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LETTER FROM THE EDITORS

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

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

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

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

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

Inge Nickerson, Barry University
Charles Rarick, Barry University

CASES

SITEASY FURNITURE COMPANY GOES INTERNATIONAL

Richard Sjolander, The University of West Florida

CASE DESCRIPTION

The primary subject matter of this case is the first introduction of a company's products into International Markets. Secondary issues include conducting secondary market research by small firms in foreign markets; international terms of trade; identifying relevant tariffs; market segmentation; exchange rates and exchange rate fluctuation. This case has a difficulty level of 4-5 and is targeted at business students in a first course in international business or international marketing. The case can be used either as an introductory course case, as it covers many of the problems typically encountered as a business expands into international business, or as a relatively straightforward functional case on pricing in the international environment. One hour of class time should be sufficient to handle the case discussion and students should budget 3-4 hours of time for case preparation.

CASE SYNOPSIS

The SitEasy Corporation is a small manufacturer of quality furniture located in Colorado Springs, Colorado, USA. Sales at the 12 year old company have grown steadily and the company expanded two years ago into a much larger factory capable of doubling their output, while maintaining their quality level. However, the housing market peaked shortly after their move in 2005 and in 2006 it started to soften. Current distribution is to exclusive stores on the west coast and the upper northeast in the U.S. The idea for foreign expansion was initiated in response to flat sales in current markets and a lot of excess capacity in the new factory. Past comments from two, large northeastern retailers that a large number of their customers were shipping the furniture directly to Canada led to the idea of exploring international markets. Following a discussion of the relative change in value of the US dollar and the Canadian dollar, the case fast forwards to the issue at hand, answering the inquiry from a potential Swedish distributor met at a German furniture trade show.

Pricing must be established for a portion of their exclusive furniture line for the Swedish market, along with forecasts of expected sales and expected effect on plant capacity and firm profitability. This requires identification of accepted terms of trade, relevant tariffs on the type of goods being offered, consideration of exchange rates, and most importantly, the expected size of the market for SitEasy furniture in Sweden.

INTRODUCTION

The SitEasy Corporation is a small privately held manufacturer of tables and chairs made from the hardwoods of the northwest located in Colorado Springs, Colorado, USA. The company was formed 12 years ago by two old college friends, Bill Martin and Greg Huth. They had been involved with industrial design for a number of years and were quite successful. They wanted to furnish their homes with quality, contemporary pieces and found it difficult to find the type of furniture they desired to match their lifestyles in the marketplace. After an extensive search of the furniture market in Colorado, they identified a niche in the market for residential furniture that they stated in the following way: people desiring high quality pieces if contemporary furniture, made largely by hand, resembling some of the early twentieth century classics and bringing them into the contemporary homes of the affluent. Each piece should be signed by a craftsman and numbered. Given the vision for the products to be produced, great emphasis was placed on quality workmanship in production and achieving placement in the right retail environments. These were defined as retailers of similar lines of expensive, quality furniture, who could be counted on to properly display and merchandise their products. The promotional mix was designed with a target market of individuals much like themselves in mind to reinforce the uniqueness of the individual product and its value as a representation of true craftsmanship. The company achieved moderate success during the first five years with distribution in west coast markets. They have since expanded into east coast markets, primarily in the northeast.

SUCCESS BRINGS NEW PROBLEMS

Sales grew steadily and the company expanded two years ago into a much larger factory capable of doubling their output, while maintaining their quality level. The new factory had both a larger production floor for more specialized machinery and a much larger warehouse for storing raw materials. One problem they had experienced was high materials cost for the small orders of exotic hardwoods the company was forced to make in its original factory. They moved into the new factory in 2004. Material cost per unit did, in fact decline in the second half of that year by almost 5 percent, indicating that their estimates were not unfounded. In 2005 the new housing market peaked and in 2006 it actually started to soften. Sales of all kinds of furniture are closely correlated to, and slightly lagged from, the amount of new housing constructed in the US market. This relationship is well known and accepted in the industry.

Thus, in early 2006, Lisa Morgan, Vice President for Marketing, was meeting with Bill and Greg regularly to discuss strategies for continued success in this new, more competitive market for high end furniture. Bill, CEO, outlined the issues for the group.

"Clearly, we made a risky strategic move three years ago when we decided to double our capacity. I have reviewed that decision and while it looked like a slam dunk at that time, we may have placed an overly high probability on our forecast of continued almost double digit growth for the rest of the decade. Our new factory is fantastic, but, as you all know, we need $15 million in new sales just to break even on the cost of our additional overhead from our expansion and so far the best we have been able to come up with is 8 million. Sales for the fourth quarter of 2005 were actually flat from the previous year and the first two quarters of this year have seen negative growth. Greg, production manager of the plant reminded the group that at least in terms of materials cost, the new factory, even at current operating levels showed a significant savings. We are also able to attract a higher quality of wood, given our larger orders, which is further improving the quality of our product. They turned to Lisa, hoping for answers. She responded with the same 'excuses' for the flat sales that they had already heard – a decline in the house building market, high gas prices, a flat stock market, etc.

Under further questioning, Lisa mentioned that two of her best performing retailers, both in the Boston area, had mentioned when she was last in their showrooms that they were getting a healthy trade from Canadians taking delivery in Quebec, Montreal, and as far away as Toronto. One of them stated that the Canadian dollar, 'the Loonie', was appreciating against our dollar. "I looked into this and they were correct. Four years ago their dollar was only worth 72 cents U.S. and today it exchanges for 90 cents. That's quite a difference. Maybe we should consider moving into international markets?"

They agreed that Lisa should do some preliminary market scans, which she did. In the process she contacted the Colorado Off ice of Economic Development and International Trade, which led to them inviting SitEasy to attend a Trade Show being organized for furniture manufacturers and distributors in Düsseldorf, Germany. Bill decided to personally attend the show in September, 2006 with a group of business people from the Denver Chamber of Commerce. His purpose is to explore new markets for the specialty line of tables and chairs manufactured by the SitEasy Corp. Their line of furniture has come to be accepted in 'better' middle class homes across the United States. This is Bill's first experience on a trade mission and he was understandably shocked to find that people actually come to these shows with their checkbooks in hand.

While he was still in Germany, Lisa returned from lunch to find the following e-mail message from his boss marked URGENT! - This was not the way she planned to spend her Friday afternoon.

Lisa: *Great trade show. More interest in our model 1308 and 1600 chairs than I thought possible. Check market in Sweden for viability. Looks like that will be our first move into the EU.*
Need your reply tomorrow. Have a meeting scheduled for 10 am with our new distributor.

Bill

ANALYSIS

Lisa looked at her watch and tried to remember the time difference to Frankfurt – Düsseldorf, whatever. Failing on the instant conversion, the next step was to punch in 'time in Germany' on her favorite search engine: 10:12 pm. Looking at her watch she noted that it was 2:12 pm in Denver. Eight hours time difference meant that tomorrows meeting would actually take place in a few short hours. She would have to make use of materials on hand and whatever she could find on the internet to provide the needed answers.

Lisa quickly identifies three general areas for research on the Swedish market. First is the overall size of the market. The company would like to expand into new markets to optimize capacity utilization in their plant, without causing capacity constraint problems for the firm of 62 employees producing 73 million dollars in sales for 2005. They are currently operating at about 65 % of capacity and domestic expansion, which had been at the rate of 8% per year for the first four years of the decade slowed to 6% last year and has been flat so far this year. However, their labor productivity gains have been averaging higher than the average for non-farm labor over the same period, or about 4%. This is due primarily to the fact that the business is relatively new and invested in the latest equipment. This has helped to hold down labor cost. She ponders how to answer Bill's e-mail. First, she decides it would be good to have an estimate the number of years to capacity for their facility given current estimates of domestic demand?

Getting back to the issue at hand, answering her boss, she decides to begin her search for Swedish data at government websites. http://www.buyusa.gov/sweden/en/ccg.html and choosing Sweden as the country brings her to the Country Commercial Guide for Sweden, produced by the Department of Commerce staff at their office in Stockholm, Sweden. Here she finds a general narrative about the country and its business climate. Nothing specific to the market size here, but there is a wealth of information on her second issue: general economic climate. Information includes an assurance that Sweden has signed the European Patent Convention of 1973. She notes although import tariffs should be low, there is a 25% value added tax (V.A.T). This is a form of sales tax preferred in a lot of countries, Lisa remembers. She finds the following list for the calculation of import taxes to Sweden:

> The value for customs purposes is directly based on the value of transaction and the following additional costs:
> - freight costs up to the place of importation to EU
> - insurance costs
> - loading/other handling costs
> - broker fees
> - package costs
> - royalties or license fees

- the seller's yield in case of further sale to a third party

Most goods imported to Sweden are subject to customs duty and also a value-added-tax (VAT). The general VAT rate is 25%, with a lower rate of 12% for food and certain services, and 6% for books and periodicals.

She makes a note to tell Bill about that so he will be sure to specify who is to pay this in the contract. It appears that the way customs calculates the applicable fees is by the following formula: (CIF + duty) * 25% = VAT. She finds what she hopes is the applicable tariff information on the web (Table 1), but is still not entirely clear about the VAT. A mistake here could easily turn any foreign sale from profitable to a large loss. For the purpose at hand she decides to assume that the beginning point for negotiations on selling price to the Swedish distributor should be at least as profitable as domestic sales. Therefore, she makes the following notes;

Our fob East coast distributor's dock cost is currently $602 for the 1308 and $791 for the 1600 model chairs. These prices allow for a 15% mark up on cost for SitEasy.

A quick call to her freight company tells her that a ballpark figure would be an additional $50 per chair for export packing and shipping in container loads to Gothenburg or Oslo, Norway, and an additional $10 to Malmö, or Stockholm.

Marine insurance is an additional 1.5% of product cost and a 40 foot container will hold 32 chairs.

Lisa realizes that the firm attempts to earn a minimum of 15% mark up on cost on all domestic sales, she decides to use this target as her starting point on the pricing of the international sales, as well. At the same time is gathering this information she notices that families get 12 months of paid childcare leave after the birth of each child to be taken by either spouse. She wonders if Bill is aware of this, as he just had his second child.

TABLE 1: EUROPEAN UNION COMMON CUSTOMS TARIFF COMMISSION REGULATION (EC) No. 1789/2003 of 11 September 2003 CHAPTER 94 FURNITURE; BEDDING, MATTRESSES, MATTRESS SUPPORTS, CUSHIONS AND SIMILAR STUFFED FURNISHINGS; LAMPS AND LIGHTING FITTINGS, NOT ELSEWHERE SPECIFIED OR INCLUDED; ILLUMINATED SIGNS, ILLUMINATED NAME-PLATES AND THE LIKE; PREFABRICATED BUILDINGS Page 370:

C N Code	Description	(%) rate of duty
9403	Other furniture and parts thereof:	
9403 20 91	- - - Beds	Free

TABLE 1: EUROPEAN UNION COMMON CUSTOMS TARIFF COMMISSION REGULATION (EC) No. 1789/2003 of 11 September 2003 CHAPTER 94 FURNITURE; BEDDING, MATTRESSES, MATTRESS SUPPORTS, CUSHIONS AND SIMILAR STUFFED FURNISHINGS; LAMPS AND LIGHTING FITTINGS, NOT ELSEWHERE SPECIFIED OR INCLUDED; ILLUMINATED SIGNS, ILLUMINATED NAME-PLATES AND THE LIKE; PREFABRICATED BUILDINGS Page 370:

C N Code	Description	(%) rate of duty
9403 20 99	- - - Other	Free
9403 30	- Wooden furniture or a kind used in offices: - - Not exceeding 80 cm in height:	
9403 30 11	- - - Desks	Free
9403 30 19	- - - Other : - - Exceeding 80 cm in height:	Free
9403 30 91	- - - Cupboards with doors, shutters/flaps; filing, card-index and cabinets	Free
9403 30 99	- - - Other	Free
9403 40	- Wooden furniture or a kind used in the kitchen:	
9403 40 10	- - Fitted kitchen units	2.7
9403 40 90	- - Other	2.7
9403 50 00	- Wooden furniture or a kind used in the bedroom	Free
9403 60	- Other wooden furniture:	
9403 60 10	- - Wooden furniture of a kind used in the dining room and the living room	Free
9403 60 30	- - Wooden furniture of a kind used in shops	Free
9403 60 90	- - Other wooden furniture	Free
9403 70	- Furniture of plastics:	
9403 70 10	- - For use in civil aircraft (1)	Free
9403 70 90	- - Other	Free
9403 80 00	- Furniture of other materials, including cane, bamboo or similar materials	5.6
9403 90	- Parts:	
9403 90 10	- - Of metal	2.7
9403 90 30	- - Of wood	2.7
9403 90 90	- - Of other materials	2.7

Source: International trade Administration, August, 2006

She looks in the World FactBook for general information about Sweden. At https://www.cia.gov/cia/publications/factbook/index.html The World FactBook is compiled and published by the CIA, which seems to be interested in gathering information useful to business, as well as government. Here she found interesting comparisons between the statistics for Sweden and the US markets. Remembering that her market is particularly upper-middle class consumers with high disposable incomes, she paid particular attention to the Household consumption figures. The CIA reported that in Sweden the income of the highest 10% of households was 20.1 % of total income and the lowest 10% was 3.7%. Comparing with data listed under the US she found it was 30.5 % and 1.8%. She will need to examine this information further to determine how it might affect demand for furniture.

Sweden uses its own currency called the Swedish Krona. Looking at several internet currency exchange sites she finds one providing historic data. Lisa notes that the krona has been revaluing against the dollar rather steadily during thepast four years, last quarter of 2002-third quarter of 2006. The current exchange rate on the 28th of September is 7.32076 Sw. Kr. Equals one dollar. She realizes it will be best to provide Bill prices in both currencies and wonders what difference it would make if they insisted on paying in kronor.

Next, she looks at the Composition of the market. At http://www.census.gov/ipc/www/idbnew.html The international database of the US Census Bureau provided a wealth of statistics on the population of Sweden. She stumbled on this data almost by accident and realized her time was running out. She copied the following tables for Sweden and the US. Highlighting the target age group of 40 – 70 and computing some summary statistics, she arrives at the following tables. She assumes that their products are currently marketed to approximately one third of the United States population and given the small size of the Swedish market she thinks she should include all of it.

Table 2: Sweden: Midyear Population, by Age and Sex: 2005 and 2025
(Population in thousands)

	2005			2025		
AGE	TOTAL	MALE	FEMALE	TOTAL	MALE	FEMALE
TOTAL	9,002	4,459	4,543	9,316	4,601	4,715
0-4	469	242	227	495	255	240
5-9	467	239	227	500	257	243
10-14	603	309	294	483	248	235
15-19	606	311	295	484	249	235
20-24	528	270	258	504	259	245

Table 2: Sweden: Midyear Population, by Age and Sex: 2005 and 2025 (Population in thousands)						
	2005			2025		
AGE	TOTAL	MALE	FEMALE	TOTAL	MALE	FEMALE
25-29	532	270	262	511	260	251
30-34	595	302	292	650	330	319
35-39	625	318	308	645	327	318
40-44	*641*	*327*	*314*	*554*	*280*	*274*
45-49	*580*	*294*	*286*	*540*	*270*	*270*
50-54	*577*	*291*	*286*	*586*	*293*	*293*
55-59	*620*	*311*	*310*	*602*	*299*	*303*
60-64	*592*	*297*	*295*	*602*	*300*	*303*
65-69	*429*	*210*	*219*	*525*	*257*	*269*
70-74	349	163	186	490	234	255
75-79	312	135	177	469	216	253
80-84	257	102	155	369	162	207
85-89	156	53	103	188	73	116
90-94	54	13	41	83	25	58
95-99	10	1	9	28	5	22
100+	1	0	1	6	1	5
Source: U.S. Census Bureau, International Data Base, August 2006 version						

Table 3: US: Midyear Population, by Age and Sex: 2005 and 2025 (Population in thousands)						
	2005			2025		
AGE	TOTAL	MALE	FEMALE	TOTAL	MALE	FEMALE
TOTAL	295,734	145,309	150,425	349,666	171,918	177,748
0-4	20,495	10,471	10,024	23,518	12,015	11,503
5-9	19,467	9,954	9,512	23,163	11,831	11,332

Table 3: US: Midyear Population, by Age and Sex: 2005 and 2025
(Population in thousands)

	2005			2025		
AGE	TOTAL	MALE	FEMALE	TOTAL	MALE	FEMALE
10-14	20,838	10,670	10,167	22,888	11,692	11,195
15-19	21,183	10,871	10,312	22,469	11,496	10,972
20-24	20,897	10,719	10,178	22,125	11,296	10,829
25-29	19,804	10,060	9,744	21,441	10,882	10,559
30-34	19,885	10,021	9,864	22,993	11,647	11,347
35-39	20,903	10,479	10,424	23,080	11,654	11,425
40-44	*22,748*	*11,294*	*11,454*	*22,319*	*11,232*	*11,087*
45-49	*22,458*	*11,080*	*11,377*	*20,682*	*10,327*	*10,355*
50-54	*19,984*	*9,772*	*10,212*	*20,044*	*9,914*	*10,130*
55-59	*17,359*	*8,415*	*8,944*	*20,292*	*9,945*	*10,346*
60-64	*13,017*	*6,203*	*6,814*	*21,128*	*10,185*	*10,944*
65-69	*10,123*	*4,712*	*5,412*	*19,647*	*9,284*	*10,363*
70-74	8,500	3,804	4,697	16,041	7,346	8,695
75-79	7,376	3,094	4,282	12,268	5,377	6,891
80-84	5,576	2,117	3,459	7,557	3,079	4,478
85-89	3,206	1,072	2,135	4,353	1,609	2,745
90-94	1,431	397	1,034	2,312	750	1,562
95-99	412	91	321	1,018	282	737
100+	71	12	58	327	74	253

Source: U.S. Census Bureau, International Data Base, August 2006 version.

Third, she looks at the ability to move from Sweden into other markets. She realizes that the information she has gathered so far may be somewhat biased, given its US governmental sources. Therefore, she looks for a Swedish source and found the Swedish Statistical Bureau. At http://www.scb.se/eng/index.asp Lisa found little to help her here. A wrong keystroke put her into what she assumed was a wealth of statistical information. Unfortunately, it was written in a foreign language, probably Swedish. She was right, and had stumbled onto a stark fact of international research. Governments tend to publish data in their own languages. In fact, Sweden was the first country to begin conducting a regular census of the population hundreds of years ago. Information was readily available - in Swedish - on median disposable income for households by age, number of households by age, size of households by age, and the usual variety of statistics used in secondary marketing research. Making a note to herself to find out more about researching international markets, Lisa began to prepare her e-mail to Bill around the three themes: Market size, Economic climate, and future potential for SitEasy expansion. (in fairness, it should be noted that the Swedish Statistical Bureau site does note that it is expanding its English language information on the website).

What should her response include? After exhausting the information included here, visit the websites she used in her analysis and look for facts she overlooked in her haste to compile her response. How could this new information affect her response concerning the Swedish market? Be specific in your comments and remember to source all information.

CASE QUESTIONS

1. Discuss the motivations behind the plant expansion and advantages and threats caused by this action.
2. Should SitEasy expect that the decreases in material cost for its furniture will continue to decline in the future? Explain your answer.
3. What type of forecasting does it appear that SitEasy is using for its demand forecast?
4. Estimate the number of years to capacity for their facility given current estimates of domestic demand. Be specific in terms of the assumes being made and try to come up with a range of estimates, rather than just one point.
5. What is the main problem illustrated in this case?
6. How large is the change in the relative value of the ‘Loonie’ over the past 4 years and what might be some of the factors leading to this change, and why is the money called ‘loonies’?
7. What will Lisa include to Bob about pricing? Include a detailed answer of the each the cost items and conclude with cost per unit for each chair, as well as target price. Is there any room for downward negotiation?
8. What type of forecast numbers could Lisa develop quickly for the Swedish market? Come up with specific assumptions and forecasts.

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INTERLANDDATA WEB HOSTING: STRUCTURING THE ORGANIZATION FOR GROWTH

Javad Kargar, North Carolina Central University

CASE DESCRIPTION

The primary subject matter in this case is formulating strategic decisions that need to be made regarding a small entrepreneurial firm's future direction. The owners are a couple who are faced with the decision of whether or not to expand as well as with the challenges of obtaining the necessary financing, structuring the organization for growth, and allocating management time. This raises several issues and illustrates several lessons. In particular, management proposes potential changes, offering students the opportunity to critique their plans. Evaluated carefully, students should identify the critical success factors and whether and how these elements can be leveraged as they implement their expansion plans. The purpose of this case is to provide students with enough information about the business situation to be able to chart what course of action the company should take at a given point in time. This case has a difficulty level of four, appropriate for senior level. It is designed to be taught in two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

During the summer of 2004, the owners of InterlandData, Mark and Susan Hamidi, began to assess their current position within the Web hosting industry and their alternatives for expansion. After nine years in operation, the company had achieved a reasonably stable, yet not highly profitable financial footing. Both owners are experiencing considerable pressure to expand their organization. They believe that opportunities exist to franchise the operation, or grow by expansion. The case ends with the co-owners faced with making a strategic decision about the best way to expand and how to find both the managerial and financial resources to do so. An implicit question in the case involves the long-term viability of the business.

INTERNAL ENVIRONMENT

Brief History

The two entrepreneurs responsible for InerlandData's success were Mark Hamidi and Susan Hamidi, founder and Chief Technology Officer, and CEO/Director of Marketing, respectively. They have worked as a team since 1995, when Mark founded InterlandData. Initially, Mark operated the business on a part time basis from the basement of his home. Before 1995, Mark had worked for IBM. In 1991, he was assigned to a project for IBM through the National Science Foundation. The project team developed the initial hardware and software that we now know as the Internet. While working in teams of five to eight scientists at various sites around the country, Mark was able to envision the potential success of the application of this new technology in the future. "I knew this thing called the Internet would be big. I just didn't know how big," Mark said.

Through word of mouth and various search engines in the initial stages of the Internet boom, businesses requested services from InterlandData. By June 1996, it had 100 customers and Mark had moved the business out of his basement into the company's first office. In November 1997, new office space was leased. In 1998, the company became incorporated, and by June 1999, it had reached a milestone of 1,000 customers. The twenty-first century brought more changes for InterlandData. In July 2000, the company offered its own domain registration services. In the first quarter of 2004, the company had grown to a client base of more than 2500 in 42 countries, and the owners believed that the business was only operating at about 60 percent capacity.

Management and Personnel

There were five employees at InterlandData including Susan and Mark Hamidi. Susan was President and CEO of the company. She joined the venture in 1996 and had previously worked as a Staff Accountant at a network-marketing firm for three years. After graduation from the University of London, where she earned a Bachelors degree with honors in Biology and Psychology, she studied accounting and passed the Certified Public Accountants exam in May 2002. Her managerial responsibility included direct supervision of two employees, Mary and Pam.

As CEO, Susan's primary goal was to increase the customer base in the state of North Carolina in which the company operated. She felt that one of her biggest strengths was the ability to relate to women. On the contrary, Susan stated time management as her major weakness. She worked diligently towards her goal by exhibiting at various trade shows and networking at local professional association meetings.

Mark had only one employee under his direct supervision, Bill, and hence identified his main weakness as his lack of desire and ability to manage people. Yet, Mark felt that his main strength was the ability to analyze and correct technical issues. He felt that one of his biggest accomplishments was the continued growth and profitability of the company despite the economic downturn. Mark earned a Bachelors of Science degree in Electronic Engineering and a Masters in Computer Science from the University of London.

Mary was an Accounts Receivable Manager with over 12 years of customer relations experience. She was responsible for setting up new customer accounts, managing all accounts, handling customer inquiries related to billing, and collections. Her expertise was utilized to keep existing clients happy and, in turn, solicit referrals for potential clients. Furthermore, Mary monitored a specialized software program, which was used to generate invoices automatically. The system had a 10 percent error rate, which was corrected by Susan monthly through a manual audit. All accounts were prepaid. Once an account became fifteen to thirty days past due, Mary would start the collection process. If a new customer did not pay within thirty days, their sites would be terminated. For more established customers, the collection efforts began after forty-five days.

Bill had been employed with InterlandData for just over two years and was Mark's right-hand man. He received formal training at North Carolina State University in the Computer Engineering curriculum. His general duties included building and maintaining the servers on site as well as responding to customer service issues. Both Bill and Mark maintained the servers daily and weekly.

Pam, the Senior Web Designer handled most of the Web design jobs, and provided customer service as needed. She felt that Web design was her "niche" given her background and experience in this arena. Pam wanted to have more direct relationships with the clientele to produce quality, personalized services. Having been working together for some years, Bill and Veda had developed a good working relationship and seemed to complement each other's strengths. Susan and Mark were generally happy with the performance of their employees and the relationships they had built.

Mark and Susan owned 100 percent of the stock in the company. They had not set any long-range goals. The company had no written business plan, and the management team did not feel that a formal plan was necessary. "We have been too busy surviving to think about where we should be five years from now," says Mark. "But now that the company is on its feet, we're going to think about the future, especially about ways to create more customers." The company also had no organizational chart or written job descriptions, but all the personnel believed that they had clear understandings as to their responsibilities and authority.

Products and Services

InterlandData's operations consisted of Web hosting, Web design, IT solutions and other Web services. Under Web hosting, the company offered both dedicated and virtual Web hosting packages. Dedicated plans started at $149 per month, while virtual plans ranged from $19 to $60 a month. A standard dedicated hosting package included generous amounts of bandwidth, several email accounts, user accounts, virtual hosts, large amount of disk space, a back-up server, SSL certificate, and 24/7 technical support. These features were relatively consistent among competitors in the hosting industry. According to Mark, "One component to the company's growth is our flexible hosting plans that range from virtual hosting plans to dedicated and managed hosting."

Unlike most of the Web hosting firms, InterlandData did not have an established fee for every feature or service. After a potential client noted where his/her interests lay, the company would begin negotiating procedures with the customer until an agreement was formed between them.

The company was also able to offer e-commerce websites, which often included flash animations and database driven features.

With regard to IT solutions, the company offered the independent services of systems programming, computer cabling/networking, secure certificate installation and custom software development. These services like e-commerce services were charged on a project-by-project basis with factors such as time and intensity of the project being weighed. The same tactic was often utilized when providing Web design services. Unlike many other Web hosting providers, InterlandData neither offered custom nor template Web design as a standard feature of Web hosting packages.

Operations

InterlandData's office included a reception area, three offices and one room dedicated for servers and technical equipment. The company owned and operated the servers guaranteeing them with a 99.99% uptime. According to Mark, the servers needed to be replaced every twelve to eighteen months.

The company's Data Center was outsourced to a local company. Although InterlandData had back up files, it was very difficult to switch the Data Center if the need should arise. The Data Center staff provided continuous observation through a closed circuit TV system to protect against unauthorized entry. The Network Operations Center was the central nervous system for the Data Center, and it included servers that were housed in a high-tech, locked cabinet with customer security at heart. The cabinets were only accessible by authorized team members and staff. A high-capacity heating, ventilation and air conditioning (HVAC) system maintained temperature and relative humidity levels to ensure that equipment stayed up and running. Onsite diesel-powered generators were ready and waiting to prevent service interruption at the first sign of loss power. In the event of power disruption, the Automatic Transfer Switch would power the generators within seven seconds for continuous operations.

The company's Web site was setup on a shared server, and was designed with easy to read text font, color and legible content. All the pages had a link to the site's home page. The Website had no flashing, moving or zooming features to distract the viewer. Likewise a site directory was lacking on its home page and there were incomplete directories on other pages. Some syntax and spelling errors were noted, and in general, content contained redundancies.

Strategic Partnerships

A chief component of InterlandData's strategy was to partner with organizations that would add to its content and service offerings. To provide full e-commerce solutions to its customers, IntelandData had partnered with the following ten organizations:

- In February 1996, InterlandData entered into a technology agreement with Microsoft for various products such as Microsoft Frontage, Sharepoint, Windows 2000/2003, SQL, Exchange, Action Pack, CRM. Microsoft provided a lot of value added hosting products and operating systems.

- In August 1996, the company entered into a technology agreement with Allaire/Macromedia ColdFusion. The partnership was primarily for the "ColdFusion" application server software, which the company hosted and supported on its servers. It allowed InterlandData to sell ColdFusion-enabled web sites at a premium price.

- In January 1997, InterlandData partnered with Network Solutions/VeriSign to provide domain registration services. Network Solutions had a monopoly on domain registration until 2000. After other organizations were allowed to participate in the domain registration marketplace, Network Solutions merged with VeriSign and sold copies of the WHOIS database to anyone who would pay.

- In October 1997, InterlandData entered into agreement with Thawte for SSL Certificates for e-commerce.

- In November 1997, InterlandData entered into an agreement with Cybercash for credit and merchant services for its e-commerce clients. This company was subsequently purchased by VeriSign.

- In June 1999, InterlandData made an alliance with Miva to provide shopping carts for e-commerce. The company's alliance with Miva allowed it to purchase licenses in bundles and receive an excellent savings while charging higher prices for Miva-enabled e-commerce sites.

- In May 2000, IterlandData entered into an agreement with GeoTrust (formerly Equifax). Most SSL certificates for InterlandData and its clients were obtained through GeoTrust because of both their better process and margin. It was an essential component for e-commerce.

InterlandData's Customers

The customers served by InterlandData were both individual resellers and businesses around the world. Susan estimated that about 2,500 customers used the Web design and Web hosting services of the company in early 2004. In the USA, the largest customer concentrations were found in the states of Texas, North Carolina, California, New York, and Florida. They had only 216 customers in their own state of North Carolina. Of the USA's customers, eighty percent were small businesses (less than 500 employees), fifteen percent were medium sized companies (between 500 and 1000 employees), and large businesses (over 1000 employees) accounted for about five percent. In the foreign market, the larger customer bases were located in Germany, Australia, England, West Africa, Portugal, Sweden, and Thailand. The company had planned to evaluate a presence in Mexico and other Latin American countries.

As of May 2004, only twenty customers were subscribed to the company's Web design services. There were about seventy domain registrations a month, which generated approximately ten percent of the company's revenue. Buyers of domain registration service were not included in the headcount of continuous service subscribers. About ninety-nine percent of the customers subscribed to Web hosting services.

Marketing and Advertising

InterlandData's marketing objectives were to attract more users, to retain the business of current users, and to enhance the company's brand awareness. To achieve these objectives, the company used newspaper advertising, direct mail, trade publications and magazines, yellow page advertising, brochure distributions at trade shows, referral incentives, and presentations at professional association meetings. In 2002, the company's marketing and advertising budget was about $19,600, the majority of which was focused on growing the customer base.

