Teaching Notes for Chapter I – The Nature of Moral Problems in Business Management

The basic argument in this chapter is that moral problems are not moral because a respected moral authority says that they are. They are moral because some people are benefited while others are harmed by a given decision or action, or some people have their rights respected while others have their rights ignored. It is this conflict between benefits and harms, between rights respected and rights ignored, that generates the special conditions of a moral problem. And it is this conflict between benefits and harms, between rights and wrongs that make these moral problems so difficult to resolve. How do you decide if the benefits to some are large enough to overcome the harms to others, or if the rights of some are important enough to ignore the rights of others? People do get harmed in this world, and rights are ignored all too frequently. How does one decide on what is the best or proper thing to do, or convince others to reduce the harms and recognize the rights. The graphic below is the process for solution proposed within this text:

Understand all Moral Standards
Convincing
Recognize all Moral Impacts
Define Complete Moral Problems
Determine the Economic Outcomes
Consider the Legal Requirements
Evaluate the Ethical Duties
Propose Moral Solution

For the first three to four class sessions I draw out this graphic on the board, so that it is clear, and then I use that graphic to guide, not to force, the class discussion of the cases. I also draw out on the board the other graphic that was printed in Chapter I, on the determination of individual moral standards. I want to continually emphasize during the discussion of the cases that all of us differ in our moral outlooks for perfectly good and legitimate reasons:

Religious/Cultural Traditions

Personal Goals
Personal Norms
Personal Beliefs
Personal Values

Subjective Standards of Moral Behavior

This, and the other teaching notes on the chapters in the text, will follow the same format with 1) assignment questions, 2) start-up methods, 3) discussion issues, and 4) an analytical outline for each of the subsequent cases:

1. <u>Assignment questions</u>. I do not use assignment questions for the chapter readings because I find that they are generally ignored in the students' preparation. You may have better luck than I with those questions, so here are some that I think would focus attention on the major issues in Chapter 1:

   What does "right" really mean? How do you know when something is truly "right" or totally "wrong"?

   Why do people's views on what is "right" and "wrong" differ? Why would an unemployed sawmill worker in northern California feel differently about cutting old growth forests than a young lawyer, working in San Francisco, who enjoys hiking in the Sierras?

   How do you attempt to convince people who disagree with you about what is "right"? What arguments should that unemployed sawmill worker make if he/she were at a meeting with the young lawyer? What counter arguments should the lawyer make?

2. <u>Start-up methods</u>. I also do not go over the material in the text during the class, except in the form of a short "mini-lecture" at the end, because I find that class repetition generally detracts from student preparation. "Why read this material carefully tonight if we're going to talk about it throughout the class tomorrow?" seems to be the prevalent attitude. Instead, I move directly onto the discussion of the cases.

   An alternative, however (and this is not a bad choice), is to start the discussion by bringing into class an ethical issue that is currently in the news. Now, I realize that any example I mention in this teaching note will soon appear to be dated, but in the summer of 2010, while I was writing these notes, a good example of a well-publicized moral issue (this one, however, is probably <u>not</u> going to seem old and dated) was the Gulf oil spill. Don't try to address the whole issue that you select from a newspaper. Just pick a part of it. For example – if the oil spill were still in the news – should BP compensate the owners of hotels and motels along the coast for lost tourist revenue if oil had not come destructively ashore on their particular beaches, but vacationers had not come to the area because they were worried about that possibility?

   Another alternative, and sometimes this works even better, is to inform your class that you would be glad to have anyone who finds what he or she thinks is an interesting moral problem in a newspaper or on the internet to present that problem to the class provided a) it does not have any religious or ethnic implications; and b) the alleged facts can easily be checked.

3. Discussion issues. As explained previously, I generally do not start the early classes in the course by talking about assignment questions or by bringing up current topics (although I would be tempted even during the early part of the term to bring up something as serious as the Gulf oil spill). Instead, when teaching I usually went directly to the case or cases, but with a difference. First, I would call upon one or two students to "set the stage" (that is to describe the situation) for the case we were next going to discuss. As explained earlier in the "General Suggestions" portion of this teaching note, in the section dealing with the Syllabus, I sometimes assigned two short cases rather than one, but divided up responsibility for those cases between the front and the back halves of the classroom, or the right and left sides. I liked to pack lots of material into the class time, and to provide plenty of opportunities for small or large group meetings. Before breaking up into those groups I would ask individual students, whom I called upon at random, to describe the situation described in the case. I found that it was necessary, particularly during the early going in the term, to call upon students at the start of each class to ensure adequate preparation, and also I wanted to have all of the groups – if I was going to break the class into groups that day – to start from the same set of understood facts.

