.

The decision was made to forego undertaking an in-depth feasibility study. Rather, based on the success of catalogs such as *The Hemmeter Collection, Faith Mountain,* and *Sundance*, it was decided to proceed directly to a test market. The strategy was to develop a high quality, distinctive catalog that would appeal to the socially conscious consumer.

Expected costs associated with the first year's mailings in 1993 were much higher than expected revenues: catalog design costs, consulting fees, and other start-up costs associated with this research and development effort were understandable. A consultant's feasibility study estimated that, based on industry experience, it would take 2 or 3 years before the catalog achieved profitability. In the business plan developed by another consultant, published in January of 1993, profitability was predicted in 1994.

In pursuing its strategy RurAL CAP relied on knowledgeable consultants for overall planning, product selection, catalog copy, mailing list evaluation and choice, promotion planning and execution, and in projecting results. Fulfillment operations (order taking, billing, packing and shipping, and information tracking) were to be contracted out to other organizations, as is common in catalog operations. RurAL CAP was responsible for the procurement of product and overall approval of various aspects of the project. It was the intention of RurAL CAP to bring responsibilities in-house, over time, as their expertise improved.

The intention of RurAL CAP was to have three mailings of a 24 page catalog during 1993; once on August 1, a second in late September, and a third in November, which would include four pages of Christmas items. Advertisements in publications touting the catalog and specific products were planned. The merchandise mix was to include some native and some non-native products in several categories, including jewelry, native dress, candles, food, artwork and other sundry items. In addition, short articles about Alaska and Alaska natives were to be included. If the results were encouraging, the intention was to expand the catalog operation to four mailings in 1994. A continued reliance on consultants in 1994 again was expected to result in high costs.

Internally one employee, the Economic Development Manager, spent the majority of her time on the catalog project. Other employees contributed according to their areas of expertise as time allowed. Some of this was quite extensive. After the first year's mailings a marketing specialist who had retail experience, as well as experience as an assistant buyer for Nordstroms, was hired to assist in the procurement and management of inventory. Shortly afterwards the Economic Development Manager had to leave Alaska because of a job offer for her husband, and the marketing specialist was thrust into that slot. Another woman was hired to assist her, and the two of them devoted all their energies to the project. One interesting practice was a weekly, one hour catalog project meeting that involved various RurAL CAP program managers and talented professionals, including the internal CPA and the Executive Director. The purpose was to brainstorm and to discuss problems and issues.

THE FUNDING CONTROVERSY

Initially the funds for planning the catalog operation, including travel, personnel time, sample acquisition, and consulting fees, were obtained by borrowing funds from child care, alcohol and abuse programs, and from the planning and research component of a Community Services Block Grant. The intention, of course, was that funds borrowed from programs would be returned.

In December of 1992 RurAL CAP requested an amendment of $190,000 to its current year Federal Community Services Block Grant (CSBG), administered through the State of Alaska's Department of Community and Regional Affairs (DCRA), to fund the catalog project. The request was denied, however, on the grounds that the proposed catalog was controversial and had not gone through the required application process and had not been part of the required public hearing.

The controversy regarding the project was largely the result of the president and founder, as well as the investors, of *The Great Alaska Catalog*. As a privately funded firm, *The Great Alaska Catalog* had been struggling for several years to build up its business to where it would be a viable, ongoing concern. The business required a lot of hard work, a lot of risk taking, and a lot of uncertainty. To find that a new competing operation was now in the arena was bad enough, but to find one that was run on lots of public grant money that did not have to be repaid was galling. How could a private firm, accountable to shareholders and lenders, compete against an organization that did not have to turn a profit, and could easily hire high-paid consultants and others?

The market for Alaskan products was not perceived to be overly large or expandable, and so the two catalog operations were perceived to be in direct competition for a fixed number of customers. Both were targeting the same customers with the same product mix through the same channels.

Not only were the two organizations competing for the same customers, they were also competing for supplies. Both featured a variety of native and non-native Alaskan goods. Supplies, particularly native products, were limited - there were only so many talented artists producing so many sellable products. *The Great Alaska Catalog* people argued that RurAL CAP’s efforts, particularly RurAL CAP's policy of accepting whatever prices the natives wanted, were affecting their ability to obtain products from the small number of sellable artists. A museum buyer found that none of RurAL CAP’s artists were unknown and without a current market for their products.

The Great Alaska Catalog people argued that RurAL CAP, to the extent they should be allowed to compete at all, should be restricted to promoting and selling rurally produced products from unknown artists in the bush.

An official complaint against the Department of Community and Regional Affairs was filed by the president of *The Great Alaska Catalog* with the Office of the Ombudsman on April 12, 1993, prior to the first mailing, contending that:

> *“(1) The catalog has not been supported by an adequate departmental review for compliance with federal requirements that funded activities must have a measurable and*

potentially major impact on the causes of poverty in the community or those areas of the community where poverty is a particularly acute problem.

(2) DCRA's approval of federal funds for this project is in conflict with Alaska's stated encouragement of private enterprise and the development of small businesses to provide needed goods and services whenever possible."

RurAL CAP and its supporters felt RurAL CAP had the right to help develop markets for their constituents, had a mission that went beyond making a profit (although they certainly intended to do that), and were entitled to the funds. They also argued that using non-native products and well-known native artists was a legitimate way to build a successful catalog operation. RurAL CAP also contended that they were, in fact, selling little-known artists, and further, that other talented, enthusiastic natives were gearing up.

In early to mid-1993 the Department of Community and Regional Affairs brought together both groups to try to come to a reasonable compromise. At that less-than-cordial meeting RurAL CAP's planning manager rejected any joint undertaking, since, to paraphrase her, far too much money had already been invested in their current operations.

Both sides lined up supporters and argued their points. No less than 3 State Representatives and 1 State Senator actively supported the stance of *The Great Alaska Catalog*. RurAL CAP had support from at least 1 State Senator and various native organizations and native leaders. A petition was circulated during native community and village functions, and garnered well over 200 signatures in support of RurAL CAP's *Aurora Catalog* project. Legislative hearings on the issue were held in November 1994.

The Department of Community and Regional Affairs was, of course, very concerned about this. Early in 1993 the Commissioner sought advice from the Alaska State Attorney General's office. In March, 1994, approximately 1 year later, the Attorney General's office simply responded that there was no legal prohibition against using CSBG money to fund a for-profit venture. This clearly wasn't enough to decide one way or the other whether to continue funding this project.