The company did not have much success with the use of dedicated sales staff in promoting the company's services. According to Susan, the resulting sales volume and the return on investment was not sufficient to support the costs of a sales position. In addition, Susan found print advertising too expensive for the company. She creatively arranged cheaper advertising in some high profile publications. "When I called upon technical magazines, the advertising prices were way too high. I told the advertising managers that we would advertise long term if they could just give us a discount for one month. Some agreed to do so. I then tracked the customers very carefully via an Excel spreadsheet to calculate return on investment" Susan said.

InterlandData discontinued advertising in the "Internet World" magazine, the "Tech Journal" and "The Triangle Business Journal" due to budgetary constraints. However, the company maintained a presence in the Yellow Pages of the local telephone directories. It also had memberships in some of the local Chamber of Commerce organizations in North Carolina, including

Chambers in the cities of Raleigh, Cary, Apex, Morrisville and Charlotte. In addition, Susan held membership in several professional organizations. They included the Women's Business Owner's Association, National Minority Suppliers Development and the National Association of Female Executives. It was through networking at trade shows and meetings with other individuals in these organizations that many business referrals were generated. Informational flyers and brochures were mailed to businesses and distributed at events. Web site promotions were also used at the company's Web site. The frequently repeated banners advertising low prices were highly visible and attracted a significant number of customers. Testimonials from customers speaking to the high quality of service and products provided by InterlandData were also dispersed throughout the company's Web site.

Susan spent time analyzing competitor Websites, product offerings, prices, and their guarantees especially. According to Susan, "Most of our Web hosting competitors in 1996 offered 30 days money back guarantee. We offered 60 days and still we do." This market pricing and product offering research helped the company develop strategies and remain a solvent player in the industry through the year 2004. The company planned to employ the strategy of cross selling to increase the volume of services provided.

InterlandData's most effective means of attracting customers was through referrals from existing customers. One of the company's incentive programs was tied to the referral business segment. Some customers who referred others received free hosting services for a designated number of months, others received deep discounts on service charges, and still others received cash rebates. From this activity often derived testimonials. In many cases with large account customers, the company offered the customer a portion of free services for a specified period of time in exchange for advertising space on the customer's Website. Susan believed that word of mouth was vitally important in the growth of the company. Historically about fifty five percent of the company's new sales had been a direct result of word of mouth. In 2002, about eighty percent of the company's sales revenue was from direct sales that were primarily the result of referrals, while twenty percent was from the reseller network.

Customer Service

InterlandData's management believed that attentive customer service was critical to retaining and expanding its customer base. Customer service representatives were available 24 hours a day, seven days a week to provide assistance via e-mail or phone. Customers could call the company at any time during the day and speak with one of the associates. Bill stated, "Customer service to us means responding to customer requests in a timely fashion. At InterlandData, you can always get a live person, rather than an automated machine. I also believe that staff knowledge and dedication is very critical in the Web hosting business." Although there was no on-site staff at the company's office twenty-four hours a day, the company had a system that received calls after business hours.

Customers needing tech support would either email or call InterlandData. After business hours, the on call person who was designated according to rotation, would be responsible for checking the email messages from home and carrying the pager that indicated when the company had received telephone calls. Furthermore each server was checked every 2.5 minutes by an automated machine, and if there were a problem, the machine would page the person on duty. These methods allowed the company to have a quick response time to customer's problems.

According to Pam, the e-commerce customer could sit back hands free of Website maintenance. The company handled all activities involved in managing an e-commerce site including credit card transactions, heavy flow of customer traffic and content management. This was an important feature for e-commerce customers since their site information was backed-up and the company possessed generators for any possible outages.

The company's "churn" rate was about one percent per month, which was far less than the industry average. However, the company possessed one setback regarding the customer service activity. There was no way of knowing a customer was truly satisfied with the services he or she received from InterlandData. According to Pam, "There was no measurement for customer satisfaction. There was no system in place to have customers provide feedback on an ongoing basis."

Historical Financial Performance

Like many new ventures, InterlandData's first three years of operation were financially unstable, in part because their services were new to the market. Early marketing efforts generated positive publicity as well as numerous word-of-mouth referrals among clients. By the fourth year of operation, the financial picture had stabilized as a result of improving operations. In 1998, InterlandData made its first operating profit of approximately $2,500 on nearly $175,000 of revenues, after paying modest salaries to the directors. Exhibits 1 and 2 present the company's income statements and balance sheets from 2000 through 2003.

Historically, the business' growth had been financed through retained earnings, and a line of credit with Bank of America. In 2001, the company had its highest amount of long-term debt of $26,038. As of 2000, the company had no long-term debt. In general, the management did not like debt, but occasionally they drew cash on a credit line and paid it off within two weeks. In 2001, InterlandData made an investment in a small local business. There was $50,000 on a note payable in 2004, and an additional $15,000 in stocks and bonds.

In particular, operating profits in year 2003 had declined (see Exhibit 3). Further, even though total revenue had been growing in previous years, it became evident that its rate of growth had started to slow or remain at 28 percent.

Exhibit 1
InterlandData Income Statement, 2000 – 2003

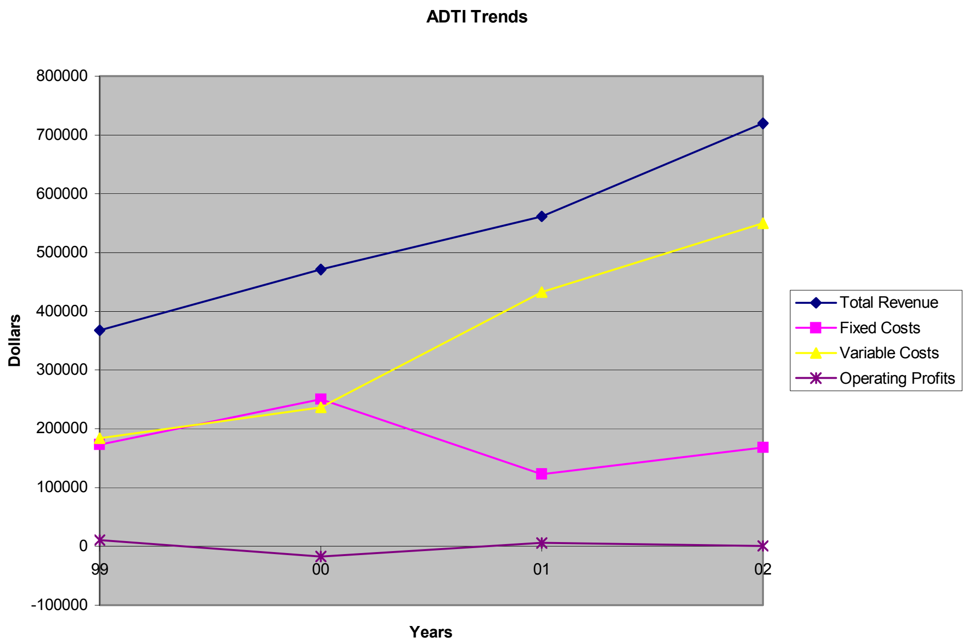
	2003	2002	2001	2000
Net Sales	$719,345	$561,572	$470,628	$367,763
Cost of Sales:				
Hardware/Software/Marketing	268,631	195,167	70,185	22,656
Wages & Salaries	281,363	236,980	166,542	160,989
Gross Profit	$169,351	$129,425	$233,901	$184,118
Total Operating Expenses	$168,273	$123,196	$250,652	$173,560
Operating Profit (Loss)	$1,078	$6,229	$(16,751)	$10,558

Exhibit 2
InterladData Balance Sheet, 2000 - 2003

	2003	2002	2001	2000
Assets				
Cash & Cash Equivalents	$55,484	$42,661	$86,260	$156,813
Accounts Receivables	24,421	59,123	6,765	(5,477)
Prepaid Assets	74,430	73,380	83,481	806
Current Assets	$154,335	$175,164	$176,506	$152,142
Net Fixed Assets	20,984	14,941	2,300	19,344
Total Assets	$175,318	$190,105	$178,806	$171,486
Liabilities & Equity				
Current Portion of LT Debt	25,502	31,619	3,753	2,628
Accounts Payable	19,645	11,114	3,101	1,993
Deferred Revenue	138,047	156,356	161,243	113,292
Total Current Liabilities	$183,194	$199,089	$168,097	$117,913
Long Term Debt	0	0	26,038	12,679
Total Liabilities	$183,194	$199,089	$194,135	$130,592
Capital Stock—Common	100	100	100	100
Retained Earnings	(7,976)	(9,084)	(15,429)	40,794
Total Liabilities & Equity	$175,318	$190,105	$178,806	$171,486

Mark and Susan wanted to reverse these trends and insure a strong position for their business in the future. The company had been making positive profits, and there still existed a lot of upside potential. Thus, no thought was being given to abandoning the business.

Exhibit 3
InterlandData Income Statements



INDUSTRY AND COMPETITIVE ENVIRONMENT

The Web hosting industry was characterized by a wide variety of different types of providers, most of them small. In 2004, it was estimated that there were over 10,000 Web hosting providers worldwide. Providers ranged from One-Source Providers, to Application Services Providers and Managed Service Providers. Products and services from One-Source Providers included custom Web site design, custom programming, strategic consulting, marketing and promotion. Application Service Providers incurred the costs of building and maintaining applications and databases for their corporate clients. With Managed Service Providers, the clients had their own servers in addition to being provided with full monitoring and maintenance services and around the clock technical support. Numerous innovations were occurring in the Web hosting market.

According to Doug Kays, a Web hosting analyst, customers ranked price and service quality among the most important factors to be considered when selecting a Web hosting company in the late 1990's. By 2004, it was more important to choose a company that appeared to be stable and positioned to remain in business. Customers were more concerned about service disruptions created by hosting companies whose doors were closing for business. The large number of Web hosting businesses, which failed or were being acquired through merger, caused such apprehension with customers.

In 2004, the Web hosting market was highly competitive, in part because the market was saturated, supply remained greater than demand and there was a high degree of fragmentation. The existing players in the market in addition to pure Web hosting companies included Application Server Providers (ASP), Internet Service Providers (ISP), telecommunications companies, computer hardware suppliers and large information technology firms. Of the thousands of companies in the industry, some of the major players included Interland, Verio, AT&T, IBM, Sprint, Dell Host and Navasota. Although there were big names, there were no big profits within the industry. They intended to serve the market by achieving economies of scale and efficiency in their operations. Standardization of products and services permitted the use of standardized processes reducing costs and easing operations. For example, in formulating its business strategy, Verio concluded that large, national Web hosting providers lacked local presence to provide customized, hands-on support, while the smaller, local providers did not have economies of scale and resources to provide a full range of services at an acceptable quality and price level.

There had been an endless stream of bankruptcies, mergers and acquisitions in the industry to incur profitability. The Web hosting industry was saturated and had passed its climax. It was predicted that only strong companies would survive in the years to come. Competing factors across the Web hosting industry included prices, reliability (reducing down time), quality technical support, technology (having the necessary software and platforms), strategic alliances, search engine tools and web design portfolios.

Many Web hosting providers had turned their differentiation efforts to the customers. The Web hosting industry had two main customer groups. These customer groups were resellers and individuals, or any person or organization that needed a website. Resellers were individual smaller companies who purchased a dedicated server space and sold the space to smaller individuals that most large Web hosting firms did not cater to. The four common options that were offered to resellers were: volume discount, discount per domain, affiliate and private label reselling. Historically, performance and speed were the top priorities for customers without price being a big factor. The main reason for the customers' strong preference for reliability was largely due to the fact that in 1995, the Web hosting industry's biggest customers were dot-coms. Although these high tech customers had capable personnel, they lacked the resources necessary to operate a data center. The Internet infrastructure at that time could not keep up with the demand therefore forcing most customers to rely on Web host service providers to give them an edge over competition. These customers dominated the industry for five years. In year 2001, the dot-com firms took a great fall, and as a result the Web hosting industry growth declined. Web hosting customers were seeking Web hosting company stability, cost, service and security. This had been consistent regardless if the customer was a reseller or an individual. Specifically, the most important things that most customers looked for were good technical support, fast connection speed, 99.7% or better availability and exclusive domain name.

Despite the declining trend in the Internet economy, which began during 2001 and continued through the first quarter of 2004, the hosting industry continued to grow because businesses were increasingly using the Web for commercial activities. International Data Corporation, a leading market research firm, predicted that the Web industry revenues would increase from $5 billion in 2001 to over $19 billion in 2004. It was expected that much of the expansion would come from small to mid-sized enterprises (SMEs). Most hosting providers were strategically positioning themselves for this boom in SME demand by specializing in dedicated and professionally managed hosting services.

According to Rawlson O'Neil King, an analyst at the Web Hosting Industry Review, in the early days of the Web hosting industry, the opening costs for launching a Web hosting business was low, which created lower barriers to entry. Nonetheless, with the emergence of professional and managed services, the cost of investment was much steeper and required heavy capital expenses in equipment, network connectivity and physical plant.

According to the office of the Small Business Advocate, about 66% of businesses with employees remain open at least two years after startup, 49.6% are open at least four years, and only 39.5% are open after six years. Many small business hosting providers exceeded these forecasts. For instance, some small hosting providers had not only weathered the economy's most recent downward spiral but had prospered. The keys to their successes were different from one another. The success stories were dependent upon the following business standards: reputation, word of mouth, customer service, and enticing incentives to attract new customers, promote referrals and persuade existing customers to extend contracts.

Web hosting firms directly depended upon several resources to operate. Major resources included software, hardware, a data center, as well as experienced high tech support staff. All of these resources were equally important, although software suppliers usually had the advantage when forming business partnerships with web hosting firms. Software packages and data centers were constantly upgrading to provide better service for the customers. In order to compete, Web hosting firms had to be able to adapt to these changes in order to meet their customers' needs. All firms, whether large or small, depended upon software giants such as Microsoft or Red Hat. Data center providers like Info and Peak 10 were also critical to business operations. Technical support staff not only needed the ability to analyze a current problem, but also needed to posses the ability to respond and correct the problem in a timely and efficient manner.

Web sites were increasingly becoming the media of choice for advertising and information dissemination. It was easier through a web site to update material and to tailor content to fit the intended market. Substitutes for Web hosting services included newspaper and magazine advertising, radio and television marketing, the Yellow pages, flyers and brochures. The cost of Web hosting services was significantly cheaper than any of the noted substitutes. The reach of Web sites was global with extensive market penetration. Costs associated with switching to a Web presence were very low. Brand loyalty also did not prevent switching from substitutes because of the resulting large savings associated with the use of web services. Web sites as substitutions for points of sale were increasing but at a slower rate. Advances in security technology were raising consumer confidence and usage.

Between 2001 and 2002, the largest threat to Web hosting providers was the poor state of the economy, which generated little consumer confidence in any business. The new trends in 2003 had included substantial price discounting, more standardization of Web hosting products and services and use of do-it-yourself software and books. Shirley Siluk Gregory, a Senior Analyst with the ebiGroup reported there was also a new breed of Web hosts that emerged onto the field ventures. These hosts included On Smart Network, Server Beach, and Ready-Set-Web who roamed the furthest into new territory with its "ready-made Websites for rent" and a range of templates that included domain name registration and regularly updated site content. The competition became more intense with the 2002 launch of small-business hosting providers such as Yahoo! with its "business-class Web hosting service" and AOL with its "AOL for Small Business" offering for small-office/home-office customers. Both Yahoo! and AOL had economies of scale as well as an established brand-name with millions of consumers and entrepreneurs.

Outsourcing marketing functions and public relations of Web hosting providers were also developing trends in 2004. Marketing agencies could assist Web hosting firms with all components of marketing communications, from developing the marketing plan and strategy to actual execution of advertising plans or public relations. Advertising and marketing agencies could negotiate media-buying rate discounts of up to 40 percent on behalf of Web hosting clients. These volume discounts provided an economies-of-scale cost savings that even large Web hosting companies could not achieve on their own. Another service that marketing agencies provided was a lead-generating service that helped hosting providers develop new business more efficiently.

POSSIBLE GROWTH STRATEGIES

Susan and Mark believed that timely decision-making was critical to the long-term growth of the firm. Given the competitiveness of the Web hosting business, it was foreseeable that Web hosting would become as competitive in the future. Opportunities lost would not be easily regained. Mark believed that the companies that provided low prices would eventually decline and go out of business due to the lack of qualified support staff. They felt they needed to make plans and could not afford to wait another year and adopt a “wait and see” attitude. In addition, they had to think about where the funds for the expansion were going to come from should they decide to pursue growth.

The Franchising Option

Mark and Susan were considering franchising the company’s operations thinking that it would increase profits with minimal investment on their part. Because they knew little about the pros and cons of franchising, Mark and Susan contacted a university professor together with a team of MBA students to help them analyze this option. In exploring the franchise option with the help of the team, they found some guidance on what makes a franchise successful.

First, they realized that the current operation must be successful both operationally and financially if it is to be amenable to franchising. The prospective franchisor must be able to demonstrate to the prospective franchisee the capability to provide proven ideas or there would be little buyer interest. The franchisee must see a benefit, such as potential profit, in the relationship before becoming willing to invest.

Second, a successful franchise must be based on a concept that was not only capable of being duplicated but that could not be easily copied by outsiders. In order to be sold to a franchisee, operating systems must be standardized to the point that an individual other than the founder could take on the concept and implement it. This required development of operating manuals that were standardized, an idea that could not be easily replicated by competitors, name recognition or brand identity associated with the franchisor, and/or systems in place that provided a competitive advantage to the franchisee not available to the sole entrepreneur.

Third, standardized operating procedures that would allow the business to be taught to a franchisee needed to be in place. To the extent that a business depended on the initiatives of any individual entrepreneur or group of entrepreneurs, it would become less easy to franchise.

Fourth, successful franchisors provided continuing support, allowing the entire franchise system to capitalize on economies of scale in marketing, advertising, operations or new product/service developments. This ongoing support would help franchisors avoid the potential problems that could arise when a franchisee had learned the system and felt independent enough to operate without the franchisor’s advice and help.

Mark and Susan believed these criteria were reasonable and were concerned about the extent to which InterlandData’s concept and operations met them. The revenues from franchising the operation might help stabilize cash flow, but franchising would create costs, for instance increased legal fees, more marketing, and training and support for franchisees.

Although about 1 out of every 12 U.S. retail businesses was a franchised business, there were only a few Web hosting companies that franchised their businesses. They were Dollars by Design.com, Quick Internet Services, WSI Internet, and Team Internet. Dollars by Design.com was a global Website Design and Web Hosting Center. In 2003, it hosted over 300,000 business websites. Its liquid capital requirement was less than $10,000. Quick Internet had 200 franchise locations throughout the world. It was the only ISP with local offices in every city that they serviced. Its two main products were high speed Internet and Web services. The company's liquid capital requirement was $55,000 to $65,000. WSI Internet had been in the franchise business since 1998. It had established more than 700 franchises in 87 countries. WSI Internet's objective was to help small and medium sized companies to profit from the Internet. The company's liquid capital requirement was $35,000 with a total investment requirement of $39,000 to $50,000. The Team Internet Franchise model was set up to be unique for Web hosting in Europe in 2000. It partnered with local businesses that wanted to sell their services under the company's brand. By partnering with Team Internet, businesses were able to have their own Team Internet website, run their own business and let Team Internet take care of the technical aspects such as hosting and setting up the accounts. The liquid capital requirement for franchisees was $20,000 in start-up costs.

A franchise operation required capital for legal fees, inventory, and startup costs unless the primary business generated enough cash by itself to support the new system. The capital requirements to initiate a franchising strategy appeared to be expensive for InterlandData in light of its cash flow. It was believed that franchising InterlandData would require anywhere from $50,000 to $200,000 in start-up capital. Because InerlandData was a service organization that did not require inventory, the bulk of the capital would be needed for legal fees for the franchise agreement. The owners had one estimate of $100,000 for legal fees for the first two years of getting the project started. Other expenses of franchising included developing and printing of operating and training manuals, and administrative forms. These expenses would be partially offset by a franchising fee estimated at $10,000 and franchising royalties at 10 percent of the franchisees' gross revenues, figures in line with other franchise fees and royalties in similar businesses.

In addition to the capital requirements, Mark and Susan needed to explore the operational and managerial requirements of running IterlandData. The two entrepreneurs wondered whether they had the managerial capabilities within their small organization to develop a successful franchise operation, particularly since franchising would require a great deal of their own attention. Further, they wondered whether there might not be other ways to grow that were less risky and therefore concurrently explored several alternative growth strategies.

Alternative Growth Options

One possible growth option was to grow via expansion, such as through branch offices, or through licensing of the concept. Another was to pursue niche strategy through focusing on either one attractive industry globally or all small businesses in the state of North Carolina. Still another option was to pursue diversification through consulting.

Branch offices.

Branch offices might provide a way for InterlandData to expand its primary market, while maintaining close control over operations. Branch offices could be managed as independent units or an extension of InterlandData's main unit. It appeared that the branch offices had to be organized and managed as independent units with their own management, employees, and client base, rather than as outgrowths of the main office. In addition, good branch managers were essential.

On the pro side, branch offices did not need a large capital investment. Office space and equipment could be obtained inexpensively, or the branch could even operate out of the manager's home during start-up. This method of growth would allow InterlandData to retain control of the operation while minimizing its capital and managerial investments. Despite the apparent advantages of control, Mark and Susan were still concerned about the amount of managerial time, training, and support that would have to be devoted to branch managers. They knew that they would need to undertake some market research and develop a business plan, and that branches would require nearly as much support as would franchises.

Licensing.

Licensing involved developing a legal contract with the licensee to purchase InterlandData's intellectual assets that were developed and retained internally by the company. Licensing as a growth strategy was most often used to market a product or service in a foreign market. The license relationship would end at the sale of the package with provisions in the agreement restricting the right to transfer or share ownership of the package. Under the agreement, InterlandData would basically provide a start-up kit in return for a one-time fee. On the plus side, licensing offered the potential for smoothing out or at least increasing cash flows, while bringing much greater market recognition to the organization. Part of the licensing agreement could have provided for royalty payments based on the licensee's net sales thus further increasing the amount of positive cash flow for the licensor. The problem with this relationship, however, was lack of control over future operations of business carrying the InterlandData name. Particularly troublesome was the rights to intellectual property and the means to control them. Unlike most successful license ventures, InterlandData was a service organization which meant that the company could not control its licensees through inventory management, product quality, and techniques available to product-oriented licensors, and instead had to depend on the quality of management running licensed operations.

Niche market development.

This growth strategy involved knowing the end goals and prioritizing the most important markets and segments in vertical industries. Small businesses were not able to attract and train information technology (IT) professionals. They were looking for a vertical partner that could give them the much-needed IT expertise required to expand their online businesses. To fulfill this need, Web hosting firms needed to have experienced staff fully knowledgeable of how their customers' businesses operated, or had staff that previously worked within those niche markets. Furthermore, staff should also be familiar with the latest beneficial technologies.

Customers were mainly non-profit organizations or small businesses that knew little about web design and web hosting. Most small businesses were looking for a Web hosting firm, which specialized in their markets. According to Robin Britt in Nexus Technology, "In order to create a niche demand, you must first listen to the needs of the clients, then educate them about your services." The central theme was that no special advertising was done. For some, superior customer service and word of mouth was the key to their success. "We don't do any formal advertising. Our work speaks for itself. Most of our business is referral and they hear about us by word of mouth," stated Ashleigh Brown of Sites Computer. Also, Matthew Latterell of NetCorps stated, "Reputation is everything. Most people when selecting a web host or design go with who they know or who they trust."

Market penetration.

This growth strategy involved aggressive marketing for InterlandData's products and services. One way in which the company could have increased its market share was to have increased advertising. Special sales promotions, the addition of sales staff and increased publicity through community reinvestment activities were ways in which the company could have increased its market share. Another alternative for aggressive marketing was to consider outsourcing its marketing functions. The marketing agency could assist the company in developing a marketing plan and execution of advertising plans. Large marketing firms had a worldwide footprint and the ability to spread the news in every major market around the globe. By outsourcing its marketing function, InterlanData would only focus on building a solid, secure, reliable infrastructure, and retaining the staff that could deliver on its promise. However, the marketing services that have both the technical knowledge of web hosting business and experience serving foreign markets would command higher fees for their services.

FUTURE DIRECTIONS

With all of these alternatives facing them, Mark and Susan knew they had to make some choices and begin planning InterlandData's future. With financial and managerial resources a primary concern in this decision, the question was which direction to choose and how to best plot a path toward a successful future. To Mark and Susan, none of the choices sounded all that great. Maybe there was something they were missing.

DISNEY'S RESPONSE TO THE NEW GOVERNANCE LANDSCAPE

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CASE DESCRIPTION

The primary subject matter of this case is corporate governance, and The Walt Disney Company is used as an example of the strengths and weaknesses that can be found in governance systems. Secondary issues examined include CEO role duality, board independence, entrenchment, and succession planning. The case has a difficulty level of four and is most appropriate for undergraduate or graduate-level business education, either in strategic management or leadership. It is designed to be taught in 1½ class hours and is expected to require 1-2 hours of outside preparation. Specifically, students should first become familiar with the federally-legislated Sarbanes-Oxley Act of 2002 and would be well-served to read the case titled Michael Eisner and his Reign at Disney, which can be found in this issue. The case here seeks to demonstrate that what appears to be strong governance may in fact be a facade, by elucidating the subtle components of corporate governance that can slip under the radar but which are crucial if governance is to be effective. When is meeting the letter of the law enough, and how is that determined by shareholders?

CASE SYNOPSIS

This case discusses the corporate governance practices at The Walt Disney Company. It discusses the company's governance issues and mechanisms prior to the breakout of scandalous activity in corporate America, which began with the crisis at Enron in 2001. We discuss the years that immediately followed, with particular attention to the changes in the governance landscape – that is, the new expectations imposed on US businesses, either voluntarily or by federal legislation or stock exchange regulation. Among the topics discussed are board independence and board size, fees for services, succession planning, diversity, entrenchment, and CEO duality. We then address the steps that The Walt Disney Company has taken towards complying with these new rules, not only to highlight how far the company has come but also to show how much more needs to be done in order to restore investor confidence and corporate reputation. In a separate case in this issue, we discuss the conflicts that arose among the company's CEO and two of its board members, which may have contributed significantly to negative perceptions regarding Disney's governance practices.

INTRODUCTION

Accordingly, the Board of Directors of the Company recommends that you vote AGAINST this proposal, and your proxy will be so voted if the proposal is presented unless you specify otherwise www.disney.com).

So went the board recommendation regarding each of the more than 10 shareholders' proposals from 1999 to 2003. This, together with a downward trend in the company's stock, may find shareholders taking pause as to whether Disney's board of directors is truly aligned with the company's owners and whether the board is fulfilling its role in the governance process. Few would refute the value Disney provides to consumers. The company creates magic and commands a premium price for its products and services across its varied lines of businesses. But, as mentioned above, not all stakeholders have cause to celebrate. Revenue for Disney increased at a steady rate from 1994-2004, yet profits dwindled. As a shareholder, consider this – $10,000 invested in 1998 had a value of $4,878 five years later, representing an average annual loss of 15.44%. If such an investor held 200 shares, he would have had little clout with the board of directors in initiating any changes.

With the number of shares outstanding significantly diffused among investors, there were only rare instances of concentrated ownership. However, with institutional ownership on the rise, at 67 percent of all outstanding shares in 2003, large-scale investors had increasingly more voting power. Shareholder litigation escalated, and corporate governance at The Walt Disney Company has been vulnerable to media scrutiny. In 1996, the company was ranked Number 14 on *Business Week's* infamous list of "Worst Boards", and, in 1997, the same year in which Eisner had actually been booed by investors at a shareholders' meeting, Disney had the dubious honor of being named as the Number One worst board! Shareholders were not alone in criticizing the Disney board. Michael Useem, a management professor at the University of Pennsylvania's Wharton School, described it as "an egregiously bad board – a train wreck waiting to happen" (Byrne, 1997, pg. 94). Eisner's response to such attacks? As quoted in the *Business Week* article, "Eisner shows no signs of backing down. 'We have a fantastic board,' he insists, 'and I hope I'm not intimidated into changing the direction of the board'". Investors and analysts were not impressed by Eisner's overall response, and in 2000 the Disney board was again named the worst in the country. Although there have been a number of recent governance changes at Disney, many feel that the company has dragged its feet over the years in making significant improvements. Most notably, Eisner was still Chairman of the Board.

DISNEY'S GOVERNANCE PRIOR TO LEGISLATION

Composition of the Board of Directors

As of the company's proxy statement issued in 2003, all except four of the current directors were up for re-election to the Disney board. They were

John E. Bryson, 59, on the Board since 2000, has served as Chairman of the Board, President and CEO of Edison International, the parent company of Southern California Edison, an electric utility, since 1990. He was also a director of The Boeing Company, Pacific American Income Shares, Inc. and Western Asset Funds, Inc.

Roy E. Disney, 73, on the Board since 1967, has been Vice Chairman of the Board of Directors of Disney since 1984, and since November 1985 has also served as head of the Disney's animation department. He was also Chairman of the Board of Shamrock Holdings, Inc., an investment firm which, through its subsidiaries, was engaged in real estate development and the making of investments. He is also a nephew of company founder Walt Disney.

Michael D. Eisner, 60, on the Board since 1984, has served as Chairman of the Board and CEO since 1984. Prior to joining the company, he was President and COO of Paramount Pictures Corporation. Prior to joining Paramount in 1976, he was Senior VP of Prime Time Programming for ABC Entertainment.

Judith L. Estrin, 48, on the Board since 1998, was the President and CEO of Packet Design, LLC, a company that she co-founded in May 2000 to develop networking technology. She served as Chief Technology Officer and Senior VP at Cisco Systems, Inc., from 1998 until April 2000, and as President and CEO of Precept Software, Inc., which she co-founded, from 1995 until its acquisition by Cisco in 1998. She was also a director of FedEx Corporation and Sun Microsystems, Inc.

Stanley P. Gold, 60, on the Board since 1987, was President and CEO of Shamrock Holdings, Inc. and Shamrock Capital Advisors, Inc. He also served as Chairman of Tadiran Wireless Communication Industries, Ltd., a manufacturer of wireless communications products, and was a director of Pacific Dunlop Limited, a diversified manufacturer of healthcare products and tires.