   I described the use of these "in-class" and "break out" groups in the earlier "General Suggestions" of this Teachers' Guide, and won't repeat those comments here. Let me just add that both types of groups seemed to work very well. They give each member of the class an opportunity to express his or her opinion under conditions that are less imposing for many than having to speak in front of the full class, and of course they break up the time and provide an opportunity for students to meet other students and listen to other opinions. And lastly, my major argument is that it is necessary to learn how to present a convincing ethical recommendation; that takes practice and the groups provide greater opportunities for practice.

   Also as mentioned previously in the "General Suggestions" section of this Teacher's Guide, I generally try to save ten minutes at the end of each class session to present a summary of what I thought were some of the good points raised in the discussion,(with a compliment to the student who brought up that particular issue) or some of the important topics from the text that had been ignored (though I try not to do this in a complaining mode; instead I say something like "Here is something you may want to consider next time").

   The theme of these last ten minute mini-lectures is "This is what I hope you learned from this class." At the end I try to relate that learning to the next assignment, saying "Look at this next case or next chapter from this point of view," and quit. I always try to quit 5 minutes early, partially to give me time to prepare for the next class but primarily to give students an opportunity to think about the issues that have been raised. Probably most of them do not use that time to think about those issues, but some do and that – in my view – makes it worthwhile. Now, on to the cases:

Condominium Owners vs. Condominium Employees
(1st of the Three Short Cases for Chapter I)

1. Who is benefited and who is harmed. This at first glance seems pretty straightforward. The 273 condominium unit owners benefit from the savings of $35,000 per year, while the cleaning service employees suffer from the loss their jobs. It might be noted, however, that those savings amount to just $128 per unit ($35,000/273 units). It also might be noted that the total loss to the unionized employees who are to be replaced by non-union workers is considerable greater in total than that $35,000 savings to the owners as the workers lose their wages until they are able to find other employment, which may take a while given that the case stresses the period of economic downturn.

2. Whose rights are recognized and whose are ignored? This is the non-straightforward part of this short case. Employment in the United States is legally at the "will of the employer", so the condominium owners do indeed have a right to fire the employees. And, it can be assumed that this firing will take place at the end of the union contract period, so the employees do not have a lawful claim. But, do employees gain a right to a job if they do that job to the satisfaction of the employer over a number of years? Many workers believe strongly that they do gain that right after they've done their best over time.

3. State the perceived moral problem "Is it right to fire employees who have performed well over a number of years in order to gain cost savings for the employer that will be considerably smaller in total than expected wage losses to the employees?"

4. Determine the economic outcomes. There clearly is a competitive market for apartment and condominium cleaning employees in New York City, and all the condominium owners in this instance have done is to meet that competitive wage level. It has to be admitted that, theoretically, this is more economically efficient as long as the external costs imposed upon the fired workers are included.

5. Consider the legal requirements. As explained above, employment within the United States is legally at the will of the employer and, if the firing does indeed take place at the end of the duration of the union contract, it would appear that the employees have no legal claim.

6. Evaluate the ethical duties. I like this case because it provides a rejoinder to the all-too-frequently expressed "It it's profitable and it's legal, do it!" claim. Here there are ethical duties that seem relevant to me:
    - Personal virtues. Would any of the condominium owners feel boastfully proud in telling his/her friends over a beer at a tavern (or iced tea at a restaurant) "I voted

to fire all of the condominium cleaning workers, who had been doing satisfactory work –I certainly had no complaints – to save myself $128 per year"?

- Religious injunctions. The question here is whether this firing treats the discharged workers with kindness and compassion, and whether it builds a sense of community between the workers and the owners.
- Universal rules. If it is right for the condominium owners to fire the condominium workers with no complaints about past performance, just to save relatively small amounts of money, then according to Kant it has to be right for the employers of those condominium owners to fire them, regardless of their past work history, also to save small amounts of money.
- Distributive justice. The condominium cleaning employees are clearly the "least amongst us" in this combined group of owners and workers.
- Contributive liberty. This is a bit of a stretch, but probably there are some of those cleaning employees who are going to night school, attempting to improve their skills and thus their lot in life.

7. <u>Propose convincing moral solution</u>. I don't think that I ought to provide my preferred solution for a moral problem in any of these teaching notes. My suggestion is that at the end of class you express your thoughts, and the reasons behind your decision, as clearly as you can, then attempt to clear up any uncertainties that surfaced during the discussion, compliment the students who expressed their views clearly, whether you agree with them or not, ask if there are any questions, and then move on.