While the controversy raged, DCRA did provide almost $600,000 to RurAL CAP for the project during 1993 and 1994. The pressure to suspend future financing was intense, but so was the pressure to continue the financing.

It was finally decided to see whether the project could be self-sustaining, or whether it would always have to be subsidized with public and grant money. No one in the Department was excited about continually funding a losing proposition that did, indeed, compete against private sector operations. Therefore, a consultant was hired to see if the project warranted the investment of money from a private sector perspective. In other words, would private investors invest in a project characterized by the risk and returns that had been experienced so far?

THE AURORA CATALOG - THE MARKETPLACE EXPERIENCE

RurAL CAP developed a beautiful catalog. In fact, it won an award at the Direct Marketing Association conference as the best new catalog of the year. There was no question it was beautiful, and that it portrayed Alaska and Alaska natives in a favorable light.

At least partially because of funding difficulties there were two, rather than three, mailings of a 24 page catalog in 1993; one in mid-September and another in early November. The catalog and select products were advertised in consumer magazines, and the catalog and seven products were highlighted in an insert that accompanied mileage statements for 168,000 Alaska Airlines' frequent flier customers

During 1994 print advertising and similar activities were not undertaken. Instead, RurAL CAP opted for investing in more catalogs. Again, there were only two mailings. Table 1 provides income statements for 1993 and 1994, along with circulation numbers, the number of orders, and the average order size for the two years.

Table 2 provides information regarding the sales/book (as the sales/catalog is referred to in the industry), response rates, and average order sizes for 1993 and 1994 for various types of customer lists.

In order to appreciate these results it is necessary to understand industry terms and the way in which a catalog operation builds a profitable operation. Building a profitable catalog business is contingent upon building a sizable House Buyer File. The House Buyer File consists of customers who have purchased a catalog's products. These are people or organizations that have clearly demonstrated an interest in a catalog's products. Customers in this file buy more frequently than average, and usually spend more. A more general list is referred to as the House File, which generally includes the names of people who have contacted the catalog company for one reason or another, and may include as past purchasers (here past purchasers are reflected only in the House Buyers File). In Table 2 the House File contains the names of people who contacted RurAL CAP in 1993 and were mailed a catalog in 1994. House Files are built through advertising the catalog, advertising select products from the catalog, and by sending catalogs or other promotional materials to lists owned by others (referred to as outside runs or outside tests).

Table 1 Income statements and other data, 1993 and 1994

	1993		1994	
	Dollars	% of Net Rev.	Dollars	% of Net Rev.
REVENUES- Merchandise Sales	$204,786.00	111.53%	$284,770.02	104.85%
Less Returns and Allowances	$21,164.00	11.53%	$13,184.05	4.85%
TOTAL NET REVENUES	$183,622.00	100.00%	$271,585.97	100.00%
COST OF GOODS				
Product purchases	$107,183.00	58.37%	$129,506.00	47.69%

Table 1 Income statements and other data, 1993 and 1994				
	1993		1994	
	Dollars	% of Net Rev.	Dollars	% of Net Rev.
In-Bound Freight	$829.95	0.45%	$3,709.00	1.37%
TOTAL COST OF GOODS	$108,012.95	58.82%	$133,215.00	49.05%
GROSS MARGIN	$75,609.05	41.18%	$138,370.97	50.95%
EXPENSES				
Direct Marketing Expense	$184,891.00	100.69%	$239,182.00	88.07%
Operations Expense	$41,683.79	22.70%	$34,983.00	12.88%
Administrative	$229,655.26	125.07%	$206,255.00	75.94%
TOTAL	$456,230.05	248.46%	$480,420.00	176.89%
Income (loss) from Operations	($380,621.00)	-207.29%	($342,049.03)	-125.95%
List Rental Income	$0.00	0.00%	$359.81	0.13%
Net Income from Operations	($380,621.00)	-207.29%	($341,689.22)	-125.81%
GRANT FUNDING	$361,450.00		$360,874.00	
NET REVENUE FROM OPERATIONS & GRANTS	($19,171.00)		$19,184.78	
Circulation	187,846.00		374,886	
Number of Orders	2,096.00		3,452	
Average Order Size	$87.61		$78.67	

Table 2: Sales/book, response rates, and average order sizes 1993-1994						
	Sales/Book		Response Rates		Average Order Sizes	
	1993	1994	1993	1994	1993	1994
Catalog Requests	$0.88	$0.82	1.29%	1.13%	$67.79	$73.07
Outside Tests	$1.06	$0.53	1.10%	0.71%	$96.09	$74.25
Outside Runs	$0.92	$0.66	0.95%	0.87%	$96.89	$75.66
Multi-Buyers	$2.83	$1.66	2.35%	2.06%	$120.54	$80.61
House File*		$0.76		1.01%		$74.95
House Buyers	$3.31	$4.14	0.82%	4.06%	$403.50	$101.82
Overall	*$1.03*	*$0.71*	*1.06%*	*0.92%*	*$87.61*	*$78.67*

*Those who formerly requested a catalog

Typically catalog operations 'rent' lists of people from other catalogs, magazines, and other sources. Results from rented lists are listed in Table 2 as Outside Tests and Outside Runs. The cost/rented name for the Aurora catalog operation was $.14/name. Rented names normally can be used once/contract. If the recipient does not respond to the mailing, the name is lost. However, if a recipient contacts the organization that rented the name for any reason, that name and address is added to the House File, and the organization can use it as it pleases. It can even rent that name to others for their use. Catalog operations will rent a relatively large number of small lists when searching for lucrative lists. They may, for example, rent 20 different lists of 5000 names (e.g., 5000 names from *Good Housekeeping*, 5000 names from *Outside Magazine*). When the catalog operation, through these outside tests, which essentially is a type of reconnaissance prospecting, finds a list where the response rate and sales/book is high, they will commit to renting much larger lists of names, and the names associated with these lists are termed outside runs. Costs associated with outside runs are similar to prospecting and development costs: the primary purpose is to locate customers who can be added to the House Buyers File or the House File. Usually the costs of finding customers through the use of rented mailing lists are expected to exceed the net revenue from initial purchases. Therefore losses in the initial years of a catalog are expected.

In Table 2 there are two other lists: Catalog Requests consist of the results from sending the catalog to those who have asked for one during the current year's operation, and Multi-Buyers, which consists of the names of those that have purchased more than once. Finally, note that the lists are all mutually exclusive: if a person's name is added to the Multi-Buyer list, for example, it is deleted from the House Buyers list. No name appears on more than one list.