Robert A. Iger, 51, on the Board since 2000, has served as President and CEO of Disney since January 2000, having previously served as president of Walt Disney International and Chairman of the ABC Group. From 1974 to 1998, Mr. Iger held a series of increasingly responsible positions at ABC, Inc., and its predecessor Capital Cities/ABC, Inc., and was President of the ABC Network Television Group from 1993 to 1994 and President and COO of ABC, Inc., from 1994 to 1999. He was a member of the Board of Directors of Lincoln Center for the Performing Arts in New York City.

Monica C. Lozano, 46, on the Board since 2000, was President and COO of La Opinion, the largest Spanish-language newspaper in the Los Angeles metropolitan area, and Vice President of its parent company, Lozano Communications, Inc. She was a member of the Board of Regents of the University of California and a trustee of the University of Southern California. She was a trustee of Sun America

Asset Management Corporation and a director of Union Bank of California, the California Health Care Foundation and Tenet Healthcare Corporation.

Robert W. Matschullat, 55, on the Board since 2002, was a private equity investor, served from October 1995 to June 2000 as Vice Chairman of the Board of the Seagram Company, Ltd. He also served as CFO of Seagram until January 2000. Prior to joining Seagram, he was head of worldwide investment banking for Morgan Stanley& Co., Inc., and was one of six management members of the Morgan Stanley Group board of directors. He was also a director of The Clorox Company and McKesson Corporation.

George J. Mitchell, 69, on the Board since 1995, was a partner of the law firm of Piper Rudnick LLP in Washington, D.C., and senior counsel to Preti, Flaherty, Beliveau & Pachios in Portland, Maine. He previously served as Chairman of the law firm Verner, Liipfert, Bernhard, McPherson & Hand in Washington, D.C., which merged with Piper Rudnic in 2002. He served as a US senator from 1980 to 1995 and was Senate Majority Leader from 1989 to 1995. He was a director of FedEx Corporation, Staples, Inc., and Starwood Hotels & Resorts. He has also served as Chairman of the Peace Negotiations in Northern Ireland and the International Fact-Finding Committee on Violence in the Middle East. Mr. Mitchell has served as a consultant to Disney and was known to be very closely aligned with Michael Eisner.

Thomas S. Murphy, 77, on the Board since 1996, was Chairman and CEO of Capital Cities/ABC, Inc., from 1966 to 1990 and from February 1994 until his retirement in 1996. Mr. Murphy was also a director of Doubleclick, Inc., a provider of internet advertising services.

Leo J. O'Donovan, S.J., 68, on the Board since 1996, was president Emeritus of Georgetown University, having served as president of the university from 1989 to 2001. Father O'Donovan has served on a number of high education boards, including that of the Association of Catholic Colleges and Universities, and on the Board since 1974, was a member of the Steering Committee of Presidents for the American Reads initiative. He also was a former member of the national council on The Arts of National Endowment for the Arts, past chair of the Consortium on Financing Higher Education and past president of the Catholic Theological Society of American.

Raymond Watson, 76, on the Board since 1974, has served as chair of the executive committee of the Disney's board since 1984 and was Chair of the Board from May 1983 to September 1984. Since 1986, Mr. Watson has been Vice Chairman of the Board of the Irvine Company, a land development company. From 1985 to 1986, he was Regents Professor in the Graduate School of Management at the University of California, Irvine. He was also chairman of the Public Policy Institute of California, a non-profit public policy research institute.

Gary L. Wilson, 63, on the Board since 1985, has been Chairman of the Board of Northwest Airlines Corporation since 1997, having served as co-chair of the board from 1991 to 1997 and as a director since 1989. From 1985 to 1989, he was Executive Vice President and CFO of Disney. Mr. Wilson was a director of CB Richard Ellis, Inc., a commercial real estate services, company, and Yahoo! Inc. He also served on the board of trustees of Duke University and the board of overseers of the Wharton School at the University of Pennsylvania.

For 20 years, Michael Eisner has filled the roles of both CEO and Chairman of the Board, a practice often criticized for its potential to create conflicts of interest. Further conflicts of interest may have arisen from directors' relationships with Eisner or The Walt Disney Company (See Table 1). Shareholders view such connections with suspicion, wondering whether directors can truly be open or even confrontational without fear of sabotaging the relationship. Further, two board members, Roy Disney and Stanley Gold, expressed concerns over a lack of in-house talent to succeed Eisner when the time comes, as a stream of executives had departed Disney for top spots elsewhere.

Table 1: Potential Conflicts of Interest at Disney
Robert A.M. Stern Architects, of which Mr. Stern is Senor Partner, was retained by the Company, for a variety of architectural services to Disney and its license and other affiliates. Among these were Oriental Land Co., Ltd, which owns and operates Tokyo Disneyland, and Euro Disney S.C. A., the French company that owns and operates the Disneyland Paris Resort, and a new resort development at Walt Disney World in Florida. Stern's firm received the following from either Disney or its licensees for services rendered: $459,963 in 1998; $71,731 in 1999; $318,562 in 2000; $76, 513 in 2001; and $105,668 in 2002.
Senator George Mitchell has provided consulting services to The Walt Disney Company with regard to international business operations and development efforts, and for service rendered received $50,000 in each of the years from 1998 to 2001. In addition, the Company retained the law firm of Verner, Liipfert, Bernhard, McPherson & Hand of which Mitchell was special counsel, and paid the following for services rendered: $766,020 in 2000; $1,279,425 in 2001; and $442,872 in 2002.
In 2002, Jennifer Gold, daughter of director *Stanley Gold*, was employed by a subsidiary of The Walt Disney Company in the capacity of senor marketing manager. Ms. Gold received $94533 in salary and bonus for the year.
In 2002, David Watson, son of director *Raymond Watson*, was employed by a sub of The Walt Disney Company in the capacity of executive director for new media, and received $175,917 in salary and bonus for the year.
In 2002, Louise Bryson, wife of director *John Bryson*, served as Executive President- Affiliate Sales and Marketing for Lifetime Entertainment Television, in which Disney has a 50% equity stake. She received $386,483 in salary and allowances for the year.
Air Shamrock, owned by Shamrock Holdings, Inc., received $623,782 in reimbursement for the use of its aircraft in 2002. Specifically, travelers included director Roy Disney and those directors and employees who accompanied him. Director *Roy Disney* is both a director and owner (along with his family) of Shamrock Holdings, and director *Stanley Gold* is President and CEO of Shamrock Holdings and is a director of Air Shamrock.
Eugene Bay, father-in-law of Disney President and director *Robert Iger*, is a principal of Eugene Bay Associates, Inc., a marketing company that was retained by Disney subsidiary ESPPN since 1990 to provide sports marketing services. Mr. Bay's company received $69,892 for services provided in 2002.
Director *Thomas Murphy*, former Chair of Capital Cities/ABC, Inc., prior to its acquisition by Disney, received secretarial and transportation from ABC in 2002 at a cost of $202, 150 to The Walt Disney Company.
Source: Walt Disney proxy statements filed with SEC, 2000-2004.

Summary tables of the composition of the Disney board are provided in Tables 2 and 3. Table 2 reflects representation on each of the board's committees, which include the Executive Committee, Compensation Committee, Executive Performance Subcommittee, Audit Committee, Nominating Committee, and Capital Stock Committee. Table 3 provides information on the number of other directorships held by board members over the five-year period ending in 2003, indicating that several directors had served on multiple boards simultaneously and therefore may have been overcommitted.

Table 2: Committee Composition of the Disney Board of Directors, 1999-2003

Directors *	Committee Membership					
	Executive	Compensation	Executive Performance Subcommittee	Audit	Nominating	Capital Stock
Reveta F. Bowers		1999–2002	1999-2002	1999–2002	1999-2000	
John E. Bryson		2002–2003	**2002**	2002	2002, **2003**	
Roy E. Disney	1999-2003					
Michael D. Eisner	1999-2003					
Judith L. Estrin		2002, **2003**	2002	1999–2002	2001-2003	
Stanley P. Gold		1999-2001	**1999–2001**		**1999-2002**	
Robert A. Iger						
Sanford M. Litvack						2000-2001
Igancio E. Lozano, Jr.			1999–2001	**1999-2000**, 2001		
Monica C. Lozano				2002-2003	2003	
Robert W. Matschullat				**2003**		
George J. Mitchell				1999-2000	1999-2002	**2000**, 2001
Thomas S. Murphy	1999-2003	**1999-2002**		2001-2002		
Leo J. O'Donovan, S.J.		2003		1999-2000, **2001-2002**, 2003		2000-2001
Sidney Poitier		1999–2003	1999–2001			
Irwin E. Russell	1999-2001					
Robert A.M Stern						
Andrea Van de Kamp		2001–2002		2001-2003	1999-2002	
Raymond L. Watson	**1999-2003**	1999-2002		1999-2003		
Gary L. Wilson					1999-2003	2000-2001

* Shading denotes directors who are considered to be insiders, defined by their employment (past or present) with The Walt Disney Company or any of its affiliates or acquired companies.
** Dates which are bold type indicate committee chairmanship.
*** The following directors retired from the Disney board in 2003: Reveta F. Bowers, Sidney Poitier, Robert A.M Stern, and Andrea Van de Kamp.
Source: Disney 10-K filings, http://Disney.go.com/home accessed February 3, 2005

Table 3: Directorships Among Disney Board Members, 1999-2003

Directors	Number of other Directorships				
	1999	2000	2001	2002	2003
Reveta F. Bowers	Many	Many	Many	Many	
John E. Bryson ***			6	5	4
Roy E. Disney [a, ***]	1	1	1	1	1
Michael D. Eisner [b, ***]	0	0	0	0	0
Judith L. Estrin, ***	2	2	2	2	2
Stanley P. Gold, ***	0	0	0	2	2
Robert A. Iger, ***			2	2	1
Sanford M. Litvack [c]	0	0			
Igancio E. Lozano, Jr.	Many	Many			
Monica C. Lozano, ***			6	6	6
Robert W. Matschullat, ***					2
George J. Mitchell, ***	6	6	6	6	3
Thomas S. Murphy, ***	0	2	2	2	1
Leo J. O'Donovan, S.J., ***	Many	Many	Many	0	0
Sidney Poitier	0	0	0	0	
Irwin E. Russell	2	2			
Robert A.M Stern	0	0	0	0	
Andrea Van de Kamp	5	6	6	6	
Raymond L. Watson [d, ***]	6	1	2	2	1
Gary L. Wilson, ***	5	4	5	6	5

*** Up for re-election in 2003.
[a] Roy Disney served as Vice Chairman of the Disney board for all five years.
[b] Michael Eisner served as Chairman of the Disney board for all five years.
[c] Sanford M. Litvack served as Vice Chairman of the Disney Board, along with Roy Disney, in the year 2000.
[d] Raymond L. Watson is a past Chairman of the Disney board.
Source: Disney 10-K filings, http://Disney.go.com/home accessed February 3, 2005

Board Scrutiny and Shareholder Activism

Day-to-day governance of corporations often goes unnoticed, but Disney's poor performance in the board rankings, together with its declining performance on Wall Street, captured the attention of shareholders. Top-level decisions were called into question and shareholder litigation broke out in full force. In reviewing some of the recent litigation faced by Disney, the potential impact of disgruntled shareholders is highlighted.

In 1991, the Winnie the Pooh franchise owners filed a suit against Disney, seeking damages and threatening to take away the license it gave to Disney for having shortchanged them on royalties. To the dismay of Disney shareholders, the pending lawsuit and its potential implications were not disclosed until May 2002. Shareholders allege that this nondisclosure constituted a fraud on the market that artificially inflated the stock price, only to see it decline after the disclosure. Purchasers of Disney common stock between August 1997 and May 2002 have filed a class action suit against the Disney Company, its CEO (also a board member) and its CFO.

In a more publicized lawsuit, in 1997 shareholders in Delaware and California filed suit against the board, attacking the employment and termination agreements of former president Michael Ovitz. An Eisner crony, Ovitz was said to have been hired unilaterally in 1995, with Eisner informing only three board members of the decision. Ovitz assumed the position while his employment agreement was still under negotiation and left the company one year later, having worked with Eisner to extract the maximum benefit from his contract. The package, which included approximately $93 million in cash and stock options, has shareholders up in arms, and they blame the directors, who "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision." The risks may be theirs alone, as insurers increasingly add exclusions to their D&O (Directors' and Officers') liability policies regarding executive compensation litigation.

Disney shareholders were also considering litigation over Eisner's new, ten-year employment package which had awarded him an additional $195 million in stock options. Eisner's existing options, valued at $358 million as of 2003, and his total Disney pay to that date exceeding $1 billion, have raised eyebrows. With board members whose relationships may find them beholden to Eisner, including his lawyer, his architect, and his sons' school principal, there have been questions as to whether his longevity and pay can truly be attributed to his performance.

GOVERNANCE IN THE NEW MILLENNIUM: THE CHANGING LANDSCAPE

In recent years the governance landscape has undergone a multitude of changes, and, what was once considered poor or weak governance – and even unethical -- is now illegal. Corporate governance is now regulated by the Sarbanes-Oxley Act of 2002, which introduced a set of new rules that corporations must implement over the next few years, although these rules do not apply to firms with fewer than 300 employees. Rules proposed by the New York Stock Exchange (NYSE) and the Nasdaq in 2002 were approved by the Security and Exchange Commission (SEC) on November 4, 2003. Companies listed on each of these exchanges must answer to their respective standards as well as to those mandated through the federal Sarbanes-Oxley legislation.

Federal Legislation

The Sarbanes-Oxley Act requires that the board's audit committee include at least one financial expert (defined as someone who has or does serve as an accountant, auditor, or CFO), and that all audit committee members be independent of the company. It also requires that the audit committee set up procedures that will allow whistleblowers to submit information about suspect financial and/or auditing practices in a manner that will guarantee confidentiality and anonymity, and that these procedures are made public. Further, the Act requires rotation and reviewing of the firm's auditor every five years. In addition, auditing firms are prohibited from providing the following services to their client firms: bookkeeping, financial information systems design and implementation, appraisals or valuation services, actuarial services, internal audit outsourcing services, management and human resources services, broker/dealer and investment banking services, and legal or expert services unrelated to the audit service. Any other non-audit services, including tax services, require pre-approval by the audit committee. The federal Sarbanes-Oxley legislation does not address nominating committee requirements, nor does it set forth any requirements for a board's compensation committee.

Stock Exchange Regulation

Both the Nasdaq and the NYSE require its listing companies to post codes of conduct to their corporate websites. In fact, the NYSE requires the development and disclosure of governance guidelines as well. Both exchanges insist that the majority of board members be independent directors. As for the election of board members, Nasdaq requires that the selection process be controlled by independent directors, whereas the NYSE requires that the nomination committee be composed entirely of independent directors. Additionally, both require at least one executive session each year, with no insider directors present, and both require that all equity compensation plans and all repricing of underwater stock options be approved by shareholders. Finally, firms listed on the NYSE must investigate any audit committee members who serve on the audit committee of more than three boards.

DISNEY'S RESPONSE TO THE NEW GOVERNANCE LANDSCAPE

In September 2002, Michael Eisner began traveling the country to meet with powerful investors and shareholder rights groups in an attempt to shore up the company's reputation (Grover, 2002). He also sought the advice of Ira Millstein, a leading authority on corporate governance, and began making a variety of changes to Disney's governance structure. According to the board, the directors, along with senior management are "committed to the highest standards of corporate governance." As a strong improvement over 1997 and 1998, in 2002, Disney made the *Business*

Week list of "most improved" boards. Many of the changes, which are listed below, address the new regulations directly. Others respond to what had been deemed "best practices" and thus are meant to enhance the company's ability to comply with the new mandates.

Independence and Board Size

In addition to a reduction in board size (from 17 to 13), Disney sought to better its board by reducing the size of committees, with committee chairs and members rotating among independent directors and by posting its governance guidelines to the company's website. The company's own governance guidelines state that only independent directors may serve on the Audit, Compensation and Governance and Nominating Committees, and that at least half of the members of the Executive Committee must be independent. Disney welcomed former Seagram Vice Chairman Robert Matschullat to chair the Audit Committee. He had no apparent ties to Eisner, and his strong background in finance should appease investors. Non-employee board members are now required to own $100,000 of company stock and are also required to meet outside of the presence of management. Disney also adopted a more rigorous definition of director independence and now requires that a "substantial majority" of the board be comprised of directors meeting the new criteria. In a letter to investors in February 2003, the board emphasized its commitment to director independence, which it believes will help assure that the board acts in the best interest of shareholders and hold management accountable and responsible.

Table 2 indicates that only five of the 13 board members up for re-election in 2003 were considered insiders, according to Disney's new standards for independence. Eisner, Iger and Disney were considered inside directors because of their employment as senior executives of the company. The board concluded that Stanley Gold was not independent due to his significant relationship with Roy Disney. Gold, whose daughter works for Disney, is CEO of Shamrock Holdings, the Disney family's investment company. This cost him his position as chair of the powerful Governance and Nominating Committee. Robert A.M. Stern similarly was not independent because of architectural services that he had been providing to Eisner, although Stern retired from the board in 2003. George Mitchell, the other fees-for-services recipient, was deemed independent. He will now serve as presiding director, an outsider position, created to alleviate concerns over Eisner's dual roles as CEO and Chairman of the Board.

Other directors who are not returning are Reveta Bowers (the elementary principal of the school once attended by Eisner's sons), actor Sidney Poitier (who, missing 25% of the 1996 Disney board meetings, was named as part of the 1997 *Business Week* best-and-worst-boards story as one of the ten directors who had the worst no-show records), and Sotheby's West Coast CEO Andrea Van de Kamp.

Fees for Services

In the wake of the accounting scandal at Enron, Disney announced its decision to split the auditing and consulting functions, whereby it will no longer purchase consulting services from PricewaterhouseCoopers LLC, the company that audits its books. In 2001, Disney paid PWC $8.6 million in auditing fees and about $31.9 million in other fees, including consulting, an arrangement increasingly viewed by the public as a possible conflict of interest. In addition, Disney announced it would no longer pay two board members, architect Robert A.M. Stern and attorney George J. Mitchell, for professional services. Stern's firm collected more than $2.5 million in design fees from Disney and its affiliates since 1996, and Mitchell's law firm has received nearly $2.2 million for lobbying. Mitchell, a former senator, was also paid by Disney for his consulting services.

Succession Planning

Disney is also addressing criticisms regarding inadequate succession planning and a lack of qualified, finance-savvy directors. As part of the new order, Disney's CEO is required to meet with outside board members at least once a year to discuss potential successors. The CEO must also "have in place at all times a confidential written procedure for the timely and efficient transfer of his or her responsibilities in the event of his or her sudden incapacitation or departure . . ." As of May 2003, there had not been any public announcement of Eisner's successor. Stanley Gold maintained that the board has never had a serious discussion about the CEO's successor, and that the "confidential written procedure" consists of Eisner having the name of his successor in a sealed envelope in his desk.

Diversity, Entrenchment, Duality and Number of Directorships

In 2002 Disney's board approved mandatory retirement guidelines for non-management directors at age 72 (with the exception of former Disney CEOs, who will be allowed to serve on the board until 75 years of age). No term limits had been set, however. Directors with full-time jobs elsewhere are limited to serving on three public boards at a time, and directors who are retired from active employment are limited to six. The 2003 13-member Disney board had two females (Judith Estrin and Monica Lozano), for a total of five female directors since 1999. Two directors since 1999 have been African-American (the actor Sidney Poitier, and the elementary school principal Reveta Bowers), and two Hispanics have served on the board in that time (Igancio Lozano, Jr., and Monica Lozano).

Regarding role duality, as of the end of 2003, Eisner had refused to step down as chairman of the board. Instead, former Senator Mitchell was appointed presiding director when the board meets without the Disney executives for the required executive sessions. In addition, the company announced that it would provide orientation programs for new directors, a relatively underused procedure generally lauded by governance experts, both to familiarize them with the company's businesses and to develop and maintain skills necessary to perform their responsibilities.

> "We have established governance as a high priority at Disney for one simple reason-it's the right thing to do. By investing in Disney, shareholders are placing their trust in the board to help shape the overall course of the company's business and to hold management accountable for its performance. In the end, governance is all about creating an environment that promotes informed, objective decision-making in the interests of all shareholders." (George Mitchell, Disney board member and presiding director)

CONCLUSION

Disney had come a long way since 1996 when it received publicity as one of the worst corporate boards in America. As it became clear that governance had the potential to make or break investor confidence, Disney initiated several changes, and continued to do so as required by law. Perhaps the most serious charges against Disney's board had been directed at its lack of independence, so Disney set out to alleviate this perception. The question is whether the new board of directors is truly a more independent one, or whether the directors have just been conveniently relabeled so as to appear that way. Senator Mitchell, for example, received fees from The Walt Disney Corporation for his consulting services only one year prior to replacing Eisner as Chairman. He was deemed independent, of course, unlike Robert Stern, who provided architectural services to the company. In another move, this time presumably to reduce the overall board size, director Andrea Van de Kamp was asked to step down. However, she claims that she was forced off against her will. In a memo to other directors, Van de Kamp said that her ouster "gives the appearance that rubber-stamping Michael's decisions is an unwritten prerequisite for continued board membership." Attorney Bert Field, who has opposed Disney in several high-profile cases, agrees that board members have tended to go along with Eisner. These and other examples have cast doubt on the motives behind these reforms. Were the actions and motions transparent, a result of forced pressure, or would the changes allow for real improvement in the operation of the Board? Only time, and Wall Street, will tell.

ASSIGNED QUESTIONS

1. Review The Walt Disney Company's definition of board independence, which can be found on the company's website. Are there any inconsistencies in the way "insider" and "independent" are defined? Which directors could be seen as taking advantage of those loopholes?

2. Using the Internet,research the events that led up to Congress enacting the Sarbanes-Oxley Act in 2002. In addition to the citations you find in your general search, explore the SEC website for information (www.sec.gov).

3. Evaluate the Disney board against the following governance components: age and diversity, and the number of other boards on which the directors serve.

4. Select two or three of Disney's key competitors, such as Viacom, AOL Time Warner, and/or GE. Other competitors can be found in annual listings of the Fortune 500 companies, among other places.
   a. Since 1996, Business Week has surveyed industry experts four times to create lists of the best and worst boards (the four issues were published in Nov. 25, 1996; Dec. 8, 1997; Jan. 24, 2000; and Oct. 7, 2002). How did Disney's rankings change over time? How did they rank compared to the key competitors you identified?
   b. Consider the issue of board independence. How do the criteria used by Disney's competitors compare to that used by Disney? When did board independence begin to be an issue for these companies? You will need to review proxy statements (especially the 2002 and 2003 proxy statements) which can be accessed from the SEC website (www.sec.gov).

5. Entrenchment refers to the unchanging composition of the board, which can lead to stagnation and apathetic board performance, as opposed to the stimulation of ideas and diverse perspectives. Evaluate the extent to which the board and its committees are entrenched.

6. Briefly examine investor confidence in Disney at the end of 2003. Compare Disney to the market—has it suffered in the past few years? What might be expected in the next 2-3 years given the corporate governance issues facing the company?

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ALZA CORPORATION: A CASE STUDY CONCERNING R&D ACCOUNTING PRACTICES IN THE PHARMACEUTICAL INDUSTRY

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CASE DESCRIPTION

The primary subject matter of this case concerns variable interest entities (VIEs), accounting for research and development (R&D) arrangements, and consolidated financial statements. The case has a difficulty level of four for five, appropriate for senior or first-year graduate level. The case is designed to be taught in one class hour and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

This case illustrates the innovative off-balance sheet financing techniques used by ALZA Pharmaceuticals Corporation in the 1990s to fund its R&D activities. The case shows that, although ALZA technically adhered to generally accepted accounting principles (GAAP) in effect at the time, its financial statements failed to reflect economic reality by overstating revenues and net income. The case is a prime example of how accounting for VIEs prior to current GAAP failed to capture economic reality. The case details two of ALZA's R&D funding arrangements, illustrates the accounting practices used to capture them, and evaluates the manner in which their results were reported in the financial statements. Furthermore, the accounting and reporting procedures used will be compared to those required by ARB No. 51, Consolidated Financial Statements, FASB Interpretation No. 46(R) Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51, and EITF 99-16, Accounting for Transactions with Elements of Research and Development Arrangements. This comparison will help students understand the relevance and need for the new pronouncements.

INTRODUCTION

ALZA Pharmaceuticals Corporation was incorporated under the laws of the State of California on June 11, 1968. Its founder, Alejandro Zaffaroni, was a member of the scientific team that invented the birth control pill (Moukheiber 1999). By mid-1980 the company had developed into a leading provider of controlled-dosage drug delivery systems ranging from skin patches to low-current electric devices that administer drugs through the skin. ALZA is responsible for such world-class delivery systems as "the patch" for Nicoderm CQ, the leading smoking cessation drug. Other drugs utilizing ALZA's technology include Procardia XL, an oral angina/hypertension treatment, and Sudafed 24, an over-the-counter allergy medication.

Prior to the 1990's ALZA's revenues consisted solely of royalties from sales of other companies' products that used ALZA's delivery systems. Early in the decade, ALZA devised a plan to complement its already existing drug delivery systems by developing its own drug products thereby becoming a fully integrated pharmaceutical company. To accomplish its objective, ALZA adopted an off-balance sheet strategy to finance the required R&D activities. During the years 1993 through mid-1997, its required R&D activities were provided through Therapeutic Discovery Corporation (TDC), a development-stage company formed by ALZA. In 1997, ALZA dissolved TDC and created a, a similar development-stage company, Crescendo Pharmaceuticals Corporation, for the same purpose. Crescendo operated during the years 1997 through 2000, after which that company was dissolved. The following paragraphs explain the details of the TDC and Crescendo arrangements and discuss the methods used by ALZA to account for the activities and report the results of the two corporations.

THE TDC ARRANGEMENT

In late 1992 and mid 1993, ALZA created TDC by paying $250 million for the new corporation's common stock. ALZA retained ownership of 100 shares of Class B Common Stock and issued approximately 7.7 million shares of Class A Common Stock to ALZA shareholders as a special dividend of units. Each unit consisted of one share of TDC Class A Common Stock and one warrant to purchase one-eighth of one share of ALZA common stock at an exercise price of $65 per share. The TDC Class A Common Stock and the ALZA warrants were listed and traded independently on the NASDAQ stock market. TDC's 1993 Form 10-K filed with the SEC stated that the value of the units was $44.9 million and that the value of TDC's stock apart from the units could not be ascertained.

TDC's 1993 10-K states that TDC owned no facilities and leased corporate offices from ALZA. TDC's executive officers included: Gary Neil, President and Chief Executive Officer; David R. Hoffmann, Vice President of Finance and Secretary; and Suzanne C. Martin, Vice President of Research and Development Administration. At the time, Mr. Hoffmann and Ms. Martin served as officers of ALZA as well. Mr. Hoffmann was Vice President and Treasurer of ALZA Corporation, and Ms. Martin was Senior Director of Research and Development Administration of ALZA. The two provided services to TDC under the agreement with ALZA, but received no compensation from TDC.

To record the contribution of $250 million to TDC's capital and the distribution of TDC stock to ALZA shareholders, the following journal entries were made on each company's books:

TDC (in millions)			ALZA (in millions)		
Cash	250		Retained Earnings	36.6	
Paid-in Capital		250	Paid-in Capital	213.4	
			Cash		250

ALZA's financial statements for 1993 reflected the $250 million contribution to TDC in its statement of stockholder's equity as a $36.6 million charge against retained earnings and a $213.4 million charge against paid-in capital. In its 1993 statement of cash flows, ALZA listed a negative cash flow of $250 million labeled "Contribution to TDC" in the financing activities section.

TDC's Form 10-K filed with the SEC explained how R&D activities would be provided and financed. During TDC's existence, TDC would be required to use the entire $250 million received from ALZA (plus any investment income earned thereon less organization costs and administrative expenses) on the development of TDC products. ALZA would specify the products to be developed by TDC and provide the actual R&D activities. TDC would then make payment to ALZA for providing those activities. Therefore, ALZA's $250 million investment in TDC would flow back to ALZA as R&D revenue.

Table 1 shows the Product Development Revenue recorded on the books of ALZA and the R&D Expense recorded on the books of TDC during the years 1993 through 1997. As shown, the total revenue recorded by ALZA was $275.1 million while the total expense recorded by TDC was $254 million.

Table 1: Comparison of ALZA R&D Revenue and TDC R&D Expense (in millions)

	1993	1994	1995	1996	1997	Total
ALZA's Product Development Revenue from TDC	$4.9	$31.6	$70.1	$100.7	$67.8	$275.1
TDC's R&D Expense to ALZA	$4.9	$31.6	$68.9	$100.0	$48.6	$254.0

When preparing its consolidated financial statements, ALZA did not include the assets, liabilities, equity, revenue, or expense accounts of TDC; therefore, the financial results reported in TDC's financial statements were not reflected in ALZA's consolidated financial statements. TDC received an unqualified audit opinion for each year of its existence.

When ALZA formed TDC, it retained the right to purchase all (but not less than all) of TDC's Class A Common Stock at any time during the period ending on December 31, 1999. This period would be extended if TDC had not used at least 90 percent of the available funds initially supplied by ALZA. If ALZA exercised its right to purchase TDC's Class A Common Stock, the purchase price would be determined by a formula as the greatest of four different computations. During the period of TDC's operation, ALZA, as the sole holder of the Class B Common Stock, was entitled to vote separately as a class to prevent any merger or liquidation of TDC or the sale, lease, exchange, transfer or other disposition of any substantial asset of TDC.

By mid-1997, TDC had exhausted most of its funds and ALZA purchased TDC's Class A common stock held by ALZA stockholders for $100 million. ALZA's creation and use of TDC as an R&D vehicle had several economic benefits. ALZA benefited by reporting Product Development Revenue of $275.1 million on its statement of income, which bolstered critical Wall Street revenue and earnings ratios. ALZA shareholders benefited by receiving TDC's Class A Common Stock for zero investment. Although they received no dividends during TDC's operation, they did receive the $100 million paid by ALZA when the company purchased the TDC Class A Common Stock in September 1997.

THE CRESCENDO ARRANGEMENT

After TDC was liquidated in 1997, ALZA sought to duplicate the success of that venture by creating another development-stage company, Crescendo Pharmaceuticals Corporation. In this arrangement, ALZA paid $300 million for Crescendo's common stock, retained ownership of 1,000 shares of Crescendo Class B Common stock, and distributed approximately five million shares of Crescendo Class A common stock to holders of ALZA's common stock and convertible debentures. As in the previous arrangement with TDC, Crescendo Class A common shares were traded on the NASDAQ stock market separately from the ALZA stock. Crescendo's 1997 Form 10-K listed the value of the Class A Common Stock as approximately $57.7 million.