<u>Motel Rates After Hurricane Katrina</u>
(2nd of the Three Short Cases for Chapter I)

I expect to use the structured 7-point form of analysis for each of the teaching notes because I believe that it will be easier and quicker to read, but that does not mean that I recommend that you follow this structured method in each of the class discussions. That is, I would not inevitably ask the first member of the class I called upon, "Who was benefited and who was harmed?

I think that this case is particularly well suited for a "start-at-the-end" approach. You could explain to the class that one of the clerks at the motel essentially lost her job -- although it is true that she first quit voluntarily, but then was fired when she wanted to return to work– for having said, "That's not treating people right".

Then you could ask for volunteers, for members of the class who agreed that raising rates on people who were forced to seek shelter because their homes had been badly damaged or destroyed, was "not treating people right". Following that explanation you could suggest that those volunteers assume that: a) they were not clerks but instead were management trainees at that motel; b) that this motel was part of a large resort chain, not a small single ownership unit; and c) that this was a job that they felt had great future prospects, and that they really wanted to keep. In short, they should assume that their classmates at the college or university from which they had graduated considered that they had gotten a "real plum" job that would eventually lead to well-paid, high responsibility positions and pleasant lives in pleasant resort locations. Given those assumptions, how would they have responded to the instructions to double the rates? Would they have said, "That's not treating people right"?

Lastly, to give the person you called upon some time to think, I suggest that you conclude by saying that a large part of this course is going to be on how to do what you think is right without getting fired. Ask volunteers and non-volunteers alike to write out their opening sentence to the headquarters person who called you and said, "Raise the rates to the seasonal limit". Call on a number of people. Write their opening sentences on the board. Have the class vote on the best one, and record the voting scores next to each entry. When discussion runs down, compliment the people who did volunteer, say that you realize that it is very hard for them to think fast on their feet, but that this is a skill that everyone has to learn, and that you appreciate their willingness to try. All that will get you more volunteers next time. Now, on to the analysis:

1. Who is benefited and who is harmed? Clearly the motel owner was benefited by doubling the rates after the hurricane, and equally clearly the hurricane refugees who were forced to flee after their homes were badly damaged or destroyed were the ones who were harmed.

2. Whose rights are recognized and whose are ignored? The motel owner clearly has a right to set prices, as long as those prices are not legally exploitive, and here that particular issue of legality seems resolved because the higher rates that are now to be charged were set as "standard" a year earlier, though for seasonal demand rather than emergency need. You might explain in class that here is an example of the difference between demand and need in marketing terms. The hurricane survivors, who have that need, clearly have a right not to be exploited, but the legal difference between pricing in response to market demand and pricing to take advantage of consumer need is going to be difficult to establish in a courtroom.

3. Define the perceived moral problem. This moral problem can be expressed very simply in my view: "Is it right for the motel owner to apply seasonal demand pricing to an emergency need market?"

4. Determine the economic outcome. The economic theory that market demand versus market supply establishes equitable pricing is normally both relevant and rigorous, but what happens when the customer utility function changes from "I want that" to "I and my family need that"? The theoretical response would be that this then becomes a public policy issue, and that either new laws should be passed or emergency shelters be provided by the local government. But, usually there just isn't enough time.

5. Consider the legal requirements. My understanding is that most travel based services – particularly hotels, motels and airlines – have standard published rates for periods of high demand, and then discounts off those standard rates that are not published and that vary with vacancy availability and customer insistency. This constantly varying pricing policy has irritated many non-insistent customers for years, but so far as I

know it is practiced widely and is not illegal. If you have time, ask your students to consider if they were legislators and if they felt that the raising of rates in this case was wrong:: a) how they would write the law so that hotels and motels would not be able to raise their rates during an emergency; and b) how they would ensure passage of that law by convincing other legislators that it truly was needed.