The results from the Aurora Catalog were discouraging. While much of what the RurAL CAP consultants predicted would happen in 1993 did occur, at least with regard to market reaction, and much of it was better than expected, the 1994 results were very disappointing. In looking for explanations, a number of problems and potential causes were cited, including the following:

1. *Poor performance by the fulfillment houses. Because of complaints and a lack of confidence in the fulfillment house used in the first year, a different organization was used the second year. But several people, including the RurAL CAP consultants, felt that information capture, and performance, of the second fulfillment house was suspect. One RurAL CAP consultant said she heard that 24 out of 200 orders were not entered, recorded, or fulfilled by the second organization. As a result, plans were made to bring fulfillment operations in-house, even though this was expected to drive up costs considerably.*
2. *Suspension of advertising and promotion for the catalog during 1994. RurAL CAP decided they wanted to put all money into catalogs and mailings, rather than spend any money on promoting the catalog through advertisements, or promotions such as what was done with Alaska Airlines. On hindsight, it was felt that those activities could have been important.*
3. *Not all catalogs were delivered by the U.S. Post Office. There were no efforts to control for this possibility, such as sending catalogs to employees.*

4. *Prices were high. The margins were too narrow, some thought, to support a catalog operation.*

While not a reason for the poor performance, clearly RurAL CAP employees, particularly the Executive Director, were discouraged and frustrated by the intense and continuing effort that had to be devoted to obtaining and justifying funds. It distracted her and the other employees from focusing on doing a good job.

The Department of Community and Regional Affairs consultant decided to project the income statement out to 1997 based on different combinations of factors from the 1993 and 1994 experience. In all cases the results indicated that the cash flows would be large and negative. Table 3 contains some representative pro forma income statements.

Table 3: Representative pro forma income statements, 1995-1997

	1995	1996	1997
REVENUES- Merchandise Sales	$920,586.29	$2,556,277.37	$5,271,485.63
Less Returns and Allowances	$95,170.45	$264,268.61	$544,967.54
TOTAL NET REVENUES	$825,415.84	$2,292,008.76	$4,726,518.10
COST OF GOODS			
Product purchases	$393,640.82	$1,093,058.98	$2,254,076.48
In-Bound Freight	$3,714.37	$10,314.04	$21,269.33
TOTAL COST OF GOODS	$397,355.19	$1,103,373.02	$2,275,345.81
GROSS MARGIN	$428,060.66	$1,188,635.74	$2,451,172.28
EXPENSES			
Direct Marketing Expense	$535,196.00	$1,269,197.00	$2,046,376.00
Operations Expense	$137,141.09	$297,925.56	$515,781.32
Administrative	$231,041.73	$261,840.18	$331,870.95
TOTAL	$903,378.82	$1,828,962.75	$2,894,028.27
Income(loss) from Operations	$(475,318.16)	$(640,327.01)	$(442,855.99)
PROPOSED GRANT FUNDING:			
Grant 1	$400,000.00	$400,000.00	$400,000.00
Grant 2	$100,000.00	$100,000.00	$100,000.00
CSBG Grant	$250,000.00	$250,000.00	$250,000.00
TOTAL GRANT MONEY	$750,000.00	$750,000.00	$750,000.00
NET REVENUES FROM OPERATIONS AND GRANTS:	$274,681.84	$109,672.99	$307,144.01

Another tack was to compute the break-even point for this operation based on the 1994 experience. Table 4 provides some of what was computed based on a detailed analysis of RurAL CAP figures (some numbers are not directly derivable from Table 1). The analysis is incomplete, though, in that it does not take into account printing and mailing costs. The average printing and mailing cost per name in the House File (those people who either had purchased from RurAL CAP before, or requested a catalog) was $.38. The average cost/name on rented lists was $.14 higher, or $.52 each. This reflects the charge of using someone else's mailing list on a one-time basis. (As stated above, once the customer has contacted the organization seeking a response that name can be transferred to the House File list, where it may be used without an additional charge.)

Table 4: Breakeven analysis data based on 1994 experience

FIXED COSTS:	
Marketing Expenses	$47,260.00
General and Administrative	$191,257.00
TOTAL	$238,517.00
Contribution Margin as a Percentage of Gross Merchandise Sales Before Catalog Variable Expenses*:	
Gross sales	100.00%
Returns and allowances	-4.63%
COGS	-46.78%
Excess S&H charge	-12.28%
Variable Administrative Expense	-5.27%
Adjusted Gross Margin	31.04%
*In Table 1 total net revenues is equal to 100%.	

DISCUSSION QUESTIONS

1. Do you believe it made sense to forego a detailed feasibility study and instead actually put together a catalog operation, complete with products, contracts with fulfillment houses, etc.? What are the dangers of pursuing such a strategy? What are the benefits? Under what conditions does acting, rather than analysis, make sense? Under what conditions do analysis, prior to acting, make sense?

2. Are there other ways RurAL CAP could achieve the objectives and goals set out for the catalog? In other words, what other marketing strategies could be considered as competitors to a catalog operation? Do you believe that a catalog is the best means for achieving the identified goals?

3. RurAL CAP decided to target individual, upscale, socially conscious consumers. What other target groups could have been chosen or considered?

4. Examine the results for 1993 and 1994 (Tables 1 and 2). Do the results bode well for the catalog operation? What conclusions can you, as an analyst, draw from these data? Does your examination of the pro formas in Table 3 support your expectations?

5. Complete the break-even analysis begun in Table 4. In doing so, assume only 2 categories of lists: outside runs (rented names), and House Buyer File names. Further, assume 9 outside run names need to be used for every House Buyer File name (this is necessary to replace House Buyer File customers who cease to be interested in the catalog's products). Finally, assume the average sales/book for House Buyer names is \$4.14, while the average for rented lists is \$1.00. The \$4.14 figure represents the sales/book for 1994 for those sent to names in the House Buyers File. The \$1.00 figure is admittedly on the high side for the rented names, but will suffice for this exercise.