Crescendo's 1997 Form 10-K filed with the SEC states that the company relied on ALZA for personnel, facilities, and administrative services, including accounting and legal services. The officers of Crescendo were the same as for TDC. Dr. Gary Neil was Crescendo's President and Chief Executive Officer; David R. Hoffmann was the Vice President of Finance and Secretary, and Suzanne C. Martin was the Vice President of Research and Development Administration. As in the TDC arrangement, Mr. Hoffmann and Ms. Martin also served as officers of ALZA. Mr. Hoffmann was ALZA's Vice President and Treasurer, and Ms. Martin was ALZA's Vice President of Development Programs. They provided services to Crescendo under the agreement with ALZA, but received no compensation from Crescendo.

The following journal entries were made on the books of each company to record the contribution of $300 million to Crescendo and the distribution of the Crescendo stock to ALZA shareholders:

ALZA's financial statements for 1997 reflected the formation of Crescendo somewhat differently than the formation of TDC had been. The formation of Crescendo affected ALZA's income statement in addition to the statement of stockholder's equity and statement of cash flows. The income statement reflected a $247 million one-time charge against earnings, and the statement of stockholders' equity listed a $49.1 million decrease to retained earnings. The statement of cash flows showed a $49.1 payment labeled “distribution of Crescendo shares to ALZA stockholders” in the financing activities section. To make the entry balance, there must have been a debit of $3.9 million to some other account. The identity of this account is not disclosed in the financial statements or notes. The income statement does, however, indicate an $8 million distribution to debenture holders, and this $3.9 million may very well have been included in that amount.

Crescendo (in millions)			ALZA (in millions)		
Cash	300		Contribution to Crescendo	247	
Paid-in Capital		300	Retained Earnings	49.1	
			??	3.9	
			Cash		300

At the time of the Crescendo’s creation, Crescendo and ALZA entered into a number of agreements, including a development agreement, a technology license agreement, and a license option agreement. The development agreement was similar to the one with TDC. It stated that ALZA would conduct product development and other related activities on behalf of Crescendo. Crescendo was required to spend the $300 million contributed by ALZA (plus investment earnings less Crescendo’s administrative costs and other fees) on activities under the development agreement. The initial products under the development agreement were products started under the TDC collaboration.

The technology license agreement granted Crescendo a worldwide license to use ALZA technology to develop Crescendo products. Under the agreement, ALZA received a monthly one million dollar technology fee from Crescendo for three years. The license option agreement granted ALZA the option to license each Crescendo product developed under the development agreement, and Crescendo was prohibited from licensing its products to any company other than ALZA.

Table 2 shows the product development revenue recorded on the books of ALZA and the R&D expense recorded on the books of Crescendo. Over the term of the agreement, ALZA recorded total product development revenue of $283.5 million, and Crescendo’s recorded total R&D expense of $278.2. Therefore, ALZA’s total revenue exceeded Crescendo’s total expense by $5.3 million over the term of the arrangement.

Table 2: Comparison of ALZA R&D Revenue and Crescendo R&D Expense (in millions)

	1997	1998	1999	2000	Total
ALZA’s Product Development Revenue from Crescendo	$29.7	$95.0	$90.5	$68.3	$283.5
Crescendo’s R&D Expense to ALZA	$32.3	$106.0	$97.7	$42.2	$278.2

At first glance, the numbers seem to be confusing since Crescendo's expense exceeds ALZA's revenue in all but the final year. Apparently there were some timing issues regarding ALZA's recording of product development revenue and Crescendo's recording of R&D expense. As with TDC, ALZA did not incorporate the assets, liabilities, equity, revenue, or expense accounts of Crescendo in its consolidated financial statements. In addition, Crescendo received an unqualified audit opinion for each year of its existence.

Crescendo's Restated Certificate of Incorporation prohibited Class A stockholders from taking or permitting any action that might impair ALZA's rights under the Purchase Option or increase Crescendo's authorized capitalization without ALZA's permission. In September 2000, with Crescendo's funds exhausted, ALZA exercised its option to purchase Crescendo's Class A common stock for $100 million.

As with the TDC arrangement, both Crescendo's Class A common stockholders and ALZA reaped several economic benefits. Crescendo's stockholders received no dividends during Crescendo's existence, but they did receive $100 million when ALZA exercised its purchase option. Since they received that stock at no cost, their investment was zero. ALZA's benefit was lessened in the Crescendo transaction since $247 million of the initial $300 million investment was charged to the income statement during the year of Crescendo's creation. The immediate charge to income, however, was softened somewhat by the commencement of revenue streams from TDC products. In addition, ALZA's subsequent recognition of R&D revenue once again bolstered critical Wall Street ratios.

SUMMARY

ALZA's financial reports disclosed the details of its relationship with TDC and Crescendo along with the amounts invested and revenue received from each. ALZA's financial reports stated that the revenue from the two companies were recorded on ALZA's books and reported in the financial statements. Financial reports also stated that when the revenue from the two companies was netted against the R&D expense reported in ALZA's income statements, those activities did not contribute significantly to operating results. The amounts included in ALZA's financial reports for R&D revenue, R&D expense, the one-time charge to income for the creation of Crescendo, and net income for the years of TDC's and Crescendo's operations are shown in Table 3. Note that the amounts of ALZA's R&D revenue received from TDC and Crescendo are given as well.

The TDC and Crescendo arrangements were very successful. Some of the products developed through these off-balance sheet arrangements include Ditropan XL for over active bladder, Concerta for hyperactivity, and the cancer treatments known as Viadur and Doxil. As a result of the TDC and Crescendo arrangements, ALZA did indeed become a fully integrated pharmaceutical company, and, in 2001, merged with the Johnson and Johnson family of companies in a tax-free reorganization treated as a pooling of interests for financial reporting purposes. As a result, ALZA no longer exists as a publicly traded company.

Table 3: Items Included in ALZA's Financial Reports (in millions)									
	1993	1994	1995	1996	1997	1998	1999	2000	Total
*Total R&D Revenue	$46.8	$68.7	$104.0	$131.2	$135.0	$124.4	$120.8	$100.1	$831.0
Total R&D Expense	53.1	76.1	103.4	141.6	156.8	182.8	183.6	190.8	1,088.2
Net R&D Expense	$6.3	$7.4	($.6)	$10.4	$21.8	$58.4	$62.8	$90.7	$257.2
One-Time Crescendo									
Charge to Income					$247.0				
Net Income	$45.7	$58.1	$72.4	$92.4	($261.1)	$108.3	$91.0	$223.3	$430.1
**Total R&D Revenue includes the following amounts from TDC and Crescendo:*									
TDC & Crescendo Revenue	$4.9	$31.6	$70.1	$100.7	$97.5	$95.0	$90.5	$68.3	$558.6

DISCUSSION QUESTIONS

1. What effect did the TDC and Crescendo arrangements have on ALZA's R&D reported on the income statement? What were the balance sheet effects?

2. Do you agree with the claim in ALZA's financial reports that the impact on net income of the TDC and Crescendo arrangements was not significant? Why or why not?

3. What is earnings management? Do you believe ALZA used TDC and Crescendo to manage its earnings? Explain.

4. What is meant by the term "off-balance-sheet financing"? Would the TDC and Crescendo arrangements constitute off-balance-sheet financing? Why or why not?

5. Refer to ARB No. 51, *Consolidated Financial Statements*. According to that statement, when should consolidated financial statements be presented? Do you think those requirements were met with the TDC and Crescendo arrangements? Why or why not?

6. Refer to FASB Interpretation No. 46 (R) (FASB 2003) *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51*. What is the definition of the term variable interest entity? Would TDC and Crescendo be classified as variable interest entities? Why or why not?

7. Summarize the content and purpose of EITF 99-16, Accounting for Transactions with Elements of Research and Development Arrangements. What impact might this standard have had on the timing of ALZA's decision to repurchase Crescendo? Has this standard effectively shut down the off-balance sheet strategy used by ALZA in this case?

8. Refer to Statement of Financial Accounting Standard No. 141, *Business Combinations*. How might the enactment of this standard have influenced the timing of Johnson & Johnson's acquisition of ALZA?

KOMBAR REX: ADVENTURE FILM PRODUCERS

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CASE DESCRIPTION

The primary subject matter of this case concerns the interpretation of contracts and the calculation of revenue. Secondary issues examined include distinguishing cash flow vs. GAAP (Generally Accepted Accounting Principles) income, understanding the timing of revenue recognition and understanding how to budget revenue. The case has a difficulty level of three (appropriate for junior level). The case is designed to be taught in 1-1.5 class hours and is expected to require 3-5 hours of outside preparation by students.

CASE SYNOPSIS

In this case study, students must examine a film distribution agreement to determine its validity, scope and consequences. Adventure Film Producers entered a movie distribution agreement with a large movie theatre chain, Mammoth Theatres, Inc. One of Adventure's "hit" movies was bundled with four "filler" films, each requiring a certain number of screenings. Consideration for the contract was based partly on lump sum payments and partly on the number of screenings. In exchange, the distributor was given exclusive screening rights. After the distributor discovered that the films were being shown in Canada (where Mammoth had no theaters) they alleged that Adventure breached the agreement and demanded a return of all monies paid. Students must examine whether Adventure breached the exclusivity provision of the contract by allowing showings in Canada and must then perform the financial analyses to determine revenues. In order to analyze revenue, students must prepare a budget of expected minimum revenues, apply established revenue recognition criteria, and calculate the reportable revenue using GAAP principles. Students then prepare a schedule showing cash flow and distinguish that number from revenue.

CORE CONCEPTS

Accounting concepts: Financial Concept 5, cash flow vs. GAAP income, Financial Concept 8, understanding the timing of revenue recognition, and Managerial Concept 5, understanding how to budget revenue.

Business Law concepts: Business Law Concept 1: offer and acceptance of contracts; enforcement of contracts: interpreting the parties' intent.

CASE

Adventure Film Producers (Adventure) is a producer and distributor of motion picture films. It specializes in action adventure films popular with males, mostly in the teen and young adult market. While it has only been in business for 7 years, it has produced several moneymaking hits as well as many more minor "B" films that are shown on cable networks and through video rental stores.

Adventure has recently completed the production of five new films. This set of five films contains one film ("Kombat Rex") that marketing research indicates will be a top box office hit. The other four (KR II, KR III, KR IV, KR V) are "filler" films that will be bundled with the hit and licensed to theatres for exhibition. To receive access to the hit, theatres must agree to show all films a minimum number of times.

In July 2003, Adventure entered into an exclusive contract with Mammoth Theatres, Inc. (Mammoth), a large theatre chain with approximately 475 theatres across the United States. This contract provided in part as follows:

> *Agreement: Mammoth is granted the right, license, and permission to display the five films listed herein during the contract period. In consideration of this contract, Adventure will receive:*
> *$5,000,000, payable $2,500,000 upon contract signature and $2,500,000 on September 1, 2003. $500 for each film showing in each location.*
>
> *Contract period: The contract period shall be the six months commencing on September 1, 2003.*
>
> *Limitation on screenings: Mammoth agrees to show Kombat Rex no more than 42 times per theater and the four accompanying films (KR II, KR III, KR IV and KR V) no fewer than 18 times each per theater.*
>
> *Exclusivity: Mammoth shall have exclusive screening rights during the contract period. Adventure acknowledges that an integral inducement in consideration of the contract is Mammoth's interest in being the sole source, without competition from other theaters in the market, during the contract period.*

At the signing of the contract, Mammoth paid $2,500,000 of the $5,000,000.

Mammoth sent checks to Adventure for $2,500,000 on September 1,2003, and $5,462,500 on January 20, 2004, along with an audited statement detailing the number of showings as of December 31, 2003. The following is a summary of that information:

Film	Number of Showings	Amount Due
Kombat Rex	8,550	$4,275,000
KR II-V	2,375	1,187,500
	10,925	$5,462,500

In March 2004, Adventures received a demand notice from Mammoth that all monies previously paid were to be returned or they would file a lawsuit. In their letter, they enclosed a newspaper clipping from a movie theatre in Toronto, Canada that was advertising the set of five films for showing the second week of February, 2004.

Required:

In your analysis of this case, include the following:

1. Did Adventure breach the contract? Specifically discuss whether the showing by a competitor movie chain in Toronto constituted a violation of the Adventure/Mammoth agreement.
2. Assuming the contract is valid, prepare the following financial analyses:
    a. Prepare a budget of expected minimum revenues under the contract. Show the sources of revenues from the set of five films and the fee.
    b. What are the general revenue recognition criteria established under Generally Accepted Accounting Principles (GAAP?
    c. How would you apply the GAAP criteria for revenue recognition to account for the revenues under this contract? Explain your logic for both realizable and earned.
    d. Using the logic you developed in part c, calculate the revenue that Adventure Films should report for the set of five films for the year ended 12/31/2003,
    e. For the year ended 12/31/2003, prepare a schedule that shows the cash flows received from Mammoth from the contract.
    f. Why do cash flows and revenues recognized differ, if they differ under your calculations?

Note: To the extent that you may recognize any antitrust issues (which we would not expect) please ignore them for purposes of this analysis.

KIBBUTZ TZUBA: MEETING THE SOCIAL AND ECONOMIC CHALLENGES OF A CHANGING ISRAELI SOCIETY

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CASE DESCRIPTION

The primary subject matter of this case concerns business policy. Secondary issues examined include organizational theory, marketing decision-making and the effects of cultural institutions and political orientations on decision-making. The case has a difficulty level of four, appropriate for senior level courses. The case is designed to be taught in two class hours and is expected to require three hours of outside preparation by students.

CASE SYNOPSIS

This case deals with a culture (Israeli) about which most students know little and an Israeli institution (the kibbutz) about which most students know nothing. It presents the history of the kibbutz movement and its evolution to the present. This is done to establish the cultural environment in which a particular kibbutz, Kibbutz Tzuba, operates. Like other kibbutzim, Kibbutz Tzuba was founded as a socialistic agricultural collective. And like most of the other kibbutzim, it has had to adapt and embrace elements of capitalism to survive the social and economic changes within Israeli society. While it has retained some elements of socialism, Kibbutz Tzuba has become entrepreneurial and has engaged in a number of capitalist ventures. However, the decisions it has made may not be sufficient to ensure its long-term survival.

INTRODUCTION

Located on the outskirts of Jerusalem, atop a high mountain overlooking an awe-inspiring view of the Judean Hills, is Kibbutz Tzuba. Founded in 1948, as an agricultural collective, this kibbutz (pl. kibbutzim), like many of the other kibbutzim in Israel, has evolved to meet the changing social, political and economic environments of the country. The problems it must contend with, though, threaten its viability.

HISTORY OF THE KIBBUTZ MOVEMENT IN ISRAEL

The Hebrew word *kibbutz* means a communal settlement. The kibbutz movement in Israel was started by a group of singles who had immigrated to [then] Palestine in the late 19th and early 20th centuries, mainly from Russia. These individuals were imbued with the ideals of socialism and the spirit of the period which led to the Russian Revolution. They also believed in a Zionism based on the return to the land of Israel and the tilling of its earth. They believed that this would lead to the creation of a new Jewish identity and to the establishment of Jewish settlements in Palestine.

The first kibbutz was established at Degonia, near the Sea of Galilee, in 1910, by a group of young pioneers who had drained swamps near Hadera and lived as a collective community. Kibbutz Degonia was an independent farm owned by its worker-members. The idea behind the kibbutz was that everyone would contribute to the [kibbutz] society according to his capabilities and would draw from it according to his needs. This was the embodiment of total equality and mutual responsibility. All assets were jointly owned by the members; there was no private ownership of anything. Kibbutz Degonia was set up in the form of a self-supporting cooperative communal village, relying on agriculture as the basic income to support the commune.

Other kibbutzim soon followed. These early settlements regarded themselves as enlarged families and kept membership small. In 1913, for example, Degonia had only twenty-eight members. These settlements were poor, life was harsh and work required the draining of swamps and the removal of rocks from hills, transforming parts of the desert into fertile farmland. The settlers had to cope with extreme heat, malaria and food-related illnesses.

During the 1920s and 1930s, the settlements' societies of singles changed to ones in which families were formed, leading to the establishment of schools and children's houses. Small industries began to appear, mainly as extensions of agriculture, and these soon became profitable enterprises. The kibbutzim emerged as large, self-sufficient communities, combining agriculture and industry. The 1930s also witnessed the beginnings of a religious kibbutz movement which, in contrast to its secular predecessors, saw the ideals of the movement, including equality, mutual help and building the Land, as a realization of the Jewish way of life.

ORGANIZATION OF THE KIBBUTZ

Most kibbutzim are laid out according to a similar plan. The residential area encompasses carefully tended members' homes and gardens, children's houses and playgrounds for every age group, and communal facilities such as a dining hall, auditorium, library, swimming pool, tennis court, medical clinic, laundry, and grocery. Adjacent to the living quarters are, typically, sheds for dairy cattle and modern chicken coops, as well as one or more industrial plants. Agricultural fields, orchards and fish ponds are located around the perimeter, a short tractor ride from the center.

The organization of the kibbutz is based on the ideals of democracy; all members have an equal say in its operation. The sovereign decision-making body, the general assembly, consists of all members and convenes weekly to vote on major proposals and decisions that the secretariat and various committees have made. The daily affairs of the kibbutz are run by a secretariat, made up of the elected secretary, treasurer, and economic coordinator, along with ten other kibbutz members who meet at the conclusion of the working day. Members of the secretariat are elected by the general assembly for a period of three to five years, depending on the individual kibbutz, and are accountable to the general assembly that must ratify all major decisions. For all the main activities and aspects of kibbutz life, individual committees are elected. Each kibbutz has approximately 15 committees, including economic, labor, adult training, education, culture, welfare and health. Since every member has the possibility of holding any position, the formation of either an elite or a hierarchy is discouraged. Members also have the right to appeal any decisions that are made.

Although each kibbutz is socially and economically an autonomous unit, a number of national federations provide coordination of activities as well as some services. The largest of the national federations is the *United Kibbutz Movement* with which about 60% of the kibbutzim are affiliated. About 32% of the kibbutzim belong to the *Kibbutz Artzi* movement. Religious kibbutzim, which comprise 6% of the total, are affiliated with the *Kibbutz Dati* movement; the rest are ultra-Orthodox kibbutzim affiliated with *Poalei Agudat Yisrael*.

FINANCING OF THE KIBBUTZ

Between 1936 and 1951, all kibbutz capital was entirely financed by the settlement department of the Jewish Agency (a governmental body). This was necessary since many new kibbutzim were fulfilling social functions as well as idealistic ones of settling the land, particularly in outlying border areas. In the initial years the kibbutzim showed no profit and the Jewish Agency considered it their duty to support them. The agency allocated funds on a per capita basis for 30 years with extended grace periods. The first repayment installment was usually ten years after disbursement. Interest rates were nominal and at times lower than the rate of inflation.

Subsequently, the government, itself, and commercial banks became sources of kibbutz financing. Government credit was granted on much easier terms than similar commercial loans, with the interest rate usually 3%-4% above inflation. However, repayment terms were stricter than those of the Jewish Agency, on the order of ten to 15 years. Bank credit was the main source of short-term finance and was guaranteed on a commercial basis at a higher prevailing interest rate than government loans.

Currently, the kibbutz system is financed by the main bank of the kibbutz movement, *Keren Ha'takam*. The bank raises funds for the kibbutzim from the Jewish Agency, other government bodies, free market borrowing from commercial banks, and, to a small degree, from other kibbutzim, via the mutual reliance system, whereby the richer kibbutzim help the poorer ones to develop and grow. Representatives of the kibbutzim sit on the governing body of the bank. Because it has a higher credit rating than an individual kibbutz and a resulting lower risk to lenders to the bank, Keren Ha'takam can raise funds and loan them to kibbutzim at lower than normal interest rates.

LIFE ON THE KIBBUTZ

Kibbutzim do not have any unemployment. If a member is unemployed, (s)he is being wasted. A person unproductive in one area is moved to another area to work. Beginning in the 1960's, when kibbutzim began to diversify and to open new industries, they found it necessary to hire employees who were not kibbutz members. This was because it was too expensive to take on new members, particularly families with young children. To avoid ideological conflict, some kibbutzim accepted foreign volunteers who earned their keep while working on the kibbutz as they learned about Israeli life. In this way, the kibbutz considered itself as an educational unit.

Until comparatively recently the kibbutz provided wages in kind, each family according to its need. Living accommodations were provided by the kibbutz, including three meals daily in a central dining area. Other things (for example, the size of living quarters) were provided by the kibbutz according to each individual's requirement and not according to their position or status in the kibbutz. The kibbutz provided 24-hour-a-day care for children from the age of four weeks until 18 years, when they entered National Service. This enabled the mothers to return full-time to their kibbutz duties. Schooling of children until high school was provided on the kibbutz. High school children attended a regional high school with tuition paid for by the kibbutz. Any member of the kibbutz who wished to continue with higher education following National Service could apply to the kibbutz education committee to pay for their fees. All children and students when they were not studying were expected to work on the kibbutz.

Even today, each family has a budget according to its size to spend in the kibbutz store. A small amount of pocket money is given to each member each month to spend as they wish. The kibbutz pays for members' medical insurance.

To join a kibbutz, a potential member has to undertake a probationary year living and working on the kibbutz like any other member. During that year (s)he has full benefits (for example, paid tuition and medical insurance) but cannot participate in the running of the kibbutz. Following the probationary year the kibbutz absorption committee will recommend either accepting or rejecting the individual and the general assembly will vote on the recommendation.

By 1948, with the establishment of the State of Israel, the kibbutz movement had not only succeeded in creating a unique society; it had also been instrumental in many aspects of the struggle towards the creation of the State and in its early development. Kibbutzim had assumed key functions in the settlement of outlying areas and along the country's future borders. They had a major role in the absorption of new immigrants, in the defense of the country, and in the development of agriculture. However, once these functions were assumed by the government, the significant interaction between the kibbutzim and society at large was diminished.

CONFRONTING CHANGES AND CHALLENGES ON THE KIBBUTZ

Changes in Israeli society have necessitated changes within the kibbutzim. Israel has evolved from a society that emphasized the collective, the nation and the people to a society in which the individual is the focal point. Personal freedom has become more important to people than economic security.

Since the 1960s, many kibbutzim have diversified into industry, due to the maturing of the agricultural market and the increase in the market for industrial products. This diversification required an infusion of capital and labor. Many kibbutzim borrowed heavily so that they could satisfy the growing demand for industrial products by producing such things as sophisticated agricultural equipment, furniture, and glass. Increasing the labor supply was a problem.

Many kibbutzim found that it was too costly to accept new members. They hoped to rely upon their existing members to satisfy their labor needs. However, several factors contributed to a decline in kibbutz membership. First, the kibbutz practice of separating children from their parents was problematic. Children lived in a separate house and were raised communally. They could visit their parents in the afternoons and on weekends, but they slept in special quarters and not with their parents. This resulted in family instability and alienation, with many kibbutz children not sharing their parents' values, including the value of the kibbutz way of life. These children, in their teens, began to abandon the kibbutzim. By the end of the 1970s kibbutzim gradually began to stop separating children's sleeping quarters from those of their parents. Today, no kibbutz separates children's and parents' sleeping quarters.

Second, the heavy borrowing of funds by kibbutzim led to a financial disaster in the 1980s. Many kibbutz enterprises (for example, Nerot Etzion, Israel's biggest candle factory, located in Kibbutz Merav and the Tafnukim diaper factory, owned by Amir Paper Products of Kibbutz Amir) were forced into bankruptcy and others were on the brink of collapse. One result of this was a mass exodus of kibbutz youth. Children of kibbutz members chose to abandon the ailing kibbutzim before they turned 18 and received kibbutz membership, which would automatically saddle them with debt. Finally, many young couples also began to desert kibbutzim. The annual living allowance of $4000 was not a financial inducement to have them stay as members when they could earn the same money in a month outside of the kibbutz.

The only way to solve the kibbutzim's labor shortage was to employ non-members. In fact, presently, most workers in kibbutz industries are not kibbutz members while members occupy senior and managerial positions. This has led to the creation of a hierarchical system and a compromise of kibbutz ideology, as these external employees have no say in the running of the industry. On the positive side, employing non-member labor means that older members can undertake light work instead of manual labor.

Economic conditions in Israel in the 1980s were a wake-up call for kibbutzim. Triple-digit inflation and exorbitant interest rates, which brought many kibbutzim to the brink of disaster could have spelled the end of the kibbutz movement. Kibbutzim had amassed over $2.25billion in debt. The Israeli government, commercial banks and the kibbutz federations hammered out several agreements for canceling and restructuring kibbutz debts. The price was heavy – some kibbutzim had to sell agricultural land to pay off their debts; many others were forced to slash operating costs, which they did by reducing their spending on basics like food, non-essential medical care, education and travel. Kibbutzim found it necessary to find new sources of income and to increase productivity.

Kibbutz Ga'ash, on the coast near Tel Aviv, sold lots for $1000 to $1850 per square meter. Kibbutz Shefayim nearby sold individual plots for half a million dollars each. In the process, these and several other kibbutzim actually became wealthy by selling off their government-granted land.

Kibbutz Lohamei Hagetaot, located between the towns of Acre and Nahariyya, branched out from farming and operating a small electric-condenser factory to producing soy foods. Their brand, Tivall, currently controls 70% of the Israeli market for soy products. To break into the international market, the kibbutz teamed up with Osem, a Nestle subsidiary. Tivall now reports about $55 million in annual sales. A second kibbutz, Hatzor, located near Ashdod, expanded from farming and die casting into the production of soy ingredients. They produce a caramel-colored soy pellet that is used for everything from food products to isoflavones, a supplement for menopausal women. The kibbutz' brand, Solbar, has become a multinational force in soy food ingredients.

Many kibbutzim located adjacent to each other have entered into joint economic ventures. Granot, for example, is owned by 38 kibbutzim and services Emeq Hefer, Sharon, and the Shomron areas in the north of Israel with packaging houses for fruits and vegetables. Other groups of kibbutzim have created their own regional supply and marketing cooperatives which involve, for example, floral processing plants and packing houses, with the goals of realizing economies of scale and increasing marketing efficiency. The kibbutz movement has ten such regional cooperatives, each employing up to 1000 people. These cooperatives sell their products to the National Marketing Board and to such producer-cooperatives as Tnuva (for home sales) and Agrexco (for export).

Essentially, the 1980's required kibbutzim to assess what they needed to do to survive. Elements of the socialist model that had driven kibbutzim for more than half a century had already been abandoned. Now many kibbutzim realized that they would have to adopt many elements of capitalism if the movement were to continue. "Entrepreneurship", "private property", "differential salaries" and "board of directors" became part of the movement's vocabulary.

EVOLUTION OF THE KIBBUTZ

In December, 2003, the United Kibbutz Movement, seeing the changes taking place in kibbutzim, met and officially blessed the dissolution of the original collectivist ideal that was the kibbutz and proclaimed the birth of a new construct, the "renewed kibbutz". In the renewed kibbutz, members would own their own houses, be able to work outside the kibbutz, and receive differential salaries according to their contribution to their kibbutz' economy. In order to maintain their status as cooperatives, the kibbutzim assured the Israel government that all productive assets would remain in the ownership of the kibbutzim, but kibbutz members would be allowed to own shares of these assets.

In addition, to attract new members the kibbutzim would use a more flexible definition of membership to make it easier to join the kibbutz. Concurrently, kibbutzim would improve social security programs, particularly pension plans, for the rapidly aging kibbutz population. All members would also be entitled to education, health care, welfare and care for members with special needs. In April, 2004, the Israeli Cabinet approved these kibbutz reforms.

It is believed that about two-thirds of the country's 287 kibbutzim will embrace the principles of the renewed kibbutz. Kibbutz Kfar Hanasi, near Tel Aviv, for example, plans to start building an expansion neighborhood within its municipal jurisdiction, offering young families an opportunity to enjoy the advantages of the kibbutz, strong schools, health care and a rural environment, without assuming the burdens of kibbutz membership. The neighborhood of Kfar Hanasi will consist of one-eighth-of-an-acre plots, with homes starting at 120 square yards. Potential owners must be Israeli citizens and approved by something similar to a co-op board.

Kibbutz Yahel, located 65 kilometers north of Eilat, is attempting to attract new residents by offering free plots of land of between 75 and 100 square meters. Those who accept the offer and are approved will receive a government grant of about $9000. About 185 plots will be offered for people to build luxury villas at a cost of $130,000 each. Before being approved, interested persons will have to spend a weekend on the kibbutz to become familiar with it. Those who accept the offer will be able to rent a house on the kibbutz for $400 a month until their own villa is ready. They will not have to become kibbutz members. In addition, Kibbutz Yahel is in the early stages of setting up a commercial center.

In the renewed kibbutz, enterprises have become profit centers and are created or continued only if they are economically profitable. These enterprises are run by managers who are responsible to a board of directors. These boards have replaced the kibbutz' general assembly.

After many years of declining membership, 2003-2004 witnessed an increase in the number of new kibbutz members, possibly due to the reforms that are in place. It is estimated that 12,000 people are waiting to join the renewed kibbutzim. The average age of kibbutz members, now 54, is starting to decline as almost 2000 new members, the vast majority of whom are under the age of 30, joined kibbutzim in the last two years. The kibbutz movement presently includes 102,000

Israelis, and accounts for ten percent of Israel's manufacturing output and half of its agricultural production. Clearly, the health of the movement is crucial to Israel's economy, society and security.

KIBBUTZ TZUBA

In 1948, 50 former members of Palmach (at that time, the name of Israel's Defense Force) established Kibbutz Tzuba, at that time called Kibbutz Palmach-Tzova. The government of the new State of Israel recognized the importance of safeguarding the access to Jerusalem and provided the land and the funding for the creation of the kibbutz, which was strategically located near Highway #1, the primary access route to the State's capital.

Like all other kibbutzim, Kibbutz Tzuba started as a socialistic agricultural collective. And like most of the other kibbutzim, it has had to adapt and embrace elements of capitalism to survive. It has even created the position of director of marketing. The person holding this position is responsible for the marketing of Kiftzuba, the Hotel Belmont, and the dining room, which are discussed below.

The kibbutz has a living area of 75-100 acres; orchards and an industrial area are located on approximately 250 acres; and there are 875,000 acres of agricultural fields. It presently has 266 members, about 30% of whom work outside of the kibbutz, and employs an additional 150 part-time workers. Approximately 600 people live on the kibbutz. Members do not own their own homes and they do not pay any rent. The average age of members is 50.3, with more than 50% of them over the age of 45. The annual budget for members' expenses is about $2.7million.