6. <u>Evaluate the ethical duties</u>. Here again – similar to the first case in this series -- is a situation in which the Pareto Optimal economic outcome may be efficient because the rooms will all be rented regardless of the doubled price and the customers who refused to pay that doubled price did have the option to purchase, so they should not complain. But, it also possible to look at that increased charge as an external cost imposed upon the hurricane refugees without their consent, which does lessen the economic efficiency argument. The legal requirements don't appear to be precise enough or current enough to prevent the motel owner from seizing that profit opportunity. Here again, in my view, is a situation where the ethical duties appear to be more relevant:
   - Long-term interests. Higher rates during emergencies are bound to irritate many people, but that has not in the past appeared to deter future customers. And, in this instance, people who have lost their homes probably aren't going to be future customers.
   - Personal virtues. This one does seem applicable. No motel managers would want to be heard proudly boasting, "Boy, we made buckets of money when we hammered those poor families feeling Hurricane Katrina by doubling our rates"
   - Religious injunctions. This is another that seems applicable. Certainly raising rates on families who have lost their homes shows little compassion or kindness, and it creates no sense of community, of people working jointly towards a common goal. .
   - Universal duties. If it is right for hotel or motel managers to raise rates for customers who come up to their front desks in needful situations, then it has to be right for hospitals and medical practitioners to raise rates on patients – maybe members of the motel owner's family, who come to an emergency room in similar situations
   - Distributive justice. Members of a family who have just lost their home and much of their property to hurricane winds have to be viewed as the "least amongst us", and as such deserve not to be harmed.

One last point you might raise in your "summarize and quit early" end of class comments would be to ask whether a management trainee who, when told to double the rates, said, "Sure, we can get that done within the next 10 minutes" would avoid any damage to his or her career. You might suggest to your students that if the motel chain was sued, either by the Attorney General of the state in which it was located for price gouging, or by an aggressive trial lawyer representing families forced to pay the higher rates, and if there were a jury trial which would be easy for the resort chain to lose, frequently blame is pushed down upon the lower levels of management. "They did that, not us, and we got rid of them" is a public relations ploy frequently used by large companies.

Citigroup and the $100 Million Bonus
(3rd of the Three Short Cases for Chapter I)

I would suggest that you start the discussion of this case by essentially reading the assignment question, and then call upon someone to say what he or she would do, and why.

> Mr. Hall has a valid contract, and he did earn a very substantial profit for the company at which he works. But that company has been subsidized by a cash payment of $45 billion and a credit pledge of $335 billion, both of which essentially come from U.S. taxpayers, most of whom have never earned more than $50,000/ year in their lives. Should the $100 million bonus be paid to Mr. Hall this year? Assume that you are a consultant on executive compensation, and have been asked to advise members of the board of directors of Citigroup. What would you say?. Remember, you should be prepared to logically convince the members of that board.

1. Who is benefited and who is harmed?. Those benefited are Mr. Hall and his associates and staff members at Philbro, and they benefit very substantially. Those harmed are the taxpayers of the country, but they are harmed almost anonymously. Unlike the cleaning staff at the condominium in the 1st case or the hurricane survivors at the motel in the 2nd, they're not a small group of people who have been graphically harmed by the actions of others. Instead, taxpayers are such a huge group – just about everybody in the country – and they've been harmed – if indeed it is right to think about the use of governmental funding to support the parent firm of Philbro as a harm to taxpayers– very indirectly. Certainly, Mr. Hall, his associates and staff did nothing themselves – as far as is known – that brought harm to any individual taxpayer or group of taxpayers.

   But, and this is the important issue that has to be remembered, if $45 billion in governmental funds had not been awarded to Citigroup, the corporate owner of Philbro, and if $301 billion of government assistance (90% of the total toxic mortgage portfolio held by Citigroup) had not been pledged to Citigroup, then Philbro would have been forced into bankruptcy along with all the rest of Citigroup. Philbro, as one of the prime assets still held by Citigroup, would have been sold to the highest bidder with all of their energy trading strategies, energy trading contacts and computerized trading programs intact. That highest bidder might or might not have wanted to retain Mr. Hall, his associates and staff given that the successful bidder already had all of the information that Mr. Hall, his associates, staff and predecessors had developed over a lengthy period of time. The most basic question in this case is: Was it the collection of personal trading skills that enabled Philbro to earn so much money, or was it the range of corporate trading strategies, contacts and programs? The skills, or course, could walk out the door if the bonuses were not paid; the strategies, contacts and programs could not legally be taken on that journey to the nearest available abandoned Connecticut dairy farm. The highest bidder doubtless would institute criminal liability claims if it could be shown that those strategies, contacts and programs were indeed taken without permission by the former employees.

This is a side issue, but my understanding is that many of the non-physical and non-financial assets of divisions or subsidiaries that are different from those in the main firm, such as the complex computer programs and digital data bases in this instance, are often keep off-site in a leased storage bank by many of the division or subsidiary managers on a "just in case" basis. If you have time at the end of class, ask member of your class whether they would do this, whether in their view this was outright theft or sensible precaution?