6. A useful analysis is to compute the customer acquisition cost, and the contribution from each customer over the customer's lifetime. These numbers can be used to generate customer lifetime values. When answering the following ignore all taxes.
   a. How much money will *The Aurora Catalog* lose or make on a mailing to 1000 rented names? How much per acquired customer? Consistent with *The Aurora Catalog*'s experience, assume i) the marginal cost of renting names and mailing a catalog to each person is \$.52, ii) the response rate is .9%, iii) the average order size is \$76, and iv) the contribution margin is 31.04%.
   b. Once a person becomes a customer costs go down and response rates and sales/book go up. Compute how much money RurAL CAP will make or lose, on average, the next time they send customers acquired from the initial list of 1000 a catalog, assuming i) the cost of sending a catalog to each customer is \$.38 (note the cost is lower because the names are not rented), ii) the response rate is 4% (that is, there is a 4% chance each customer will buy), and iii) the average order size is \$102. Further, assume that the contribution margin remains 31.04%. These figures, of course reflect *The Aurora Catalog*'s experience. Determine how much RurAL CAP will net on this mailing, as well as how much they will net per acquired customer.
   c. If we assume that the 4% response rate will be good for 2.5 years (5 mailings), and that the average order size remains at \$102, compute the net present value of renting a list of 1000 names using a discount rate of 5%/half year. Under the assumptions implied in this analysis, is renting names a good investment strategy for *The Aurora Catalog*?

7. In addition to the quantitative analyses relating to RurAL CAP's experience, what else would you want to know before making a judgment as to whether this catalog has a chance of becoming profitable? If you were part of RurAL CAP's management team, what would you recommend?

8. When do you think public money should be used to support for-profit forays by nonprofits? Should DCRA continue to support the catalog? Under what conditions? If you were the Commissioner of the Department of Community and Regional Affairs what would you recommend?

CJ MCLAINE'S DELI & BAKERY, LLC: A SMALL FAMILY BUSINESS CASE STUDY

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CASE DESCRIPTION

The primary subject matter of this case concerns small business strategy. Secondary issues examined include: family business strategy, start-up businesses, changes caused by external forces, and small business sustainability. The case is appropriate for undergraduate small business and entrepreneurship courses, a family business course, or an introductory management or marketing course. It would also be appropriate for a use in studying small business strategies in a business policy and strategic management course. The case is designed to be assigned for reading prior to class, discussed during one 75 minute class period, and is expected to require one and one-half to three hours of outside preparation by the student (depending on whether the discussion questions are assigned for discussion purposes or written submission).

CASE SYNOPSIS

CJ Mclaine's Deli and Bakery, LLC, a family owned small business venture, operated in the town of Evergreen, Colorado. The Italian style deli and bakery focused primarily on its lunch business but also offered a limited breakfast menu, a dinner takeout menu, and general catering services. The business was launched in 2004 and gained significant momentum in its first year of operation. This initial success encouraged the family owners. During its second year, however, changes in the competitive environment and an economic recession created new obstacles that affected the business' sales and bottom line. Somewhat discouraged, the owners recognized that strategic alternatives had to be considered if the business was to survive. The case demonstrates the difficulty of starting a business and sustaining its growth and momentum. It highlights the vulnerability of the small business to changes in the macro environment, especially changes in economic factors, and changes related to industry and competitive forces.

THE ROOTS

As Josephine settled into her seat aboard an airplane headed east to her home in North Carolina, she reflected on her visit with her family in Colorado. She mused about the joy that she experienced sharing time with her grandchildren. But her thoughts quickly turned to an exciting exchange of ideas that occurred between her and her daughter Dina and daughter-in-law Angela over lunch the previous afternoon. After ordering lunch and discussing their successful shopping adventures, the idea of starting a family business crept into the conversation. The idea of being in business with Dina and Angela intrigued Josephine. In the last several months, both women had explored possible career moves. Angela had recently left her job as manager of a very successful bed and breakfast because she needed a job that would let her meet her responsibilities to her children and her husband's business. Dina was in a dead end job and was looking for a change. In the course of the conversation, the idea of the three women buying a bed and breakfast emerged. In an animated exchange it was proposed that Josephine could supply the funding, Angela could manage operations and Dina would help with operations and use her extensive restaurant experience to run a catering business from the kitchen of the inn.

No formal plans were made and Josephine returned home. Angela was going to see if there were any bed and breakfasts for sale in the area. It turned out that none were on the market, so the conversation dropped for a while.

Several weeks later, Josephine, Dina, and Angela discussed the idea of opening an Italian style deli in their town of Evergreen. There were no authentic Italian delicatessens or restaurants in the area. Angela and Dina found that the more they talked about the idea to local people, the more support they received. Thus, the journey began. The women compiled research about the market for the type of deli they envisioned. Their research included identifying possible locations for a business like this, the type of products that would best suit the market, and the ideal operating hours. They discussed their personal strengths and how they could best be used in this type of entrepreneurial venture.

PERSONAL STRENGTHS

Angela began working at an upscale bed and breakfast directly out of high school. Over the last 10 years she wore many hats and was able to work her way into management. While working at the bed and breakfast, Angela developed the inn's website and maintained its computer reservation system. She and the owners shared the duties of preparing the hot and cold breakfast items, taking reservations, and attending to guest needs at the front desk. In another role, Angela collaborated with the owners of the inn and produced a specialty cookbook which was for sale in the reception area of the Inn. Angela was a hard worker with creative ideas. She thought that working for herself would give her the flexibility she needed to manage her family responsibilities as wells as the personal satisfaction that comes from creating a business and watching it grow. Angela took her work very seriously. Her friendly but businesslike personality made her successful in the bed and breakfast industry.

Dina also lived and worked in Evergreen. She had worked in various food service capacities from fast food establishments, to institutional facilities, to fine dining restaurants. Her positions included counter service, meal planner, waitress, restaurant manager, and cook/chef. Dina brought a willingness to work hard and expertise with the operation of food service kitchens with her. Her formal training was in computer networking but she had always hoped to operate her own catering business. Since she was a single mom, Dina didn't feel she could leave her full-time job to start a catering business, but the idea of an Italian deli interested her. Dina, too, took her work seriously. However, she had a pleasant and gregarious personality culled from her 15 years experience in the retail food industry.

Josephine, a CPA and educator, lived on the east coast. Nearing retirement she thought that investing in a venture like this would be an interesting project. Her family had a successful history in small entrepreneurial ventures. Her father owned a fuel oil delivery company while she was growing up. Her brother owned an excavation company. Her son, Angela's husband, was a building contractor. Early in her career Josephine ran a small CPA firm. So she understood the basics of small business operations. She knew that Angela and Dina had the right skill sets and were willing to work hard. Josephine was willing to help with the accounting needs. She even considered helping out in the deli during busy seasons after she retired. Josephine's biggest contribution to the venture would be the start-up capital and working capital in the event that it was needed. Josephine's skill set was grounded in the practical. She looked to her partners for the creative aspects of the deli and welcomed her role as business advisor.