The general assembly has been retained and meets every two to three weeks to discuss the major issues of kibbutz life. It also ratifies the annual budget and oversees the elections of key kibbutz personnel. However, the Kibbutz Authority, consisting of a series of committees, governs all aspects of kibbutz life. The two major committees are the Secretariat, which authorizes all the other committees, and the Economic Board, which makes all the economic decisions that affect the kibbutz.

KIBBUTZ TZUBA ENTERPRISES

Kibbutz Tzuba raises chickens that are sold to the producer-cooperative, Tnuva. This venture is not profitable. Grapes grown in the kibbutz' vineyards have been sold to a wine-producing company in the nearby town of Abu Ghosh. The kibbutz has decided to establish its own winery and olive oil factory and to market its own brand of wines and oil through a visitors' center. Nectarines, apples, kiwis, cherries and pears grown in the kibbutz' orchards and cotton, corn and organic vegetables grown in their agricultural fields are sold in the open market through a regional packing center.

In 1975, a furniture factory and store were founded on the kibbutz, providing work for about ten members. The factory specialized in office and residential furniture made of pinewood. Because the factory became unprofitable, it was closed in mid-2003. The factory space was taken over by the kibbutz' glass factory (see below) for the production of glass and aluminum products. The furniture shop was rented to Kibbutz Ein Charod.

In 1979, the kibbutz built a glass factory, specializing in safety (that is, bulletproof) glass. The glass is used for automobiles and for office buildings. Kibbutz Tzuba is the largest provider of safety glass for the government of the State of Israel, which purchases this glass on a bidding basis. This operation nets the kibbutz more than $4.5million annually.

A garage located on the kibbutz services members' cars and is also the authorized service center for Renault and Nissan automobiles. The garage employs five people, three of whom are kibbutz members.

There is a workshop for several senior members whose handicrafts are sold from a store located near the dining room. The store hours, however, are limited and irregular. The kibbutz has a young children's education program (nursery and kindergarten). Half of the attendees are members' children and half are children of non-members. There are three teachers for each ten children. This venture only breaks even.

KIFTZUBA

Unlike many other kibbutzim which sought new opportunities in the industrial market, Kibbutz Tzuba began to explore the consumer market and, in 1997, it built *Kiftzuba*, an outdoor family entertainment center, targeted at children ages 1-14. The park offered children the opportunity to bounce, slide and climb on huge inflatables, as well as picnic tables for families.

Recognizing the competitiveness of the entertainment market, the kibbutz decided it would have to regularly upgrade the park and, in 1998, it constructed an air-conditioned indoor facility, housing ten different activity areas, including an area for preschoolers, and areas for table games like air hockey and soccer, LEGO® construction toys, computers, developmental games and a mini-market. The facility also has a restaurant with abundant seating accommodations.

A separate indoor skating rink was added in 2000, using synthetic ice. A state-of-the-art sound system and lighting effects enhanced the skating experience for children and adults. This facility also included a machine games arcade, including video and shooting games for prizes and a food counter.

In 2001, an outdoor area was added for bumper cars, battery-operated motorcycles and scooters and in 2002, a children's petting zoo was relocated from the inner grounds of the kibbutz to Kiftzuba. In 2004, because of exorbitant labor and insurance costs, the skating rink was closed and replaced with a two-story foam ball cannon arena. In addition, a jungle locomotive was also introduced.

Kiftzuba is the only family entertainment center in Israel that is open 362 days a year. Its hours of operation are Sunday-Thursday, on school days, from 1:00-7:00PM; Sunday-Thursday+Saturday, on holidays and during the summer months, from 10:00AM to 7:00PM; and on Friday and the eve of Jewish holidays, 10:00AM to 5:00PM.

Admission to Kiftzuba is 52 shekels (the monetary unit of Israel. At this writing, 4.3 shekels = $1) for children ages 1-14 and 29 shekels per adult. During the last three hours of operation, admission is 37 shekels per child and 15 shekels per adult. A ten-entrance discount card is available for 275 shekels and can be used Sunday through Friday, excluding Jewish holidays and their intermediate days. During the summer vacation season, admission using this discount card is only from 4:00PM. Each visit with the discount card entitles two accompanying adults to free admission.

Kiftzuba has an administrative staff of nine kibbutz members and employs 30-35 paid workers during the summer season and three or four paid workers during the off-season. The park is heavily promoted, including advertisements in the media and in a major journal, the "Encyclopedia of Tourism". An internet site is maintained. Kiftzuba works with travel agents to bring school groups to the park. Various events are scheduled including beginning and end of summer parties and a major end of Passover party. Coupons and reduced price tickets are also employed. T-shirts advertising Kiftzuba are available for purchase.

The operation of Kiftzuba is profitable, although figures are not available. However, the current intifada, the terrorist attacks on Israeli civilians, has necessitated tightened security at the park. Packages carried by people entering Kiftzuba are subjected to a search, resulting in an increase in the time it takes one to pass through the entrance. The heightened security is also a reminder of the potential danger of being in a place with a concentration of people. This, most likely, has kept many families away from the park.

Kibbutz Tzuba boasts a natural Spring Park, consisting of an ancient spring, the underground tunnel of Ein Zova and other archeological sites, such as a cave believed to be the place where John the Baptist anointed his disciples. The underground spring is open on Saturdays in the winter from 10:00AM to 4:00PM and in the summer from 10:00AM to 5:00PM. Entrance to the spring is free with the purchase of any ticket to Kiftzuba. The tunnel is open on weekdays for groups by reservation. The other archeological sites are in open agricultural areas, allowing hikers to approach them freely.

THE BELMONT HOTEL

The signing of the Oslo Peace Accord in 1993 by Israel and the Palestinian Authority was followed by a number of years of optimism. There was hope that peace in the Middle East would result in economic prosperity and an increase in tourism. With this in mind, Kibbutz Tzuba decided, in 1998, to build the *Belmont Hotel*, at a cost of close to $700,000, with the Israeli government contributing 20% of the cost.

The hotel has a spacious lobby with indoor and outdoor lounge areas, a coffee shop, 64 suites, a lecture hall seating up to 150 people and four conference rooms for seminars and meetings. Each suite offers two separate air-conditioned rooms, a full bath, a refrigerator and facilities to make coffee, color television, two telephones, internet connection on request, and a balcony with a magnificent view of the surrounding hills and valley. In season, there is an outdoor full-sized heated swimming pool for adults and a separate pool for younger children. A hairdresser and cosmetician are on the premises and a variety of holistic treatments is available. The hotel rates are 500 shekels per couple, bed and breakfast, and 115 shekels per child ages 2-12.

The hotel offers many attractions both in the immediate area and within a short drive away; a hike to the Crusader castle "Belmont"; a guided tour of the natural spring and archeological digs; burial caves from the First Temple period; *Sataf*, the reconstruction of an agricultural village built around an ancient natural spring; tours of local wineries, natural springs and stalactite caves; cycling paths; horseback riding; and the city of Jerusalem.

The Belmont Hotel is slightly profitable, contributing a little more than $200,000 of the kibbutz members' salaries. However, because of the intifada that was begun in 2000, the spate of tourists to Israel hadn't materialized and the hotel's occupancy rate was only 40%. In 2004, there was a recovery and the occupancy rate is currently around 60%.

No advertising is done for the hotel. It is promoted through travel agents and an internet site is maintained. A club membership was created to reward frequent guests.

THE FOOD SERVICES BRANCH

Like the other kibbutzim, Kibbutz Tzuba's kitchen prepared the meals for its members from ingredients often grown or raised on the kibbutz, its bakery provided breads and other baked goods, and members ate in the communal dining room for free. Later on, the kibbutz opened the "Col-Bo", an on-site supermarket, from which members could purchase food to prepare and eat in their residences. These four units, the kitchen, the bakery, the dining room and the supermarket, were run as not-for-profit enterprises, each with its own manager. In the 1980s, the kibbutz decided to centralize these food services in order to reduce expenses and it created the *Food Services Branch* (FSB), with one manager and a smaller multi-task workforce moving, as needed, between the different units of the FSB.

The dining room, which became kosher in 1998, has a seating capacity of 250 and served kibbutz members, their guests, and employees, exclusively, until Hotel Belmont opened in 2000. At that time, the FSB was converted to a profit center from a service center, with the dining room as the dominant revenue producer. The FSB employs over 30 workers (members and paid employees), has a budget of approximately $180,000, and grosses about $1.4million annually.

The largest group that the FSB serves is the kibbutz' fixed population, consisting of its members, their children and personal guests, non-member residents, and the employees working in the kibbutz' various enterprises. The FSB also serves the temporary non-resident kibbutz population, consisting of guests at the Hotel Belmont, organized groups of tourists sightseeing in the area, and guests of those working in the kibbutz' enterprises.

The dining room offers three buffet-style meals daily and at any given time, the population using the FSB's services can be between a few dozen to over 1,200 people, such as at the annual kibbutz founding celebration.

Kibbutz members no longer get their meals for free since the communal food budget has been privatized. Members continue to pass their salaries to a common pool and live on budgeted allowances but they are expected to pay for their own meals. However, the cost of those meals to members is subsidized by the kibbutz. For example, the cost for breakfast is normally about $7.00, but members pay less than 90 cents; the cost for lunch is about $9.30, but members pay about $1.33.

The only promotion of the dining room is with travel agents who can arrange meals for their clients who might be staying at the Belmont Hotel or who are sightseeing in the area.

Even though members' meals are subsidized, they see themselves as cash-paying customers, just like the Belmont's guests. As such, many are beginning to expect better quality food than what they are now offered. In the future, meal subsidies are likely to be abolished as the kibbutz further expands the privatization process and business efficiency improvement programs are implemented. If food quality is not improved, members may abandon the FSB in favor of other meal sources.

In addition, informal surveys of FSB guests eating in the dining room show that, although there are few complaints about either the quantity or quality of the food, many guests do not care for the buffet-style meals. They would much rather have waiter service with a fancier ambience than that offered by the spartan dining room. Of course, they want the prices of meals to remain the same.

CONCLUSION

Historically, the kibbutz movement has been an integral part of Israeli society. But kibbutzim have had to evolve to survive in contemporary Israel. It remains to be seen if the decisions made by the kibbutz movement, in general, and by Kibbutz Tzuba, in particular, will contribute to their continued viability.

DISCUSSION QUESTIONS

1. What role did the kibbutzim play in Israeli society?

2. What role do the kibbutzim have in contemporary Israeli society?

3. Evaluate the "renewed kibbutz".

4. What are the benefits of becoming a member of a kibbutz?

5. Should kibbutzim encourage membership? What are the consequences of doing this? How can it be done?

6. Is Kibbutz Tzuba a traditional or a renewed kibbutz?

7. Evaluate the organizational structure of Kibbutz Tzuba.

8. Should Kibbutz Tzuba sell off its housing to its members? How might the proceeds from such a sale be used?

9. What marketing opportunities exist for Kibbutz Tzuba?

CASINO CITY, INC. V U.S. DEPARTMENT OF JUSTICE CAMPUS ACCESS TO INTERNET GAMBLING AND THE FIRST AMENDMENT

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CASE DESCRIPTION

The primary subject matter of this case is the concept of "standing" which mandates that, under Article III of the United States Constitution, each litigant is permitted to pursue his or her cause of action only if it presents a genuine "case or controversy," in the absence of which the federal district courts lack jurisdiction to adjudicate.

This case also explores United States statutes declaring internet gambling to be illegal, and examines whether First Amendment protection of commercial speech precludes government restrictions on advertisements promoting internet gambling.

Finally this case reviews the rapid growth of the online gambling industry, the swiftly increasing participation of university students in online gambling, the ethical implications of marketing efforts designed to entice university students to engage in internet gambling, and the Federal income tax consequences of gambling online.

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

CASE SYNOPSIS

Michael A. Corfman, the founder and CEO of Casino City, Inc., a Louisiana corporation that operates gaming websites that disseminate information about gambling, initiated a lawsuit against the United States Department of Justice (DOJ) seeking declaratory judgment that prosecution by the Department of Justice for accepting advertisements for internet gambling operations on CasinoCity.com violated its First Amendment right to engage in commercial speech..

Casino City's website attracts individuals seeking gambling information, and gambling establishments throughout the world advertise on Casino City's website, providing Casino City with substantial advertising revenues.

Casino City claims that the Department of Justice threatened to prosecute broadcasters who accept advertisements for online gambling for aiding and abetting illegal activities, and issued subpoenas to media outlets, internet portals, public relations companies and technology companies to obtain information about advertisements purchased by online casinos and bookmaking companies. Casino City also alleges that these threats of prosecution infringe upon Casino City's right to engage in commercial speech contrary to the First Amendment.

This case analyzes (1) the requirement in Article III of the United States Constitution mandating that Federal courts can entertain only those causes of action that present a genuine "case or controversy," (2) the protection accorded to commercial speech under the First Amendment, (3) the legality of internet gambling, (4) the rapidly increasing participation in online gambling by university students, and (5) the ethical implications of marketing efforts designed to entice university students to engage in internet gambling.

Careful discussion of the case should enable the students to better understand (1) the concept of "standing" and "ripeness" which prohibit courts from exercising jurisdiction in hypothetical claims prematurely presented for court resolution; (2) the legal and ethical implications of the vastly expanding business of online gambling; (3) the application of First Amendment protection of commercial speech to internet gambling advertisements; (4) the rising participation of university students in online gambling and dangers posed by those activities through the increasing incidence of pathological gambling; (5) the effectiveness of marketing strategies which promote online gambling; and (6) the Federal income tax consequences of gambling activities.

CASINO CITY v UNITED STATES DEPARTMENT OF JUSTICE

The Rise of Online Gambling

The internet gambling industry is both significant and flourishing. The first online casino was started in August 1995, and today there are more than 2,300 websites offering bingo, casino games, lotteries, and sports betting (THE PHILADELPHIA INQUIRER, March 18, 2005, at C1; Clark, May 23, 2005, at 50). Fifty-four governments around the world permit internet gaming(Gottffried, 2004), and it is estimated that 14.5 million users place bets on the internet (Walters, 2003), that annual global revenues from internet gambling are somewhere between $4.2 billion to $5.7 billion per year, and that internet gambling revenues will triple to $17 billion per year by 2009.

Not surprisingly, the phenomenon of Internet gambling has found its way to college campuses. "It's hot with college kids . . . and is the fastest-growing segment of the $10 billion Internet gambling industry" (Brady, 2005, at 72). An estimated 1.6 million college students play poker online, almost all of whom are male (Kerkstra, 2006, at A1). Further, a 2005 survey conducted by the Annenberg Public Policy Center at the University of Pennsylvania found that 26% of college males gamble in online card games and that 4% gamble online once a week or more.

In one case, Michael Sandberg, a Princeton University senior majoring in political science, admits to spending half of his time gambling online and in Atlantic City casinos, and claims that, in the seven months since his senior year began, he made $30,000 in the casinos and $90,000 playing at PartyPoker.com, an online casino licensed by the government of Gibraltar (Cheng, 2005). Sandberg can spend ten hours a day playing poker, sometimes simultaneously playing three online games, each involving hundreds of dollars (Cheng, 2005). He admits that gambling has hurt his academic performance, but is unconcerned about his GPA, because "you don't have to hand your resume to the casino when you walk in" (Cheng, 2005, at B4). His success at poker has encouraged him to view gambling as a career opportunity, and, believing he can earn one-half million dollars per year, he has postponed looking for a job or applying to graduate schools (Cheng, 2005).

Sandberg's experience appears to reflect several "warning signs" that are indicative of "pathological gambling," a syndrome defined by the American Psychiatric Association as an impulse control disorder, which affects 11 million people and drives gamblers to wage increasing amounts of money to achieve a desired level of excitement (*The Worst of All Bets*, 2005). Some scientists have concluded that "the prefrontal cortex, that part of the brain responsible for decision making and impulse control, [may be] impaired in pathological gamblers." (*The Worst of All Bets*, 2005, at 54). Those "warning signs" are: preoccupation with gambling; gambling with larger pots of money to achieve the desired level of excitement; unsuccessful attempts to curtail gambling; becoming irritable when trying to reduce gambling; gambling as an escape from work or a depressed mood; returning to gambling to make up losses; lying to family members or friends about gambling; engaging in illegal conduct to raise funds for gambling; jeopardizing family, friends, jobs or careers to gamble; and borrowing money to pay off gambling debts. Others have found that the dopamine receptors of pathological gamblers are particularly sensitive, requiring larger amounts of dopamine to create the "high" associated with gambling, thereby creating a vicious cycle: gambling triggers the dopamine rush, more dopamine is needed to achieve the high, and more gambling ensues.

Despite the danger posed by pathological gambling, "access to poker games has never been as easy as the internet makes it, and undergraduates and students of youth gambling say that the interest has never been so high" (*The Worst of All Bets*, 2005). There are multiple websites to choose from; they give new players cash bonuses to play; and the "only thing you have to do is give an e-mail address and a credit card and accept a form that says you are 18 or older"(Bracy, 2005). Unfortunately, there is little regulation of online casinos, permitting them to stack the odds in their favor and put university students at risk by: utilizing software that causes gamblers to lose money once they reach an initial win threshold; inflating the players initial win ratio during free introductory games thereby encouraging them to engage in the next round in which they invariably lose money; refusing or delaying to refund money gained in gambling or left on the table using software to identify and personalize the odds for each bettor permitting the casino to take advantage of the bettor's emotional tendencies; offering a gambling experience that is more highly addictive than traditional casino-based gambling (Clark,2005, at note at 53).

Casino City, Inc.

Michael A. Corfman is the founder and CEO of Casino City, Inc., a Louisiana corporation that operates a number of gaming portal websites that disseminate information about gambling, including interviews with professional gamblers, advice and expert columns, directories, playing strategies and tips, weekly news publications and news clips. Because Casino City's website attracts individuals seeking gambling information, gambling establishments throughout the world advertise on Casino City's website, generating advertising revenues (Ante, 2005, at 82). Casino City's principal website, CasinoCity.com, provides information on over 3,000 casinos worldwide, and supplies ready access to online.casino.com, an online casino and gaming directory consisting of 1,197 online casinos, 265 online poker rooms, 607 online sports betting books, and 143 online bingo sites.

Corfman also maintains three related websites: casinocitytimes.com, which provides access to news articles about the gambling industry, columns written by "gaming gurus" in which they answer questions and provide gambling advice, and a weekly online magazine called *Gaming News*; casinocitypress.com, which offers a variety of publications, directories, almanacs, and reports for sale, and solicits advertisements from companies seeking to do business with the casino industry, and gbdonline.com, which provides an online directory of casino executives and managers throughout the world.

Casino City depends on online casino advertising for its sales, and the internet gaming advertising revenue generated by CasinoCity.com is a substantial component of its income stream. Because of a series of events described below, however, Corfman began to fear that the United States Department of Justice (DOJ) had decided to prosecute web site operators and broadcasters for accepting advertisements from online gambling establishments and thereby aiding and abetting illegal gambling activities. If so, the principal source of Casino City's income (if not its entire business) was in jeopardy.

Warnings from the Department of Justice

On June 11, 2003, the Deputy Assistant Attorney General for the Criminal Division of the Department of Justice sent a letter to the National Association of Broadcasters (NAB) expressing its concern about advertisements for internet gambling and offshore sports bookmaking operations. The text of the letter appears in Exhibit A. In his letter, the Deputy Assistant Attorney General noted that advertisements for internet gambling have become ubiquitous on the internet, and mislead the public into believing internet gambling is legal when it is not. The Deputy Assistant Attorney General also expressed the opinion that accepting money for placing such advertisements may be considered aiding and abetting the commission of illegal internet gambling operations, and urged the NAB to forward the letter to its member organizations which may be running such advertisements so that they might consult with their counsel and take other appropriate actions.

Preemptive action by Casino City, Inc.

On August 9, 2004, fearing that its business was in jeopardy, Casino City, Inc. filed a complaint in U.S. District Court in Louisiana seeking declaratory judgment that prosecution by the Department of Justice for accepting advertisements for internet gambling operations on CasinoCity.com violated its First Amendment right to engage in commercial speech. The crux of Casino City's complaint was that the threat of the Department of Justice in its June 11, 2003, letter to NAB to prosecute those who accept advertisements for online gambling for aiding and abetting illegal activities, coupled with the issuance of subpoenas to media outlets, internet portals, public relations companies and technology companies seeking information about advertisements purchased by online casinos and bookmaking companies, created a fear of prosecution within the advertising industry which chills the exercise of commercial speech contrary to the First Amendment.

First Amendment protection of commercial speech

Government regulation of core First Amendment areas, such as political, religious, artistic and scientific speech, is impermissible unless the regulation represents a "compelling" interest and is the "least restrictive means" available (Eberle, 1992). In contrast, commercial speech, which has been defined as a proposal for a commercial transaction and an expression related solely to the economic interests of the speaker and its audience, receives a lower but nevertheless substantial level of protection, under which the government regulation is impermissible unless the governmental interest asserted to support the regulation is substantial, and the government regulation not only directly advances the asserted governmental interest but is no more extensive than is necessary to serve that interest (Pittsburgh Press Co. v Pittsburgh Commission on Human Relations, 1973; City of Cincinnati v Discovery Network, Inc., 1993; Central Hudson Gas & Elec. Corp. v Public Service Commission of N.Y., 1980; Rubin v Coors Brewing Co.,1995).

First Amendment protection of commercial speech was first recognized in *Virginia State Board of Pharmacy v Virginia Citizens Consumer Council, Inc.* (1976, hereinafter *Virginia Pharmacy*). In *Virginia Pharmacy*, consumers of prescription drugs brought suit against the Virginia State Board of Pharmacy, challenging the validity of a Virginia statute declaring it unprofessional for a licensed pharmacist to advertise the prices of prescription drugs. Recognizing that price information is important to consumers because it enables them to make intelligent decisions, the Court determined that the First Amendment protects the right to advertise any legal product or service, regardless of how tasteless and excessive the advertisement might be (at 764, 772). Nonetheless, *Virginia Pharmacy* emphasized two characteristics of commercial speech -

namely, it was more verifiable and durable than political speech - that caused the Court to provide only "an intermediate level of protection for commercial speech" (*Central Hudson Gas & Electric Corp. v Public Service Commission of N.Y.*, 1980; and Langvardt, 2000).

The test for determining whether government action violates First Amendment protection of commercial speech was developed in *Central Hudson Gas & Electric Corp. v Public Service Commission of N.Y.* (447 U.S. 557, 566, 1980):

> At the outset, we must determine whether the expression is protected by the First Amendment. For commercial speech to come within that provision, it at least must concern lawful activity and not be misleading. Next, we ask whether the asserted governmental interest is substantial. If both inquiries yield positive answers, we must determine whether the regulation directly advances the governmental interest asserted, and whether it is not more extensive than is necessary to serve that interest (447 U.S. 557, 566 ,1980, at 566).

In its most recent commercial speech decisions, the United States Supreme Court has strengthened the First Amendment protection of commercial speech. More particularly, Court has carefully analyzed the operation of the restriction at hand, and required the government to provide evidence that the restriction materially advances the stated policy interest. Likewise, the Court examined more closely the regulatory landscape in which the restriction operated to satisfy itself that the restriction would in fact achieve its expressed end and that no less restrictive, alternative means exists to achieve the stated policy (See *Rubin v Coors Brewing Co*., 1995; *Greater New Orleans Broadcasting Association , Inc. v United States*, 527 U.S. 173, 1999; *Lorillard Tobacco Co. v Reilly*, 2001; and *Thompson v Western States Medical Center*, 2002).

Legality of online gambling

Several federal statutes are designed to outlaw online gambling (Gottffried, 2004). First, the "Wire Act," prohibits anyone "engaged in the business of betting on or wagering" from "knowingly us[ing] a wire communication facility for transmission in interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest, or for the transmission of a wire communication which entitles which entitles the recipient to receive money or credit as a result of bets or wagers (18 U.S.C. § 1084(a)).

Originally enacted in 1961, the Wire Act makes it a federal felony punishable for up to two years in prison for anyone to accept bets over any device using telephone lines. Because virtually all online communication must travel over at least a portion of a telephone line, and because even wireless connections use wire transmissions someplace in route, placing a bet within the United States or sending a bet from the United States to an offshore online casino likely constitutes a violation of the Wire Act (Walters, 2003). Indeed, as long as the electronic communication at some point in its travel from sender to receiver moves across a wire, the Wire Act is applicable. If the communication places a bet or facilitates the placement of a wager, the prohibition against gambling applies and exposes the individual doing so to criminal sanctions.

The application of the Wire Act to online gambling is demonstrated by *UNITED STATES v Cohen* (260 F.3d 68, 2001), a decision of the United States Court of Appeals for the Second Circuit. The defendant, Jay Cohen, established a company called World Sports Exchange (WSE) in the Caribbean island of Antigua where gambling is legal. The sole business of WSE was bookmaking on American sports events. WSE required its customers to open up accounts with WSE in Antigua and to wire funds (at least $300) to that account. When those customers wished to place a bet, they would either telephone WSE or contact WSE via the internet and request that a particular bet be made. In response, WSE would issue an immediate acceptance and confirmation of the bet, and use funds in the customer's account to execute the transaction. FBI agents in New York contacted WSE by telephone and internet numerous times during a six month period to open accounts and place bets. Cohen was convicted for eight counts of violating the Wire Act, and sentenced to a prison term of twenty-one months. The Second Circuit ruled that, even though the transfer of funds executing the wager occurred through the account maintained by WSE in Antigua, the transmission of information assisting in the placement of the bets, as well as the transmission of the bets themselves, were prohibited by the Wire Act. Because bookmaking is illegal in New York, and because the transmission of information via telephone or internet which facilitated the placement of the bets originated in New York, Cohen's conviction for violating the Wire Act was upheld. 18 U.S.C. § 1952 Other findings have been less clear, however, suggesting that internet gambling on a game of chance is not prohibited under the Wire Act (See United States v Kaczowski, 2000; People ex rel. Vacco v World Interactive Gaming Corp., 1999).

Second, the "Travel Act" prohibits the use of "any facility in interstate or foreign commerce . . . to promote, manage, establish, carry on, or facilitate the promotion, management, establishment, or carrying on of . . . any business enterprise involving gambling . . . in violation of the laws of the State in which they are committed or of the United States" (18 U.S.C. § 1952). The Travel Act has been used to prosecute employees of illegal gambling casinos who cross state lines in commuting to their jobs, People v. World Interactive Gaming Corp., 714 N.Y.S.2d 844, 851-52 (N.Y. Sup. Ct. 1999). and to prosecute a bookmaker who conducted illegal gambling activities via the telephone (United States v Barrow, 1966; United States v Cerone, 1971). Because the Travel Act uses the term "facility in interstate commerce," it covers gambling via the internet, and was used to against a Delaware corporation's casino, licensed in Antigua, that promoted gaming opportunities via the internet to New York residents (*People v World Interactive Gaming Corp*., 1999).

Third, the Interstate Transportation of Wagering Paraphernalia Act prohibits carrying or sending "in interstate or foreign commerce any record, paraphernalia, ticket, certificate, bills, slip, token, paper, writing, or other device used, or to be used, or adapted, devised, or designed for use in" gambling activities (18 U.S.C. § 1953). Because the use of computer generated communications may fall within the term “other device,” the Paraphernalia Act may be used to prosecute internet gambling (Gottffried, 2004).

Finally, the Illegal Gambling Business Act prohibits conducting, financing, managing, supervising, directing or owning “all or part of an illegal gambling business” (18 U.S.C. § 1955a). An “illegal gambling business” is defined as “a gambling business which is in violation of the law of a State or political subdivision in which it is conducted, involves five or more persons who conduct, finance, manage, supervise, direct or own all or part of such business; and has been or remains in substantially continuous operation for a period in excess of thirty days or has a gross revenue of $2,000 in a single day” (18 U.S.C. § 1955b). While it has not yet been employed to combat internet gambling, the Illegal Gambling Business Act may be applicable to internet gambling operations when the website is operated for thirty days or more, uses a computer support staff of five or more persons, and generates revenues of $2,000 on a given day Gottffried, 2004).

Response of the Department of Justice

In response to Casino City’s Complaint, the Department of Justice filed a Motion to Dismiss on the grounds (1) Casino City lacked standing to pursue the action, (2) Casino City’s claim was not ripe for review, and (3) Casino City’s First Amendment rights were not violated.

In support of its argument that Casino City lacked standing to pursue its action, DOJ noted that Casino City had neither demonstrated nor alleged that it was threatened with prosecution, received the letter addressed to the NAB, received any subpoenas, or ceased advertising the internet gambling businesses. There being no demonstration that Casino City was in fact injured, that DOJ caused an injury, and that any injury would be redressed in the lawsuit, DOJ claimed there was no actual claim to be adjudicated. Likewise, there being no demonstration Casino City was being prosecuted by the government or that there was a credible threat Casino City will be prosecuted, DOJ claimed Casino City lacks standing to challenge the constitutionality of a criminal statute. Hence, rather than asking the Court to resolve an actual controversy between the parties, Casino City asked the Court to exercise jurisdiction over a purely hypothetical situation, contrary to Article III of the Constitution which confines the federal courts to adjudicating actual “cases” or “controversies” (Allen v Wright, 468 U.S. 737, 750 (1984).

In support of its argument that Casino City's claim was not ripe for review, DOJ argued that Casino City's allegations presented merely a hypothetical claim based on contingencies uncertain to occur in the future. There being no demonstration Casino City was actually and immediately threatened with prosecution, and Casino City having alleged its advertising activities were entirely lawful, Casino City's claim was prematurely presented to the Court.

In support of its argument that Casino City's First Amendment rights were not violated, DOJ argued that, because First Amendment protection of commercial speech did not apply to advertising for illegal activities, Casino City claim must fail, because: (1) if Casino City advertisements related to lawful gambling activities, there could be no prosecution, and (2) if Casino City's advertisements related to unlawful gambling activities, there could be no violation of Casino City's First Amendment commercial speech rights.

Accordingly, DOJ asked the Court to dismiss Casino City's Complaint either because the Court lacked jurisdiction over the claim or because the Complaint failed to allege a claim upon which relief could be granted.