If I were teaching this class I would not explain the possible consequences of the bankruptcy of a parent firm upon the employees of a profitable subsidiary until after a considerable number of students had expressed their views that a) Mr. Hall and the other employees at Philbro had made large profits for Citigroup; b) that Mr. Hall and the other employees had valid contracts that promised them large bonuses as a percentage of those profits; and c) that those contracted bonuses should rightfully be paid.

But, once the consequences of Citigroup bankruptcy come up, then the question becomes, "Do Mr. Hall and the others have a responsibility to the taxpayers who enabled Citigroup to avoid that bankruptcy, that would have had dire consequences to Philbro and themselves, to now help in the repayment of the $45 billion in government funds and the reduction of the $301 billion federal guarantees

2. <u>Whose rights are recognized and whose are ignored</u>? Mr. Hall and the others did not abuse anyone's rights, as far as is known, while they were successfully conducting their energy trading strategies. But now the question is whether the taxpayers have a right for the profits of that trading to be used repay some of the $45 billion in TARP funds that were advanced – in cash – to Citigroup, and also for some reduction of the $301 billion in federal guarantees of the toxic securities issued by Citigroup. The major issue in the case is whose rights takes precedence, and which party has a duty to observe those primary rights?

3. <u>Define the perceived moral problem</u>. Should Citigroup pay the cash bonuses that were fully earned by the executives, managers and staff members at Philbro, and legally owed to them by the terms of their employment contracts, or should those funds be used to repay the cash advances and to reduce the credit guarantees that were the essential funds that permitted Philbro to continue operating as a wholly owned, highly profitable and independently managed subsidiary of Citigroup?

4. <u>Determine the economic outcomes</u>. Pareto Optimal efficiency considerations just don't seem to be relevant here. The $45 billion cash advance and the $301 billion credit support were provided on an emergency basis, not as part of a market exchange, to prevent the bankruptcy of Citigroup that would have severely constrained Philbro and sharply reduced its earning potential. The emergency

negotiations, however, did not include any specific provisions relative to Philbro, nor to its executives, managers and staff. Those executives, managers and staff may or may not have had a personal duty to help repay the cash advances and the credit guarantees that keep them operating, but economic theory does not look at personal duties in business management; it only considers financial outcomes and legal requirements.

5. Consider the legal requirements. As part of the emergency investment of taxpayer funds there doubtless were provisions for Citigroup to repay the cash advance and reduce the credit exposure, but doubtless also there was no extension of those provisions to Philbro, a wholly owned but independently managed subsidiary that got lost in the chaos. In short, legal requirements don't seem to be relevant here either, because they simply don't exist, beyond the contractual obligations for Citigroup to pay the earned bonuses that were negotiated years before the narrowly avoided bankruptcy.

6. Evaluate the ethical duties. A duty, in ethical terms, is a perceived obligation to take actions that will benefit either other individuals or the full society, and that perception is based upon various universal principles that have been developed over time. The problem is that many of these seem to lose their power of logical conviction among the recipients of large cash payments. But, remember here the decision on bonus payment is to be made by the board members at Citigroup, not by the recipients at Philbro::
    - Long-term interests. It would be in the long-term interests of Citigroup to repay the advances and reduce the guarantees as quickly as possible in order to maintain the confidence of governmental agencies and regulatory officials for the future.
    - Personal virtues. It would be in the reputational interests of Citigroup to repay the advances and reduce the guarantees in order to restore confidence in their intention of acting with openness, honesty and pride among the public. .
    - Religious injunctions. Compassion and kindness aren't issues here, but building a sense of community, of everyone working jointly for a common goal, certainly is. This favors debt repayments to the government over bonus payments to executives.
    - Government requirements. The law, due to the hurried negotiations during the emergency allocation of funds, does not say anything about the repayment from the profits of subsidiaries; it is, however, specific about the payment of contractual bonuses.
    - Utilitarian benefits. This principle is only about the margin of benefits over harms that is generated by a given decision or action. The rule is to always pick the alternative with the largest margin; it is not concerned with the distribution or use of that margin.
    - Universal rules. This principle is only concerned with the judgment of the rightness or wrongness of a single action; it cannot be used to compare two actions unless one were clearly universalizable and the other not. Both are universalizable here.

- Distributive justice. The least amongst us in this situation are clearly the taxpayers, not the executives, managers and staff who are to receive large cash bonuses. Repayment of the debt would be favored over payment of the bonuses.