LOCATION

Evergreen was a sprawling suburban community in the mountains about 35 miles west of Denver. It was a town full of things to do. Many weekend visitors arrived looking for the relaxing activities that were available in the area, such as open space parks, mountain parks, recreation centers, golf courses and a public lake in the center of town. Accommodations could be found in one of the ten bed and breakfasts, six cabin complexes, or the one hotel in the immediate area.

The town of Evergreen, an upscale suburb of Denver, had approximately 16,000 households (41,000 people) with a median age of 42 and a median household income of $98,000. The average house sold for approximately $475,000. The town was a sprawling metropolis nestled in a valley with the commercial area situated next to a recreational lake. Most of the houses were built on the sides of the surrounding mountains. There were clusters of apartment complexes, both large and small, and several large housing developments, one of which was built around a golf course. Because of the sprawling nature of the town, a car was needed for even the simplest errand.

In addition to the businesses supporting the tourist trade in Evergreen, there were office and retail complexes. The office complexes housed financial services firms, professional service firms and medical services firms. Other businesses included building suppliers and building contractors. There were no manufacturing operations in Evergreen.

COMPETITION

Josephine and Dina were part of an Italian family and grew up in New York. All three partners knew what good Italian food was. Their original idea blossomed because there were no Italian delicatessens or restaurants in Evergreen. Informal market surveys resulted in very positive support for a business venture of this type. Angela's husband mentioned to his business contacts that she was going to be part of an Italian deli, and the new venture received overwhelming support. Dina discussed the possibility of the deli with her local contacts in the food industry, and received the same supportive reaction. Angela's mother was very active in the Evergreen Chamber of Commerce and once again the members expressed support for the new business venture.

There were delicatessen sections in the local supermarket and a sandwich shop that advertised sandwiches made with top brand cold cuts. However, no competitors specialized in Italian cold cuts and authentic pasta dishes.

EARLY DECISIONS

Angela, Dina and Josephine decided to form a Limited Liability Company called CJ Mclaine's Deli and Bakery, LLC. CJ is Dina's son and Mclaine is Angela's daughter. The three women would share equally in ownership and profits or losses. Josephine would lend the company the money it needed and in turn, would receive regular payments including interest starting the second year of operations. Angela and Dina would receive a guaranteed weekly draw. (Note: An LLC is treated as a partnership for tax purposes).

It was decided that the deli would serve specialty coffee and pastries in the morning and a full range of menu items for lunch. In addition, CJ Mclaine's would build a business that provided catering services to individuals and businesses in the Evergreen area. Dina would open the deli at 7 A.M. and begin the day's preparations. Angela would come in around 10 A.M. to help with the lunch preparation and go home early in the afternoon. In addition to working in the store, Angela would be responsible for banking and bill paying. In this way there was an overlap when both women were working. It was expected that business would be slow on Saturdays. So the partners decided that there would be shortened hours on Saturdays and that Dina and Angela would take turns working on these days.

Part-time help would be a necessity. The ideal time for such an employee would be to start at noon leave at 6 P.M. The duties of the part-timer would include helping with the lunch business, making deliveries when necessary, and cleaning the premises before closing.

FACILITY

Angela and Dina selected a location in a small mixed use shopping center and signed a three year lease which ran from December 1, 2004 until November 30, 2007. The space was between a Curves exercise franchise and a tanning salon. Other occupants of the two story strip center included a beauty salon and an upscale real estate office. The center was located across from the fire department and an elementary school. Directly behind the center was a large building used by a large insurance company as a trading floor. Several up-scale housing developments were close by.

The shopping center was situated between a large retail area and the old town center. The large commercial area was about two miles away from the chosen site and consisted of a cluster of shopping centers that housed grocery stores, restaurants and specialty stores (e.g. toys). The town center was located about three miles away and resembled an old western town. Most of the businesses in this part of town served the tourist industry and included restaurants, craft shops, and western specialty stores. There were office complexes and other businesses in small office and business complexes scattered through the areas between CJ Mclaine's and the retail center and the old town.

The leased space was approximately 18 feet by 60 feet. It had been a chiropractor's office and was separated into cubicles. The landlord required tenants to do their own improvements, therefore the first task of the business was to redesign the space and complete the leasehold improvements. Extensive renovations were completed quickly and business began the first week of December 2004.

The women wanted to create a warm and inviting atmosphere. They chose rich earth tones for the customer area which recreated the feeling of an Italian villa. Marble tiles covered the floor and the faux marble wallpaper continued the theme. Family pictures adorned the walls – a picture of Nana (Josephine's Italian mother) as a teenager being the customers' favorite. Most of the space in the rear of the store was used for food storage and preparation – refrigerators, chopping tables, sandwich tables, sinks, and cooking appliances. A small office took some of the space from the rear of the store. Cold cut, bakery, and soft drink cases took up most of the space in the front part of the store. The second and third pictures in Appendix A show the layout of the front part of the store. There were three small bistro tables in the front of the store for people who wanted to eat in.

THE FIRST MONTH – DECEMBER 2004

That first December was wonderful. Angela and Dina were excited. They were able to hire a hard working, young man with food service experience. Their family and friends had been spreading the news about the new deli coming to town. Angela's mother, Linda, hand delivered flyers and bakery samples to the surrounding businesses. There was a special aura about the deli. Customers experienced the mix of coffee aromas and pastries baking in the morning, and Italian food offerings cooking throughout the day. Angela and Dina were personal hits and their food offerings received the accolades of their customers. Sales for the first 3 weeks of operations averaged $2,500 a week. The women were working hard and their work was paying off.