Opinion of the Federal District Court

The Federal District Court for the Middle District of Louisiana issued its opinion and order dismissing Casino City's complaint on February 15, 2005. The Court ruled that Casino City did not have standing to maintain its action against DOJ (*See* Lujan v Defenders of Wildlife, 1992; and Babbitt v United Farm Workers Nat'l Union, 1979), because CasinoCity failed to allege it intended to engage in activities prohibited by statute, but insisted not only that its activities were perfectly legal but that it had taken steps to insure it would not accept proceeds from illegal gambling activities. Likewise, because Casino Gambling did not allege or show that it intended to engage in conduct proscribed by statute, that it has been served with a subpoena, or that it had been contacted by the DOJ in any way, it failed to show it faced a credible threat of prosecution (Casino City, Inc. v United States Department of Justice, 1995). Hence, because Casino City had failed to present a genuine case or controversy, Casino City lacked standing to file its claim against DOJ.

Similarly, Casino City failed to allege a valid claim that its First Amendment right to engage in commercial speech was violated, because (1) the First Amendment protects advertising which promoted legal activities; (2) the advertisements appearing on Casino City's webpage promote online gambling which is illegal, and therefore beyond the purview of the First Amendment; and (3) the advertisements appearing on the webpage are misleading because they falsely portray internet gambling as legal (Casino City, Inc. v United States Department of Justice, 1995, at 14-15). Hence, even if Casino City had standing to pursue its claim, it failed to a valid cause of action in its Complaint.

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EXHIBIT A

U.S. Department of Justice
Criminal Division

Office of the Deputy Assistant Attorney General Washington, D.C. 20530

June 11, 2003

National Association of Broadcasters
1771 N Street, N.W.
Washington, DC 20036

Re: Advertising for Internet Gambling and Offshore Sportsbook Operations

Dear Sir or Madam:

As you are no doubt aware, advertisements for Internet gambling and offshore sportsbook operations are ubiquitous on the Internet, in print ads, and over the radio and television. The sheer volume of advertisements for offshore sports books and online casinos is troubling because it misleads the public in the United States into believing that such gambling is legal, when in fact, it is not. Because of the possibility that some of your organization's members may be accepting money to place such advertisements, the Department of Justice, as a public service, would like you to be aware that the entities and individuals placing these advertisements may be violating various state and federal laws, and that, entities and individuals that accept and run such advertisements may be aiding and abetting these illegal activities.

With very few exceptions limited to licenses sportsbook operations in Nevada, state and federal laws prohibit the operation of sportsbooks and Internet gambling within the United States, whether or not such operations are based offshore. United States Attorneys' Offices in several districts have successfully prosecuted offshore sportsbookmaking and Internet gambling operations, and the Department of Justice will continue to pursue such cases.

Notwithstanding their frequent claims of legitimacy, Internet gambling and offshore sportsbook operations that accept bets from customers in the United States violate Sections 1084, 1952, and 1955 of Title 18 of the United States Code, each of which is a Class E felony. Additionally, pursuant to Title 18, United States Code, Section 2, any person or entity who aids or abets in the commission of any of the above-listed offenses is punishable as a principal violator of those statutes. The Department of Justice is responsible for enforcing these statutes, and we reserve the right to prosecute violators of the law.

Broadcasters and other media outlets should know of the illegality of offshore sportsbook and Internet gambling operations since, presumably, they would not run advertisements for illegal narcotics sales, prostitution, child pornography or other prohibited activities. We'd appreciate it if you would forward this public service message to all of your member organizations which may be running such advertisements, so that they may consult with their counsel or take whatever other actions they deem appropriate.

Very truly yours,

JOHN G. MALCOLM
Deputy Assistant Attorney General
Criminal Division
United States Department of Justice

TAKE THE MONEY AND RUN: WHITE COLLAR CRIME AT DHR PATIO HOMES, LLC[1]

Herbert Sherman, Southampton College – Long Island University
Daniel J. Rowley, University of Northern Colorado

CASE DESCRIPTION

This is a field-based disguised case which describes how a small family business deals with crimes committed by a trusted employee. The problem for the characters in question is how to deal with their most trusted employee, someone they treated like a family member, who they discovered had stolen nearly $25,000 from them over a two year period. Several factors complicate the owners' decision as to how to proceed: the person in question was their most tenured employee and had become part of the family, the employee and his family were renting a house built by the protagonists for the employee until the employee could establish his own credit, and the employee's brother worked for the firm. The case has a difficulty level appropriate for a sophomore or junior level course in business ethics or small business management. The case is designed to be taught in one class period (may vary from fifty to one hundred minutes depending upon the course structure and the instructional approach employed, see instructor's note) and is expected to require between four to eight hours of outside preparation by students (again, depending upon instructor's choice of class preparation method).

CASE SYNOPSIS

Derived from observation, field interviews, and e-mails, the case describes how two college professors operating several businesses were confronted with the fact that their most senior and competent employee appeared to have purloined nearly $ 25,000 in company funds. The employee in question, Alan Thompson, was originally hired with his wife Wilma to finish basements in Davis and Hodgetts' rental units. This project was such a success that as the business moved into private home construction Alan became the defacto on-the-job contractor. Growth in their business cost them their bookkeeper and they secured the services of James Carroll, CPA for the firm. When examining the firms' books, Mr. Carroll noticed that certain expenses were either for personal items or duplicates for similar expenses incurred a short time ago. An audit indicated that Alan Thompson was the culprit for these expenses as well as the fact that several charge card receipts had a signature that was not Mr. Thompson's. Davis and Hodgetts had to decide what if any legal action would they take, if they wanted to try to recover any of the stolen funds and if so, how; and how do they want to confront Alan with their findings?

"Jim," Richard Davis managing partner of DHR Patio Homes, LLC shouted in disbelief, "are you trying to telling me that over the past two years my right-hand man and foreman, Alan Thompson, has embezzled nearly $25,000?" "Figures don't lie but liars figure," retorted James J. Carroll, CPA, the new accountant for the firm. "I've audited your three firms' accounts for the past two years and found that purchases have been charged to Thompson's corporate credit card that either have nothing to do with the business, like the purchase of a Christmas tree, or seem implausible, like buying gasoline six times in the same day for the same vehicle. Worse, I've noticed that for several purchases the signature on the receipts do not even come close to matching the signature on the back of the corporate credit cards. I think someone who is not authorized has used this card - that's not only embezzlement, my friend, that's credit card fraud and forgery!"

COMPANY BACKGROUND & HISTORY

Davis and Hodgetts owned three firms: D & H Management LLC, DHR Construction LLC, and DHR Patio Homes, LLC. See Figure 1, below.

Figure 1
Richard Davis and Stephen Hodgetts' Businesses

Business #1

D & H Management LLC was started in August 2002, when the Dow Jones Industrial Average dipped under 8000. Davis and Hodgetts, friends and coauthors, were lamenting their ever shrinking retirement funds. Neither was getting any richer on a faculty member's salary nor did they expect any windfalls from relatives, their book sales, or lottery tickets. As Hodgetts was fond of saying "America believes in education: the average professor earns more money in a year than a professional athlete earns in a whole week."[2]

After a long discussion, they decided that they could not longer bear "the slings and arrows of outrageous fortune"[3] and consequently needed to become masters of their own economic fate. Davis had done preliminary research on the real estate market in their area and convinced Hodgetts (who had a bad experience renting his house several summers ago) that there was money to be made becoming what Hodgetts half jokingly called "slum lords."

The basic premise behind their business was quite simple. New starter homes (3 bedroom, 2 bath) in their area sold for about $175,000 and could be purchased with as little as a 5% down payment. Davis was working with a real estate agent who noted that there were numerous families looking to get into these starter homes. However they either did not have enough cash for the down payment and/or had a poor credit history and could not qualify for a mortgage. These families lived in either mobile homes or apartments and were paying rents ranging from $1100 to $1400/month. They seemed to be willing to sign a three year lease on a new home with an option to buy. The three years would allow these families to build up a positive credit history and/or a down payment.

Davis and Hodgetts, with the assistance of Davis's real estate agent, found six families in three months and worked with these families to find them homes in the $175,000 price range that the families would be happy to lease and eventually purchase. The deal was so attractive that they even had a waiting list for new tenants. The six homes though had gobbled up their initial investment of $100,000 and required an additional $80,000 (which Hodgetts loaned the company) although their monthly cash flow was positive ($1,500/month).

Business #2

The second business started off as just a small capital raising venture. Hodgetts and Davis would finish off the basements of their rental homes, get the homes reappraised, and then re-mortgage the properties pulling out an additional $10,000 - $20,000 per home. These funds could then be used as down payments for future rental homes.

Davis and Hodgetts had originally approached several builders in the area who priced the job at about $15,000. In discussing the prospect of finishing off basements with their renters, one renter claimed that he could finish off his own basement and save the firm from $2000 to $5000. This was Alan Thompson, who, with his wife Wilma, moved from a trailer home to become one of Davis and Hodgetts' first renters. They would not be able to do any of the technical work i.e. HVAC (Heating, Ventilation, Air-Conditioning), plumbing, or electrical, but would be able to do all the other work including framing, dry walling, finishing and painting.

In chatting about this matter further will Alan and Wilma, Davis and Hodgetts proposed that Alan and Wilma also finish off all of the other basements of their tenants. Davis explained to them that they would have to form their own LLC and act as any other subcontractor. They would have to obtain their own business insurance and home construction permits, pay their own taxes, and supply their own tools and raw materials. Alan and Wilma estimated that they could make at least $2000 per job, since the work was labor intensive. They both could work on the weekends to complete the basements in a timely fashion. From Davis and Hodgetts' perspective, even if they were to save only $2000 per home, that would net them a $12,000 savings on their six homes. This would free up cash for future home purchases. Davis and Hodgetts went on to purchase six more homes, five of which had their basements completed by Alan and Wilma (as A&W Construction, LLC). This was an excellent arrangement for Alan and Wilma since they could finish off a basement in about a month's time and net a profit of about $2000 per basement. This income was of great benefit to Alan and Wilma since Wilma was a stay-at-home Mom who was home teaching her four children and Alan was a low wage day laborer.

Alan and Wilma enjoyed working on these basements so much that they approached Davis and Hodgetts about figuring out a way that they could keep them occupied all year round. The gist was that Alan wanted to quit his job and come work for Davis and Hodgetts. However, there was nothing that Davis and Hodgetts could do for Alan and Wilma at that time. Yet a few days later the situation changed dramatically. Their basement designer, David Russ, was Davis's student. He approached Davis with the idea that Davis and Hodgetts could cut out the middle man in terms of the rental business if they built their own homes. Davis thought that Russ was crazy at the time but they talked after class and Russ said that he would be happy to act as the general contractor. Russ also stated that he knew all of the subcontractors who were needed in order to construct new homes. Alan and Wilma would do all of the interior work, and Alan could hire some part-time workers to help out. In any event, Davis and Hodgetts could build the rest of the homes they wanted to rent under a different company name, sell it to themselves for a profit, and then make a profit renting the homes. On a $150,000 home Davis and Hodgetts would net about a 20% profit, that's around $30,000 over a two to three month time period (the time it took to build a 1200 square foot three bedroom, two bath home).

The profit derived from this little construction company lead Davis and Hodgetts to backward integrate their operation. They were now going to build homes for public consumption as well as for D & H Management (as rental units). In May, 2003 DHR Construction LLC was formed and broke ground on their first construction site in the St. Andrews development.

This shift in strategy however uncovered some troubling operational problems. While on the surface everything seemed to be going fine, an undercurrent of discontent was running through the ranks of DHR's subcontractors, especially Alan and Wilma. They complained bitterly to Adrienne Davis (Richard's wife) that Russ was both crude and rude in his dealings with them and the other subcontractors. Further, Russ had threatened to fire them if they protested his actions to Davis and Hodgetts. Other subcontractors were complaining to both Davis and his wife as well. They'd be called into a project by Russ either too early, when the work was incomplete (and therefore they could not do their own work), or too late (they'd have to work around someone else's work). Property was also disappearing from the work sites, especially with wrong orders where goods would have to be picked up for return by the deliverer. Homes were running over budget and the quality of the work being performed was inconsistent and not always up to building codes.

Less than two weeks into construction at St. Andrews, Adrienne decided to intervene and have a chat with David Russ. She wanted to give him a chance to reflect on the negative feedback that she was getting from all of the subcontractors. The meeting went well according to Adrienne, however the situation was getting worse. She confided in Hodgetts a week after the meeting that David Russ was undermining Davis and Hodgetts' relationships with various subcontractors by setting unrealistic deadlines. Alan was the one who smoothed things over with the subcontractors once David Russ left the job site; otherwise the subcontractors would have walked off the site.

Hodgetts had a nice chat with Richard Davis who concurred that a meeting would put this issue to bed once and for all. The meeting went well according to Davis but David Russ's deplorable behavior did not desist. This matter came to a head only a few weeks later, in early July, when Richard Davis and his wife took a two week trip to Europe. Hodgetts also planned to be out of town at the same time. This left Davis's son Robert to represent both Davis and Hodgetts' interests while they were away and Robert was given the formal authority to act on Davis and Hodgetts' behalf.

Robert had scheduled a luncheon appointment with each of the subcontractors during the time his parents were away in order to give him a chance to connect with all of the subcontractors and catch up on events. The fact that Robert was speaking to subcontractors without permission from David Russ caused David Russ to become quite agitated. David Russ then proceeded to threaten Alan and Wilma, saying that none of the subcontractors were to speak to anyone but himself and that he would report any information necessary to the Davis' or Hodgetts. Wilma reported this conversation back to Robert Davis, who immediately forwarded this information onto Richard Davis and Hodgetts. In July, 2003, Hodgetts and Davis reluctantly agreed that they needed to rid themselves of their co-owner, David Russ, given the negative reports they had received from their subcontractors and Davis's son. Both Davis's wife and son found Russ's behavior intolerable and evidently these behaviors were not going to be corrected in the near term. Davis was forced to choose between his family and his business partner and his business partner drew the short straw.

In November 2003, Davis and Hodgetts bought out David Russ's interests in DHR Construction. By January 2004 they had completed three homes at St. Andrews. They then shifted their building site to another location, the Florence Development, which they felt had a more up-scaled look and would allow them to build nicer and more expensive homes. By April, 2004 they had built three homes in Florence, had plans to build five more in that area, and were looking at other developments for future growth and expansion. On April 12, 2004 the Florence Development Corporation failed to pay their landscapers and each of the properties that were owned by Davis and Hodgetts in the development had a substantial mechanic's lien placed on it. This made it impossible for Davis and Hodgetts to build on these properties until the matter was resolved.

Business #3

While a deal was being brokered to clear Davis and Hodgetts' liens, in June 2004 Davis had located a brand new development about 10 miles east of where they currently were building, in an area called Snowy Mountains. Snowy Mountains was a unique project for the area since the developers had built lakes, a golf course, and a club house (including a three star restaurant) and had very specific designs for community development. The housing currently in the development (phase one) ran the gamut of homes, from two bedroom condominiums (that started around $140,000) to million dollar estate homes on the lake. Every member of the community was given access to the club house (which included a pool and a play ground), the several lakes dotting the development, and a discount at the restaurant and golf course. The developers also sponsored fishing, golfing, boating, and concert events. There was even an island that could be rented out for weddings and other parties and included fully equipped restrooms with showers, electricity, and a kitchen service cabana.

Davis believed that he and Hodgetts lucked out in that one of the home construction companies in the Snowy Mountain development had pulled out of their project, Mountain Trails, after a disagreement with the developers. The company had built approximately ten patio homes[4] starting in 2002 in a forty-five lot area, leaving the remaining lots vacant. Thirty-three of the lots had been sold back to Snowy Mountain; the other two lots were in foreclosure and held by two different banks. This was the last remaining section of Phase One which needed to be completed before Phase Two could be developed. Justin Martin, the developer, was reluctant to open Phase Two without a commitment from a home builder for the rest of Phase One. He was afraid that the Phase One property would remain dormant. Homeowners in this section of the development were getting quite upset that no action had been taken to complete their part of Snowy Mountains and clearly a solution was needed before the developer faced possible legal action. After several discussions with the local residents, Davis and Hodgetts felt that they were like white knights coming to the rescue of both the developer and the neighborhood.

DHR Patio Homes, LLC was therefore established in August 2004 by Richard Davis and Stephen Hodgetts in order to separate their construction projects in Florence from their latest project, Mountain Trails. DHR Patio Homes developed a simple business model. Homes would be priced at 20% above cost with Richard Davis acting as the architect and head of operations of construction. His job was to work with the subcontractors to ensure that their work met schedule and building code requirements and to make sure that subcontractors' bills coincided with the work provided. Alan would work with Richard Davis on the job by helping to coordinate the subcontractors as well as continue his own subcontracting work dealing with wall hanging, lining, spackling, molding, and painting. Wilma worked along side Alan (though Wilma was paid by Davis and Hodgetts directly) while Alan also hired his younger brother Marvin in order to help out. There was plenty of work to do and Alan wanted people he could trust. Alan's LLC received $6000/month to pay himself and his brother and pay federal income tax.

TEAM BUILDING

Davis and Hodgetts, both being academics, had a much more egalitarian approach to management and business ownership than a typical small business contractor. Although both held Ph.D.'s and were fairly well published and therefore considered experts in their own fields, they took a democratic approach to business operations and did not laud their education over their workforce. On many occasions they would meet with their subcontractors to brainstorm how a home should be designed and built, soliciting input from their subcontractors as often as possible. They treated their subcontractors as colleagues, specialists in their own fields, and it was clear from the feedback they received from their subcontractors that this style of management was both refreshing and appreciated.

Alan and Wilma, having worked with Davis and Hodgetts the longest of all of the subcontractors, seemed to flourish under this leadership style. Alan was a soft-spoken individual who had really never been given the opportunity to work the way he wanted to work. Davis gave Alan the autonomy to purchase tools and other building materials as needed, allowed him to use the business truck as his own vehicle, and gave Alan the authority to deal directly with the other subcontractors. Alan was therefore the point man for the building operation and focused on quality workmanship by building a solid network of subcontractors.

Davis and Hodgetts' trust in Alan and Wilma seemed to be reciprocated by their devotion to the business. Alan and Wilma had stuck with Davis and Hodgetts through the business's tough times and they developed what the Davis family thought were strong social bonds. Alan was always the man on the spot who worked weekends to get the job done on time and Wilma was always there to lend him a hand. This dedication to the job and to the business was taken very much to heart by the Davis family who, on many occasions, would invite Alan and his family to barbeques, dinners, and family outings (i.e. sports events). Hodgetts, who was at arms length from the business because of his own academic interests, was always impressed with how close the Davis' had become with Alan and Wilma and was always pleased to see Alan, Wilma, and their family at the Davis household during Davis and Hodgetts' weekly business meetings. Hodgetts could not recall a major business event (i.e. Christmas party, business opening, or anniversary) where Alan and Wilma were not in attendance. When Alan's brother Marvin came on board for the Mountain Trails project, social events included Marvin's family as well. This cemented the familial bonds within the business. Davis and Hodgetts were even renting the home that they had built for Alan and Wilma to them until their credit was established and they could obtain a decent mortgage rate. All seemed to be well from Davis and Hodgetts' standpoint given their previous trials and tribulations since the business now seemed in solid hands with Alan and Marvin.

PARTING IS SUCH SWEET SORROW

Typical of most small business owners, Davis and Hodgetts employed a friend of the family, Sally Stone, a bookkeeper, to keep the records of the businesses in order. Sally would take all of the monthly receipts, deposits, and bills from Adrienne, record them in the firm's journals, and write out any checks for outstanding bills. Adrienne would then receive a monthly statement from Sally for each of the businesses which she would then share with her husband Richard. Richard in turn would pass a copy to Stephen Hodgetts during one of their weekly brainstorming meetings where they would discuss the ramifications of the statements.

As the operation grew, however, Sally realized that she was getting in over her head and that the services of an accountant were needed. For example, the real estate management firm held most of the firms' assets and therefore any loan that Hodgetts made to the business' operations were done through D & H Management LLC. However, on many occasions the funds secured by this company were used by one of the construction companies; in essence D & H was lending money to another firm and the books of all of the firms involved needed to record this transaction. Sally knew how to record these transactions but was afraid that there may be more that Davis and Hodgetts needed to know that she was not aware of. With a heavy heart, Sally informed Davis and Hodgetts that she could not longer properly service their firms and that she would reconcile the books at the end of their fiscal year, December 31, 2004 and then depart.

Although Hodgetts and Davis understood Sally's reasoning, they were surprised that Sally would give up such a fast growing company. Sally, to her credit, had provided them with a list of local accountants that she subcontracted with, yet none of them had any experience with real estate management firms and construction companies. Davis and Hodgetts felt that if they had to hirn an accountant, they wanted one who was not only familiar with the construction industry but had several construction clients. Furthermore, they decided they wanted to work with a small accounting firm (best case scenario: a sole proprietor) since it was their belief that they would obtain the most personalized service from a small, independent accountant.

ENTER THE ACCOUNTANT!

After chatting with several of the other small local builders, and one or two larger ones as well, Davis made several phone calls to prospective accountants. They all seemed very competent, but one in particular, James J. Carroll, CPA, not only understood the business but also owned rental property. Davis and Hodgetts met with Carroll in early February 2005 and hit it off quite well with him. It turned out that Carroll was a professor of accounting at another local college and shared their passion for learning, Shakespeare, and Sherlock Holmes. Carroll immediately had several suggestions for the businesses including setting up a 401K retirement plan. Hodgetts and Davis turned over a copy of the books to him directly at the end of the meeting.

A few days later, Carroll, having just landed another construction company as a client, was perusing Davis and Hodgetts' books to obtain a feel for the company's expenses and revenue streams as well as the way in which the company's bookkeeper checked receipts against claimed expenses. "Let's see … digging into October 2004 corporate credit card charges … This is strange … I've got six gas receipts charged on the same credit card for the same day for the same vehicle .. how is that possible?" Digging into the older receipts Mr. Carroll noticed numerous strange credit card charges to the same credit card: a Christmas tree and gifts from Home Depot, over two hundred dollars of food purchased at Wal-Mart, and fifteen to twenty specialty tools purchased over and over again in a span of just a few weeks.

Carroll, having worked with several other small businesses, knew that some small business owners would charge family expenses to their corporate credit cards. He hoped that this was not the case. Mr. Carroll was a highly ethical accountant and always explained to his new accounts that personal expenses could not be treated as business expenses. Mr. Carroll would not service any client who mixed these expenses, specifically, those clients who hid personal expenses in their businesses. He decided that before he would discuss the ramifications of this behavior with Davis and Hodgetts, that he better do more digging. Perhaps he could discern a pattern which would explain such behavior.

THE SEARCH IS ON

Carroll felt like Sherlock Holmes as he plodded through all of the receipts, checks, and journal entries. He was astounded at what he found. First, Davis and Hodgetts had set up separate credit card accounts for each of their corporations, an extremely sound practice since this made it quite easy to track and separate corporate expense. This built a paper "wall" between the businesses. Most small business owners with multiple LLC's that Mr. Carroll advised had to be taught to divide up expenses by business; Davis and Hodgetts were ahead of the game. This lead Carroll to assume that Davis and Hodgetts had some awareness as to the proper handling of business expenses. Perhaps these personal charges were at best accidental or at worst temporary "loans" that they would pay back their businesses. Yet more digging revealed additional interesting data.

When Davis and Hodgetts set up these corporate accounts, they were intelligent enough to assign a specific card to each person who was issued a corporate credit card. There were usually three cards issued per account; one to Richard Davis, a second to his wife Adrienne, and a third to Alan Thompson. The credit card company tagged each card so that when the company reported the monthly charges they did so by the person who accrued the expense for the firm. It was therefore possible to track individual spending patterns and determine who spent how much on what.

Carroll quickly noticed that the personal expenses all seemed to be made by only one person, Alan Thompson. Carroll tabulated these expenses, along with expenses he thought were perhaps frivolous or questionable (for example, the purchase of the same tool three or four times in a three to four month time span), and found about $25,000 of these types of expenses over a two year time period. Mr. Carroll also checked the signature of the Thompson's card (Davis and Hodgetts had made copies of each of the credit cards, both sides, in case they got lost or were stolen) and noticed that on several occasions the signature was different on the signed credit card receipt than on the actual credit card.

He took his findings to Richard Davis, who, at first, was totally incredulous. However, after examining all of the evidence knew that he had a real problem. The question is, what should he do about it? He decided to talk with Stephen Hodgetts and his wife Adrienne before he took any action.

THE MEETING

Richard Davis recapped the situation of the misappropriated funds to his partner Hodgetts, who sat still throughout the entire proceedings. When Richard came to the end of his tale of woe, the silence was deafening.

"So now what do we do?" Stephen said to break the stillness. "Clearly Alan has abused his corporate credit card and we must put an end to that immediately." "Done" interrupted Adrienne. "I have called the credit card company and immediately cancelled his card. I told Alan not to use his credit card since we are in dispute with the credit card company over some charges." "So you lied to him" responded Richard. "You don't think that he will now put two and two together and figure out that we're onto him?" "What else could I do, Richard? Cancel the card without telling him and have him find out that the card is no longer valid when he tries to use the card? That would seem even more suspicious! Or worse, should I have allowed him to continue to put unwarranted expenses on the card? What would you have had me do?"

"Wait a minute, slow down the both of you!" chimed in Hodgetts. "We can't fight amongst ourselves on this, that won't get us anywhere. Let's look at all of our options and what we immediately need to do to protect our businesses. If we have cut off Alan from his ability to spend company funds then we have at least dealt with one short-term issue." Both Richard and Adrienne nodded their heads in agreement. "Good" continued Hodgetts "then what are the next steps we need to take in order to protect ourselves and deal with this theft of funds?"

"Good question" exclaimed Richard. "I see that we have at least three issues to deal with. One, what if any legal actions can we take and do we want to take at this time? Two, do we want to try to recover any of the stolen funds and if so, how? Three, Alan and his family have been part of our businesses since the beginning. What actions do we want to take with Alan and how do we want to confront him with our findings?"

Adrienne seemed very disturbed by the entire conversation. "We are all struggling with this feeling of loss and betrayal" she said in a saddened tone. "These are tough decisions we need to make. I think we need an objective view, so I'll contact our lawyer first thing Monday morning. His advice will be extremely helpful." "An excellent suggestion my dear" Richard declared. "Let's hear what our lawyer has to say about this terrible debacle and see what sense he can make out of it. In the interim, mums the word to Alan, his wife, or his brother. I don't want to accuse anyone of anything until I know what the possible liabilities are for us if such accusations are contested or worse, wrong!"

ENDNOTES

1 This is a disguised case. The name of the company and the characters in the case have been changed at the request of the owners.

2 http://www.quotationspage.com/search.php3, August 27, 2003.

3 Hamlet (III, i, 56-61)

4 A patio home is a detached form of condominium. The homeowners association performs all exterior maintenance and collects fees from the individual homeowners.

JOJA'S DELI: A FRANCHISE IN NEED OF DIRECTION

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CASE DESCRIPTION

The subject matter of this case addresses the problems and opportunities for a new franchise concept. This case would be most appropriate for undergraduate courses in entrepreneurship, small business management, franchise management, and strategic management, as a written assignment—and graduate courses as a class discussion. The case is designed to be discussed in one to one and one-half hours and should take students no more than three hours of outside preparation.

CASE SYNOPSIS

At one level, this case traces the success and growth pains of a small business transformed into a franchise. It follows a family business from start-up, through change, to success, and finally to potential high value creation. Throughout this journey the problems and opportunities of running a small business are illustrated.

SITUATION

In 1938 George Levin opened a small grocery in the historic neighborhood of a large southern city. George was a butcher by trade and offered his customers the best meats and poultry in the area. His small grocery did remarkably well and George Levin became one of the fixtures of the city. In 1941 George's first son Joseph was born, followed in 1943 by his second son Jacob. Both boys worked in the grocery while growing up and followed their father into the business in the early 1960s. Levin's sons continued the family business with the same attention to courtesy and service, arriving at 6 a.m. to cut the meat and often staying after the store closed at 10 p.m. Years of long hours convinced Joe and Jacob Levin the business needed some new twists. New supermarkets were popping up everywhere and they were killing the family run small grocery store.

In 1968, Joe and Jacob decided to devote their energies to capitalizing on strengths --- providing high quality meats and poultry and personalized service. The result was the first JoJa's. They concentrated on providing specialty meats such as Virginia hams, gift and corporate baskets, gourmet items, and other novelties. The first JoJa's was successful, but things did not really take-off until a deli counter was added in 1971. The brothers provided the highest quality deli sandwiches, soups, stews, salads, and desserts. From there the rest is history. The original store expanded twice and another store was added in another section of the city in 1982. Joe ran the original store and Jacob ran the new store until 1996, when Joe's son Joey took over operations at the original JoJa's. Both stores won numerous awards for their food and customers raved about the cuisine. JoJa's won "Best Deli" a record 10 times and was considered a town tradition. Additionally, the Levin's treated all customers like family.

Many times the Levin brothers were asked about franchising their deli concept and had been approached about possibly selling their business. While they were young and the business was going so well they had refused all offers of changing or selling their company, but in 1998 Jacob's son Steve took over the newer JoJa's, leaving both founders to think about what to do next? Several opportunities existed for JoJa's --- opening up new locations, expanding their corporate catering business, or possibly selling the business or the concept to investors. None of these possible opportunities appealed to the Levin brothers. First, selling a family business to outsiders seemed like blasphemy to both their father and to their sons, Joey and Steve. Next, after 40 years of working in the business both of the brothers were looking for a change of pace. Finally, both Levin brothers felt that JoJa's had a lot of unrealized value that they needed to unlock.

In December1998, Joe and Jacob decided to franchise their deli concept. First, they developed a series of operation manuals, planning guides, training videos, and created a Web site, translating 40 years of deli knowledge into a documented system. Next, they hired lawyers, CPAs, and other specialists, and drew up all the necessary papers and documents. These documents were filed with the proper local, state, and federal agencies and JoJa's Deli, Inc. began selling franchises. The franchising costs were substantial --- over $120,000 plus their time and effort, but the Levins felt that they would recover their investment very quickly. The new company consisted of just the franchise business, which Joe and Jacob operated. Joey Levin became the owner/manager of the original unit and Steve Levin became owner/manager of the other JoJa's. Both stores were required to pay 2% of gross sales for royalties to the new corporation. All-in-all everyone was happy and the Levin brothers optimistically waited for the franchise royalties and sales to roll-in.