This is a case in which probably neither of the two solutions – pay the executive bonuses or repay the federal advances -- will achieve a unanimity of opinion in any group. My suggestion is that you put on the blackboard three options – pay, pay half and half, don't pay – and take a vote. Then end the discussion by asking members of your class to assume that they had been skilled enough or lucky enough to be hired by Philbro as a management trainee. What, if any, duties would they feel they owned to Citigroup, the corporate owner of Philbro? What do the answers you probably will receive to that question mean for the management of highly skilled and highly profitable corporate subsidiaries located in a different city or town from the main corporate offices?

<u>Bernard Madoff and the Largest Financial Scam in History</u>

This is a very different case from the three shorter ones that preceded it. Those all focus on the question, "What is the right thing to do?" Here the wrong thing has already been done, on a massive $65 billion scale. My suggestion is that you focus the class discussion on the why and how it happened, and on the lessons that should be learned from that why and how. That is, my suggestion is that you follow the assignment question, and that you start each section of the class by reading the relevant question:

1. <u>Why in your opinion did Bernard Madoff do this</u>? He had been exceedingly successful in the electronic exchange trading that he had started and that his firm continued, and he had clearly achieved both wealth and stature. What was it that drove him, again in your view, "off the cliff"? What does this say about human character? What does this say about the nature and/or culture of the investment community? There are a number of points to be discussed here:

   People differ greatly in their goals, norms, beliefs and values. The text says that these differences are derived from their cultural and religious traditions and their and economic and social situations, but something more basis is sometimes, not often, involved. That something more basic can be described in very non-scientific terms as "a main spring that is wound much tighter than anyone else's". People have quirks of personality and evidently for Bernard enough just wasn't enough.

   Maybe this desire for more money, yachts, homes, dinners, positions and associates (I won't say "friends" because it appears that he didn't have friends, he had victims) came from the very easy early stages of his career, in which nothing ever went wrong. Maybe it came from the very innovative ideas he had and the highly risky actions he took during those early stages: his founding of a securities firm with an investment of just $5,000; his positioning of that small firm as a middleman between large institutional traders; his automation of the trading function at his firm to reduce costs; his transformation of the Cincinnati Stock Exchange into the automated NASDAQ. Maybe he felt that he was owed more because of those innovative ideas and high risks.

But, more likely in my view, is that Bernard was one of those people who just wanted more. I would suggest that you end this section of the class by asking students the very direct question, "How do you know when enough is enough, how do you know when to stop?" Students won't talk about personal goals in class, particularly when those goals involve wealth, but after a few tenuous comments you might say "Think about this 'what do you want out of life' issue as you leave the class today. Always striving for more can destroy a person's life. It destroyed Bernie's". .

2. Why was it so easy for Bernard Madoff to raise so much money? The case describes a "network of trust and an aura of probity". How does a person build a network of trust and aura of probity while running a dishonest operation? Give some thought here. It may help you to avoid a similar situation in the future.

   Bernard Madoff's early success, which was both innovatively and honestly earned, doubtless laid the foundation for his later exploitation of investors. People look at an individual's past accomplishments, or lack of accomplishments, and expect the same trends of success or failure to continue, without sudden changes. People are impressed by wealth and position, particularly if neither is ostentatiously exhibited but more quietly and privately enjoyed. People of similar cultural backgrounds and religious affiliations tend to feel part of a group, particularly if that group has experienced some unwarranted opposition in the past, and group attitudes that "we'll all stick together" and "we can trust each other" frequently develop. And lastly, the quiet marketing and apparent exclusivity, in my view, played a major role. Potential investors couldn't just mail a check to Madoff Corporate Headquarters; they had to be introduced to him, or be represented by a "feeder" organization and knew him.

3. The Wall Street Journal (August 20th, 2009, p. B5) published three articles on the lessons that business schools should teach and business students should take away from the financial meltdown that had occurred. The huge Madoff investment losses were part of that meltdown. What are the lessons that you think are important from the Madoff investment fraud as part of that overall meltdown?

   My suggestion here is that you assign a group of three to four students to prepare a 20-minute report on the lessons that business school students should draw firstly from the financial meltdown, and then from the Madoff financial scam. Classes, in my experience, always seemed to go better if the class time was broken into sections, and those sections should not just have different topics but different participants and different activities. One of my rules was that the group presentation would be graded, but also that members of the listening audience could get a good mark for class participation if they were among the first to ask relevant and challenging questions.