THE FIRST YEAR – 2005

The client base and product offerings grew during the first year of operations. Angela and Dina were quick to respond to the requests of the customers. The lunch trade was drawn predominately from surrounding office buildings, particularly an office building that housed a large insurance company, and the local fire house. Initially the breakfast menu offerings consisted mainly of bakery products. At the request of clients, the breakfast offerings were augmented to include such things as breakfast burritos. CJ Mclaine's also responded to the needs of the real estate agency located in their shopping center. Platters of food were prepared for the agents in the real estate office for them to serve at the agent open houses for newly listed properties. In response to requests from customers with very busy schedules, complete family style dinners were prepared for take-out. These orders had to be received in the morning so that the food items could be prepared fresh. For those who did not order in the mornings, there was a freezer full of frozen pasta dishes to choose from. A fax ordering system was developed to reduce the waiting time for large lunch orders. Fax orders received by 11 A. M. were ready for pick-up by noon. Another client, a small coffee kiosk located a half mile away ordered trays of pastries that were delivered to them early in the mornings. Other customers included parents who would drop their children at school and stop at the deli for the specialty coffees, teas and cappuccinos. They often ordered dinners to go and generally patronized the deli during the school week. CJ Mclaine's also served the long-term project work crews staying at the local hotel who frequently lunched at the deli.

Meeting the demand for lunch was the prime purpose of the business. However, Angela and Dina quickly discovered that serving breakfast items in the morning and lunch fare late into the afternoon added to their contribution margin, which was important for covering fixed cost. There were no additional labor costs to provide these services since Dina was at work early in the morning to get ready for the day and the part-timer was working into the late afternoon cleaning up after the day's business.

In looking at what they had accomplished during their first year of operations, Angela and Dina were proud to say that they had developed solid business relationships with their customers. They had developed a cadre of regular lunch customers. In addition, they were building a sound reputation for catering and were beginning to see repeat business on this front as well.

Going into the second full year of operations, Angela and Dina felt very positive about the direction of the business. They had learned about the seasonality of the business, such as the decline in sales when schools were closed (long holiday breaks, spring recess and the summer months) and the increased catering business opportunities that holiday and summer activities in the town afforded them. They entered the second year of operations with high hopes. Income before depreciation and partners' draw was over $60,000. (See Table 1 for Details) If the business continued to grow at the same rate, they would more than cover all expenses and begin to repay the loan to Josephine.

YEAR TWO – A YEAR OF CHANGE

During year two, many things happened to dampen Angela's and Dina's spirits. The women had to spend time recruiting capable part-timers, competition entered the marketplace, the real estate market was stagnant, and the insurance company housed in the office building located within close proximity to the deli moved its operations to Denver, taking with it many of CJ Mclaine's lunch customers.

Evergreen's economy was based on service industries, with tourism being the largest of these industries. The employee pool for food service, grocery clerks, and other unskilled labor is large and the rate these workers earn is low. As a result, employee turnover is high as they seek jobs that pay a little better. Because the deli is a small shop and reliant on customer service, it was important to hire employees that fit the personality profile. So, in year two, when the deli's first part-time employee left for a better position, replacing him was not an easy task. Much of Angela's and Dina's time was spent recruiting and training people that quit after working only a few months.

Within a two month period, two competing locations opened. The first opened about a half mile from CJ Mclaine's. It was billed as a deli, and unlike CJ Mclaine's it included convenience store items. Its operating hours were longer than CJ Mclaine's. Rather than charging a set price, this competitor sold deli sandwiches by the pound. Dina and Angela were told that customers were uncomfortable not knowing the price of their order until it was completed, and were disappointed when the price of the item was greater than expected.

The second competitor was a catering business that featured foods prepared by a chef who had attended a famous culinary institute. While the bulk of their business was based on catering parties, their shop was open to the public. They had the space to set up hot tables buffet style, which allowed customers choose what they wanted. The food here was also sold by the pound. After several months, this business stopped selling lunches. However, they soon realized that while the lunch business was not a profitable as they wanted, it contributed to contribution margin and therefore helped to cover fixed costs. So they reopened their lunch hours.

Another small area of competition came from a former customer of CJ Mclaine's. The coffee kiosk moved from its location in a busy parking lot to the commercial section of Evergreen. Therefore, the Deli lost the kiosk's business since they were able to make their own pastries in their larger space.

During this period, the economy in the Denver area was suffering. New home sales had dropped significantly, and homeowners were sitting tight while they waited for a busy housing market to return. Therefore, the income received from providing food platters to the real estate agents was greatly reduced.

In an effort to combat the competition, Angela and Dina got permission to convert the sidewalk in front of the store to a patio with additional seating. (See this improvement in the first picture in Appendix A.)

During 2006, sales decreased by $30,000 and expenses showed a small decrease. Angela and Dina were forced to take salary cuts as a temporary measure (See Table 1 for Details). Josephine increased her loan to the business. Planning began for year three – the third year of the lease. Josephine preferred to finance a plan for change rather than to maintain the status quo. While it was early in the economic downturn in the United States, it was obvious that a business could not be as reliant on a boutique marketplace as they had been. Discussions centered on ways to increase sales revenue while only minimally increasing operating expenses.

IDEAS

Since Angela's and Dina's goal was to create a successful business that would give each of them enough to meet their financial obligations in the short run and to provide income in excess of their ordinary needs in the long run, there was much discussion regarding what steps should be taken to improve their operating performance. Angela and Dina were beginning to feel discouraged. They were working hard. They got a lot of positive feedback about their menu. Customers clearly liked and respected them, but the business wasn't earning what they thought it should. It was clear that something had to be done to rekindle the excitement that the partners shared when the business first opened. But there was disagreement on what options were the best and on the direction that the business should take.

MAJOR CHANGES

Could they develop a product that they could market over the internet? Angela had created a website for the business already, so it was feasible that expanding it to include a mail order business was a possibility. Many products were discussed and dismissed. Many of the ideas they had were already being developed. For instance a search for sources of mail order barbecue sauce returned thousands of hits. And mail order cupcakes had already hit the market.

Angela and Dina were very popular with their customers and everyone loved their food. Could they move their business to a larger location? They often had customers tell them that they would have breakfast meetings or business lunches at the deli if they were sure they could get table space. CJ Mclaine's was not seen as a destination for a sit down meal. There were several locations available in high traffic areas that would require extensive leasehold improvements.

The idea of buying a food truck was discussed. With the number of open space parks, mountain parks, and recreation centers in the area, the partners saw a market for hot and cold drinks, water, snacks, and other light foods. This option would require them to get permits from the appropriate governmental agencies. This food service could be offered on a part-time basis and staffed with part-time employees.

PRODUCT DIVERSIFICATION

The only drinks sold at CJ Mclaine's were specialty coffees, teas, cappuccinos, water and soft drinks. The partners discussed the possibility of getting a license to sell beer and wine coolers. The licensure process was expensive and there was the possibility that they would be turned down because of their proximity to a school. However, they believed that increased sales would result from this additional product line.