By 2000 the Levin brothers had not sold any franchises. The reason was simple --- Joe and Jacob knew how to operate a great deli, but knew nothing about operating a deli franchise. Still they continued down the road of hard-knocks. Finally in 2001, two former UPS drivers (Phil Tyler and Bill Walters) bought the first JoJa's franchise. The location was 100 miles away in another large metropolitan area, but within the same southern state. Phil and Bill located their JoJa's on the street level of the financial district of a small city. To augment sales they offered corporate lunch catering. Their first store became a huge success and today it is the top performing JoJa's, with yearly sales of nearly $900,000. The amazing part of the story is the store only stays open on Monday through Friday from 7 a.m. until 3 p.m. One year later Phil and Bill opened their second JoJa's in another financial district of another large city. It is the second best performing JoJa's with yearly sales of nearly \$800,000. (These two units became the top performers averaging \$850,000 in yearly sales.) While the Levin brothers were thrilled with the success of the first and second franchised JoJa's, they realized that it had taken them nearly three years to sell two units. Additionally, Phil and Bill were able to buy the franchises for only \$5,000 each, a discount of \$60,000 (2 x \$30,000) off the original franchise price. While they were paying the 2% royalty fee on gross sales, they had discussed cutting that fee because of the lack of support. Phil and Bill pointed out to the Levin brothers that while they had done a wonderful job of preparing them to open their first JoJa's --- providing a great concept, training, location assistance, vendor contacts, and such, they had done little since then. There was no marketing, advertising, or corporate or field support after a franchise was launched. The Levin brothers countered that most franchisors charged 4-6% of gross sales for royalty versus the 2% they were paying and that they received a substantial discount on their franchise fees. By now, it began to dawn on Joe and Jacob they might need some help operating the franchise business (see Exhibits 1, 2 and 3). They were not receiving the return that they had expected and had little idea about what they should do to support the franchisees and push the JoJa's concept.

During the next four years, the Levins were able to sell six more units to six different franchisees. All of the new locations were in the same southern state. Four followed the Levin formula for locating JoJa's --- an urban location with lots of foot traffic and high-density businesses. All four of these locations became median performers with yearly sales averaging \$650,000. Two other franchisees opened their stores in strip centers in college towns. The Levin brothers had advised against these locations, but approved the sales agreement in the end. Without foot traffic and business worker support the units struggled with yearly sales of only \$575,000 and EBT of only 1.5%. Clearly, for the JoJa's concept to work it was necessary to get the right location. Additionally, a few franchisees did not follow menu, recipe, and operation procedures. However, Joe and Jacob did not follow-up on these infractions and this tended to increase the independence of the franchisees.

The JoJa's concept: Open only when and where it is busy for lunch

The beauty of the JoJa's concept is its simplicity. Provide the absolute best deli sandwiches, meats, salads, stews, soups, desserts, and gourmet items to customers at a reasonable price, in a clean, convenient location, and operate the business when and where sandwiches are sold most often --- work lunches. Consequently, the Levin brothers have developed the franchise to run like a clock, if franchisees follow this set of rules:

1. Locate the store on a busy urban street corner, with lots of foot traffic. Phil Tyler and Bill Walters further refined this rule --- locate the store near the financial district of an urban

area, where the JoJa's can cater business lunches. This represented another revenue stream. In fact, the two top performing JoJa's (owned by Phil and Bill) receive 30% of their revenues from business catering --- almost three times the norm, and this business had the highest profit margin.

2. Have multiple streams of income. Besides the deli, JoJa stores should also cater business lunches, sell corporate gift baskets, and provide gourmet foods and novelty items. The corporate gift basket business provides 10% of total sales on average, but during the Thanksgiving/Christmas holiday season this percentage jumps to 24%. Here is an average breakdown of all possible revenue stream percentages, averaged across all JoJa's:

Corporate/gift baskets	*10%*
Corporate lunch catering	*12%*
Breakfast	*5%*
Gourmet/specialty foods	*7%*
Lunch	*66%*
Total	*100%*

3. Kitchen and food preparation areas should be organized as outlined in the franchise manual. Additionally, all equipment specified by the manual should be purchased. All franchisees agree that the Levins know how to create and equip an efficient production platform. The franchise manual has detailed specifications for all equipment and supplies.
4. Provide customers with all items on the JoJa's menu. Additionally, follow all recipes, portions, and specifications for all menu items. The food and service is what brings people back. The food has won awards in every new location --- so do not mess with success.
5. Remember all JoJa's depend on repeat business. Most JoJa's customers work and shop close to each store and buy lunch everyday. It is important that each customer is completely satisfied. Additionally, it is imperative that each JoJa's offers a wide selection of quality soups, sandwiches, salads, meats, desserts, and other gourmet items. The main marketing appeal is to attract as many customers as possible and offer something new, appealing, and different for every customer visit.

The JoJa's concept has been very successful. The stores generally open at 7 a.m. for a simple breakfast offering of self-serve gourmet coffees and pastries, assorted fruits, and such. In the morning, catering and large lunch orders are created and packed. By 11:00 the delivery services pick up the catering and delivery lunches. Walk-in customers begin arriving around 11:30 and both eat-in and take-out traffic continues until 2:00. From 2:00 until 3:00 the deli is closed, cleaned, re-stocked, and night delivery orders are prepared. At 3:00 the delivery services pick-up the orders and the team leaves for the day. Sales per customer seat, square foot, and per hour of operation are extremely high and the operation is one of the most efficient concepts of its type (see Exhibit 1).

A FANTASTIC FRANCHISE OPPORTUNITY AND CHEAP TOO!

The Levins have created a first rate franchise opportunity that is very affordable for many potential franchisees. Below are the average costs for launching a JoJa's (there are two prototypes --- a stand alone deli and a full-service deli/specialty shop). The actual cost to open a JoJa's has been between $100,000 and $120,000, because none of the franchisees, to date, have paid the full franchise fee. The start-up cost is comparable to a Subway Sandwich Shop and much less inexpensive than a Jason's (i.e., start-up costs are estimated to be $650,000. Jason's food and service are very close to JoJa's, but the two concepts have different operation strategies).

Types of Expenses	Stand alone JoJa's	Full-service JoJa's
Rent and deposit	3,000	3,500
Equipment	60,000	60,000
Computer	1,500	1,500
Office supplies	500	500
Fixtures	7,000	10,000
Opening inventory	6,000	10,000
Business insurance	2,000	3,000
Administrative expenses	5,000	7,000
Signage	3,000	5,000
Working cash	10,000	20,000
Sub-total	98,000	120,500
Franchise fee	20,000	35,000
Total	$118,000	$155,500

Dilemmas for JoJa's: What should the Levins do?

Joe and Jacob Levin have business problems, even with a wonderful business. First and foremost is the poor growth of their franchise business. From 1998 until 2005 they sold a total of eight franchises. Two of the franchises are extremely successful, and four others have reached sales and profits of the original JoJa's. The other two units are struggling, due to locating their stores in small college towns. Besides this, all franchises are located in one state. Next, the Levin brothers have not been able to acquire "stated" value for franchise fees. For example, Phil Tyler and Bill

Walters only paid $5,000 for each of their stores, substantially less than the stated $35,000. Additionally, Joe and Jacob realize that they must begin to control and support the franchisee units. There is an "informal" communications system among the franchisees and potential franchisees, where critical information is shared, such as sales and fees. There are provisions in the franchisee agreements for increasing the royalty fee due to such things as corporate advertising, management costs, training, further development, etc. Finally, the Levin brothers need to determine if they have the capacity to lead this business. If not, then they need to look at their options.

A QUESTION OF ETHICS IN A UNIVERSITY SENATE

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CASE DESCRIPTION

The primary subject matter of this case is the ethical use of power and peer pressure within a group of people with significantly different status – a university senate comprised of a provost, deans, administrative VPs, faculty members, and students. Secondary issues include how the same events can be experienced differently, leading to different assessments as to the ethical behavior of those involved. Case difficulty is 2 (sophomore). The case is designed to be taught in an introductory management or ethics course requiring from 50-75 minutes of class time and either no outside preparation, or about 20 minutes of pre-class preparation.

CASE SYNOPSIS

This case is about a University Senate meeting in which lobbying is done by the Chair of the Senate prior to the meeting. The Chair caucuses a group of student senators and pitches her views regarding an upcoming vote. As the Chair is a senior faculty member, she has power over the students – even though the ideology of the university senate in question is that all members are equal. During this caucus, the Chair asks for a show of support to vote down a motion – thereby making public among those present an expression of each person's intended vote. The Chair's use of power and status and her use of peer pressure among students are questions to be explored.

Ethical decision making is frequently learned through experiential means – short cases and role play exercises. It is often taught by providing multiple perspectives on an issue and generating confusion or ambiguity in the minds of the learners regarding their initial 'right' and 'wrong' views of a situation. It is not the clearly unethical situations that cause people to get into trouble. Most black and white situations are easy to identify. Rather, it is situations in between – the gray areas that are challenging and require discussion and dialogue. These more complex and sometimes confusing situations are reasons why faculty members provide students with ethical frameworks through which they might recognize their own values and then learn to make choices that are consistent with those values.

The case provides two points of view on the same situation and can be used to demonstrate different ethical frameworks, e.g., comparing the ethical philosophy of Hobbes (1958) to that of Kant (1959). Each view in the case below is by a different newcomer to the Senate – a new student senator and a new dean senator. The differences in their roles, perspectives, and how the caucus and outcome of the vote affects them are significant.

A UNIVERSITY SENATE

The Senate is a University governance vehicle intended to facilitate open communication among University constituencies so that they may discuss issues pertaining to their diverse stakeholders' interests at the institution. The Senate is a place where the voices and votes of students, staff members, faculty members, deans, and administrators are intended to be equal. The student, staff, and faculty participation is based on formal elections held each year. The dean and administrative members are members due to their formal positions within the institution. This meeting's agenda, including a motion to change the membership on one Senate committee, was distributed to all senators five weeks in advance of the meeting, giving all time to consider the agenda items.

The key motion to be addressed at this meeting is for a change to be made to the *University Senate Constitution* which would allow the college deans to send an assistant/associate dean to fully participate in a particular University committee on the dean's behalf. The *Constitution* currently names the dean of each of the five colleges to serve with this committee in question. The deans, if the amendment is accepted, could send a proxy; a liaison between themselves and the University committee charged with making policy recommendations for the University. The originator of the motion is the provost on behalf of the deans.

A STUDENT SENATOR'S FIRST UNIVERSITY SENATE MEETING

It's the first University Senate meeting of the year, but the second scheduled meeting. The first meeting was cancelled because of hurricane weather. You are a student senator by way of a student association election which you won. This grants you the right to be on the University Senate comprised of faculty members, deans, senior university administrators, and other student leaders such as yourself. Being new to the Senate, you are not sure what the underlying issues are with respect to the motion that is going to be put forward. You could have contacted others to discuss this, but chose not to as the idea made you feel uncomfortable.

The first meeting was preceded with a half hour 'social' – a getting together with other senators to share a beverage, snacks, and conversation. You are attending the social to become familiar with other senators and ease into this new role for you. The social is consistent with the University's mission – which articulates truth, unity, and caring as core values.

You recall an e-mail received from a senate committee chair (not the Chair of the Senate) a couple of days before the cancelled meeting. The e-mail shared a motion passed at the last committee meeting stating that the committee wished **no change** to the *Constitution* and prefers the participation of the deans with this committee. The committee chair's e-mail offered the names of senators who could be contacted for more discussion. The list of names included that of the Chair of the Senate.

Having not sought out information regarding today's motion, you attend the social before the meeting. As you meet other student senators you are rallied into a pre-meeting caucus by the Chair of the Senate. The Chair identifies herself as a member of the committee that is to be discussed in the motion today – she does not mention that she is the Chair of the Senate. She offers her views on the potential dilution of university governance should today's motion to change the *Constitution* permitting deans to send their assistant/associate deans as their proxy to select committee meetings.

When a senior-looking male joins the group, you take notice. He is wearing a name tag indicating he is the dean of one of the colleges. He doesn't say much, even when asked. You are surprised by the dean's reluctance to add a view to the conversation. Surely, someone affected by the results of today's vote would have an opinion.

A few minutes later the Chair of the Senate brings the meeting to order. You realize that this is the same person that was running the caucus. The Senate meeting begins and about 10 minutes into the meeting the motion to amend the *Constitution* is presented. The committee chair, also a faculty member, presents the motion passed unanimously by this committee requesting defeat of the constitutional change motion. The quoted committee meeting minutes were distributed to all committee members – all deans have been sent the views of the committee regarding today's motion.

Several deans speak to the issue – generally indicating that it would be helpful to them if they could send one of their direct report assistant/associate deans to those committee meetings which have agenda directly related to that assistant/associate dean's responsibilities. The dean, quiet at the caucus, speaks to support the constitutional change and reinforces the view that having the right person at a committee meeting means having the person there who has responsibility for the topic areas being discussed. As debate continues, a point is made by one faculty senator who notes a recent Rules and Review Committee report focused on the University's governance climate. From that report, the faculty senator cites a need for greater communication between the administration and faculty/students and urges the defeat of motion. The belief shared is that if deans are not in attendance at these committee meetings, effective communication among students, staff, faculty, and other administrators will be lessened.

The customary vote is called, which is a show of hands unless a role call is requested by a senator. Being new to the Senate, you had no knowledge of this. The majority of students, staff, and faculty vote "no". The deans and provost vote "yes". Three of the twelve student senators and one administrator senator have abstained. The reason for student abstentions seemed to be related to being new to the Senate and unfamiliar with operating structures. The administrator probably did not want to alienate any constituency.

The motion to change the *Constitution* is defeated. College deans will continue to be required to attend the committee meetings in question, and if they cannot or choose not to attend, their college will have no voting voice in the decisions made at missed meetings.

A DEAN SENATOR'S FIRST UNIVERSITY SENATE MEETING

It's your first Senate meeting. You are a senator by way of being a dean that places you on the University Senate comprised of faculty members, staff, deans, senior university administrators, and student leaders. The meeting started with a half hour 'social' – a get together with other senators to share a beverage, snacks, and conversation. You attended the social to meet some of the other senators in an informal setting prior to the meeting.

The Chair of the Senate, a tenured faculty member, gathers the student senators in a circle at the back of the room near the snack table. You are getting some snacks and overhear the conversation taking place within the circle. The discussion, initiated and lead by Chair of the Senate, is around a motion to change the *University Senate Constitution* – a motion that is soon to be discussed. She presents her views on this issue, entertains questions but no discussion, and asks for a public commitment of the student senators to support voting down the motion.

As you enter the 'circle' the conversation abruptly stops and someone says, "Oh here is a dean now. What do the deans think about the motion?" Not having participated in discussion of the motion with the three other academic deans, you respond, "I don't know what other deans think – I guess that is what we are here to discuss." You make small talk and leave the circle to get more snacks. You overhear the Chair of the Senate's request that the student senators vote 'no' on the upcoming motion. She asks for and receives a show of support -- student senators' nod and comment to each other that they intend to vote down the motion.

Other than information sharing on the upcoming budget, the Senate meeting focuses on the constitutional change motion. The discussion is open and lively with several dean senators articulating how passing this motion would help them in their leadership positions by involving and empowering their assistant/associate deans to attend select senate committee meetings when they personally cannot attend. The counter argument shared by several faculty senators was that the dean should always attend these Senate committee meetings, and that if an assistant/associate dean were in attendance, they should have no vote. Hence the motion should be voted down.

A show of hands vote is called by the Chair of the Senate who proceeds to make eye contact with each of the student senators. Most of the student senators vote to oppose the motion, with one in support of it and three abstentions. The deans and the provost voted to support the motion. The motion fails.

ENDNOTE

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MANULIFE FINANCIAL AND THE JOHN HANCOCK ACQUISITION

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CASE DESCRIPTION

This case mainly deals with the opportunity for Manulife Financial to acquire the legendary John Hancock Financial Services, Inc. Students must consider both financial and non-financial aspects of the acquisition decision. Secondary aspects include a host of other financial and strategic issues facing Manulife Financial. The case would be relevant for either a senior undergraduate or graduate course in strategy or financial management as it requires analysis and support drawing from both disciplines. The case is designed to be taught in one to two class hours and is expected to require approximately five hours of outside preparation time. Students need to be familiar with financial management concepts and strategic analysis and formulation.

CASE SYNOPSIS

In 2003 Dominic D'Alessandro is facing his most challenging time since becoming CEO of Manulife almost ten years prior. D'Alessandro must not only decide where to invest Manulife's large cash reserve now that a competitor, Great West Life, became the successful bidder for Canada Life Financial, he must also look at the strategic direction he is to set as consolidation in the financial services industry comes to a close. There are many investment alternatives, including the relatively safe bond market; but, more risky and rewarding options may be required if D'Alessandro wants to continue Manulife's legacy of exceptional financial performance.

Aside from the investment and related strategic decisions, D'Alessandro must contend with an appreciating Canadian dollar, the increased re-insurance risk made evident by the events of September 11th, 2001 and the emergence of the Sudden Acute Respiratory Syndrome (SARS) in the Asian continent. In short, D'Alessandro must pursue an investment course that is strategic, and formulate and implement a plan that will ensure the future profitability and viability of Manulife Financial in the short and long run.

INTRODUCTION

June 2003. It has been almost ten years since Dominic D'Alessandro was appointed President and CEO of Manulife Financial. There have been many changes at Manulife Financial during his tenure and today Dominic D'Alessandro is currently facing a different future with room to maneuver. Manulife has a large cash reserve accumulated to bid for Canada Life Financial. D'Alessandro must decide where to invest the cash now that a competitor, Great West Life, won the bid. There are many options, including the relatively safe bond market; however, a more rewarding option is required if D'Alessandro wants to continue Manulife's exceptional financial performance. The three most viable alternatives are: 1) attempt to takeover another insurance company or 2) lobby the government to ease restrictions and merge with one of the big five Canadian banks, or 3) formulate a new strategy since the consolidation period is coming to an end.

Whatever course is chosen, D'Alessandro must devise a plan to face an apparently less certain world, now that the September 11th, 2001 attacks have occurred. The risk of terrorism is much larger than originally thought and the war in Iraq now has investors seeking greater security. Also, the Sudden Acute Respiratory Syndrome (SARS) scare in Asia, although apparently in retreat, reminds health officials and insurers alike that plagues and pandemics are not beyond the realm of possibility in this new century. Finally, the rapid appreciation of the Canadian dollar is expected to hurt Manulife's profitability since Canadian services will now be relatively more expensive internationally and overseas profits will be smaller when converted into the Canadian currency. These circumstances make it difficult for D'Alessandro to achieve Manulife's current objectives of earning a return of 16 percent on equity and increasing earnings per share by 15 percent per annum. D'Alessandro must convince investors that Manulife will continue as a superior performer in the face of these new market realities.

HISTORY AND DEVELOPMENT OF MANULIFE FINANCIAL

The Manufacturers Life Insurance Company, or simply Manulife, has a rich history steeped with Canadian culture. The company was incorporated in 1887 with the former Prime Minister of Canada (Canada's first Prime Minister), Sir John A. Macdonald, elected as Manulife's first President. By 1897, ten years after inception, Manulife had expanded into Asia and planned to and did enter the U.S. market a few years later. Its head office in Toronto, Ontario Canada is still presently the Company's global headquarters. Throughout its history, Manulife was known as a company that anticipated change and, for example, it was the first insurance company in Canada to offer low-policy rates to non-smokers and was the first insurance company in Canada to adopt mainframe computer technology with the installation of the IBM 650 series computers in the 1960s. More recently, Manulife was the first Canadian insurance company to open a bank with the launch of The Manulife Bank of Canada in 1993.

Like all insurance companies, Manulife generates much of its cash from insurance premiums that are invested in mostly long-term instruments at rates that ensure a surplus after policyholder's claims are paid out. In addition to providing financial protection, Manulife offers wealth management products in Canada, the United States and Asia, with customers in 15 countries and territories worldwide. The company's offerings include individual life insurance, group life and health insurance, pension products, annuities and mutual funds to individual and group customers. Manulife is also active in reinsurance, asset management and investments. The vision is expressed as follows:

> *"Our vision is to be the most professional life insurance company in the world: providing the very best financial protection and investment management services tailored to customers in every market where we do business."*

Manulife has a set of written values that are made more memorable by the acronym PRIDE. The PRIDE acronym is used by Manulife Financial to guide all of their actions, from strategic planning to day-to-day decision-making, to the manner in which customers and other stakeholders are treated. PRIDE stands for:

- *Professionalism:* We will be recognized as having professional standards. Our employees and agents will possess superior knowledge and skill, for the benefit of our customers.
- *Real value to our customers:* We are here to satisfy our customers. By providing the highest quality of products, services, advice, and sustainable value, we will ensure our customers receive excellent solutions to meet their individual needs.
- *Integrity:* All of our dealings are characterized by the highest levels of honesty and fairness. We develop trust by maintaining the highest ethical practices.
- *Demonstrated Financial Strength*: Our Customers depend on us to be here in the future to meet our financial promises. We earn this faith by maintaining uncompromised claims paying ability, a healthy earnings stream, and superior investment performance results, consistent with a prudent investment management philosophy.
- *Employer of choice:* Our employees will determine our future success. In order to attract and retain the best and brightest employees, we will invest in the development of our human resources and reward superior performance.

Manulife experienced significant expansion during the 1980s. Growth in the United States was led by two key acquisitions - the National Liberty Life Insurance Company of America and the Maine Fidelity Life Insurance Company. Manulife began a demutualization process in 1993 whereby shares were sold to the public and began trading on The Toronto Stock Exchange (TSE) and the New York Stock Exchange (NYSE) under the ticker 'MFC'. Manulife used proceeds from debt and equity issues to acquire other insurance companies and continue its acquisitions into the 21st century. A few of Manulife's recent acquisitions include Commercial Union's Canadian life insurance business, Zurich Life Insurance Company of Canada, Daihyaku Mutual, the in-force life insurance business of MetLife Insurance Company and CIGNA's agency business. These have proven worthwhile as consolidation in the financial services industry led, at least at first, to greater scale and scope efficiencies. Today, Manulife is a firm with operations spanning the globe, with divisions set up by geographic locations as part of its globalization strategy. The five divisions are:

- *United States Division (34% of Net Income): provides insurance and wealth management products to select markets. It is the largest contributor of premium revenue and net income.*
- *Canadian Division (27% of Net Income): provides life insurance and wealth management products including banking products, annuities, and group pension products.*
- *Asian Division (19% of Net Income): Manulife has operated in Asia since 1897, beginning in Hong Kong and the Philippines, and recently in Shanghai. It provides individual and employee life and health insurance, and investment products.*
- *Japan Division (8% of Net Income): The Japan Division operates in one of the largest and underserved insurance markets in the world. It focuses on delivering universal life insurance to middle and upper-income individuals and small to medium sized business.*
- *Reinsurance Division (13% of Net Income): The Reinsurance Division provides risk management solutions, specializing in life retrocession.*

These five divisions have experienced rapid change and growth, as reported in Canada's National Post Newspaper: "*When Dominic D'Alessandro came to Manulife, it was a staid, old-school insurer. Today, he presides over an innovative financial-services giant that rivals the banks in size, services and global ambition" (2002 and pp. 52 - 53).* After joining Manulife, D'Alessandro continued to endorse and promote service to the community. He is, for instance, Campaign Chair for the Salvation Army, he sat as Chair for the Greater Toronto United Way Campaign and he served as Co-chairman of the Corporate Fund for Breast Cancer Research.

Dominic D'Alessandro

Dominic D'Alessandro has been President and Chief Executive Officer of Manulife since January 1994 and has guided the Company to nine consecutive years of exceptional financial performance, as revenues and net income have quintupled. During his tenure, D'Alessandro led the company's successful demutualization, was named Canada's Outstanding CEO of the Year 2002, and received the CEO Award of Excellence in Public Relations in 2001.

D'Alessandro has an extensive and varied background, mainly in finance and financial services. He graduated with a Bachelor of Science degree in Physics and Mathematics from Loyola College, became a chartered accountant in 1971, and he was awarded an Honourary Doctorate from Concordia University in 1999. From 1968 to 1975, he was employed with the accounting firm Coopers & Lybrand. In 1975, D'Alessandro joined Genstar Ltd. where he worked as Director of Finance and General Manager, and later as Vice President of Genstar's Materials and Construction Group. D'Alessandro moved to Canada's largest bank, the Royal Bank of Canada, in 1981 where he held a number of positions including Controller and Executive Vice President of Finance.

OVERVIEW OF INSURANCE INDUSTRY BUSINESS MODEL

Essentially, an insurance company collects a premium from a client in return for providing financial assistance in the case of a catastrophe. Determining the price of the premium is a complex process performed by actuaries. The mathematical principal of expected value is used to calculate the premium whereby the probability of each future scenario is multiplied by the total cash payout under each scenario (Saunders and Thomas 2001).

Since there is a timing difference between when the premium is collected (present day) and when the potential cash payment occurs (future date), the time-value of money must be taken into account when calculating the price of a premium. As such, actuaries must make assumptions regarding the rates of return earned on the premiums. Essentially, the price of the premium is set to equal the present value of the probable future cash outflow plus the administration costs.

The business model and nature of the insurance industry makes it evident that returns realized on the investment of premiums is critical to the financial success of company. If the expected return used to calculate the price of the premium is greater than the return actually realized, the transaction will not be profitable and the insurance company will lose money. On the other hand, the company should experience high levels of profitability if the returns realized from the many policies are greater than that expected returns.

Insurance companies tend to invest their premiums in a balanced portfolio of stocks, bonds, and long-term investments in subsidiaries. Risk management is essential during the investment process because excess risk could eventually bring insolvency.

RECENT FINANCIAL PERFORMANCE

Manulife has generated a 25 per cent compound annual growth rate in earnings per share (EPS) over the past nine years and earned record profits in 2002. However, Manulife's financial performance has slipped in 2003. For example, in the first quarter of 2003, the U.S. division contributed $107 million in profit, down $11 million from a year earlier, while the Canadian division profit was $94-million, up by only $1 million. The Asian division accounted for $58 million in profit ($53 million in the prior year) and the Japanese operations saw profits slip to $25 million from $30 million. Reinsurance reported a profit of $57 million, up from $50 million. The first quarter annualized return on shareholders' equity was 15.8 per cent compared to 16.3 per cent for the same period last year, while EPS, which includes a one-time charge of $15 million related to the abortive takeover bid for Canada Life Financial, increased four per cent to $0.73 from the $0.70 First quarter results did not meet financial objectives and D'Alessandro responded: "I am pleased that we were able to perform so well this quarter given the extremely challenging conditions " (Manulife 2003a).

As mentioned earlier, Manulife's profitability is dependent upon underwriting and investing activities. Underwriting includes the sale of insurance policies and annuities, and reinsurance activities. A growth trend in premium revenue is the greatest indication of future growth in underwriting activities. Investing activities manage the company's revenues to ensure that the future claims of policyholders can be paid. Interest rates play a large role in the profitability of investing activities. When interest rates are falling, growth in net investment income will be low, as yields on insurers' bond portfolios slide. At the same time, falling interest rates increase the value of a portfolio's underlying assets (fixed-income securities) that also produce the investment income. The 2002 key ratios indicate that Manulife has been performing exceptionally well in underwriting and investing activities (see the following Table 1 for key financial ratios).

Table 1: Key Financial Ratios

	Return on Assets	Return on Equity	Return on Revenue	Net Investment Yield
Manulife	1.69%	15.66%	8.29%	13.63%
Industry Average	0.49%	N/A	2.41%	7.02%
Typical Range	0.4% - 0.9%	10% - 15%	2% - 5%	4% - 10%

The Return on Assets (net income divided by average assets), Return on Equity (net income divided by equity) and Return on Revenue (net income divided by revenue) all indicate the performance of Manulife in underwriting, while the net investment yield indicate how Manulife is doing in investment compared to its major competitors.

THE LIFE INSURANCE INDUSTRY

Manulife's main source of revenue (premiums), include premiums from Term-Life, Universal Life, and Whole Life. In 2002, the Canadian division experienced an increase in premiums, while the U.S. division has seen a decrease. The recent decrease in the U.S. division is puzzling considering the aging baby boomers (28% of the U.S. population). When baby boomers plan for retirement, they do so with a low level of faith in the social security system. As a result, demand for life insurance products should be expected to increase as many Americans turn to life insurers to provide death-benefits and savings-oriented life insurance products and annuities. The most likely cause is that the recent downturn in the economy may be causing many in the U.S. to delay their insurance and savings needs at this time.

The Asian division may suffer a decrease in premium revenues for different reasons. For example, the Sudden Acute Respiratory Syndrome or SARS outbreak has become a major factor for Manulife in Hong Kong and parts of mainland China. SARS has the potential effect to increase Manulife's expenses, as claims due to sickness and mortality may increase. Sales are also very slow in Hong Kong because Manulife agents are worried about meeting clients face to face and vice-versa.

Manulife is trying to bridge the sales gap in Hong Kong by using the telephone and direct mail, but these do not have the same sales impact as face to face selling. Sales activities have been hit hard in Manulife's emerging operations in mainland China, where SARS is believed to have originated. Thus far, its Hong Kong operation has received two or three death claims and one for hospital benefits. Although the disease seems to be under control right now, Manulife must be prepared for new waves of SARS contaminations. SARS is also having a negative effect on the Asian economy.

Manulife Taiwan has made changes to their operations in the brink of SARS. A series of new initiatives have been developed to ensure that its customers are adequately covered against any financial costs that result from the treatment of SARS. Following an increase in public concern after the government took preventive measures to control the spread of the disease, Manulife is offering SARS-related insurance coverage. Services offered are:

1. The daily hospital income benefit from Manulife medical riders will be doubled for hospital confinement as a result of SARS related cases.
2. When a policyholder recovers from SARS and is quarantined at home, 50 per cent of the daily hospital income will continue to be payable during the 10 day quarantine period.
3. For death within 30 days after the confirmation of SARS, an extra death benefit of 100 per cent of the sum assured under the life policies, subject to a maximum additional benefit of $100,000, will become payable.
4. Manulife Taiwan also confirmed that all health insurance policies include statutory infectious diseases. If policyholders have the misfortune of contracting SARS, they will be eligible to claim for medical expenses as per the standard provisions. Manulife Taiwan will be notifying all their policyholders by mail about the changes.

The Taiwan Government has been aggressively taking action to reduce the risk of contracting SARS and Manulife has been doing contingency planning, trying to make sure that enough staff will be equipped with secure communication lines to work from home or from off-site locations if hit by large-scale employee quarantines. Similar contingency planning is also underway in Canada, following Toronto's experience with several SARS related deaths.

INVESTMENTS

Manulife Investment division manages assets for the Company's insurance and wealth management businesses and for external third party clients. Life insurance premiums are invested to ensure that adequate funds are available to pay out claims and liabilities on insurance plans. The Investment operations are comprised of: securities management and asset origination.