4. What would you have done differently had you been: a) an advisor to a charitable organization that was investing substantial funds through Madoff; b) a member of a well-paid feeder fund that was collecting smaller amounts from middle income investors for transfer to Madoff; or c) a competitor who had reported to the SEC that the investment model Madoff was using was incapable of generating such large and consistent returns, but seen little or no response?

   Certainly the advisors to charitable organizations and the executives in the feeder funds had a duty to perform due diligence, which would have included understanding the investment model. None did, but that was probably caused by a lack of understanding of the complex hedge fund techniques, and by a natural refusal by Bernard Madoff to explain those techniques. If asked, he would probably have said, "Oh, I wish I could tell you how we do things, but if our methods become known then our returns are going to vanish, so I'm afraid that we have a very strict policy on secrecy".

   The lack of follow-up by the SEC is, unfortunately, all too familiar. You might ask your class why financial regulation never seems to work as well as it should. The answers, once more in my opinion, are: a) the complex methods that are poorly understood; b) the advanced techniques that are constantly changing; c) the out-of-date status of the laws that never seem to keep up; and d) the alleged intention of many regulators to switch sides and become a regulatee for the higher incomes and better positions that would bring.

<u>Lead Paint on Children's Toys: Who Was Responsible</u>?

I am going to start this teaching note by preparing the standard 7 step analytical frame work recommended in the text. None of the assignment questions specifically mention a need for this framework, but hopefully your students – even at this early point in the course – understand that if a beginning level manager is going to make a difference, and be noticed approvingly by the senior level executives for raising important issues in a competent way, it is necessary to <u>logically convince</u> most of the other people involved in a given situation. The given situation in this instance is the probable poisoning of pre-school children, and that certainly is a critical matter for a business firm.

1. <u>Understand the different standards</u>. The people in the value chain come from different economic and social positions and – once the Chinese manufacturers are included -- difference cultural and religious traditions as well:
   - National media companies. Television production, particularly for a pre-school children's audience, is a very inventive business. To succeed, you have to invent characters that have human traits but not human forms. Managers in this business tend not to think in typical managerial terms about revenues, costs and profits; a show is either a hit, and then the revenues are big enough to cover the costs and generate profits, or it isn't, in which case it's back to search for a popular theme with believable characters.

- Toy marketing firms. These are the entrepreneurial managers in this value chain. They're looking for something new, but here it is for new business opportunities, not for new cartoon characters. They do worry about revenues and costs because they are caught between the media firms and the retail chains that have the power to demand royalties and to set prices.
- Foreign manufacturing companies. The owners and managers at the Chinese manufacturing companies are the ones who feel the cost and delivery pressures. Low skill and high volume manufacturing in China must be a very competitive business in which profits depend upon minor cost savings in material purchases and small increases in labor outputs. My understanding is that the owners and managers tend to be very inventive & demanding at both.
- Large retail chains. All four of the participants in this children's toy value chain have very different business models and strategic advantages. High volume retailing is a world unto itself; the strategic success factors are demand forecasting and costs negotiating. Retailers who are good at both tend to be very profitable; those who are not tend to be acquired or go out of business
- Conclusion. Can you imagine a meeting of all four of the participants in this consolidated global value chain? They all have different business models, success factors and competitive worries, and therefore they probably all have different moral standards of behavior. In any meeting there would be a lot of talking past each other, and arguing about minor points. It would be very hard to reach a group consensus.

2. <u>Recognize the varying impacts</u>.
    - Benefits go to the national media companies and to the large retail chains in approximately equal amounts, and then to the toy marketing firms in the middle and the Chinese manufacturing companies down at the bottom.
    - Harms go to the employees at the foreign manufacturing firms who are pressured to work harder and longer in poor conditions, and to the purchasers of the toys whose children can be hurt by cost saving decisions and actions throughout the chain.
    - Rights to use their strategic positions to set prices are recognized for the three domestic companies; the Chinese manufacturers have essentially been left out.
    - Rights to product safety and to full knowledge about the product have been denied to the parents who purchased the toys; rights to health have been denied to their children.

3. <u>State the perceived moral problem</u>. "Is it right to market popular and appealing wooden toys manufactured under high cost and time pressures to the parents of pre-school children without inspecting those toys for any loose parts, sharp edges or chemical coatings that could harm those children?"