There were no newspapers sold in the closely surrounding area. Room could be made for a newspaper rack. It was thought that people who would stop to buy a paper would also pick up something to eat or drink. This was not seen as a way to substantially increase sales, but every dollar of incremental revenue was important at this point.

Selling lottery tickets was another option. Discussions with the Colorado Lottery Commission revealed that the average small business made between $5,000 and $10,000 on the sale of lottery tickets annually. While the sale of tickets themselves would not provide all the revenue needed to stay in business, it would also increase traffic through the store with the hope of selling more food and drinks.

OTHER OPTIONS

Other options that were discussed included: (1) increasing the advertising budget to make sure the CJ Mclaine's brand stayed in the public range of vision; (2) closing the store and paying off the lease; and (3) staying open and waiting for the empty office building to get new tenants and for the recession to come to an end. The last option was not financially viable without combining it with other options.

Angela, Dina and Josephine recognized that they were entering a critical period and that the future of CJ Mclaine's was dependent on the strategic decisions they were about to make. The Deli's success in the coming year would determine whether the partners would renew the three year lease and continue the business. The three women assessed the potential of the alternative strategies as they prepared to enter their third year of business.

Table 1 - Comparative Statement of Operations

CJ Mclaines Deli and Bakery
Comparative Statement of Operations

	For the year ended December 31. 2006	For the year ended December 31. 2005
Sales	$ 212,757	$ 242,026
Cost of Sales	110,199	118,140
Gross Profit on Sales	102,558	123,886
Rent	17,463	18,681
Gross Payroll (including payroll taxes)	20,501	15,715
Discounts, Credit Card Charges, and Bank Charges	4,862	5,105
Utilities and Telephone	9,042	7,867
Insurance	2,703	1,765
Office	2,874	7,258
Advertising	2,379	602
Supplies	676	6,216
Miscellaneous	431	582
Total Operating Expenses	60,931	63,791
Income before Depreciation and Partner Compensation	41,627	60,095
Depreciation	9,105	12,516
Partner Salary (Including Payroll Taxes)	51,910	78,084
Net Loss	$ (19,388)	$ (30,505)

APPENDIX A

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CAPE CHEMICAL: CAPITAL BUDGETING ISSUES

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CASE DESCRIPTION

The primary subject matter of this case concerns the issues surrounding evaluation of capital expenditures. Case provides a systematic approach to evaluating capital expenditures including a review of alternative capital budgeting methods and the relationship between the cost of capital and capital budgeting. The case requires students to have an advanced knowledge of accounting, finance and general business issues thus the case has a difficulty level of four (senior level) or higher. In particular, an understanding of capital budgeting practices and cost of capital issues is necessary to solve the case. The case is designed to be taught in one class session of approximately 1.25 hours and is expected to require 3-4 hours of preparation time from the students.

CASE SYNOPSIS

The case tells the story of Ann Stewart, President and primary owner of Cape Chemical. By most measures, the performance of Cape Chemical has been very good over the last three years. Double-digit sales growth has been achieved, new product lines have been added and profits have more than tripled. The growth has required the acquisition of equipment, expansion of storage capacity and increasing the size of the work force.

The unexpected withdrawal of one of Cape Chemical's competitors from the region has provided the opportunity to increase its blended packaged goods sales. However, Cape Chemical's blending equipment is already operating at capacity. To take advantage of this opportunity, additional equipment must be obtained, requiring a major capital investment. It is estimated that Cape Chemical must increase its annual blending capacity by 800,000 gallons to meet expected demand for the next three years Annual capacity of 1,400,000 gallons is necessary to meet projected demand beyond the next three years. The firm has no systematic capital expenditure evaluation process.

BACKGROUND

Cape Chemical is a relatively new regional distributor of liquid and dry chemicals, headquartered in Cape Girardeau, Missouri. The company, founded by Ann Stewart, has been serving southeast Missouri, southern Illinois, northeast Arkansas, western Kentucky and northwest Tennessee for five years and has developed a reputation as a reliable supplier of industrial chemicals. Stewart's previous business experience provided her with a solid understanding of the chemical industry and the distribution process. As a general manager for a chemical manufacturer, Stewart had profit and loss (P&L) responsibility, but until beginning Cape Chemical, she had limited exposure to company accounting and finance decisions.

The company reported small losses during its early years of operation, but performance in recent years has been very good. Sales have grown at double-digit rates, new product lines have been added and profits have more than tripled. The growth has required the acquisition of additional land, equipment, expansion of storage capacity and more than tripling the size of the work force. Stewart has proven to be an expert marketer, and Cape Chemical has developed a reputation with its customers of providing quality products and superior service at competitive prices.

Despite its business success, Cape Chemical is still a "large" small business with Stewart making all important decisions. She recognized the need to develop a professional managerial staff, particularly in the area of finance. Recently, she hired Kate Clarkson as the company's first finance professional and placed her in charge of the company's accounting and finance activities.

Cape Chemical's board of directors is composed of Stewart, her brother and the company's attorney. The board's existence satisfies state regulatory requirements for corporations but provides no input to business operations.

CHEMICAL DISTRIBUTION

A chemical distributor is a wholesaler. Operations may vary but a typical distributor purchases chemicals in large quantities (bulk - barge, rail or truckloads) from a number of manufacturers. They store bulk chemicals in "tank farms", a number of tanks surrounded by dikes to prevent pollution in the event of a tank failure. Tanks can receive and ship materials from all modes of transportation. Packaged chemicals are stored in a warehouse. Other distributor activities include blending, repackaging, and shipping in smaller quantities (less than truckload, tote tanks, 55-gallon drums, and other smaller package sizes) to meet the needs of a variety of industrial users. In addition to the tank farm and warehouse, a distributor needs access to specialized delivery equipment (specialized truck transports, and tank rail cars) to meet the handling requirements of different chemicals. A distributor adds value by supplying its customers with the chemicals they need, in the quantities they desire, when they need them. This requires maintaining a sizable inventory and operating efficiently. Distributors usually operate on very thin profit margins. *RMA Annual Statement Studies* indicates "profit before taxes as a percentage of sales" for Wholesalers - Chemicals and Allied Products (Standard Industrial Code number 5169) is usually in the 3.0% range. In addition to operating efficiently, a successful distributor will possess 1) a solid customer base and 2) supplier contacts and contracts which will ensure a complete product line is available at competitive prices.