The Securities Management Group manages portfolios of assets including bonds, stocks and short-term investments. In addition to managing investments for its own policyholders, Manulife has built considerable expertise providing investment counseling services to third party clientele. Through its investment subsidiaries, Elliott & Page and Seamark, Manulife ranks amongst the largest institutional investment counselors in Canada. Expanding third party management services has been a key focus for the future growth of the Company.

The Asset Origination Group focuses on creating assets to achieve superior returns and provide a competitive advantage to the Company. The group has five major operations: Real Estate, Mortgage Operations, Regional Power, Manulife Capital and NAL Resource Management Limited. Manulife College Savings is an example of an original asset generation. Manulife College Savings is accessible only in the United States and offers professional investment selection to help maximize investment opportunities, while effectively managing risk and minimizing taxes. The U.S. Division has focused heavily on this market.

A successful example of the Asset Origination Group is the Manulife Bank of Canada, a wholly owned subsidiary that was the first federally regulated bank opened by a life insurance company in Canada. Since there is no brick and mortar building, clients are encouraged to do most of their banking activities over the telephone or internet. Manulife Bank offers services and fees that are similar to the large Canadian banks. In November 2002, D'Alessandro said that Manulife Bank is "growing nicely, and primarily its activity is to lend money to our insurance clients to facilitate sales. We have a lot of clients who have a lot of money in an insurance policy and might have a need for X dollars to do something (buy a home). We can usually accommodate those customers" (National Post, 2002, pp. 58).

Manulife Bank recently increased its interest rate to 3.05 per cent, an increase of 55 basis points, for its Advantage Account (this rate is slightly higher than other internet based banks, including ING Direct who offers 3 per cent and much higher than the large Canadian banks who offer 0.5 per cent to 1 per cent on regular savings accounts). The Advantage Account allows people to earn interest on their savings with easy access to their money. "More and more, Canadians are looking at the interest they're earning, or rather, not earning on their bank accounts," said D'Alessandro, adding "Manulife Bank is committed to remaining at the forefront of this market by offering the best combination of high rates, easy access, and low fees" (Manulife 2003b). Manulife is not the only company offering high-interest bank accounts, as there is a growing number in the market. With many choices, comes greater public confusion.

INVESTMENT AND ACQUISITION OPTIONS

In the wake of all the uncertainties and emerging issues, Manulife still has to ensure that their premiums are invested in a vehicle that provides superior returns and meets financial objectives. On December 27, 2002, Manulife attempted to acquire all the outstanding common shares of Canada Life Financial to create Canada's largest insurance company. Canada Life is one of Canada's five largest insurance companies, providing services to more than 10 million policyholders. Clients are from Canada, the U.S., the U.K., and Ireland. Canada Life also provides reinsurance products in the life and financial areas and offers property insurance through Kanetix, a subsidiary. The transaction was valued at more than $6.4 billion. Under the terms of the offer, Canada Life's common shareholders could choose to receive either $40 in cash or 1.055 Manulife common shares for each Canada Life common share.

Manulife's plans were foiled when Great-West Lifeco made a takeover bid of $7.3-billion or $44.23 per share on February 17, 2003. There is approximately a $1-billion difference between Great-West's cash-and-share offer and Manulife's. Even before Great West made an offer, Manulife failed to get Canada Life's board of directors and management on its side from the start. To help persuade Great West to come in as a white knight, Canada Life agreed to give the company the right to match any competing offer and to pay it a break fee of $287-million or about $1.75 a share. Although Great-West Lifeco's stock price has recently risen dramatically after the acquisition, Manulife is sitting on a valuable consolation prize: 14.7 million Canada Life shares (9.1 per cent of the company) worth more than $650-million.

After failing to acquire Canada Life Financial, D'Alessandro still has a few viable acquisition/merger targets, in a market that's rapidly winding down. A potential target for acquisition is Boston's John Hancock Financial. John Hancock's CEO made it clear that he fully expects more takeovers and mergers, including cross-border deals. The second candidate is the Canadian Imperial Bank of Commerce. These potential mergers, however, have to be carefully analyzed before being pursued because they are risky. Having been burned by the loss of Canada Life to Great-West, Manulife will want to make sure its next major transaction is nailed down solidly before it becomes publicly known. If the potential acquisitions are overly risky, D'Alessandro still has the option of the much safer bond market.

D'Alessandro and the Manulife management are aware of the risks inherent in purchasing another company. Business literature presents some conclusions regarding mergers and acquisitions. There are many difficulties of implementing a successful value added acquisition strategy, as post-acquisition difficulties arise because managers of the acquiring company did not deeply understand the target company at the time of acquisition, or that the acquirer imposed an inappropriate organizational design on the target as part of the post-acquisition process. Also, inappropriate management incentives that exist at both the top management and divisional level led to unsuccessful mergers. Acquiring returns are greater in acquisitions in which the acquirer and the target are in the same line of business. The acquirer should have a deep understanding of the targets business and industry before negotiations (Kaplan, S. N., Mitchell, M. L. and Wruck, K. H 1997). It is also evident that the difference between a successful and unsuccessful acquisition is directly related to the post-acquisition integration strategy (Singh H. and Zollo M. 1998).

John Hancock Financial Services

John Hancock Financial Services is one of the U.S.A's leading financial services companies, providing a broad array of insurance and investment products and services to retail and institutional customers, primarily in North America with revenues over $8 billion (Table 2). The Company operates its business in five segments. Two segments serve primarily retail customers, including the protection segment and the asset-gathering segment, and two segments serve institutional customers, including the guaranteed and structured financial products segment and the investment management segment. The fifth segment is the corporate and other segment. The CEO of Hancock Financial has indirectly confirmed that he sees Manulife and Sun Life Financial Services of Canada Inc. as potentially suitable merger partners.

Table 2 - John Hancock Financial

(U.S $ in 000's)	2002	2001	2000
Total Revenue	$8,455,100	$9,109,000	$7,598,100
Net Income	$499,500	$611,500	$838,900
EPS	$1.76	$2.02	$2.67

Canadian Imperial Bank of Commerce

Canadian Imperial Bank of Commerce (CIBC) is one of the largest banks in Canada, with a presence in the United States. CIBC has consistently generated profits (Table 3) and a combination with Manulife would provide for a host of potential synergies, cost-savings and cross-sales.

Table 3 - CIBC Key Financial Highlights			
(CAD $ in 000's)	2002	2001	2000
Assets	$273,293	$287,474	$250,331
Total Revenue	$9,541	$10,062	$10,859
Net Income	$653	$1,685	$2,060
EPS	$1.35	$4.13	$4.9

However, cross-pillar mergers are currently not allowed in Canada. Many CEO's of large banks believe these maybe likely in the future by arguing that the large number of financial service companies makes the affects of a merger on competition negligible. On January 14th, 2003, Manulife attempted to buy CIBC in a move that would have created an international financial service giant, but then-Finance Minister John Manley cancelled the deal. Mr. Manley derailed the merger plan by declining to void the federal policy that prohibits the big banks from merging with either of the two biggest insurers, Manulife or Sun Life Financial. Analysts believe that the Manulife-CIBC deal would have gone through had the government not been confronted with another merger proposal (Scotiabank and Bank of Montreal). To this effect, it may be worthwhile for D'Alessandro to lobby the government in order to lift the restrictions preventing banks from selling insurance through their branches and allowing for cross-pillar mergers.

The blockbuster deal would have been the first of its kind in Canada as Manulife would have become a financial services company that could offer banking, brokerage, insurance and wealth-management services and products around the world. CIBC is the natural target. Royal Bank and Toronto-Dominion bank are too big, and neither would have wanted to become the lesser partner in a merger. Bank of Nova Scotia and Bank of Montreal were engaged in their own merger talks and may be waiting for restrictions to ease. That left CIBC, which had two key advantages. The first was that CIBC's share price, thanks to lending losses in the Enron debacle and the losses in its ailing Amicus electronic bank system in the United States, had fallen from about $57 to the mid-$40s, making it a less expensive target. The second was that CIBC has an extensive retail and wealth management network in Canada. Had the deal gone through, Manulife and CIBC together would have been one of the continent's most powerful financial services names with more than 70,000 employees, 16.5-million policy holders and customers, and annual revenue of about $33-billion.

Bond Market

Investing in bond market is a lot less risky that the other two alternatives, but bonds do not provide the same potential for growth in earnings. The current yield on Canadian and U.S. treasury bonds is revealed in Table 4. U.S. Treasury's have fallen hard over the past three years, pushing the yield on the 10-year note from 6.79 per cent in early 2000 to a recent 45-year low of 3.11 per cent.

From 1970 to 1999, the average return on long term corporate bonds has been 7.64 per cent with a standard deviation of 10.57 per cent, while treasury bills have returned 6.04 per cent with a standard deviation of 4.04 per cent. Currently, Manulife's bond portfolio is diversified across many different industries, with the highest percentage invested in the government sector.

Table 4 - Current Bond Yields			
U.S. Treasury Bond Yield		CAD Treasury Bond Yield	
Bond	Yield	Bond	Yield
2 Yr	1.30%	1 – 3 Years	3.07%
5 Yr	2.43%	3 – 5 Years	3.62%
10 Yr	3.55%	5 – 10 Years	4.28%
30 Yr	4.59%	Over 10 Years	5.08%

REINSURANCE DIVISION

Reinsurance refers to insurance purchased by an insurance company to cover all or part of certain risks on insurance policies issued by that company; retrocession is a form of reinsurance involving the assumption of risk from other reinsures. A dramatic change occurred to the Reinsurance operations on September 11th 2001, when terrorism risk appeared to be more serious than previously thought. The Reinsurance Division incurred a $145 million expense for anticipated claims in 2001, and net income fell to $48 million (Table 5).

Table 5 - Summary of Statement of Operations - For the Year-Ended December 31, 2002			
(CAD $ in millions)	2002	2001	2000
Revenue			
Premium Income	$1,063	$791	$768
Investment Income	226	231	194
Other Revenue	43	38	22
Total Revenue	1,332	1,060	984
Expenses			
Policy Benefits	1,003	963	762
Other Expenses	91	95	90
Total Policy Expenses	1,094	1,058	852
Income Taxes	54	(46)	24
Net Income	$184	$48	$108

The risk of terrorism involves prospective losses of potentially high severity and unknown frequency, which makes risk quantification very difficult. Terrorism causes potential problems because it reaches beyond first-party property coverage to involve other coverage's (such as workers compensation, liability, and business interruption) that are also difficult to quantify. Since the attacks, reinsurance premiums for property and casualty have nearly doubled, thus increasing Manulife's risk of a loss in the event of another terrorist attack. Claims resulting from the September 11^{th} attacks were recorded as a non-recurring expense in Manulife's statement of operations. However, the recent war in between the U.S. and Iraq may have increased the probability of future terrorist attacks, thus increasing the likelihood of similar losses in the future.

Warren Buffett, of Berkshire Hathaway, said in an interview that insurers and reinsurers were foolish for not pricing for man-made megacats [mega catastrophes] before September 11th. "In effect, we and the rest of the industry, included coverage for terrorist acts in policies covering other risks - and received no additional premium for doing so. That was a huge mistake, and one that I, myself, allowed. Had the attack on New York been nuclear, it is likely that most of the U.S. insurance industry - as well as reinsurers worldwide - would have been destroyed" (Berkshire Hathaway 2001).

RISING CANADIAN DOLLAR

On May 20th, 2003, the Canadian dollar climbed above 74 cents US, the highest it has been since the autumn of 1997. Economists believe that the Canadian dollar is rising because of falling interest rates in Europe, New Zealand, Sweden and possibly the U.S., combined with a lagging U.S. dollar. In general, researchers claim that once the exchange rate starts to move, its virtually impossible to predict where it will find its next equilibrium. Regardless of which direction they are moving, exchange rates typically overshoot their fundamentals. The belief at Export Development Canada (EDC) is that as the world economy gradually returns to normal during 2003 and into 2004, the Canadian dollar will slowly make its way back to the US 70 cent level, possibly a little higher. For a long time the EDC has been describing the final destination of the Canadian dollar as being somewhere around 70 to 71 U.S. cents. That landing zone is based on the relative productivity and competitiveness of Canada's producers, and is predicated on a number of assumptions, including a return to economic growth in most countries and a rebound in commodity prices and interest rates to pre- slowdown levels.

Manulife's profits are going to be negatively affected from the recent resurgence of the Canadian dollar value against the U.S. dollar. Analysts predict that Manulife's profits could fall by as much as 9 per cent in 2004 ($129 million) if the dollar remains at its current level of 73.28 cents relative to the U.S. dollar. Estimates are based on projected profits from Manulife's foreign operations that have to be converted into Canadian dollars for accounting purposes. Manulife doesn't hide the fact that "the Company may be exposed to losses resulting from adverse movements in foreign exchange rates due to the fact that it manages operations in many currencies and reports financial results in Canadian dollars" (Manulife 2002).

Canadian insurers will be at a distinct disadvantage compared to their U.S. counterparts in terms of earnings growth over the next year, or until the Canadian dollar eases. Manulife has a policy of reinvesting its U.S. profit in the United States, so it technically does not lose money on the currency conversion, however, it could affect the company on an accounting basis, since Manulife is required to report its results in Canadian dollars. The effects of the appreciating Canadian dollar are already visible. In the first quarter of 2003, premiums and deposits were up four per cent to $7.9 billion, but excluding the impact of the dollar, the growth rate would have been eight per cent ($8.2 billion). Acquisitions could also help to ameliorate any drop in profit because steep rises in the Canadian dollar this year has made it more affordable for Manulife to buy a U.S. insurer.

STRATEGIES FOR THE FUTURE

As Dominic D'Alessandro sits in his office in late June 2003, he knows that is was time to make decisive decisions regarding the future of Manulife Financial. The current market conditions and uncertainties required a thorough analysis of all relevant external and internal factors, assessment of feasible options, and formulation of a renewed strategy that is accompanied by an equally compelling implementation plan. The analysis, formulation and implementation of a plan is required to address the issues facing Manulife as well as to set a new direction for the company now that industry consolidation is coming to an end. Many questions need to be answered including these three major groups of questions:

1. Where should the large cash reserves be invested? What is the feasibility of Manulife acquiring John Hancock Financial, or merging with the Canadian Imperial Bank of Commerce? Would the safer bond market be the best place to invest the money?

2. If further acquisitions prove the best option, how would Manulife Financial handle the post-acquisition strategy to ensure that Manulife adds value in its offerings in different markets over the long term?

3. What, if anything, should be done with respect to the environmental factors such as appreciation Canadian dollar, the increased risk of SARS and other potential pandemics?

All of these circumstances will make it difficult to achieve Manulife's current objectives of earning a return of 16 percent on equity and increasing earnings per share by 15 percent per annum. D'Alessandro must determine how he can convince investors and shareholders that Manulife will continue as a superior performer in the face of these difficulties. Finally, there is the nagging suspicion that much of Manulife's success is owed to the aggressive acquisition spree that D'Alessandro engineered over the decade past. What next must be done to ensure a bright future for Manulife in the next decade, assuming it will not include many more acquisitions?

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ASSET-LIABILITY MANAGEMENT AT GEM STATE CREDIT UNION

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CASE DESCRIPTION

The primary subject matter of this case involves the use of GAP analysis to measure the interest-rate risk exposure of a credit union. Secondary issues examined include interest-rate changes in the economy overtime and the Fisher Effect. The case has a difficulty level appropriate for junior level students and is designed to be taught in about 45 minutes. This case could be used for classes in money and banking (economics), managerial economics, depository institutions management and possibly other management courses.

CASE SYNOPSIS

This case could be used to familiarize students with the balance sheet of a credit union and to understand the interest-rate risk that results from the nature of a depository institution's balance sheet. Students will also learn to calculate a GAP analysis for the credit union and to critically analyze the GAP methodology used by credit union management and are asked to offer an opinion on what this credit union could do to manage their interest-rate risk.

INTRODUCTION

Gem State Credit Union (GSCU) is a medium sized credit union located in the mountain west. In 2002, it had $50 million in assets and a relatively healthy capital-to-asset ratio of around nine percent.

Increasingly, the National Credit Union Administration (NCUA) has emphasized that credit unions show that they understand interest-rate risk due to their asset/liability structure and that they are able to manage it. In their examinations of credit unions, they look in the board of directors' minutes for evidence that the board does monitor its asset/liability structure. Also, many credit unions now have an asset/liability management (ALM) committee that typically meet monthly to examine their asset/liability structure and recommend to the board any changes in interest rates or products that are needed to limit their interest-rate risk. GSCU soundly passed their annual NCUA examination in the spring of 2002. This case takes a closer look at the ALM analysis done by GSCU.

Les Norris has been the CEO of GSCU for the past 24 years, having brought it back from the brink of bankruptcy when he was hired in 1980. He is the chair of the ALM committee. Also serving on the committee are Ken Whitmore, VP of operations, John Harris, VP of lending, and Bob Thomas, chairman of the board of directors and president of G&T Economics, an econometric forecasting firm. Members of the ALM committee have worked well together for several years, but recent economic developments have caused a divergence in opinions as to how to set future rates.

WHY IS ASSET/LIABILITY MANAGEMENT NEEDED?

Depository institutions (DIs), which include banks, savings and loan associations and credit unions, have two major types of risks. *Credit risk* is the risk a DI takes when it makes a loan that may not be paid back in full. When a loan is not paid back in full the unpaid portion must be charged-off, which reduces the DI's capital and profits. DIs try to manage credit risk by screening and monitoring borrowers.

Interest- rate risk results in changes of profitability that a DI experiences from changes in interest rates in the economy. This risk is transmitted through their asset/liability structure, since asset yields and liability costs (largely interest paid on deposits) will have different sensitivities to interest changes.

For example, a classic case of interest-rate risk that caused major problems happened to savings and loan associations (S&Ls) in the 1980's. The major assets for S&Ls were home mortgages, which typically are long-term loans of 15 to 30 years. Also, all mortgages until the mid-1970's had fixed-interest rates, as most also have today. However, the major liabilities for S&Ls were savings deposits. Thus, the S&Ls had a maturity mismatch of assets and liabilities. Their assets had long-term maturities while their liabilities had short-term maturities and were much more interest rate sensitive.

As long as interest rates did not fluctuate much, S&Ls were stable. But, in the mid-1970s, inflation helped increase interest rates to record levels. This is due to the *Fisher Effect*: the nominal interest rate = the real interest rate + the expected rate of inflation. As inflation rose, so did the expected rate of inflation, which in turn increased the nominal interest rates. In addition, the Federal Reserve further raised interest rates by conducting a tight monetary policy in 1980 and 1982. Although S&Ls charged higher interest rates on new mortgages (peaking at more than 18 percent in 1982), they were stuck earning as little as five or six percent on the mortgages made in the past (some from the 1950s and 60s), but still on their balance sheets as income earning assets. At first, as interest rates rose in the mid and late 1970s, S&Ls could not pay higher rates on their deposits above 5 ½ % because of Regulation Q (a price ceiling that held them down). But, Regulation Q was phased out under the Depository Institution Deregulation and Monetary Control Act of 1980. As nominal interest rates rose, S&Ls had to pay higher rates on their deposits because they tended to be interest rate sensitive, while the mortgages made in past years continued to earn low rates. For example, as S&Ls entered into 1982, their average cost of deposits was around 11.5%, while their average yield on mortgages was around 10.0%. Even not taking into account operating costs and charge-offs, their profits would have been negative during this time period. It is no wonder that many S&Ls failed in the 1980s.[1]

Although the above S&L case maybe an extreme example of interest-rate risk, all DIs face some degree of interest-rate risk and must monitor their asset/liability structure. And, history of the last 50 years shows us the interest rates have been volatile and probably will continue to be at least somewhat volatile in the future. For example, three-month Treasury bills were about 1 % in the early 1950s, rose to over 15 % in 1981, fell to about 3 % in 1993, rose to over 5 % in the mid 1990s and in 2000, only to fall under 2 % in 2002 and then rose to around 4.75% by early 2006.

METHODS TO MEASURE INTEREST RATE RISK

Members of GSCU's ALM committee use standard industry practices to determine rates, as described below.

The most basic measure of interest-rate risk uses *gap analysis*. To find the gap, the analyst has to examine all the assets and liabilities and determine which ones are interest-rate sensitive. Rate sensitive means that the interest rate of the asset or liability will need to be repriced if interest rates change in the economy. The period examined is generally six months-to-one year, although longer time periods are occasionally examined. The "gap" is calculated by taking the interest rate sensitive assets (RSA) minus the interest rate sensitive liabilities (RSL). Equation one shows how the gap is computed in equation form:

$$Gap = RSA - RSL. \qquad \text{Equation (1)}$$

The gap tends to be negative (RSA smaller than RSL) for most DIs, but DIs can also have positive gaps. A gap of zero is desirable, because that would indicate no interest-rate risk.

The gap can then be used to calculate effect of changing profitability on a DI resulting from changes in interest rates. The gap times the change in the interest-rate yields the effect on profitability. Equation 2 summarizes this:

$$Profit\ Change = (RSA - RSL) \cdot D\ rate \qquad \text{Equation (2)}$$

This would be for a one-year examination period. If the examination period were for 6 months, then the profit change would equal the GAP times one-half the interest-rate change. For example, suppose a credit union has \$35 million in RSA, \$60 million in RSL, and over the next year, rates increase by two percent. Substitute these amounts into equation 2 to get:

$$\textit{Profit change} = (35 - 60) \cdot .02$$
$$= -\ \$\ .5\ \textit{million}$$

Hence, a rate increase of 2 percentage points would results in $.5 million lower annual profits. Conversely, if rates went down by two percent, then profits would increase by $0.5 million.

Basic gap analysis is often used, especially by smaller DIs, to monitor interest risk. This is the method GSCU uses. However, basic gap analysis can be further developed in a couple of areas (Mishkin, 2006, p. 221). According to Mishkin, "Clearly, not all assets and liabilities in the fixed-rate category have the same maturity. One refinement, the *maturity bucket approach*, is to measure the gap for several subintervals, called *maturity buckets*, so that effects of interest-rate changes over a multiyear period can be calculated. The second refinement, called *standardized gap analysis*, accounts for differing degrees of rate sensitivity for different rate-sensitive assets and liabilities." In addition to gap analysis, *duration analysis* is used by DIs to monitor interest-rate risk. The duration gap measures the weighted average of payments received from assets and payments made on liabilities over their duration.

GAP ANALYSIS AT GSCU

In a discussion of GAP analysis at GSCU, CEO Les Norris distributed Table 1 to members of the ALM committee. Table 1 shows the balance sheet for GSCU for November 30, 2002. On the asset side of GSCU's balance sheet, auto lending was the largest category, accounting for about $26 million of its $41 million of total loans outstanding. Real estate loans were a little over $8 million, which were nearly evenly divided between fixed and variable-rate loans. However, nearly all of the real estate loans were secondary mortgages or home-equity-lines-of-credit, which tend to have much shorter maturities than do first mortgages. The secondary fixed-rate mortgages can have maturities for 15 years, but most have maturities of 10 years or less because the rates on fixed-rate mortgages go up enough after 10-year terms so that the variable-rate mortgages for the same term are about 2% less. In November 2002, the real estate portfolio had an average maturity of 99.8 months or about of 8.3 years. This average maturity for the mortgage portfolio tends to typically range from around 95 to 115 months. The other loan categories were other secured loans (RVs, etc.) at $3.4 million, VISA credit card loans at $2.6 million, and unsecured loans at $1.3 million.

On the liability side, GSCU had just over $46 million in total savings, which was distributed quite evenly among its different types of deposits. Regular passbook savings accounts was the largest deposit category at about $17 million, followed by CDs at about $13 million and checking and money market deposits at around $9 and $7 million respectively.

Traditionally, GSCU used a six-month examination period in its GAP analysis, where it would have to change rates on their rate-sensitive assets and liabilities if interest rates changed in the economy.

GSCU uses the following four categories to classify its rate-sensitive assets.

- *Rate-sensitive loans*. All of the variable-rate real estate loans are classified as rate-sensitive loans.
- *Loans that mature in six months*. These loans are calculated by first finding the average maturity of total credit union loans, excluding the variable-rate mortgages, and then dividing by six months. Then, this fraction is multiplied by total loans (less the variable-rate mortgages) to get the loans that mature in six months. In November 2002, the average maturity for all loans (less the variable-rate mortgages) was around 28 months. Hence, about 21 percent (6 months/ 28 months) of the total loans (less the variable-rate mortgages) will on average mature in six months.
- *Rate sensitive investments***.** These investments mature in six months or less, and are almost exclusively overnight and other short-term investments at a corporate credit union (a credit union for credit unions). These would be essentially the investments that mature in one year or less since on the balance sheet since the investments in the 6-12 month category are very small in size.
- *Cash adjustment*. Cash adjustment is typically a relatively small figure and was a negative $53,005 in November 2002. It is basically cash on hand (varies with deposits made and taken out) less what is needed in cash. It can be positive as well as negative, but is always very small relative to the total rate-sensitive assets. It will be negative if what is needed is greater than the cash on hand. Cash comes in and out as investments with the corporate credit union are made; excess cash is put in investments.

GSCU uses the three categories listed below to classify rate-sensitive liabilities.

- *Rate-sensitive deposits***.** Ten percent of the checking and twenty-five percent of the savings deposits are rate-sensitive. IRA savings deposits are not included as rate-sensitive at all because they pay close to one-year CD interest rates and require careful planning and administrative preparation prior to a transfer
- *CDs that mature in six months*.
- *Money market deposits*. These last two categories assume that all CDs coming due during the examination period and all money market deposits are rate sensitive.

Following credit union industry consultants and other credit unions, GSCU has used the rule-of-thumb that about 10% of the checking deposits and 25% of the regular savings deposits are rate sensitive. That is, if interest rates increased in the economy and rates did not likewise increase on checking and saving deposits, then about 10 % of the checking and 25% of the savings deposits would be moved to other types of deposits at the credit union that did have increased rates or leave the credit union all together. (Technically, a *standardized gap analysis* is used for this category). On this issue, members of the ALM committee were not in agreement. John Harris, VP of lending, believes that the 10%/25% rule underestimates rate sensitive deposits and hence underestimates the interest-rate risk of GSCU. He figures that if interest rates increase, GSCU will have to increase interest rates on all deposits to remain competitive in the local markets.

WHAT CAN GSCU DO TO MANAGE INTEREST RATE RISK?

Because of the nature of DIs, their major asset category, loans, tend to have longer maturities than their major liability category, deposits. Such is the case for GSCU. The members of the ALM committee also discussed how GSCU could try to change to rearrange its balance sheet to reduce the negative gap.

Les Norris suggested that GSCU could encourage its members to take out shorter maturity loans by increasing the difference between rates on the shorter and longer-term loans. He noted, however, that this may have only a limited effect on shortening maturities since the credit union members may prefer the longer-term loans that have lower monthly payments. GSCU could also try to encourage its members to make deposits in longer-term liabilities by increasing the difference on rates for shorter-term deposits (such as regular savings, money markets and short-term CDs) relative to long-term CDs. Conversely, if the gap happened to be positive, then the opposite actions to those above could help to reduce it.

Mr. Norris also noted that a second way for GSCU to try to reduce its negative gap is to price its loans to encourage members to take out more variable-rate loans. Variable-rate loans are most common with real-estate loans, but can also be used for other loans, such as auto loans. Variable-rate mortgages first appeared with California S&Ls in 1975. If GSCU could encourage more members to take out variable-rate mortgages (including secondary mortgages and home equity-lines-of-credit), then as interest rates rose, so would the rates that it receives on these mortgage loans.

Ken Whitmore, VP of operations, argued against this option, stating that although variable-rate mortgages do help DIs to reduce their interest-rate risk, they are still a limited help for a couple of reasons. First, these loans tend to have caps on how much the rates can change over the life of the loan. These are typically in the range of about three to five percent, in order to protect the consumer from getting into a situation where payments become too burdensome. So, if rates go up by a higher amount than the cap allows, the variable-rate loan will cover part, but not all the increased cost of interest rates paid on deposits. But, it is the second factor that has really limited how much variable-rate loans can help with interest-rate risk. This is simply the fact that most consumers tend to prefer fixed-rate loans because of the certainty of future loan payments. Mr. Whitmore felt that GSCU members would react in this way.

Table 1: Balance Sheet of GSCU, November 30, 2002	
Assets	Dollars
Unsecured Loans	$ 1,263,098
VISA Loans	2,554,055
Real Estate Loans, Fixed Rate	4,365,948
Real Estate Loans, Variable Rate	3,913,162
New Auto Loans	5,851,428
Used Auto Loans	20,240,311
Other Secured Loans	3,400,881
Total Loans	$41,588,883
(Less) Allowance for Loan Loss	(197,622)
Liquid Investments (Matures less than 1 year)	4,806,182
Other Investments (Matures greater than 1 year)	1,815,140
NCUA Deposit Insurance Fund (NCUSIF)[2]	446,136
Ownership in a Credit Union Service Organization	51,670
Net Fixed Assets	1,522,991
All Other Assets	223,681
Cash[3]	596,995
Total Assets	$50,854,056
Liabilities and Capital	Dollars
Savings Deposits	$16,419,548
Money Market Deposits	6,904,995
Checking Deposits	8,807,074
IRA Savings Deposits	1,051,961
CDs that Mature in 6 Months	5,812,083
CDs that Mature in More Than 6 Months	7,059,585
Total Deposits	$46,055,246
Other Liabilities (Such as Accounts and Interest Payable)	209,571
Total Capital or Equity (Reserves plus Undivided Earnings)	4,589,239
Total Liabilities and Capital	$50,854,056

ENDNOTES

1 Although the major underlying problem was this mismatch of assets and liabilities, other factors played a part in causing the S&L crisis. This includes poor supervision by both the federal and some state regulatory authorities and as well as some fraudulent and criminal behavior by some S&Ls. Probably the most recognized case of S&L scandal was Lincoln S&L ran by CEO Charles Keating, Jr.

2 The NCUA Deposit Insurance Fund is kept at NCUA for deposit insurance with no interest. This is similar to FDIC insurance premiums for bank and S&L deposits.

3 Reserve requirements are 3% of the first $47.6 million in checkable deposits, and 10% of deposits over that amount (Mishkin, page 405). Gem State's cash ($596,995) more than meets its reserve requirement of $264,212 (or 3% of $8,807,074). Reserve requirements may consist of cash at the credit union or non-interest bearing deposits at the Federal Reserve.

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