4. <u>Determine the economic outcomes</u>. The desired economic efficiency and its expected societal benefit of more goods produced for fewer resources consumed could not have been achieved here because: a) the customers were not fully informed (would parents have bought the toys if large signs had been posted over the display counters saying

"These toys have <u>not </u>been inspected for possible dangers to your child"); and b) the external costs of those dangers were not fully included in the pricing. Given the difficulties of detecting physical and mental developmental problems in young children, and then of connecting those problems to the ingestion of lead, it probably was not possible to estimate those external costs.

5. <u>Consider the legal requirements</u>. It was very definitely against the law in the United States and Western Europe for products of any type to be sold if they had been coated with lead paint, and it was said to be illegal in China for lead paint to be used but it was also acknowledged that this law was seldom enforced. However, inspection of products imported from China for lead paint and other harmful defects was not required by law.

6. <u>Evaluate the ethical duties</u>. The moral arguments against selling toys that might (due to the lack of inspection) be coated with lead paint appear compelling
   - Long term self-interests. The large numbers of wooden toys that were being sold and the vulnerability of the children who were playing with those toys created a potential for huge legal claims. Civil law suits against the toy marketers did follow the Consumer Product Safety Commission's recall order, but there were settlements rather than trials, and those settlements were closed (not available for viewing by non-participants) so it is not known how much money was paid to the afflicted children and their parents.
   - Personal virtues. No managers at one of the toy marketers could possibly feel pride in seeing headlines in newspapers and stories on newscasts about the lead on children's toys. The problem in the existing value chain was that managers at the media companies and at the retail chains could always say, "Oh, that's not our fault' the importers should have checked for lead".
   - Religious injunctions. There was little compassion and kindness in importing toys for children without inspecting for harmful conditions, and no sense of community, of all four participants within the value chain working for a common good.
   - Government requirements. The right to life, and consequently to health, takes precedence in Locke's expansion of Hobbes' initial proposal over the right to own and ability to trade property.
   - Utilitarian benefits. It would be difficult, as mentioned above, to compute the cost to society of the potential harm to the mental and physical development of preschool children caused by the ingestion of lead on toys. But, that lack of accurate estimation of the costs would not legitimatize any possible claim that the production and marketing of the toys resulted in an overall greater good than harm for the society.
   - Universal duties. If it was thought to be right <u>not</u> to inspect for lead on children's toys, then it has to be right not to inspect for lead on any products sold to a large market base.
   - Distributive justice. Preschool children whose physical and mental health is being put at risk by the sale of non-inspected toys are clearly the least amongst us.

- Contributive liberty. Preschool children whose physical and mental health is being put at risk are also being prevented from developing their abilities to the fullest.

Now, we will move on to the assignment questions at the end of the case. I assume that the answers here are reasonably clear following the explanations above:

1. Why did RC2 and Mattel not set up import inspection programs? Those companies were required, by U.S. law, to inspect the factory operations of the contractors who made the toys for oppressive labor practices, but not the toys themselves for possible safety defects. Unfortunately, new protective laws are generally written only to cover already disclosed personal and environmental problems; there is little foresight amongst legislators. And, the executives at RC2 and Mattel doubtless felt that they had purchase contracts with specific provisions forbidding the use of lead paint, and did not consider the possibility that the Chinese manufacturers, under growing cost pressures and with different standards of behavior, might disregard those provisions.

2. Who should bear the costs of the lead paint inspection program? Ideally all four members of the value chain should share in the cost. Ideally again, just as with market expansion and cost control, it should be a united effort. But, due to their pricing power and their relative isolation from either harm or blame, it is likely that both the national media companies and the large retail chains would refuse to participate, essentially telling the marketing specialist firms "It's your problem, not ours". So the question becomes one of convincing the executives at those marketing specialists to bear the costs; this might be easier if it were understood that specific fines of considerable size could be levied against the Chinese manufacturers for each detected violation.

3. Are there good alternatives to an inspection program? Inspecting what someone else has already done is markedly inefficient; it would be much better to get it done right the first time. The "fines of considerable size" mentioned above might help, but that still requires inspection. How does one get an unshakeable agreement – that is, one with no inspection needed – from people of different goals, norms, beliefs and values that are locally viewed as perfectly valid? It is difficult, particularly when one is pressing those people for concessions on costs. Maybe the best way to start would be to stop pressing for concessions, and to agree on a set profit percentage, difficult as that would be to compute and to verify.

4. What changed in the children's toy industry that brought about this harm? In my view, it was the substantial increase in competitive intensity and the division of managerial responsibility among the different stages in the value chain. Everyone was competing against everyone else for a greater share of the profits within that value, and no one felt responsibility for non-obvious defects in product, customer, and environmental safety.