THE SITUATION

The unexpected withdrawal of one of Cape Chemical’s competitors from the region has provided the opportunity to increase its blended packaged goods sales. That's the good news. The bad news is Cape Chemical’s blending equipment is operating at capacity, thus to take advantage of this opportunity, additional equipment must be obtained, requiring a major capital investment. It is estimated that Cape Chemical must increase its annual blending capacity by 800,000 gallons to meet expected demand for the next three years Annual capacity must increase by 1,400,000 gallons to meet projected demand beyond the next three years.

Stewart is considering two alternatives proposed by the company’s engineer. The first is the acquisition and installation of used equipment that will provide the capacity to blend an additional 800,000 gallons annually. The used equipment will cost $105,000 to acquire and $15,000 to install. The equipment is projected to have an estimated life of three years. The second option is the acquisition and installation of new equipment with the capacity to blend 1,600,000 gallons annually. The new equipment would have a substantially higher cost of $360,000 to acquire and $60,000 to install, but have a higher capacity and an economic life of seven years. The new equipment is also more efficient thus the cost of blending is less than the blending cost of the used equipment. Stewart asked Clarkson to lead the evaluation process.

Stewart thinks the used equipment could be obtained without a new bank loan. The acquisition of the new equipment would require new bank borrowing.

The evaluation of each alternative will require an estimate of the financial benefits associated with each. The marketing and sales staff estimated incremental sales of blended package material will be 600,000 gallons the first year and increase by 15% each year thereafter.

During the last year, the average selling price for blended material has been near $4.05 per gallon and material cost (not including a cost for blending the material) has been approximately $3.53. The marketing staff anticipates no significant change in either future selling prices or product costs; however they do estimate variable selling and administrative expenses associated with the increased blended material sales to be $.20 per gallon.

PROJECT EVALUATION PROCESS

The company has no formal process for evaluating capital expenditure projects. In the past Stewart had reviewed investment alternatives and made the decision based on her “informal” evaluation. Clarkson plans to develop a formal capital budgeting process using the Cash Payback Period, Discounted Cash Payback Period, Net Present Value (NPV), Internal Rate of Return (IRR) and Modified Internal Rate of Return (MIRR) evaluation methods. She will need to educate Stewart on the superiority of a formal evaluation process using these methods.

Weighted Average Cost of Capital (WACC)

Using input from an investment banking firm, Clarkson estimates the company's cost of equity to be 18%. Their bank has indicated a long-term bank loan can be arranged to finance the new equipment at an annual interest rate of 12% (before tax cost of debt). The bank would require the loan to be secured with the new equipment. The loan agreement would also include a number of restrictive covenants, including a limitation of dividends while the loans are outstanding. While long-term debt is not included in the firm's current capital structure, Clarkson believes a 30% debt, 70% equity capital mix would be appropriate for Cape Chemical. Last year, the company's federal-plus-state income tax rate was 30%. Clarkson does not expect the income tax rate to change in the foreseeable future.

Used Equipment

The used equipment will cost $105,000 with another $15,000 required to install the equipment. The equipment is projected to have an economic life of three years with a salvage value of $9,000. The equipment will provide the capacity to blend an additional 800,000 gallons annually. The variable blending cost is estimated to be $.20 per gallon. The equipment will be depreciated under the Modified Accelerate Cost Recovery System (MACRS) 3-year class. Under the current tax law, the depreciation allowances are 0.33, 0.45, 0.15, and 0.07 in years 1 through 4, respectively. The increased sales volume will require an additional investment in working capital of 2% of sales (to be on hand at the beginning of the year).

New Equipment

The acquisition of new equipment with the capacity to blend 1,600,000 gallons annually is the second alternative. The new equipment would cost $360,000 to acquire with an installation cost of $60,000 and have an economic life of seven years and a salvage value of $60,000. The new equipment can be operated more efficiently than the used equipment. The cost to blend a gallon of material is estimated to be $.17. The equipment will be depreciated under the MACRS 7-year class. Under the current tax law, the depreciation allowances are 0.14, 0.25, 0.17, 0.13, 0.09, 0.09, 0.09 and 0.04 in years 1 through 8, respectively. The increased sales volume will require an additional investment in working capital of 2% of sales (to be on hand at the beginning of the year).

REQUIREMENTS

Assume the role of a consultant, and assist Clarkson to answer the following questions.

1. Calculate Cape Chemical's weighted average cost of capital (WACC). Note: round to the nearest whole number. Discuss the theory used by Clarkson to determine Cape Chemical's optimum target capital structure (30% debt and 70% equity).

2. Since the used equipment will be financed with internal capital and the new equipment with a bank loan, should the same discount rate be used to evaluate each alternative? Explain.

3. Explain why an accurate WACC is important to a firm's long-term success.

4. Evaluate the strengths and weaknesses of the Cash Payback Period, Discounted Cash Payback Period, NPV, IRR and MIRR capital expenditure budgeting methods. Prepare a recommendation for Stewart regarding the capital budgeting method or methods to use in evaluating the expansion alternatives. Support your answer.

5. Calculate the Cash Payback Period, Discounted Cash Payback Period, NPV, IRR and MIRR for each alternative. For the calculations, assume a WACC of 15%. Based on the results of these methods, should either option be selected? Why? Solution requires preparation of a spreadsheet.

6. Stewart is concerned that the projected annual sales growth rate of 15% for incremental blended material may be optimistic. Recalculate the Cash Payback Period, Discounted Cash Payback Period, NPV, IRR and MIRR for each alternative assuming the annual sales growth rates of 10% and 5%. Assume a WACC of 15%. Does the change in growth rate alter the recommendation made in question 5? Solution requires preparation of spreadsheets. Explain.

7. The projected cash flow benefits of both projects did not include the effects of inflation. Future cash flows were determined using a constant selling price and operating costs (real cash flows). The cash flows were then discounted using a WACC that included the impact of inflation (nominal WACC). Discuss the problem with using real cash flows and a nominal WACC when calculating a project's Discounted Payback Period, NPV, IRR and MIRR.

8. What other issues should Stewart and Clarkson considered before a final decision regarding the expansion alternatives is made?

REFERENCES

Brigham, Eugene and Joel Houston, *"Fundamentals of Financial Management,"* Concise 5th edition, Thomson South-Western, a part of the Thomson Corporation, 2007.

Brigham, Eugene, and Michael Ehrhardt, *"Financial Management: Theory and Practice,"* 12th edition, Thomson South-Western, a part of the Thomson Corporation, 2008.